Market Insights

September 15, 2010

Coupon Rate, Yield and Expected Returns on Fixed Income Securities

This commentary covers the concepts of coupon rate, yield and expected return on fixed income securities.

Currently, rates in the fixed income market are very low. As of September 13, the yield on the five-year Treasury note was close to 1.5 percent. In a low-rate environment in particular, it is critical to understand the differences between and the concepts of coupon rate, yield and expected return on fixed income securities.

Coupon Rate vs. Yield

The coupon rate of a fixed income security tells you the annual amount of interest paid by that security. For example, a Treasury bond with a coupon rate of 5 percent will pay you $50 per year per $1,000 of face value of the bond. The coupon rate, however, tells you very little about the yield of the fixed income security. For most securities, the yield is a good proxy for the return of the fixed income security (that is, how much you can expect your wealth to increase if you purchase the security) and is a far more meaningful piece of information than the coupon rate. To illustrate this, consider the following two Treasury bonds:

- 8.875 percent coupon, 2/2019 maturity
- 2.75 percent coupon, 2/2019 maturity

Both of these bonds mature around the same time, but they have enormous differences in coupon. One is paying coupon interest of $88.75 per year per $1,000 of face value and the other is paying $27.50 per year per $1,000 of face value, yet one trades at a yield of 2.40 percent and the other at a yield of 2.51 percent. This means they are priced in a way to provide essentially the same return. That is, you have to pay significantly more to buy the bond with the relatively high coupon than you do to buy the bond with the low coupon. The net result is that either purchase has essentially the same yield, or expected return.

Yield vs. Expected Return

For most types of fixed income securities we purchase for our clients (for example, CDs, agency bonds and high-grade municipal bonds), yield is a good approximation of the actual return they are expected to earn. This is not true of all types of fixed income securities, however.

In particular, yield is not a good measure of the expected return for securities that have meaningful default risk, such as high-yield bonds, because the standard yield calculation assumes all principal and interest payments are certain to be received. The actual expected return for these types of fixed income securities will always be significantly lower than the yield. This also means the yields of securities with significant default risk cannot be meaningfully compared with the yields of securities with minimal default risk.

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Summary

When considering fixed income alternatives, it is important to understand the concepts of coupon rate, yield and expected return. Coupon rate is the annual rate of interest that the bond pays. Coupon rate, however, is not nearly as important as the yield of the security. For most securities, the yield is a good estimate of the return that the security will earn if it is held to maturity. For example, purchasing a bond at a yield of 3 percent that has one year to maturity means the amount of money invested will grow by 3 percent over the next year, regardless of the coupon rate. For securities with material risk of default, the yield always overstates the return that one can reasonably expect to earn.

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