

Contents

1	Introduction to the mathematics of bonds	9
1.1	Internal rate of return and investments	9
1.1.1	Theory	9
1.1.2	Connection with compound interest	9
1.1.3	Expression of the internal rate of return	10
1.1.4	Internal rate of return on various bases	10
1.1.5	Transition between bases	11
1.1.6	Connection with savings	11
1.1.7	Connection with pensions	11
1.1.8	Connection with reinvestment CF_1, CF_2, \dots, CF_n	11
1.1.9	Investments in the period between cash flows	12
1.1.10	Perpetual investments	12
1.1.11	Yields with rational exponents	13
1.1.12	Connection between rational exponents and internal rate of return	14
1.2	Composite yields	14
1.3	Variable interest rates for individual periods between cash flows	16
1.4	Variable interest rates for individual cash flows	16
1.5	Future cash flows which change in geometric progression	16
1.6	Future cash flows which change in arithmetic progression	17
1.6.1	Solved Examples – arithmetic cashflow	20
2	Parameters of bonds	23
2.1	Designations	23
2.2	General characteristics of a typical bond	23
2.3	Basic parameters of bonds	24
2.4	Designation of a bond	24
2.5	Character of interest yield	27
2.5.1	The relationship between the coupon rate and the coupon payment	27
2.5.2	Odd first coupon	27
2.6	Expression of price	27
2.7	Coupon payments (payment calendar)	27
2.8	Time (or Term) to Maturity	28
2.8.1	Perpetual bonds (perps, perpetuities)	29
2.9	Time of living of a bond and its impact on liquidity	30
2.10	Issuer (type of issuer, debtor)	30
2.11	Bonds with call option	30
2.12	Convertible bonds	32
2.13	Inflation-indexed bonds, inflation-linked bonds	32
2.14	Form of a bond and method of its transferability	33
2.15	Other rights connected with bonds	33
2.16	Specific bonds	33
2.16.1	Catastrophe bonds (CAT bonds)	33
2.16.2	Structured bonds	34

2.17 Price/yield relationship	34
2.18 Calculating bond yield	36
2.18.1 Yield to maturity, ISMA Method	37
2.18.2 US Street Convention	39
2.18.3 True Yield	39
2.18.4 Linked interest	39
2.18.5 U. S. Treasury Convention	40
2.18.6 Braeß/Fangmeyer, Moosmüller Yield	40
2.18.7 Japanese Simple Yield (JGB Simple)	41
2.18.8 Money Market Yield	41
2.18.9 Coupon Yield	41
2.18.10 Current Yield	41
2.18.11 Adjusted Current Yield	42
2.18.12 Yield with coupon reinvestment	42
2.18.13 Selected yield terminology	43
2.18.14 Yield of zero-coupon bonds	43
2.18.15 Yield of perpetual bonds	43
2.18.16 Yield of bonds with a variable coupon	44
2.19 Price of a bond expressed as a percentage	44
2.20 Sensitivity of bond prices to interest rates	45
2.21 Macaulay duration	45
2.21.1 The Macaulay duration of a typical coupon bond	45
2.21.2 The Macaulay duration of a zero-coupon bond	51
2.21.3 The Macaulay duration of a perpetual bond	51
2.22 Bond convexity	52
2.22.1 Using Macaulay duration to estimate a change in market price	53
2.22.2 Using Macaulay duration to compare reciprocal volatility	54
2.23 Modified Duration	55
2.24 Dollar Duration	55
2.25 BPV (Basis Point Value, Risk/Bloomberg, DV01)	55
2.26 Price sensitivity of bonds with a variable coupon rate	56
2.27 Change in total yield balance with a change in yield	56
2.28 Bond portfolios	57
2.28.1 Macaulay duration of a portfolio	58
2.28.2 Portfolio convexity	58
2.28.3 Portfolio immunisation	58
2.29 Total bond price (Total price, Dirty price, Full price)	59
2.30 Quoted bond price (Clean price)	60
2.31 Accrued Interest	60

3 Bond trading

3.1 Bond markets	63
3.2 Risks connected with bond trading	64
3.3 Liquidity	64
3.4 Market price development of a bond-deterministic component	65
3.5 Probability distribution of yields	71
3.5.1 Theory of the development of the market price of liquid investment instruments	71
3.5.2 Modern theories of financial markets	77

3.5.3	Economic indicators with an influence on market prices	81
3.5.4	Correlation with shares	81
3.5.5	Flying To Quality, Flying To Safety	83
3.6	Volatility of bond prices	83
3.6.1	Various development regimes of market price volatility	84
3.6.2	Finding the volatility regimes of one bond	85
3.6.3	Definition of transition points between regimes	90
3.6.4	Volatility development regimes in a portfolio	95
3.6.5	Practical consequences of different volatility regimes	100
3.6.6	Zero and negative interest rates	105
3.7	Summary of market price development	108
4	Bond futures contracts and hedging of portfolios	111
4.1	Conversion Factor, Cheapest to Delivery	115
4.2	Hedging a bond portfolio	119
4.2.1	Hedging a bond portfolio using futures contracts	119
4.2.2	Hedging a bond portfolio using option contracts	123
5	Valuation of bonds	125
5.1	Matlab functions in the area of bonds	125
5.2	Considering credit risk, OAS, z-spread	125
5.3	Setting the current interest rate using zero-coupon bonds	125
5.4	Evaluating coupon bonds using current interest rates	126
5.5	Setting the current interest rate using bootstrapping	127
5.6	Evaluating a coupon bond using IRS (Interest Rate Swap)	127
5.7	Evaluating bonds using a binomial tree of interest rates	128
5.8	Evaluating bonds with a floating coupon rate	130
5.9	Evaluating callable bonds using a binomial tree	130
5.10	Evaluating bonds using a trinomial tree	131
5.11	Evaluating bonds with reference to rating evaluation	133
5.12	Evaluating bonds in the period between coupon payments	133
5.13	Evaluating of bonds using more dimensional trees	134
5.13.1	Evaluating CAT bonds – 3D	134
5.13.2	Evaluating bonds using CAT, call able + credit risk – 4D	137
6	Literature and references	141
7	List of tables	143
8	List of figures	145
9	Selection of designations used (arranged thematically)	149
10	Index	151
11	Summary	153