The relationship between yields and prices

A bond's interest rate, or coupon, determines the amount of income earned annually from holding the bond. A bond's current yield reflects that income as a percentage of the bond's price. It changes constantly with bond prices.

Example: A £1,000 bond with a 3% coupon pays £30 in income each year (£1,000 x 0.03). If the bond's price rises to £1,100, the yield falls to 2.73% (£30 / £1,100). Thus, when price goes up, yield goes down — and vice versa. This is known as an inverse relationship.

When yield is referenced, what's typically meant is yield-to-maturity - a more complete measure of the income from a bond. Yield-to-maturity factors in reinvestment of coupons and any gain or loss on a bond as if it were held until maturity. As with current yield, yield-to-maturity is expressed as a percentage of the bond's current price.

Yield matters

It is customary for bond investors to talk about bond yields (meaning yields-to-maturity), rather than bond prices. For example, market reports will tend to say 'bond yields rose on Friday', rather than 'bond prices fell'. The focus on yield allows investors to compare bonds with different coupons and different maturities more easily, as well as to compare them with savings accounts, inflation and income from other asset classes.

Rising bond yields do not mean that coupons are increasing (coupons are set when bonds are issued and do not usually change during the life of the bond), but that prices are falling – bad news for current investors. It's important to remember, though, that bonds continue paying income even as their prices fluctuate. If prices rise, investors achieve a capital gain in addition to the income. If prices fall, the capital loss is cushioned by the income.