Talking Fixed Income with Clients? Make Sure You're on the Same Page

Yields? Distributions? Yield-to-Worst? What you emphasize depends on what clients want from a bond fund.

Joe Boyle, CFA, CPA
Fixed Income Product Manager,
Hartford Funds

By now, many of you have heard the sayings around fixed income in 2023, whether it be "bonds are back," or "there is income in fixed income," or "we have gone from TINA to TARA."[1] No matter how you phrase it, the current situation for fixed income is better than it's been in years, and the potential for enhanced fixed-income returns makes this moment in time a potentially good entry point for many fixed-income strategies.

But what are your clients' expectations? Are they looking for higher regular income payments? Higher overall returns? More importantly, are your clients comfortable with the lingo of fixed income, especially when it comes to understanding the different mindsets necessary for maximizing either income or total return?

Key Points

- The current moment in time makes for a potentially good entry point for fixed-income strategies. But the terminology you use with clients should be carefully tailored to their long-term investment goals.
- The actual distribution an investor receives may look similar to the average coupon, but the expected "yield" is really a combination of the coupon plus capital appreciation.
- It's important to speak to clients up-front about what they expect from their fixed-income allocation, whether it be total return or income, and how the components work together.

Yields: One Term, Many Meanings

First, let's talk about yields. This is where the discussion often starts because the word *yield* is where confusion often develops. People throw the word around in many phrases: "this is what my bond fund yields," or this is the "yield-to-maturity we see right now." Between the multiple ways investors use the word and the many different yield measures that exist (yield-to-worst, yield to maturity, 30-day SEC yield, etc.), it's easy to see how the potential for mixed signals can create pain points in client conversations (see yield definitions in **FIGURE 1**).

So, consider starting at the beginning. Yield is defined as the return you get based on the capital you invest. It's as simple as that—or, at least, it should be.

In bond-land, the terminology gets tricky because clients often refer to a bond's regular coupon payments as their bond yield. They may not realize that fluctuating interest rates and spreads[2] will change the value of bonds at any given moment. You can explain that bonds trade at a premium when the bond's coupon is higher than the prevailing level of rates; and they trade at a discount when the bond's coupon is lower than the prevailing level of rates. You can further explain that, depending on the price you paid for your bond (i.e., at a premium or a discount), the yield will be a combination of that difference from par combined with the coupon.

So, what does it look like today? Since coupons are higher, your clients might think they should be getting higher monthly payments from their bond fund. Should they? Well, yes—but maybe not as high as some measures of yield are quoting.

For instance, yield-to-worst (YTW) is the lowest potential yield that can be received on a bond without the issuer defaulting. It's calculated by making worst-case scenario assumptions on the issue by calculating the returns that would be received if provisions, including prepayment, call, or sinking fund, are used by the issuer.

The YTW on the Bloomberg US Aggregate Bond Index (the "Agg")[3] was 4.81% as of 2/28/23. However, the average coupon of the more than 13,000 bond issues that make up the Agg was 2.76%. Furthermore, the five largest passive core-bond ETFs managed to that Index paid, on average, a 2.93% distribution, which is more representative of the average coupon than YTW on average for February 2023. Fees were not an issue as each only charge 3 basis points.[4] So, where is the other 1.9%?

Yield Now vs. Yield Later

The other 1.9% is caught up in the discount. The missing yield isn't coupon income but, rather, capital-appreciation potential created after the historic back-up in rates. The average bond price of the Agg as of 2/28/23 was $88.97 vs. par of $100. As a bond gets closer to maturity, its value accretes closer to par. Generally, but not always, the accretion isn't physically paid from a bond fund until a bond matures or is sold. In a bond fund, despite not being paid monthly, the value of the overall NAV[5] should be increasing as the bonds accrete, enabling holders of the fund to monetize it that way if they choose.

So, the actual distribution that an investor receives may look similar to the average coupon, but the expected "yield" is really a combination of the coupon plus potential capital appreciation and may not be indicative of what the investor will be paid regularly. This can be confusing and necessitates an up-front conversation concerning the investor's goals.

When a client who seeks monthly income streams raises the question of expected yield, it may be best to rephrase the question as one of expected distributions. Oftentimes, by separating the two components—distributions received and capital appreciation potential—you can help clarify the distinction in an investor's mind. On the flipside, for clients who seek total return, YTW is likely the most appropriate yield to quote.

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Yields and Rising Rates

This often leads to another question: How long does it take to recognize YTW? While there's no guarantee of recognizing the expected total return, the actual speed of the return is going to vary with the changes in rates. A sharp decline in rates means a quicker recovery in the discount to par, thereby lifting the price of the NAV—all things being equal.

Rising rates means it will likely take longer to recover to par. While YTW is an annualized figure, perhaps the best proxy (although certainly not as precise) is the years-to-worst calculation, which is the total length of time during which the owner will receive interest payments on the investment while assuming the worst-case scenarios for bonds to be called or prepaid.

So, given these various yields measures and the different meanings and nuances around this concept, what's the best yield to quote and when?

FIGURE 1

Explaining Different Yield Types

Type	Who's It Useful For?	Explanation
Distribution Yield @ NAV	Clients interested in regular income streams	This is the most recent payment received from the fund divided by the NAV and annualized. It's likely the simplest to understand because it represents an actual payment hitting investors' accounts and is not forward-looking. The payments can, and will, vary periodically, but should be relatively close over shorter periods (i.e., month over month).
Yield-to-Worst (YTW)	Clients interested in long-term total return	This is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting. The measure takes into consideration dates that bonds may be called and is usually a more conservative measure than yield-to-maturity. The term recognizes capital-appreciation potential that may not necessarily be paid out regularly.
30-Day SEC Yield	Clients who are seeking an apples-to-apples comparison of bond-fund yields	This is a standard yield calculation developed by the US Securities and Exchange Commission (SEC) that allows for a more fair and standardized way to compare bond funds. This is a hypothetical calculation of net income earned, and, while it's standard across the industry, it has limitations in the ability to account for derivatives in a portfolio.
12-Month Trailing Yield	Clients who ask about yield during periods in which rates and spreads are stable	This is the average of the actual distributions paid out over the trailing 12 months. It's another easy one to understand but may not be of value in a year in which rates at the beginning of the year can be entirely different at the end of the year as we saw in 2022.
Yield-to-Maturity (YTM)	Clients who plan to hold a bond to maturity or a bond fund for a long period of time	This is the total rate of return that will have been earned by a bond when it makes all interest payments and repays the original principal. It assumes all securities will be held until maturity.

Bottom Line

We bring all this to your attention because we believe total-return opportunities have improved significantly in the aftermath of last year's turmoil. The current moment in time could make for a much better entry point for many investors, but this may not yet be reflected in their monthly or periodic payouts.

We consider fixed income to be a long-term, strategic holding; this approach should give investors ample time to experience these higher yields. It's important to speak to clients up-front about what they expect from their fixed-income allocation, whether it be total return or income, and how the components work together. Having this discussion before a fixed-income allocation is made can help ensure you and your clients are on the same page.

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For more fixed-income insights, please talk to your Hartford Funds representative.

[1] In financial circles, TINA is a popular acronym for "there is no alternative" to equities. TARA is an acronym for "there are reasonable alternatives."
[2] Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.
[3] Bloomberg U.S. Aggregate Bond Index is composed of securities from the Bloomberg Government/Credit Bond Index, Mortgage-Backed Securities Index, Asset-Backed Securities Index, and Commercial Mortgage-Backed Securities Index.
[4] A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices, and the yield of a fixed-income security.
[5] Net Asset Value (NAV) is the net value of an investment fund's assets less its liabilities, divided by the number of shares outstanding. Most commonly used in the context of a mutual fund or an exchange-traded fund (ETF), NAV is the price at which the shares of the funds registered with the U.S. Securities and Exchange Commission (SEC) are traded.