SUBJECT: Questions You Were Afraid to Ask #9 – What are bond yields and why do they matter?

In our last letter, we broke down some of the most common terms associated with **bonds** and what they mean. But there was one term we left unexplained – and often, it's the one you hear the most about in the media. We are referring to a bond's **yield**. So, without further ado, let's answer:

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Super-quick refresher on four of the terms we defined last time, because they'll play a role here, too:

Par Value: This is the amount that must be returned to the investor when the bond matures – essentially, the original investor's principal. (Many bonds are issued at a par value of $1,000.)

Coupon Rate: This is the bond's interest rate, paid by the issuer at specific intervals. For instance, let's say you owned a $1,000 bond with a 10% annual coupon rate. The issuer would then pay you $100 in interest each year until maturity.

Maturity: This is the amount of time until the bond is due to be repaid. A 10-year Treasury bond, for instance, matures 10 years from the date it was issued.

Price: This is the amount for which the bond is traded in the secondary market. Sometimes, bonds trade at their par value, but they don't have to. For instance, imagine Fred bought a bond from the issuer for $1000, but trades it to Fran for only $950. The bond's par value is still $1000. The price, though, is $950, and is said to be traded at a **discount.** On the other hand, if Fred trades it for $1,050, then Fran would be buying it at a **premium.** And if Fran buys it for the same price that Fred originally paid – $1000 – she would be buying it **at par**.

Financial terminology can be slippery and hard to remember. (It's like mental soap.) But keeping all these terms in mind, the definition of a bond's **yield** is this: *The return – or amount – an investor expects to gain until the bond matures*.

Simple, right? Now we can wrap this up and go about our day.

Except, not quite. While that may be the definition, the actual *ramifications* of yield go a bit deeper. To understand this, we first need to understand the most basic way yield is calculated.

A bond's current yield can be found by dividing the bond's annual interest rate payment (coupon rate) by its **price.** For example, imagine Fran buys a bond with a 10% coupon rate for its original $1000 price. The bond's yield would be 10%, too.

Now imagine that Frank buys that same bond from Fran a year later – but for $75 more. Since the bond is being traded for *more* than its par value – in this case, $1,075 – the yield would go down to 9.3%. After all, if Frank pays more than Fran for the same level of interest rate, he's getting a lower return on his investment than Fran did, who paid less. However, if the bond trades for *less* than par – say, $975 – then the yield goes *up* to 10.25%.

In other words, yields and bond prices are **inversely related**. If the price of a bond goes up, its yield will go down. If the price goes down, the yield goes up. Make sense?

Essentially, by comparing the current yield of different bonds, you can see which bonds are expected to give *more* or *less* of a return on your investment. The higher the yield, the better the expected return.

Now, that doesn't mean an investor should just look for bonds with the highest yields and call it a day. That's because high-yield bonds tend to come with more *risk* than low-yield bonds do. As we covered in our last letter, issuers with lower credit ratings will often pay higher interest rates, since there is some risk they won't be able to repay the principal by the time the bond matures. Investors must always balance risk versus reward when choosing where to put their money, and that holds true for bonds, too.

So, that's yield in a nutshell. Now, you may be wondering, "Why do I hear so much about bond yields in the media?" Well, many analysts and economists use yields to project which direction interest rates will move in the future. You see, when interest rates are expected to rise, bond prices tend to go down. (That's because an existing bond's coupon rate will no longer be as attractive as that of a new bond, meaning the owner would need to sell the bond at a discount.) And when interest rates are expected to fall, bond prices rise. For that reason, when yields rise across the entire bond market, analysts often see it as a signal that interest rates may rise soon, too. (Furthermore, when the yield on **short-term** bonds rises above that of **long-term** bonds, this can indicate that investors are concerned about a possible recession.)

Now, here's the truly important thing:

We covered a lot of concepts in a very short amount of time. Hopefully, it all made sense. To be honest, we're just barely scratching the surface of this topic – but this is precisely why we started writing this series on "Questions You Were Afraid to Ask."

The world of investing can be a complicated one. Sometimes, it's more complicated than it needs to be. You will often see terms like "yield" thrown about in the media without any explanation or context. Many investors, even experienced ones, can find all this lingo to be confusing, even intimidating. That's not how investing should be! You just need to break it down and translate it into plain English. *Everyone*, regardless of their level of education or experience, has the right to invest with confidence in their own future. It's important to understand **what you want to accomplish**, and **what steps you need to take to get there**.)

In our next letter, we're going to move away from bonds and answer some questions many investors have regarding modern investing trends. In the meantime, have a great month!

Sincerely,

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