Yield – Defined

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Which yield are they talking about?

The term "yield" is a standard term used often in fixed income investing. It has many slightly different connotations which can sometimes be confusing for the individual investor. The definitions below will hopefully clarify the term and its many uses.

Yield

In its most basic form yield refers simply to the annual return for an investment. Think of it as a farmer would crop his yield. What is my investment giving back to me? At the end of the growth period, how much interest have I earned and how much has the market price changed for the underlying investment? Yield is commonly referred to as an annual rate of return expressed as a percentage.

Yield To Maturity

Yield-to-maturity (YTM) is the bond's yield expressed as an annual rate of return with the assumption that the investment is held to maturity (principal repaid). This is often referred to as simply as yield. Bonds pay interest semi-annually (Treasuries, corporates), quarterly, monthly (mortgages), or not at all (zero-coupons). YTM takes into account the various interest payment methods, including interest on interest, and allows an investor to fairly compare performance of different bonds.

Yield-to-Call / Yield-To Worst

Many bonds are callable before maturity. Yield-to-call is calculated in a similar manner to YTM, except the maturity date is considered to be the proposed date when the bond is to be repurchased by the issuer (the bond is going to be called). When the yield-to-call is calculated for each of a bond's possible call dates, the returns can vary substantially. The yield-to-worst of these is sometimes used to give the investor a worst-case scenario glimpse at the various yields-to-call and yield-to-maturity.

Current Yield

Current yield is a snapshot version of yield which simply takes a bond's annual interest income and divides it by the current market price of the bond. If an investor pays full face value (par) for a bond, then the current yield is equal to the coupon rate. If the bond is at a discounted price (less than par), the current yield is higher than the coupon rate and will be lower if a premium (more than par) is paid. Current yield does not take into consideration interest on interest.

Nominal Yield / Effective Yield

The coupon rate of a bond is considered to be the bond's nominal yield; whereas the effective yield of is the yield of a bond when the coupon payments are reinvested (interest on interest is earned). The effective yield on the bond is higher than the nominal yield because reinvesting the coupon will produce a higher yield.