Finance essays examples

Business, Customers

Fixed Income Securities: Basic Concepts

Accrued Interests:

When a bond trades between two coupon dates, the seller is entitled to receive any interest earned from the previous coupon date through the date of the sale. This differential amount is known as accrued interests and is payable by the buyer(new owner) of bond.

Clean Price:

Clean Price is the price of the coupon bond which the buyer(new owner) of the bond has to pay excluding any accrued interest amount.

Dirty Price:

Dirty Price is the price of the coupon bond which the buyer(new owner) of the bond has to pay and includes accrued interest on the next coupon payment.

Dirty Price= Clean Price+ Accrued Interest

Arbitrage Pricing Theory v/s Traditional Bond Pricing

The pricing method under APT theory and traditional theory varies largely as under the former method, the bond issue is viewed as multiple zero coupon bonds that are valued individually and then added together to ascertain the bond value. However, under the traditional theory, the bond issue is valued as single package of cash flows that is discounted at one discount rate to find the value.

Yield to Maturity v/s Holding Period Return

The two terms differs as YTM refers to the return that an investor will earn if he hold the bond till its maturity date and invest all the coupons. However, Holding Period Return is the return earned by an investor till the time he held his investment that may or may not be until maturity date.

Duration:

It is a measure of the price sensitivity of a security to the changes in yield.

Convexity:

Convexity helps in approximating the change in price that is not explained by the duration.

Modified Duration v/s Duration computed from portfolio of zeros

Effective Duration:

It is duration calculation measure of a bond with embedded optionsEffective Duration= Price if yield decline - price if yield rise / 2(initial price)(change in yield in decimal)

Effective Convexity:

It is a measure of bond’s convexity that takes into account the convexity of bonds with embedded options.

Immunization Strategy:

Also known as Multi-period immunization, it is a strategy employed so as to minimize the impact of changes in the interest rates on the asset value.

Term Structure of Interest Rates:

Also known as Yield Curve, the curve shows relationships between interest rates and different maturities.

Term Structure of Interest Rates Theories:

There are three theories relating of term structure of interest rates:

i)Pure Expectation Theory

ii)Liquidity Preference Theory

iii)Market Segmentation Theory

Treasury Securities:

These securities are issued by the US treasury and since they are backed by the full faith and credit of the SU government, they are considered to be free from credit risk. There are three distinct types of treasury securities:

- T-Bills
- T-Notes and Bonds
- Inflation Protected Securities

Treasury Inflation Protected Securities(TIPS):

Treasury securities that make semi-annual coupon interest payments at a rate fixed at issuance but the par value of TIPS is adjusted semi-annually for changes in the Consumer Price Index(CPI). Hence, the fixed coupon rate is paid semi-annually as a percentage of the inflation adjusted par value.

Treasury Auctions:

Treasury securities are also divided into two categories on the basis of their vintage:

i)On the run issues are the most recently auctioned Treasury Securities

ii)Off the run issues are the older issues that have been replaced by a more recently auctioned issues.

Treasury STRIPS:

A treasury security that trades at discount from its face value and offers no interest payments. These securities are stripped from coupons of the bonds and notes and the sold as zero-coupon bonds.