The different ways to calculate how much a bond will return

Money $ense

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PERHAPS you have been considering investing in bonds but don't know where to begin. When reviewing a bond, one of the first factors to consider is its yield.

But what exactly does yield refer to? Depending on the context in which it is used, the term yield can have multiple definitions.

The broadest meaning of yield is the return you get on your money. There are different ways to calculate this, and we will review some of these.

Individual bonds have an interest rate and a coupon rate associated with them. The coupon rate is the amount of interest earned annually. This figure is shown as a percentage of the bond's face value, which is also called the par value.

Despite having a face value, bonds can go up and down in value with market fluctuations. The market price represents what investors are willing to buy and sell a bond for. This amount might be higher or lower than the bond's face value.

Another type of yield is called current yield. This refers to the percentage of the bond's annual interest payments compared to the bond's market price. Since the market price of bonds is constantly changing, the current yield is always changing as well.

Those investing in bonds for income each year may look at the current yield in deciding whether or not to purchase a bond.

Some investors hold bonds that they buy rather than actively trade them. If you simply buy a bond at its face value and hold it until it matures, the current yield and coupon rate are the same.

If you purchase a bond at a price higher than its face value, then you have bought the bond at a premium.

Conversely, if you bought the bond for lower than the face value, you've bought a discount bond. In these circumstances, the current yield and coupon rates are different.

A bond's yield to maturity is another way to look at a bond's performance and is useful if you hold a bond until its maturity date.

The calculation for yield to maturity takes into account the interest rate, principal value, time to maturity, and how much you paid for the bond.

The value of the interest payments as received is also reflected.

If a bond is purchased at a discount, it will have a higher yield to maturity in comparison to its current yield. This is true, as once you redeem the bond at maturity it will be for the face value. This is more than you paid for it!

In addition, you will have earned the interest income. The reverse can also be true. If you bought the bond at a premium, then the value at maturity would be less than the purchase price. The yield would be lower.

Why is the yield to maturity useful? This figure gives investors a way to compare bonds. With different maturities and coupon rates, comparing different bonds can be tough.

Yield to maturity provides useful context.

At this point, you may wonder if there are any other ways that bonds can be evaluated. One way is yield to call. This measure is especially helpful for bonds that can be called, which is when the issuer can decide to repay the bond before its maturity. With this type of evaluation, the yield is calculated to the earliest date the bond can be called.

Keep in mind, an issuer will call a bond if it is in the issuer's best interest. This may happen, as an example, if current interest rates are below the rate at which the bond was issued.

As with any investment, bonds can have many different types of risks. Some of these involve credit, interest rates, inflation, liquidity and default risk.

Be sure to evaluate all aspects of a potential bond investment carefully and consult with an investment professional or certified financial planner if you need more guidance.

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