
CONTENTS

Foreword	xv
Preface	xvii
Acknowledgments	xix
About the CFA Investment Series	xxi

PART I

Fixed-Income Essentials

CHAPTER 1

Fixed-Income Securities: Defining Elements	3
Learning Outcomes	3
1. Introduction	3
2. Overview of a Fixed-Income Security	4
2.1. Basic Features of a Bond	5
2.2. Yield Measures	10
3. Legal, Regulatory, and Tax Considerations	10
3.1. Bond Indenture	10
3.2. Legal and Regulatory Considerations	18
3.3. Tax Considerations	21
4. Structure of a Bond's Cash Flows	23
4.1. Principal Repayment Structures	23
4.2. Coupon Payment Structures	28
5. Bonds with Contingency Provisions	34
5.1. Callable Bonds	34
5.2. Puttable Bonds	36
5.3. Convertible Bonds	37
6. Summary	41
Problems	43

CHAPTER 2**Fixed-Income Markets: Issuance, Trading, and Funding 45**

Learning Outcomes	45
1. Introduction	45
2. Overview of Global Fixed-Income Markets	46
2.1. Classification of Fixed-Income Markets	46
2.2. Fixed-Income Indices	55
2.3. Investors in Fixed-Income Securities	56
3. Primary and Secondary Bond Markets	58
3.1. Primary Bond Markets	58
3.2. Secondary Bond Markets	63
4. Sovereign Bonds	66
4.1. Characteristics of Sovereign Bonds	66
4.2. Credit Quality of Sovereign Bonds	67
4.3. Types of Sovereign Bonds	67
5. Non-Sovereign Government, Quasi-Government, and Supranational Bonds	69
5.1. Non-Sovereign Bonds	69
5.2. Quasi-Government Bonds	70
5.3. Supranational Bonds	70
6. Corporate Debt	71
6.1. Bank Loans and Syndicated Loans	72
6.2. Commercial Paper	72
6.3. Corporate Notes and Bonds	75
7. Short-Term Funding Alternatives Available to Banks	80
7.1. Retail Deposits	80
7.2. Short-Term Wholesale Funds	81
7.3. Repurchase and Reverse Repurchase Agreements	82
8. Summary	86
Problems	88

CHAPTER 3**Introduction to Fixed-Income Valuation 91**

Learning Outcomes	91
1. Introduction	91
2. Bond Prices and the Time Value of Money	92
2.1. Bond Pricing with a Market Discount Rate	92
2.2. Yield-to-Maturity	96
2.3. Relationships between the Bond Price and Bond Characteristics	98
2.4. Pricing Bonds with Spot Rates	102
3. Prices and Yields: Conventions for Quotes and Calculations	105
3.1. Flat Price, Accrued Interest, and the Full Price	105
3.2. Matrix Pricing	109
3.3. Yield Measures for Fixed-Rate Bonds	113
3.4. Yield Measures for Floating-Rate Notes	119
3.5. Yield Measures for Money Market Instruments	123
4. The Maturity Structure of Interest Rates	128

5. Yield Spreads	136
5.1. Yield Spreads over Benchmark Rates	136
5.2. Yield Spreads over the Benchmark Yield Curve	138
6. Summary	141
Problems	143

PART II

Analysis of Risk

CHAPTER 4

Understanding Fixed-Income Risk and Return 153

Learning Outcomes	153
1. Introduction	154
2. Sources of Return	154
3. Interest Rate Risk on Fixed-Rate Bonds	162
3.1. Macaulay, Modified, and Approximate Duration	162
3.2. Effective Duration	170
3.3. Key Rate Duration	174
3.4. Properties of Bond Duration	174
3.5. Duration of a Bond Portfolio	180
3.6. Money Duration of a Bond and the Price Value of a Basis Point	183
3.7. Bond Convexity	185
4. Interest Rate Risk and the Investment Horizon	195
4.1. Yield Volatility	195
4.2. Investment Horizon, Macaulay Duration, and Interest Rate Risk	197
5. Credit and Liquidity Risk	201
6. Summary	202
Problems	205

CHAPTER 5

Fundamentals of Credit Analysis 211

Learning Outcomes	211
1. Introduction	211
2. Credit Risk	212
3. Capital Structure, Seniority Ranking, and Recovery Rates	214
3.1. Capital Structure	214
3.2. Seniority Ranking	215
3.3. Recovery Rates	217
4. Ratings Agencies, Credit Ratings, and Their Role in the Debt Markets	220
4.1. Credit Ratings	221
4.2. Issuer vs. Issue Ratings	223
4.3. Risks in Relying on Agency Ratings	224
5. Traditional Credit Analysis: Corporate Debt Securities	229
5.1. Credit Analysis vs. Equity Analysis: Similarities and Differences	230
5.2. The Four Cs of Credit Analysis: A Useful Framework	230

6. Credit Risk vs. Return: Yields and Spreads	249
7. Special Considerations of High-Yield, Sovereign, and Non-Sovereign Credit Analysis	258
7.1. High Yield	258
7.2. Sovereign Debt	266
7.3. Non-Sovereign Government Debt	270
8. Summary	272
Problems	275

CHAPTER 6

Credit Analysis Models 279

Learning Outcomes	279
1. Introduction	279
2. Measures of Credit Risk	281
3. Traditional Credit Models	283
4. Structural Models	289
4.1. The Option Analogy	290
4.2. Valuation	291
4.3. Credit Risk Measures	292
4.4. Estimation	295
5. Reduced Form Models	297
5.1. Valuation	299
5.2. Credit Risk Measures	300
5.3. Estimation	303
5.4. Comparison of Credit Risk Models	307
6. The Term Structure of Credit Spreads	308
6.1. Coupon Bond Valuation	308
6.2. The Term Structure of Credit Spreads	309
6.3. Present Value of the Expected Loss	311
7. Asset-Backed Securities	315
8. Summary	317
References	318
Problems	318

PART III

Asset-Backed Securities

CHAPTER 7

Introduction to Asset-Backed Securities 323

Learning Outcomes	323
1. Introduction	323
2. Benefits of Securitization for Economies and Financial Markets	324
3. The Securitization Process	326
3.1. An Example of a Securitization Transaction	327
3.2. Parties and Their Role to a Securitization Transaction	329

3.3. Bonds Issued	330
3.4. Key Role of the Special Purpose Vehicle	332
4. Residential Mortgage Loans	335
4.1. Maturity	335
4.2. Interest Rate Determination	336
4.3. Amortization Schedule	336
4.4. Prepayments and Prepayment Penalties	337
4.5. Rights of the Lender in a Foreclosure	337
5. Residential Mortgage-Backed Securities	338
5.1. Mortgage Pass-Through Securities	339
5.2. Collateralized Mortgage Obligations	343
5.3. Non-agency Residential Mortgage-Backed Securities	349
6. Commercial Mortgage-Backed Securities	352
6.1. Credit Risk	352
6.2. Basic CMBS Structure	352
7. Non-Mortgage Asset-Backed Securities	355
7.1. Auto Loan Receivable-Backed Securities	356
7.2. Credit Card Receivable-Backed Securities	358
8. Collateralized Debt Obligations	359
8.1. Structure of a CDO Transaction	360
8.2. Illustration of a CDO Transaction	360
9. Summary	363
References	365
Problems	365

PART IV

Valuation

CHAPTER 8

The Arbitrage-Free Valuation Framework 371

Learning Outcomes	371
1. Introduction	371
2. The Meaning of Arbitrage-Free Valuation	372
2.1. The Law of One Price	373
2.2. Arbitrage Opportunity	373
2.3. Implications of Arbitrage-Free Valuation for Fixed-Income Securities	374
3. Interest Rate Trees and Arbitrage-Free Valuation	375
3.1. The Binomial Interest Rate Tree	377
3.2. What Is Volatility and How Is It Estimated?	380
3.3. Determining the Value of a Bond at a Node	381
3.4. Constructing the Binomial Interest Rate Tree	384
3.5. Valuing an Option-Free Bond with the Tree	389
3.6. Pathwise Valuation	391
4. Monte Carlo Method	393
5. Summary	395
Problems	396

CHAPTER 9**Valuation and Analysis: Bonds with Embedded Options 401**

Learning Outcomes	401
1. Introduction	402
2. Overview of Embedded Options	402
2.1. Simple Embedded Options	403
2.2. Complex Embedded Options	404
3. Valuation and Analysis of Callable and Puttable Bonds	407
3.1. Relationships between the Values of a Callable or Puttable Bond, Straight Bond, and Embedded Option	407
3.2. Valuation of Default-Free and Option-Free Bonds: A Refresher	408
3.3. Valuation of Default-Free Callable and Puttable Bonds in the Absence of Interest Rate Volatility	409
3.4. Effect of Interest Rate Volatility on the Value of Callable and Puttable Bonds	412
3.5. Valuation of Default-Free Callable and Puttable Bonds in the Presence of Interest Rate Volatility	418
3.6. Valuation of Risky Callable and Puttable Bonds	426
4. Interest Rate Risk of Bonds with Embedded Options	432
4.1. Duration	432
4.2. Effective Convexity	440
5. Valuation and Analysis of Capped and Floored Floating-Rate Bonds	444
5.1. Valuation of a Capped Floater	444
5.2. Valuation of a Floored Floater	447
6. Valuation and Analysis of Convertible Bonds	450
6.1. Defining Features of a Convertible Bond	450
6.2. Analysis of a Convertible Bond	453
6.3. Valuation of a Convertible Bond	456
6.4. Comparison of the Risk–Return Characteristics of a Convertible Bond, the Straight Bond, and the Underlying Common Stock	458
7. Bond Analytics	462
8. Summary	463
Problems	465

PART V**Term Structure Analysis****CHAPTER 10****The Term Structure and Interest Rate Dynamics 473**

Learning Outcomes	473
1. Introduction	474
2. Spot Rates and Forward Rates	474
2.1. The Forward Rate Model	476
2.2. Yield to Maturity in Relation to Spot Rates and Expected and Realized Returns on Bonds	484

2.3.	Yield Curve Movement and the Forward Curve	487
2.4.	Active Bond Portfolio Management	489
3.	The Swap Rate Curve	493
3.1.	The Swap Rate Curve	493
3.2.	Why Do Market Participants Use Swap Rates When Valuing Bonds?	494
3.3.	How Do Market Participants Use the Swap Curve in Valuation?	495
3.4.	The Swap Spread	498
3.5.	Spreads as a Price Quotation Convention	500
4.	Traditional Theories of the Term Structure of Interest Rates	502
4.1.	Local Expectations Theory	502
4.2.	Liquidity Preference Theory	503
4.3.	Segmented Markets Theory	504
4.4.	Preferred Habitat Theory	504
5.	Modern Term Structure Models	507
5.1.	Equilibrium Term Structure Models	507
5.2.	Arbitrage-Free Models: The Ho–Lee Model	512
6.	Yield Curve Factor Models	515
6.1.	A Bond's Exposure to Yield Curve Movement	515
6.2.	Factors Affecting the Shape of the Yield Curve	516
6.3.	The Maturity Structure of Yield Curve Volatilities	520
6.4.	Managing Yield Curve Risks	521
7.	Summary	524
	References	525
	Problems	525

PART VI

Fixed-Income Portfolio Management

CHAPTER 11

Fixed-Income Portfolio Management—Part I 531

	Learning Outcomes	531
1.	Introduction	532
2.	A Framework for Fixed-Income Portfolio Management	532
3.	Managing Funds against a Bond Market Index	534
3.1.	Classification of Strategies	535
3.2.	Indexing (Pure and Enhanced)	536
3.3.	Active Strategies	553
3.4.	Monitoring/Adjusting the Portfolio and Performance Evaluation	554
4.	Managing Funds against Liabilities	555
4.1.	Dedication Strategies	555
4.2.	Cash Flow Matching Strategies	574
5.	Summary	578
	Problems	580

CHAPTER 12**Fixed-Income Portfolio Management—Part II 585**

Learning Outcomes	585
5. Other Fixed-Income Strategies	586
5.1. Combination Strategies	586
5.2. Leverage	586
5.3. Derivatives-Enabled Strategies	591
6. International Bond Investing	608
6.1. Active versus Passive Management	609
6.2. Currency Risk	611
6.3. Breakeven Spread Analysis	616
6.4. Emerging Market Debt	617
7. Selecting a Fixed-Income Manager	620
7.1. Historical Performance as a Predictor of Future Performance	621
7.2. Developing Criteria for the Selection	621
7.3. Comparison with Selection of Equity Managers	622
8. Summary	624
Problems	625

CHAPTER 13**Relative-Value Methodologies for Global Credit Bond Portfolio Management 633**

Learning Outcomes	633
1. Introduction	633
2. Credit Relative-Value Analysis	636
A. Relative Value	638
B. Classic Relative-Value Analysis	638
C. Relative-Value Methodologies	640
3. Total Return Analysis	640
4. Primary Market Analysis	640
A. The Effect of Market-Structure Dynamics	641
B. The Effect of Product Structure	641
5. Liquidity and Trading Analysis	642
6. Secondary Trade Rationales	642
A. Popular Reasons for Trading	643
B. Trading Constraints	645
7. Spread Analysis	647
A. Alternative Spread Measures	647
B. Closer Look at Swap Spreads	648
C. Spread Tools	649
8. Structural Analysis	650
A. Bullets	651
B. Callables	652
C. Sinking Funds	652
D. Putables	653

9. Credit Curve Analysis	654
10. Credit Analysis	655
11. Asset Allocation/Sector Rotation	655
12. Summary	657
Problems	658
 Glossary	 667
 About the Editors and Authors	 683
 About the CFA Program	 691
 Index	 693

9. Credit Curve Analysis	654
10. Credit Analysis	655
11. Asset Allocation/Sector Rotation	655
12. Summary	657
Problems	658
 Glossary	 667
 About the Editors and Authors	 683
 About the CFA Program	 691
 Index	 693