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Choosing Bonds

When investing in bonds, it is easy for investors to get shell shocked by the constantly changing economic landscape and invest groundlessly in the highest yielding bonds within a target quintile population. For example, searching for a subset of bonds with a BBB rating, +5% yield, maturity in +10 years, and a duration lower than 5 and arbitrarily selecting the names which are familiar. We first need to decide whether we are investing for 1) coupon, 2) principal appreciation, and 3) total return. We should not invest based on current yield. It is a good measure to use with coupon, but can be misleading.

Current Yield

A lot of attention has been paid to the current yield, or the coupon/market price of the bond. It is a good measure to see what our return on investment is, but that is it. For example, if a bond pays out 5% coupons, then over the year, the investor will receive $50 in installment payments. If the investor invested $1000 at the beginning of the year, it is an annualized 5% return on investment. However, if the investor invested $2000 to purchase the bond, the current yield is 2.5%. Likewise, if invested $500, the yield shoots up to 10%. It's a rather fickle figure.

Coupon

Pension plans should focus on the weighted coupon value of their bond holdings to fulfill their annual obligations. If they purchased bonds in 2008 when the bond price was 40, and the coupon was 2%, the current yield would have been 5%. So, if their obligation was 5% of the pension holdings, one could have falsely concluded they had enough incoming cash to satisfy the annual outflow payments. But the pension would have only received 40% of the annual outflow, which means the pension holdings would have needed to be sold and the book value diminished to make the payments. This leads to underfunded holdings.

We should focus on the hard cash received, since that is more difficult to manipulate than rates of returns. The coupon payment is the same, regardless of the market environment. Coupon plays are long term, so one wants to do a much more scrubbed research on the debt issuer. Will it survive for the long haul? Is there downside protection? Those who want a high stable return on investment should focus on higher coupons.

Principal Appreciation

Principal appreciation is more focused on the short term – 1, 2 years. Great example are corporate bonds which hit bottom in 2008 and then jumped 20% annually from 2009-2011. This is like an equity play, and if there is sufficient assets and cash flow appropriated for the bond holders, then it can become a sure arbitrage opportunity.

Total Return

Yield to maturity takes into consideration the premium amortization or the discount capital gain until maturity. So we could equate YTM as total return, or cash flow plus capital appreciation/depreciation.