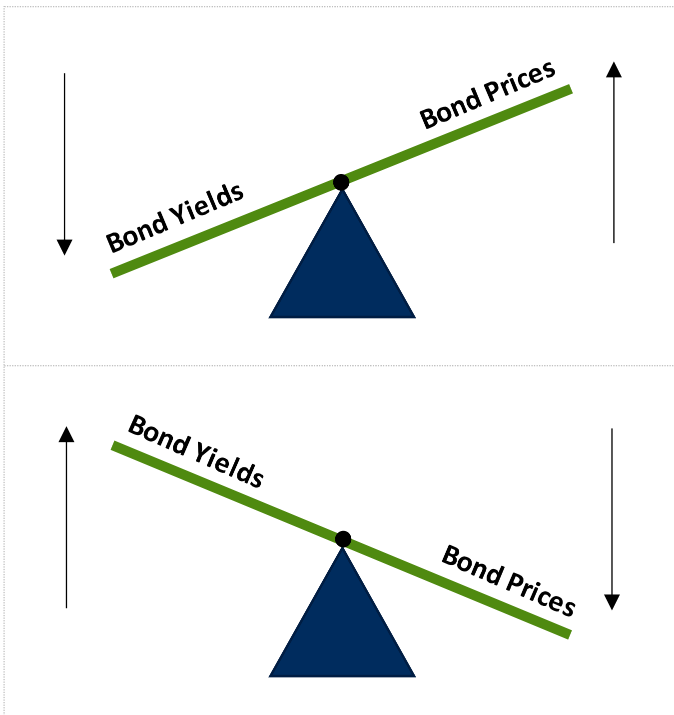
Prices, Yields and Your Personal Portfolio

When bonds with fixed coupon payments see their prices increase, the value of such holdings go up as well. Their yields, however, would move lower. When rates or yields rise, the value of those fixed payments are reduced, leading the market value of the bond to fall, all else held equal. This describes the inverse relationship that bond prices and bond yields hold. But why does this happen?

Inverse Relationship: Bond Prices and Yields



Source: Raymond James Ltd.

New bonds are issued by corporations and government entities all the time. When they are brought to market at par, they carry a coupon that provides the purchaser a yield that aligns with the current environment. Bonds that were issued in a different yield environment, such as that from just a few years prior, carry much lower coupons that reflect that period.

So, if an investor can purchase a new issue security with a higher coupon rate, how can an existing bond that carries a lower coupon stay attractive to investors? The answer is with a lower price, as the return to maturity is a combination of both the coupon payments and the difference between purchase price and maturity value.

In a rising rate environment, outstanding bonds will see their prices fall to make their yields competitive to similar investment alternatives. The opposite, of course, is in a falling rate environment, where outstanding bonds should see their prices rise. This second scenario is what economists are calling for in the coming periods.

The inverse relationship linking bond prices and yields holds true for securities with fixed coupon payments. In situations where recurring payments can increase or decrease (such as floating rate bonds), additional factors must be considered.

This information may expand your understanding of how bond prices may change based on prevailing interest rates. Combined with your own investment strategy, you can then anticipate how to best create a portfolio.