ADVISOR PERSPECTIVES

Fixed Income ETFs and Yield: A Game of Catch Up
iShares Blog
By Matt Tucker
October 4, 2011

One of my favorite fixed income topics is yield. Really, it is. What's amazing to me is how many different types of yield exist — for a bond or bond fund you could quote the yield a half dozen ways and each would be different. My theory is that bond geeks invented this array of yields to make their jobs seem more complicated or mysterious.

But understanding which yield to use can be confusing. It's easy to be enticed by what looks like the highest yield in the bunch, especially in this low rate environment where investors are searching for ways to extract extra income from their bond holdings. I want to highlight three of the most common yields investors see for fixed income ETFs, explain how they are connected and show how they have a tendency to "catch up" with one another over time.

- **30-day SEC Yield:** Providers may calculate other yields differently, but everyone must follow the same formula for SEC yield. This is a standard yield calculation developed by the SEC for fairer comparisons among bond funds. It is based on the most recent 30-day period. It reflects the interest earned during the period after deducting the fund's expenses for the period. *It is backward looking – telling investors what a fund distributed in the past.*
- **Distribution Yield:** The most recent fund distribution, divided by the most recent fund price, minus management fees. It is the annual yield an investor would receive if the most recent fund distribution stayed the same going forward. It represents a single distribution from the fund and does not represent the total return of the fund. *It is backward looking – telling investors what a fund distributed in the past.*
- **Average Yield to Maturity (YTM):** The weighted average yield of the bonds held by the fund based upon the fund's net asset value, or NAV. Fund management fees are not included and must be deducted when comparing to other yield measures. It represents the market weighted average YTM of the bonds in the fund as of the measurement date — *it essentially tells you what the YTM would look like if you purchased all of the bonds in the underlying portfolio today.*

For the purpose of this blog, we'll focus on Distribution Yield, although these general mechanics apply to the 30-day SEC Yield as well.

Now, what happens to these yields when interest rates fluctuate? The Average YTM is first to react because it is a marked-to-market yield for the bonds in the portfolio. If the Average YTM stays at its new level, the Distribution Yield will eventually "catch up" to it as the fund rebalances and acquires bonds at the new market yield. How quickly this occurs will be based on the growth and turnover of the fund. The greater the growth

and the higher the degree of fund turnover, the faster the Distribution Yield will catch up to the Average YTM. The opposite is true if growth is slow and turnover is low.

Let's look at an example: The Distribution Yield for AGG as of August 24 was 3.27%, while the Average YTM was 2.04% — the difference in yields was due to a decline in interest rates that was immediately reflected in the Average YTM. If market conditions stayed the same, an investor could expect the Distribution Yield to decline and move toward the Average YTM. Indeed, as of September 22, AGG's Distribution Yield was 2.50%, while its Average YTM was 1.82%. *Past performance does not guarantee future results. For standardized AGG performance, please click here. For AGG's most recent yield information, including the 30-Day SEC Yield, please click here.*

Of course, things aren't quite that simple because Average YTMs change every day based upon trading in the bond market, and the fund may be growing or shrinking daily as well. Nonetheless, the relationship between the Average YTM and the Distribution Yield is a good starting point for investors who are trying to understand where a fixed-income ETF's distribution may be moving over time.

Bonds and bond funds will decrease in value as interest rates rise.

