

# BASIC THINGS ABOUT BONDS (PART 3/3)



# Bond Yields



Bond yields are measurements of return. The most commonly used measurement is the yield to maturity. However, it is crucial to comprehend other yield measurements that are used in specific circumstances.

## Yield to Maturity (YTM)

This calculates the bond's return if it is held until maturity and all coupon payments are reinvested at the yield to maturity rate.



An investor's actual return may vary slightly as coupons are unlikely to be reinvested at the same rate.

When calculating YTM manually, it can be a time-consuming process. It is advisable to use Excel's RATE or YIELDMAT functions (available from Excel 2007) or a financial calculator's straightforward function for more efficient results.



# Current Yield

The current yield can be used to compare the interest income provided by a bond to the dividend income provided by a stock. This is calculated by dividing the bond's annual coupon by the bond's current price.

Keep in mind, this yield incorporates only the income portion of the return, ignoring possible capital gains or losses. As such, this yield is most useful for investors concerned with current income only.



# Nominal Yield

The nominal yield on a bond is simply the percentage of interest to be paid on the bond periodically. It is calculated by dividing the annual coupon payment by the par or face value of the bond.

It is important to note that the nominal yield does not estimate return accurately unless the current bond price is the same as its par value. Therefore, nominal yield is used only for calculating other measures of return.



## Yield to Call (YTC)

A callable bond always bears some probability of being called before the maturity date. Investors will realize a slightly higher yield if the called bonds are paid off at a premium.

An investor in such a bond may wish to know what yield will be realized if the bond is called at a particular call date, to determine whether the prepayment risk is worthwhile. It is easiest to calculate the yield to call using Excel's YIELD or IRR functions, or with a financial calculator.



# Realized Yield

The realized yield of a bond should be calculated if an investor plans to hold a bond only for a certain period of time, rather than to maturity. In this case, the investor will sell the bond, and this projected future bond price must be estimated for the calculation.

Because future prices are hard to predict, this yield measurement is only an estimation of return.



# How Bonds Pay Interest

There are two ways that bondholders receive payment for their investment. Coupon payments are the periodic interest payments over the lifetime of a bond before the bond can be redeemed for par value at maturity.

Some bonds are structured differently. Zero coupon bonds are bonds with no coupon—the only payment is the face value redemption at maturity. Zeros are usually sold at a discount from face value.





Convertible bonds are a type of hybrid security that combines the properties of bonds and stocks. These are ordinary, fixed-income bonds, but they can also be converted into stock of the issuing company. This adds an extra opportunity for profit if the issuing company shows large gains in its share price.



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