Caselet #29 – Sparky Learns about Rolling Yields

Learning Outcome Statement

After completing this caselet, students and trainees should be able to explain how rolldown affects holding period returns and why analysts should include the effect in their calculations.

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Renowned Darla Moore School of Business graduate and bond analyst Ms. Jane Gotzrox thought that she was beginning to see growing skills in her intern.

“Sparky,” she says, “the little blurb that you knocked together on total return and total rate of return started them thinking over at Pretense Associates, but they still think that yield works pretty well because changing the reinvestment rate didn’t have such a big impact. They’re slow learners, not at all like you, eh?”

“It’s time we let them in on the secret of ‘rolldown’, which will let them catch up with Marty Leibowitz circa 1971. Here’s what you are going to do.”

“Pull up the Treasury issues closest to 9-years maturity and closest to 8-years to maturity in Yield Book Add-in. Be sure to use old 10s, if they are available, instead of very old 30s. Then run Scenario Rate of Return. Use the yield on the 9-year as the starting level, the most recent coupon date as the Settlement Date, 12 Months as the Scenario length, and zero for the bp shift. Make the reinvestment rates match the beginning yield for the 9-year.”

“First, find the Dollar Return and Annualized Return with the Horizon Pricing Method set to Yield and the 9-year yield as the Value. Can you guess what you will see, Sparky?”

“Then set the Value for the horizon yield equal to the yield of the issue closest to 8-years. Step one is to write a couple of paragraphs about why that is a useful way to think about the world of bonds. Otherwise, you are just being a data entry clerk and you should expect to be paid like a clerk, eh? We aspire to much greater things for you.”

“At any rate, once you’ve run the Scenario Rate of Return for the one year horizon, I want you to do it over for a two-year horizon. Can you figure out the correct horizon yield to use? Yeah? Hah! We’ll see.”

“Once you’ve done them all, put copies of your spreadsheet calculations and a write-up explaining why the returns are as they are in your notebook. This is an important topic for when you start interviewing.