

Your Financial World: Understanding the Ads in the Newspaper

It's a normal weekday morning. You're drinking your coffee and reading the paper. After finishing the comics, you turn to the business section and something catches your eye. An investment company is advertising that their bond mutual funds returned 13½ percent over the last year. But you remember that interest rates have been pretty low – 7 percent at most. And a quick check of the numbers in the business section you're holding tells you that your recollection is correct. What's going on?

The answer is that the advertisement is about last year's holding period return, when interest rates were falling. When interest rates fall, bond prices rise and the holding period return is higher than the interest rate. And the longer the term of the bond, the bigger the price movement for a given interest rate change. To see what can happen, take an example of a 20-year, 7-percent coupon bond with a face value \$100. If the interest rate is initially 7 percent, this bond sells for \$100. But if the interest rate falls by even one-half of one percentage point to 6½ percent, the price will rise to about \$106.50 giving the owner a 6½ percent capital gain. Adding this to the 7 percent coupon payments, we get a one-year holding period return of 13 ½ percent.

So the ad isn't really much of a mystery once you think about it. But the implication of the ad, that these are great investments, is something you ought to think about. Remember, if interest rates go back up, things won't be so pretty. When it says at the bottom the "Past Performance is No Indication of Future Returns," you should take it very seriously.