Mutual Funds and Yield Calculations

Investors looking for an income-producing investment may choose to invest in mutual funds that can invest in a wide variety bonds depending upon their stated objectives. There are a number of distinctions between bond funds to be considered, one of which is the rate of income generated by the fund's portfolio.

The rate of income, or yield, produced by a bond fund is affected by several variables and may be calculated in a number of ways. This article provides an overview of mutual fund yields and helps explain the differences.

Fund Holdings and Markets Change Daily

A mutual fund is a collection of securities in which a number of individual investors share ownership. The investment manager of a bond fund may continually buy and sell individual securities as money flows into, or out of, the mutual fund, and as individual securities become more or less attractive based on the objectives of the fund and changes in the financial markets.

The concept of holding an individual bond to maturity is seldom applicable within a mutual fund since the amount of fund assets invested in a particular bond may be increased or decreased, or the bond may be eliminated from the fund holdings, prior to the maturity date. Variations will occur within a bond fund over time, including the number of securities held, the percentage of the total holdings represented by each individual security, and the daily market price (and therefore, yield) of each individual security. Due to these variables, there is no yield calculation that will accurately reflect the rate of income that will be received by an individual mutual fund investor over the period of their investment. There are several calculations that may provide reasonable approximations.

Current Yield

Current yield is a very simplistic calculation. If applied to an individual bond, the current yield would be equal to the annual dollar coupon interest divided by the price. Since the annual coupon interest on a bond is known, this calculation provides an accurate representation of the income rate that will be received based on the purchase price of the bond. It does not indicate the effect of compounding, in the event that the income received were invested at a similar rate, and it does not indicate the impact of a gain or loss on a bond that might be sold prior to maturity.

Distribution Yield

Distribution yield is provided for many bond funds. A 30-day distribution yield is generally calculated by adding the trailing 12 months' dividends per share, and dividing the sum by the fund's month-end price. This makes the result backward looking, rather than indicative of the expected income going forward. In a falling interest rate environment, this can overestimate the income paid to shareholders. In a rising rate environment, this can underestimate the income rate.

SEC Yield

The SEC developed what is referred to as the 30-day SEC Yield. This is a standardized calculation that all bond funds are required to use so that potential investors can compare funds based on a consistent method of calculating an income rate.

What does that mean?

If applied to a bond fund that pays a monthly dividend, the 30-SEC Yield calculation does the following:

- It uses the income, net of expenses, at the end of a month (i.e. the most recent monthly dividend)
- It assumes that the outstanding shares (represented by an average of the number of outstanding shares each day in the month) were all purchased at the maximum offering price on the last day of the month
- It compounds the income rate over a 6-month period
- It doubles the compound income rate to approximate income earned over 12 months

Bringing it All Together

Distribution yield describes income payments made over the prior 12 months, relative to the fund's price on a particular day, with no assumed compounding

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of reinvested income. The 30-day SEC Yield approximates an annual income rate relative to the fund price on a particular day and assumes compounding of the most recent dividend payment. The portfolio holdings in a bond fund change over time while the market price (and yield) of those holdings are also changing. As a result, the price per share and the income received by an investor can, and typically will, vary over the period of time in which the investor owns a fund.

In general, after a period of falling interest rates, the distribution yield (which is backward- looking) of many funds may be higher than the 30-day SEC Yield (which compounds the most recent income distribution). The reverse is true in that, after a period of rising interest rates, the distribution yield of many funds tends to be lower than the 30-day SEC Yield.

The 30-day SEC Yield is calculated in the same manner by each bond fund. It provides an approximate compound income rate based on a snapshot taken on a specific day under a set of actual and assumed conditions. When considering bond funds for investment, it is helpful to compare the 30-day SEC Yield, along with the fund objectives, strategies and risks described in each funds' prospectus. Investors should also consult with a financial professional to help ensure that any investment being considered is consistent with their individual financial goals.