BOND PRICES & YIELDS

Understanding the Inverse Relationship between Bond Prices & Yields

– By Prof. *Simply* Simple ™

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Why do bond yields go up when bond prices go down?

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You might have come across a rule which states that

‘When bond prices go down, bond yields go up & vice versa’.

Let’s understand this rule.

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You will agree that when a seller of a good sells at a lower cost, he makes a lower profit. However, the purchaser of the good makes a gain due to the attractive price of purchase.

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Now let's understand with a simple example.

Ravi has a corporate bond of Rs 100 which gives him 10% returns per annum.

In other words, the company would pay him Rs. 110 at the end of the year for the Rs 100 loan that Ravi has given to the corporate.

The 10% yield thus translates to a Rs 10 profit for Ravi.

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Now let's assume that Ravi has an emergency and needs money.

He goes to his friend John who quickly realizes that Ravi needs money urgently.

So he makes and offer to Ravi to buy his bond for Rs 90. Ravi agrees to the offer and sells the bond for Rs 90.

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At the end of the year, John receives Rs 110 from the corporate. Thus John earns Rs. 20 from his investment of Rs 90 in the corporate bond he bought from Ravi.

Thus, John's % return (which is popularly known as the yield)works out to:

{20/90}x100 = 22.2%

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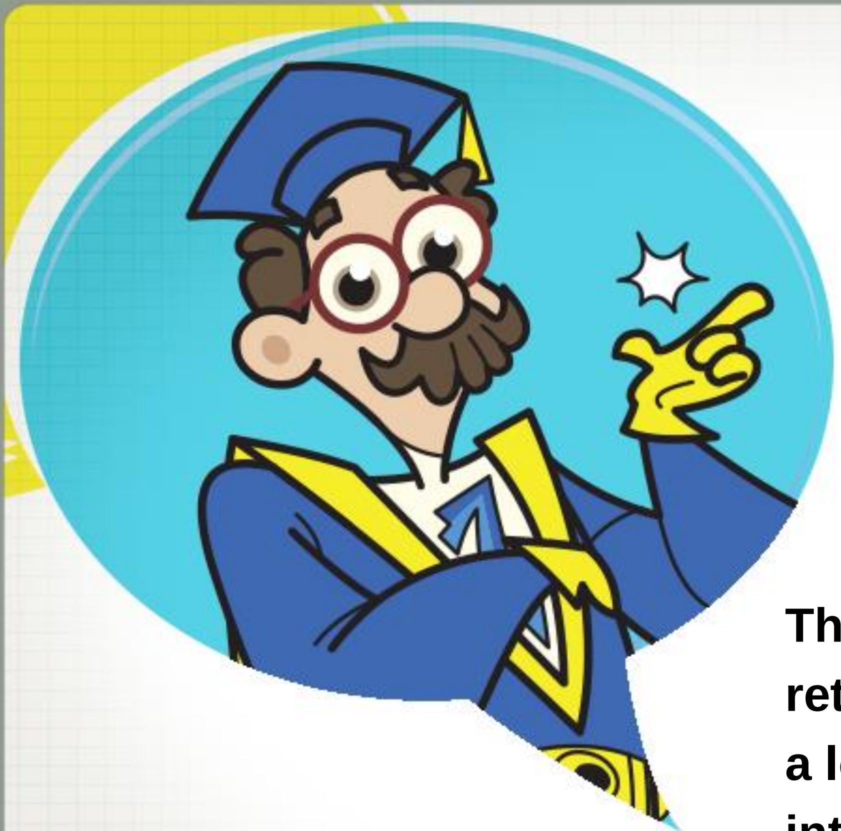

Thus while Ravi was earning a return a 10%, the sale of the bond at a lower price of Rs 90 translated into a gain for John in terms of higher yield which went up from 10% to 22.22%.

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Having understood the concept, it will not be difficult for you to appreciate the inverse relationship between the price of the bond and its yield (for the buyer of the bond).

i.e. A bond's yield goes up when its price goes down and conversely the yield of the bond comes down when the price of the bond goes up.

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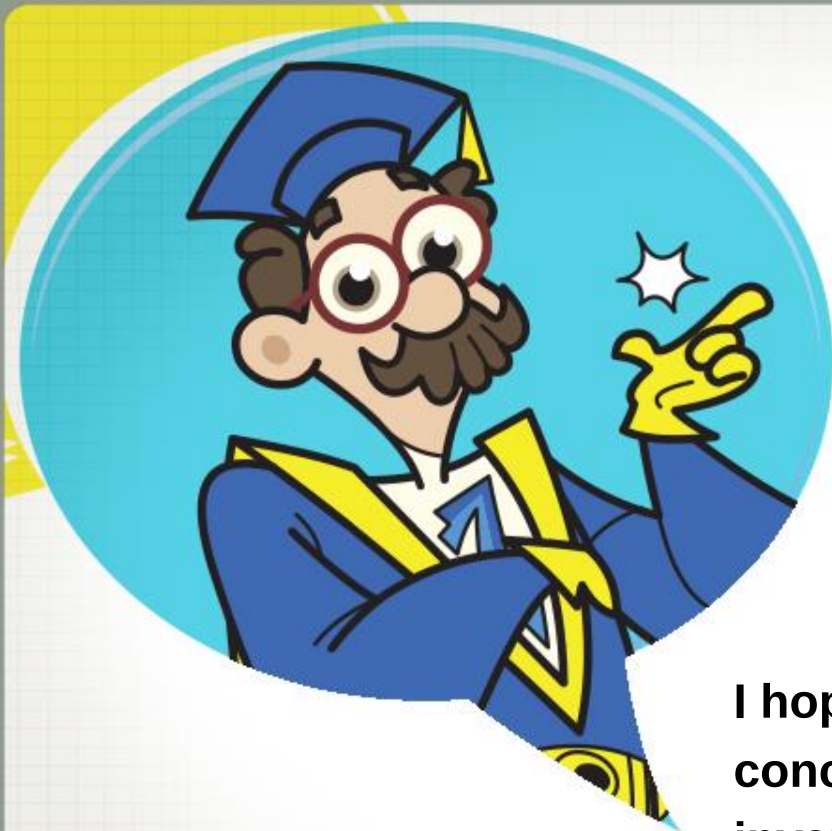

I hope you now have a better conceptual understanding of the inverse relationship between the price and yield of a “bond”.

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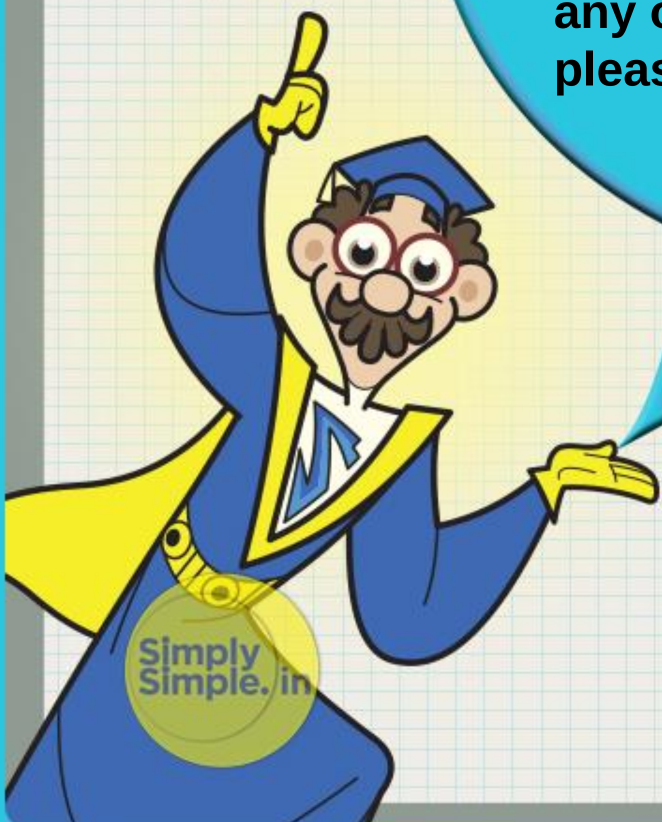
I will be glad to receive your feedback on this lesson to understand if there any gaps.

Also if you wish to demystify any other concepts,
please write to me about them.



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