Caselet #27 – Sparky Learns about Total Rate of Return

Learning Outcome Statement

After completing this caselet, students and trainees should be able to explain the importance of reinvestment income in total rate of return.

Caselet #27

Renowned Darla Moore School of Business graduate and bond analyst Ms. Jane Gotzrox asks, “Sparky? Do you know why investors buy bonds?”

Sparky, eager to impress, says, “Yes, Ms. Gotzrox, investors buy bonds for the yield.”

“Sparky, how are you going to get lottery bonuses if you keep making mistakes? Please, be more careful.”

“They buy them for the money, Ms. Gotzrox,” Sparky recovers.

“Yes, Sparky, they buy them for the money.” she repeats, “It is really disheartening to see how many portfolio managers – and I’m talking about highly paid portfolio managers – think that yield to maturity is the be-all and end-all of bond investing. Now, let’s turn to your project, eh?”

“I want you to load the US 6 2/15/2026 into your Yield Book Add-in. Display the ticker, coupon, maturity date and dated date so that you do not forget any of the details about the bond that you are analyzing.”

“Then, set up Scenario Rate of Return. Use100 for the price level and the dated date for the settlement date (yes, I know it was a long time ago). Make the Pricing Data Curve Type On-the-run and the Curve Date the Dated Date.”

“Set the horizon pricing method to Price and the Value to 100. Set both the Settlement Reinvestment Rate and Horizon Reinvestment Rate to 6 – any guesses why, Sparky? Finally, set the Scenario Months to 360 and the BP Move to zero. That’s a lot of settings, but it takes that many to control such a powerful function.”

“Once you have set up the inputs, I want you to choose Dollar Return and Annualized Return as the two outputs. Guessing the annualized return should be easy. The dollar return might surprise you.

“Sparky, when you’re done with that, I want you to do it again with a zero reinvestment rate for both Settlement and Horizon rates. Again, the numbers might come as a surprise to you. Once you are done, update your notebook to show you understand this important result.”