RBC Global Asset Management

INVESTOR **INSIGHTS**

How much is your chicken worth?

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Fixed income investments, like bonds, can sometimes feel complicated. In this article, we use an analogy to help simplify the relationship between a bond’s price and changing yields. Let’s break it down.

Imagine you are a farmer who raises chickens for their eggs. How many eggs a chicken lays per week is fundamental to how much value you place on it.

Let’s assume for years that the going price for a chicken was $25 – and each chicken consistently laid four eggs per week. We’ll call that the chicken’s yield. Find yourself with more chickens than you want? Another farmer would happily buy your extra chickens off you for $25. Times were simple.

But imagine now a breeder comes along with a new breed of chicken that can lay five eggs per week – and to get the attention of farmers, the breeder decides they will sell these new higher-yielding chickens at the same $25 price. That makes some headlines in the chicken-farming community.

You think to yourself that you’d like to make room for some of these new five-egg chickens by selling some of your four-egg chickens. But here is where the yield-price relationship kicks in.

You realize other farmers aren’t going to pay $25 for your four-egg chickens anymore when they can get a five-egg chicken for the same price. You’d have to sell your four-egg chickens for something less.

The value of your existing chickens has just declined because the yield farmers now expect for a $25 investment has gone up.

These same principles are what have driven the bond market over the last year. As interest rates rose, new bonds offering higher yields arrived in the market. The price of older bonds with lower interest rates then came down to bring their yields in line with the market.

Like the farmers’ four-egg chickens, bonds you bought at lower yields aren’t inheritably compromised. Those ‘chickens’ will still generate the four eggs per week you paid for at the time. What’s changed is that they don’t look as attractive compared to new higher-yielding chickens (or bonds).

Count your 'eggs' while they hatch

Although it can be unsettling to see bond prices fall over the short term in response to rising interest rates, it can work out for the better over the long term. In most cases, bonds you hold to maturity will repay you your original investment. Plus you'll have all those interest payments or 'eggs' you earned along the way.

It's also worth remembering that your current interest payments can be reinvested at today's higher yields. It's like using the profits from your egg sales to buy the new five-egg chickens.

With an adequate time horizon, reinvesting at higher rates can ultimately be beneficial to overall fixed income returns.

Bonds can play an important role in a well-diversified portfolio. Talk to your advisor if you have questions about your bond returns, prices changes or interest payments.

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