IV | What's Yield got to Do with It?

Ralph Waldo Emerson once said, "To be great is to be misunderstood." It is safe to assume Mr. Emerson was not talking about bond yields, but in the fixed-income investing community perhaps no other word is as misunderstood as "yield".

While most fixed income investors appreciate the relationship between a bond's price and its yield (i.e. yield goes up, price goes down), we speak with many clients and advisors who are confounded by what their bonds are truly yielding. While knowing what you own is always important, it's even more critical for long-term planning and budget purposes to have a realistic expectation of the income your bonds will reasonably produce. Because we frequently field questions about 'yield', below we discuss three of the most common yield calculations and describe how these measures can portray vastly different results for the investor.

Current Yield. Perhaps the simplest yield calculation, current yield (CY) can be misleading to investors if not taken in context. Current yield is calculated by dividing the annual coupon interest by the current price. What CY can provide is a quick assessment of the relationship between a bond's price and it's coupon in today's market. Think of it perhaps as an adjusted coupon rate at that point in time based on whether the bond is purchased above par (a premium) or below par (a discount). What CY does not tell you is the impact of writing off a portion of that premium each year (amortization), which has the practical effect of reducing income. This has become increasingly important in today's interest rate environment where the majority of municipal bonds are issued as premium bonds. Bonds bought at a discount, on the other hand, experience the opposite and effectively have income increase from accreting the discount. CY also does not account for the reinvestment of coupon income or the time value of money.

Yield to Maturity. Another of the most quoted yield calculations, yield to maturity (YTM), is an approximation of the annual return that an investor would experience if a bond is held until maturity. So, if the YTM of a 10-year bond is 3%, that means an investor should earn approximately 3% per year for the next 10 years - but only if a few things actually happen. First, the 3% YTM mathematically needs coupon income to be reinvested at the stated YTM (in all likelihood that reinvestment rate will be different). Second, YTM is based on the bond maturing and does not take into account whether a 'call' provision or a sinking fund schedule causes redemption of the bond before maturity. So what is a more accurate yield measure if a bond has a call option or sinking fund schedule, as most municipal bonds do, and the investor wants a more conservative indication of future income? Consider the next yield measure.

Yield to Worst. The most conservative measure of a bond's yield, yield to worst (YTW), is the preferred method of calculating yield and the metric we convey to our clients. This measure is derived by reporting the lower of a bond's yield to call (YTC) and its YTM, hence it's the 'worst' case. In today's interest rate environment, the majority of municipal bonds trade at a premium to par (price>100), so YTW represents the annual return an investor would receive until the issuer redeems the bond on the call date or sinking fund date to refinance it at a lower interest rate. In a higher interest rate environment or with lower coupon bonds that trade below par (price<100), YTW would actually be the YTM because the working assumption is that the bond is not called and subsequently held to maturity. That's because calling the bond would force the issuer to refinance it at a higher interest rate.

Understanding these few key concepts can equip investors and advisors to make better decisions when evaluating different fixed income investments. Current Yield is relevant at purchase but does not give an accurate picture of future income. Yield to Maturity is valid as long as the bond does not get called and is held to maturity. Yield to Worst assumes the bond remains outstanding as long as it is economically feasible for the issuer to do so, and that generally occurs as long as the bond coupon is lower than current interest rates. In our opinion, YTW has the fewest shortcomings and the fewest assumptions of the yield measures. It is also the the one we quote to clients.

It is important to remember these differences when talking about yield, and it is equally as important to ask for specifics when yield is being discussed. Your Caprin investment team is ready to guide you through the yield discussion so you are positioned to make informed decisions. Please contact us if you are interested in additional information.

CAPRIN

10 Yr State of New York GO	Non-Callable[1]	Callable[2]
Coupon	5%	5%
Price	$122	$113
Maturity	2028	2028
Call	-	2023
Current Yield	4.10	4.43
Yield to Maturity	2.47	3.44
Yield to Worst	2.47	2.19

1. 649791NA4 – CUSIP for Non-Callable bond in illustration. 2. 649791HM5 - CUSIP for Callable bond in illustration.

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