First Citizens
Wealth Management

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Fixed Income

Is Yield-to-Worst a Good Measure of Expected Returns?

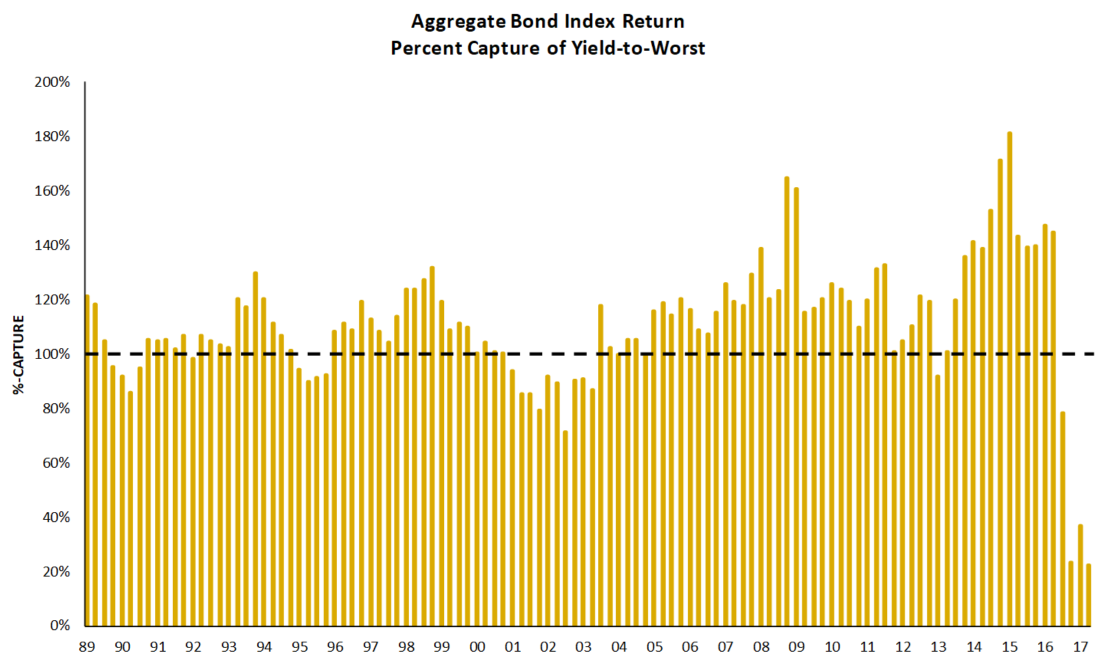
We often receive questions regarding the expected return for fixed income investments and how it relates to yield. If, for example, you buy a six-year duration bond index with a 5% yield-to-worst (YTW)[i], do you get 5% annualized return over those six years? Is a bond index's yield a good indicator of forward total return? It's a fair question.

To find out, we studied the following: For a given quarter, what was the Aggregate Bond Index's YTW, duration, and forward total return over the years of duration? And ultimately, how much of the indicated yield did the forward total return capture (Figure 1)? Using our example, 100% capture would mean you received 5% annualized total return over the index's six years of duration.

Going back to 1989, the average percent capture is 111%—meaning an investor captured, on average, 111% of the indicated yield of those bonds. This means the Aggregate Bond Index's current yield-to-worst tends to be a good indicator of future return. There are exceptions. The most severe recent exception was 2017—duration of the aggregate bond index was six years, and it achieved very low yield capture over those years. Why was the return so disappointing? Remember, we're studying the next six years of returns, including 2022 which produced historically low fixed income returns and thereby reduced the percent capture.

In the end, yield-to-worst is often a very good approximation of expected return. We've experienced one of the most significant hiking cycles in more than forty years, which drove severe negative returns for bonds in 2022. In our opinion, last year was a bit of an outlier, and the future of fixed income returns is likely to be more in line with historical norms. **As of August 25th, the Aggregate Bond Index was yielding 5.13%, which should be a decent indicator of total return in coming years.**

Figure 1[ii]



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[i] Yield-to-worst is the yield-to-maturity of a callable bond.
[ii] Bloomberg