Relationship between the price of a bond and interest rates

Life, Relationships

An inverse relationship exists between the prices of bond, and interest rates. As interest rates go up, the bond prices come down. To understand the reason behind this relationship lets consider an example. For instance, if a bond has a par value of $1000 and is currently trading at $950, then the rate of return on the bond is around 5. 26%. Now suppose that the interest rate in the market is 10%. No investors will buy the bond as they are getting a higher return on interest rates. Hence, to make the bond more attractive the bond price is pushed down to match the same return offered by interest rates.

On the other hand, if we suppose that the interest rates are at 3%, then everyone will buy the bond, and it will sell at a premium. The price of the bond will increase till it matches the rates provided by interest rates. (Shim & Siegel, 2008) What is the Capital Asset Pricing Model (CAPM) and its primary conclusion? Evaluate the concept of beta. The capital asset pricing model (CAPM) is model developed by William Sharpe that helps in analyzing the relationship between the rate of return and risk.

The basic assumption of the model is that the expected rate of return on a stock is equal to the risk-free rate plus a risk premium. The risk premium of the stock depends upon the beta of the stock, which is a measure of the stock’s relative volatility in relation to the market. The model says that if the required rate of return doesn’t equal the expected return then the investment should not be taken. The primary conclusion of this model is that the relevant riskiness of a stock is its contribution to the riskiness of a well-diversified portfolio. (Shim & Siegel, 2008)

What is behavioralfinance? How does this alternative theory of risk and return add to our understanding of how markets work? Behavioral finance is a relatively new field in which theories frompsychologyare applied to classical financial principles to understand the performance of markets. It is based on the premise that the market participants don’t make their decisions rationally. Behavioral finance was developed to explain the irrationality in the market that contradicted the efficient market hypothesis. It is closely related to the field of behavioral economics.

Two of the major concepts used in behavioral finance to understand market inefficiencies are heuristics and framing. Heuristics refer to the fact that investors may take investment decision based on their personal ideas or values, which may or may not make economic sense to an outsider. Framing refers to the fact that the way the presentation is made to the investor will influence his decision. It is how the idea is ‘ framed’ to the investor that will decide what decision the investor will make. (Shim & Siegel, 2008) Research and define technical analysis and fundamental analysis.

Provide examples of each type of analysis. Which style of analysis makes the most sense for the long-term investor? There are two ways of analyzing a stock price, technical analysis and fundamental analysis. In technical analysis, the investor estimates the future price of the stock based on its past prices and market activity. On the other hand, in fundamental analysis, the investor tries to determine the intrinsic value of the stock by analyzing the qualitative and quantitative factors affecting it like industry conditions, company’s cash flow, etc.

In the long run, fundamental analysis will make most sense as it places importance on quantitative factors, rather than relying on charts and past trends to predict future performance. To better understand the difference between the two analyses consider both types of analysts in ashopping mall. A fundamental analyst will go to each store, and study the product before deciding whether to buy or not. On the other hand, a technical analyst will base his decision on the activity of people going into each store. (Shim & Siegel, 2008)