

Contents

Advance Praise for *Fixed Income Securities* — v

Foreword — vii

Preface — ix

Acknowledgments — xi

Chapter 1: A Primer on the Time Value of Money — 1

Nominal and Effective Rates of Interest — 1

Variables and Terms to Be Used and the Corresponding Symbols — 1

The Concept of Simple Interest — 2

The Concept of Compound Interest — 2

Properties of Simple and Compound Interest — 4

Effective Versus Nominal Rates of Interest — 5

A Symbolic Derivation of the Relationship Between Effective and Nominal Rates of Interest — 5

Computing Effective and Nominal Rates in Excel — 6

Principle of Equivalency of Interest Rates — 7

Continuous Compounding of Interest — 7

Using Excel to Compute the Effective Rate with Continuous Compounding — 8

Future Value of Cash Flows — 9

Computing the Future Value Using Excel — 9

Present Value of Cash Flows — 11

Computing Present Values of Cash Flows Using Excel — 11

The Internal Rate of Return of an Investment — 12

Pure and Mixed Cash Flows — 13

Descartes' Rule of Signs and the IRR — 13

A Point About Effective Rates of Interest — 13

Level Annuities — 14

Present Value of a Level Annuity — 15

Future Value of a Level Annuity — 16

Relationship Between PVIFA and FVIFA for a Level Annuity — 16

Level Annuities Due — 17

Present Value of a Level Annuity Due — 17

Computation in Excel of the Present Value of an Annuity Due — 18

Future Value of an Annuity Due — 18

Computation of the Future Value of an Annuity Due in Excel — 19

Relationship Between PVIFA and FVIFA for Annuity Dues — 19

Perpetuities — 19

The Amortization Method of Loan Repayment — 20

Obtaining the Amortization Schedule Using Excel — 22

The Rationale for Why IPMT and PPMT Can Be Used with Two Different Sets of Parameters — 23

Amortization with a Balloon Payment — 23

Handling the Balloon Using Excel — 23

A Growing Annuity — 24

Present Value of a Growing Annuity — 24

Future Value of a Growing Annuity — 25

Growing Perpetuity — 26

Growing Annuity Due — 26

Present Value of a Growing Annuity Due — 26

Future Value of a Growing Annuity Due — 28

Growing Perpetuity Due — 28

Chapter Summary — 29

Chapter 2: An Introduction to Bonds — 30

The Leverage Effect — 31

Tax Shield Due to Interest Payments — 31

Variables Influencing the Bond Price — 33

Face Value — 33

Term to Maturity — 33

Coupon — 34

Yield to Maturity — 34

Valuation of a Bond — 34

Par, Premium, and Discount Bonds — 35

Influence of Variables on the Bond Price — 36

The Pull to Par Effect — 37

An Interesting Result about Bond Prices — 38

Eurobonds and Foreign Bonds — 40

Coupon Dates and Coupon Frequencies — 41

Zero Coupon Bonds — 42

Creating a Synthetic Zero Coupon Bond — 42

Price Quotes for Bonds — 44

Computation of the Bond Price Using Excel — 44

Different Bond Types — 45

Amortizing Bonds — 45

Bonds with Step-Up Coupons and Step-Down Coupons — 47

Payment-In-Kind (PIK) Bonds — 47

Treasury Securities — 48

Treasury Auctions — 48

Illustration of a Treasury Auction — 49

Security Identification — 50

Coupon Strips — 51

When Issued (WI) Trading — 53

Coupon Rolls — 53

Accounting for Bonds — 54

Issue of Discount Bonds — 54

Issue of Premium Bonds — 56

Risks Inherent in Bonds — 57

Credit Risk — 57

Moody's Ratings Scale — 58

S&P's Rating Scale — 58

Fitch's Rating Scale — 59

Liquidity Risk — 61

Interest Rate Risk — 62

Inflation Risk — 62

Timing Risk — 63

Foreign Exchange Risk — 63

Chapter Summary — 63

Chapter 3: Bonds: Advanced Concepts — 65

Required Symbols for the Variables — 65

Day-Count Conventions — 66

The Actual/Actual Approach — 66

The Market Method for Bond Valuation — 67

The Treasury Method for Bond Valuation — 67

Accrued Interest — 68

The Impact of Time on the Dirty Price — 70

Computation of Price and Accrued Interest Using Excel — 71

Computation of the YTM Between Coupon Dates — 73

Other Day-Count Conventions — 73

The 30/360 NASD Approach — 73

30/360 European Convention — 75

Actual/365 Convention — 75

Actual/360 Convention — 76

Comparison of Day-Count Conventions — 76

Additional Coupon-Related Excel Functions — 77

Valuing a Bond in the Final Coupon Period — 78

Yield Measures: An Introduction — 79

Current Yield of a Bond — 79

Simple Yield to Maturity — 80

Yield to Maturity of a Bond — 81

The Approximate Yield to Maturity Approach —	81
The Rationale for the AYM Approach —	81
The Realized Compound Yield —	87
The Horizon or Holding Period Return —	88
The Realized Compound Yield with Taxes —	89
Computing the YTM with Taxes —	90
The Portfolio Yield for Bonds —	90
The Taxable Equivalent Yield (TEY) —	92
Sinking Fund Provisions —	92
Serial Bonds —	93
Yield to Average Life —	94
Yield to Equivalent Life —	95
Chapter Summary —	96
 Chapter 4: Yield Curves and the Term Structure —	97
Analyzing the Yield Curve —	97
Spot Rates of Interest —	98
The Relationship Between Spot Rates and the YTM —	98
Yield Curve versus the Term Structure —	99
Required Symbols —	100
Bootstrapping to Obtain Spot Rates —	100
Practical Difficulties with Bootstrapping —	101
Coupon Yield Curves and Par Bond Yield Curves —	102
Deducing a Par Bond Yield Curve —	103
Implied Forward Rates of Interest —	104
Fitting the Yield Curve —	105
Interpolation —	105
Polynomial Models of the Yield Curve —	106
Regression Models of the Yield Curve —	106
The Nelson-Siegel Model of the Yield Curve —	106
Interpretation of the Nelson-Siegel Model —	107
Theories of the Term Structure —	109
The Pure or Unbiased Expectations Hypothesis —	109
The Liquidity Preference Theory (LPT) —	110
The Expectations Hypothesis versus the LPT: A Mathematical Analysis —	111
The Money Substitute Hypothesis —	114
The Market Segmentation Hypothesis —	114
The Preferred Habitat Theory —	115
Features of the Debt Market and Theories of the Term Structure —	115
Chapter Summary —	117

Chapter 5: Duration, Convexity, and Immunization	118
A Mathematical Definition of Duration	119
Duration of a Bond When the Settlement Date Is Between Two Coupon Dates	120
A Concise Formula for the Duration on a Coupon Date	120
The Case of a Par Bond	121
Duration of a Level Annuity	121
Duration of a Perpetuity	122
The Rationale Behind Duration	122
Factors Influencing Duration	123
Term to Maturity	123
Coupon	125
Yield to Maturity	126
Accrued Interest	126
Coupon Frequency	127
Percentage Price Change and Duration	127
Duration of Annuities Due and Perpetuities Due	128
Dollar Duration	129
Computing Duration and Modified Duration with Excel	129
Modified Duration	129
Approximating Duration	130
The Concept of Effective Duration	130
Duration as a Center of Gravity	131
Portfolio Duration	131
Bond Convexity	133
Approximating the Price Change of a Bond for a Given Change in Yield	135
Dispersion of a Bond	136
Convexity of a Zero Coupon Bond	137
Dispersion as an Expected Value	138
Portfolio Convexity and Dispersion	138
Properties of Convexity	139
The Impact of Duration	139
The Irrelevance of the Face Value	139
Dollar Convexity	139
Approximate Convexity	140
Convexity of Annuities and Perpetuities	140
Perpetuities	142
Immunization of a Bond Portfolio	142
Chapter Summary	144
Appendix 5.1: Derivation of a Concise Formula for Duration	144
Appendix 5.2: Duration of Annuities and Perpetuities	146
Appendix 5.3: Duration and Interest Rate Sensitivity	148

Appendix 5.4: Convexity of Annuities and Perpetuities — 149

Appendix 5.5: Proof of Single-Period Immunization — 149

Chapter 6: The Money Market — 152

Risk Factors in the Money Market — 153

Supervision of the Money Market — 154

Key Dates in Money Market Transactions — 155

Roll Conventions in the Event of Market Holidays — 155

The End/End Rule — 156

The Interbank Market — 156

Types of Loans in the Inter-bank Market — 157

LIBOR — 157

Interest Computation Methods — 158

Money Market Forward Rates — 159

Term Money Market Deposits — 160

Federal Funds — 161

Treasury Bills — 161

Re-openings of T-bills — 162

Discount Rates and T-bill Prices — 163

The Money Market Yield of a T-bill — 163

The Bond Equivalent Yield of a T-bill — 164

Holding Period Return for an Investor — 166

Concept of a Tail in a T-bill Transaction — 166

T-bill Related Computations Using Excel — 167

Repurchase Agreements — 169

Repo Rates — 170

Margins in Repo Transactions — 170

The Federal Reserve and Repos — 172

Negotiable Certificates of Deposit (CDs) — 173

Required Symbols — 173

Term Certificates of Deposit — 174

NCDs vs. Money Market Time Deposits — 176

The Effective Cost of a CD — 177

Commercial Paper — 177

Letters of Credit (LCs) — 178

Yankee Paper — 178

Credit Rating — 179

Moody's Rating Scale — 179

S&P's Rating Scale — 179

Fitch's Rating Scale — 180

Bills of Exchange — 180

Chapter Summary — 182

Chapter 7: Floating Rate Bonds — 183

- Call and Put Provisions in Floating Rate Bonds — 183
- Caps and Floors for the Coupon Rate — 184
- Valuation of a Floating Rate Bond — 184
- Variations on the Floating Rate Feature — 185
 - Inverse Floating Rate Bonds — 185
 - Deleveraged Floating Rate Bonds — 186
 - Dual-Indexed Floating Rate Bonds — 187
 - Range Notes — 187
- Variations on the Principal Repayment Feature — 187
- Floaters, Inverse Floaters, and Plain Vanilla Bonds — 187
 - A More General Relationship for an Inverse Floater — 188
- Duration of a Floating Rate Bond — 188
- Convexity of a Risk-Free Floating Rate Bond — 189
 - Comparison with a Zero Coupon Bond — 189
- Margin Measures for Floaters — 189
 - Simple Margin — 190
 - Adjusted Simple Margin — 190
 - Adjusted Total Margin — 191
 - The Discount Margin — 192
- Inflation Indexed Bonds — 193
- Principal Linkers or P-Linkers — 193
 - Analysis — 194
- Coupon Linkers or C-Linkers — 195
- Valuing a Risky Floater — 195
- Duration of a Risky Floater — 199
- Chapter Summary — 200
- Appendix 7.1: Duration of a Risky Floater — 201
- Appendix 7.2: Duration of a Risky Perpetual Floater — 202

Chapter 8: Mortgage Loans — 203

- Important Mortgage-Related Terms — 203
- Risks in Mortgage Lending — 203
 - Default Risk — 204
 - Liquidity Risk — 204
 - Interest Rate Risk — 204
 - Prepayment Risk — 204
 - The Role of the Mortgage Rate in Prepayments — 206
- Negative Amortization — 207
- Other Mortgage Structures — 208
 - Adjustable Rate Mortgages (ARMs) — 208
- Option to Change the Maturity — 210

Features of ARMs —	210
Variations on the ARM Structure —	210
Interest Rate Caps —	212
Example of Interest Rate Caps —	212
Payment Caps —	213
Graduated Payment Mortgages —	213
Growing Equity Mortgages —	214
A Comparison of the Three Mortgage Structures —	214
Mortgage Servicing —	218
Income for the Servicer —	219
Mortgage Insurance —	221
Sale of Mortgage Loans —	221
The Average Life of a Mortgage Loan —	222
Prepayments of Principal —	223
Single Month Mortality (SMM) —	223
Analysis of a Loan with Prepayments —	224
Relationship between Cash Flows with and without Prepayments —	225
Conditional Prepayment Rate (CPR) —	227
An Equal Principal Repayment Loan —	228
Weighted Average Coupon (WAC) and Weighted Average Maturity (WAM) —	228
Chapter Summary —	229
Appendix 8.1 —	229

Chapter 9: Mortgage-Backed Securities —	233
Cash Flows for a Pass-Through Security —	234
Cash Flow Yield of a Pass-Through Security —	237
Symbols Required for the Exposition —	237
Collateralized Mortgage Obligations —	238
Extension Risk and Contraction Risk for Mortgage-backed Securities —	242
Accrual Bonds —	243
Creating Floating Rate Tranches —	247
Notional Interest-Only Tranches —	248
Interest-Only and Principal-Only Strips —	249
Planned Amortization Class (PAC) Bonds —	249
Analysis of the SMM = 15% Scenario —	253
Chapter Summary —	254
Appendix 9.1 —	254

Chapter 10: A Primer on Derivatives —	258
Futures and Forwards: Comparisons and Contrasts —	258
The Role of the Clearinghouse in a Futures Trade —	260
Margins for Futures Trades —	261

Marking to Market of Futures Contracts —	261
The Settlement Price for Futures Contracts —	264
Movements in the Margin Account —	264
Offsetting of Futures Contracts —	265
Spot-Futures Convergence of Prices —	266
Delivery in the Case of Futures Contracts —	267
Cash Settlement of Futures Contracts —	269
Valuation of Futures and Forwards —	269
The Case of Assets Making Payouts —	272
Conversion Factors When There Are Multiple Deliverable Grades —	273
Multiplicative Adjustment of the Futures Price —	273
Additive Adjustment of the Futures Price —	274
Hedging Using Futures Contracts —	275
Hedging and Ex-Post Regret —	276
Hedging and the Case of Cash-Settled Contracts —	277
Perfect Hedges Using Futures Contracts —	278
The Importance of Terminating the Hedge on the Expiration Date —	279
The Importance of Hedging an Integer Multiple of the Contract Size —	280
Choosing an Expiration Month for Hedging —	281
Speculation Using Futures Contracts —	281
Introduction to Options —	283
Common Terms Associated with Options —	284
Exercise Price —	284
Expiration Date —	285
Option Premium —	285
Notation —	286
Exercising Call and Put Options —	286
Payoffs and Profits: A Symbolic Representation —	287
Moneyness of the Option —	288
Call Options —	288
Put Options —	288
Intrinsic Value and Time Value of Options —	289
The Absence of Arbitrage and Its Implications for Option Prices —	289
Non-Negative Option Premia —	290
Non-Negative Time Value of American Options —	290
Lower Bound for Call Options —	291
Lower Bound for Put Options —	291
Put-Call Parity for European Options —	292
Option Premia at Expiration —	292
Proof —	292
Variables of Interest for Option Valuation —	293
The Current Stock Price —	293

Chapter 12: Interest Rate Forwards and Futures	341
Forward Rate Agreements (FRAs)	341
Determining the Contract Rate	343
Using Short Rates to Determine the FRA Rate	345
Eurodollar Futures	348
Calculating Profits and Losses on ED Futures	348
Locking in a Borrowing Rate	349
Locking in a Lending Rate	351
Cash-and-Carry Arbitrage	352
Reverse Cash-and-Carry Arbitrage	353
The No-Arbitrage Pricing Equation	353
Hedging an <i>N</i> -day Loan Using ED Futures	354
A More General Argument	356
Using ED Futures to Create a Fixed Rate Loan	357
Stack and Strip Hedges	358
FRAs vs. ED Futures: An Important Point	360
Federal Funds	360
Fed Funds Futures	363
T-Note and T-Bond Futures	363
T-Bond Contracts	364
Conversion Factors	364
Calculating the Invoice Price for a T-Bond	366
The Cheapest-to-Deliver (CTD) Bond	367
The Cheapest-to-Deliver Bond Prior to Expiration	368
Risk in an Arbitrage Strategy Due to Multiple Deliverable Grades	370
Seller's Options	373
The Delivery Process	373
The Wild Card Option	374
The Quality Option	377
The End-of-Month Option	377
Hedging	378
Hedging the Cheapest-to-Deliver Bond: A Naive Approach	378
The Conversion Factor Approach	379
Hedging a Portfolio Other Than the CTD Bond	380
Changing the Duration of a Portfolio of Bonds	381
Chapter Summary	382
Appendix 12.1: Duration-Based Hedge Ratio	382
Appendix 12.2: Required Number of Contracts to Change the Duration	383
Chapter 13: Bonds with Embedded Options	385
Callable Bonds	385
Yield to Call	386

The Exercise Price —	293
Dividends —	293
Volatility —	293
Time to Maturity —	294
Riskless Rate of Interest —	294
The Binomial Model of Option Valuation —	295
The One Period Binomial Model —	295
The Two-Period Case —	297
The Binomial Model for European Puts —	299
Using the Binomial Model: The Case of European vs. American Puts —	299
Valuing a European Put Using the Binomial Model —	299
Valuing an American Put Using the Binomial Model —	300
The Black-Scholes Formula for Valuing Options —	301
Put-Call Parity and Option Pricing Models —	302
Interpretation of $N(d_1)$ and $N(d_2)$ —	303
Chapter Summary —	303

Chapter 11: The Valuation of Interest Rate Options — 305

Short Rates —	305
Issues in the Valuation of Interest Rate Derivatives —	305
Equilibrium Models of the Term Structure —	306
Arbitrage-Free Term Structure Models —	306
The Ho-Lee Model —	307
The Hull-White Model —	307
The Black-Derman-Toy Model —	307
The Binomial Tree Approach to the Term Structure —	307
Some Insights into the Ho-Lee Model —	309
Calibrating the Ho-Lee Model —	311
Arrow-Debreu Securities —	312
Calibrating the Black-Derman-Toy Model —	319
An Issue with Recombination —	320
An Issue with Calibration —	324
Valuation of a Plain Vanilla Bond —	326
Valuation of a Zero Coupon Bond —	327
Valuing a European Call —	330
Valuing an American Put —	330
Caps, Floors, and Collars —	331
Caps and Floors: A Detailed Perspective —	333
Interest Rate Collars —	336
Captions and Floortions —	339
Chapter Summary —	340

Relationship between the Yield to Call and the Yield to Maturity —	387
The Approximate Yield to Call Approach —	388
Reinvestment Assumption —	389
Concept of the Yield to Worst —	389
Valuation of a Callable Bond —	390
Putable Bonds —	394
Valuation of a Putable Bond —	395
Pricing the Callable and Putable Bonds Using the BDT Model —	397
The Callable Bond and the BDT Model —	398
Valuation of the Putable Bond —	399
Yield Spreads for Callable Bonds —	401
The Traditional Yield Spread —	401
The Static Spread —	402
The Option-Adjusted Spread —	402
Convertible Bonds —	405
Changes in the Conversion Ratio —	407
Pros and Cons of a Convertible Issue: The Issuer's Perspective —	409
Concept of Break-Even —	409
Liquid Yield Option Notes (LYONs) —	410
Exchangeable Bonds —	411
Valuing a Convertible Bond with Built-in Call and Put Options —	411
Chapter Summary —	414

Chapter 14: Interest Rate Swaps and Credit Default Swaps — 416

Interest Rate Swaps —	416
Contract Terms —	416
Key Dates in a Swap Contract —	420
The Swap Rate —	420
Risk —	421
Quoted Swap Rates —	421
Comparative Advantage and Credit Arbitrage —	422
The Role of Banks in the Swap Market —	423
Valuing an Interest Rate Swap —	423
Valuing a Swap at an Intermediate Stage —	425
Terminating a Swap —	426
Motives for the Swap —	427
Speculation —	427
Hedging a Liability —	427
Hedging an Asset —	428
Equivalence with FRAs —	431
Determining the Fixed Rate —	431
Forward-Start Swaps —	434

Amortizing Swaps — 435

In-Arrears Swaps — 436

Extendable and Cancelable Swaps — 436

Swaptions — 437

Credit Default Swaps — 438

Valuation of a CDS — 440

Using Default Probabilities to Determine the Swap Rate — 441

Chapter Summary — 443

Appendix A — 444

Goal Seek — 444

Solver — 445

Bibliography — 446

Index — 448