**Unit 3: Interest Bearing Assets Part 2- Bonds & Yields**

[**https://quizlet.com/gb/867858519/unit-3-interest-bearing-assets-part-2-bonds-yields-flash-cards/?i=24ef59&x=1jqt**](https://quizlet.com/gb/867858519/unit-3-interest-bearing-assets-part-2-bonds-yields-flash-cards/?i=24ef59&x=1jqt)

**Fixed Interest Characteristics: Negotiable**

Ownership and price can change over time.

Price can be higher or lower than nominal value.

**Coupon**

Fixed Interest payment

Often twice a year.

**How long are gilts and commercial bonds?**

Gilts: 2- 50 years (no maximum)

Corporate: 10-15 Years

**What are Permanent Interest Bearing Shares (PIBs)**

Loans to BS.

No redemption date.

Qualifying Bonds for tax.

**Permanent Interest Bearing Shares (PIBs) - Timeline**

1991-2016

Existing ones remain until redemption.

**Permanent Interest Bearing Shares (PIBs) if BS demutualises?**

Perpetual subordinated bonds

**Why did Permanent Interest Bearing Shares (PIBs) stop?**

Basel 3 regulations

**Replacement for PIBs**

Core Capital Differed Shares

**What is the nominal capital for bonds?**

Face Value

Amount repaid to bondholder on redemption date.

**Bond Issuer**

Entity that issues the bond- UK Gov, HSBC.

**4 Main Risks with Bonds**

1. Default
2. Inflation
3. Liquidity
4. Currency

**Can bond issuers default?**

Yes. Both state & companies.

**Investment Grade Bonds**

Not expected to default.

AAA, AA, A, B

**Sub- Investment Grade Bonds**

Junk Bonds

Company ‘distressed’

**Are corporate bonds covered by FSCS?**

Not directly.

Maybe if within fund.

**Why are bonds so susceptible to inflation risk?**

Both coupon and nominal value are static (unless index linked)

Longer the bond, higher the risk.

**Corporate bond liquidity**

Often very little demand.

Especially if not ‘blue chip’

**What happens to bonds when interest rates rise?**

Price Falls, Yield Rises

Returns in cash accounts higher so less demand.

Only worthwhile if can buy bonds at a discount.

**What happens to bonds when interest rates fall?**

Price Rises, Yield Falls.

Returns in cash lower, demand for bonds increase.

**What is the relationship between interest rates and bond prices?**

Inverse relationship.

Rates Up, Price Down.

Rates Down, Price Up.

**Income Tax for Bonds.**

Interest = Savings income

PSA

**CGT Tax for Bonds.**

Qualifying Bonds Exempt

Non- Qualifying Bonds CGT if sold.

**IHT for Bonds.**

Included in estate.

**Convertible Corporate Bonds**

Can convert to ordinary shares.

Non-qualifying for CGT.

Lower coupon

**Which bonds can be held within an ISA?**

Must be on recognised stock exchange.

By company on recognised stock exchange.

**Is it worth putting bonds in ISA?**

Most have PSA and CGT exempt so might be better using elsewhere.

**How can you ‘manufacture’ a higher return on bonds if they have a fixed coupon?**

Buying at a discount on secondary market.

If bond has face value of £100, Coupon 5% - Yield = 5%.

If buy for £80. 5/80\*100 = 6.25% Yield.

**How can you buy a Gilt directly ?**

Gilt-edged market maker (GEMM) bids on your behalf at auction.

Application form – if an approved investor.

**How are gilts issued?**

DMO has weekly auctions.

**How can you buy a corporate bond directly?**

Through investment bank.

Or Retail Bonds.

**Retail Bonds**

Non-tradable corporate bond.

Minimum £1000

**Mini-Bonds**

Short-term retail bond (can’t be traded)

3-5 years

John Lewis etc

**Bulldog Bonds**

Loans in sterling to foreign investors.

Give them access to UK capital market.

**Eurobonds**

Any bond denominated in currency other than:

Home currency

Market operating in.

UK firm issuing bond in USD in Japan.

**Mid-market price**

Average of buying (bid) and selling (ask) price.

**Clean price**

Ignores impact of accrued coupon payments.

Price is higher when coupon payment is nearly due.

**Dirty price**

Factors when accrued coupon.

Price will be higher.

**Cum Dividend**

Buyer entitled to next coupon.

Even if only owned it a day.

Buyers pays higher ‘dirty price’.

**Ex Dividend**

Seller keeps next coupon within certain window.

e.g. Gilts go XD, 7 days before coupon issue.

Buyers pays lower ‘clean price’.

**Running Yield**

Coupon / Clean Price \* 100

**What Clean Price would you have to pay to get X Running Yield?**

Coupon / Yield Required \* 100

If want 4% Yield, Coupon is 3.6%.

3.6/4 \* 100 = £90

**Gross Redemption Yield Purpose**

Includes capital gain/ loss at redemption

Applies where price paid is different to nominal value.

**Gross Redemption Yield Formula**

Running Yield **+-**  Capital Yield = Gross Yield

Capital Yield can be positive or negative:

* If make capital gain add to running yield.
* If make loss, subtract from running yield.

**Capital Yield Formula**

**Annual Gain/Loss %** = Capital Gain/Loss / Number of Years to redemption

**Capital Yield** = Annual Gain/Loss / Clean Price \* 100

**Net Yield Purpose**

Works out tax

Coupon: Taxable as savings income.

Capital gain exempt for qualifying bonds.

**Net Yield Formula (Assuming Used PSA)**

Running Yield x Marginal Tax Rate

Basic Rate: 5% coupon \* 0.8 = 4% Net Yield

**‘Long and Lo, Up & Down We Go’**

Long time to redemption + Low coupon = Volatile

**What does Modified Duration measure?**

Expected change in clean price if interest rates change.

Higher MD = More Volatile.

**Modified Duration Example**

If interest rise by 1%

Bonds with MD of 5 would fall by 5%.

**Normal Yield Curve : What does this say about interest rates?**

Interest rates expected to rise.

Rates Up, Price Down, Yield Up

**Inverted Yield Curve : What does this say about interest rates?**

Interest rates expected to fall.

Rates Down, Price Up, Yield Down

**What information do Yield Curves plot?**

Bonds with same risk but different maturities dates.

**Normal Yield Curve: Returns**

Investors expect higher return as longer investment = larger risk (inflation etc).

**Normal Yield Curve: Inflation**

Can be suggestive of inflation.

Interest rate rises are used to nullify inflation.

**Yield Curve Steepness**

Steeper Curve = Higher expected change in interest rate.

**Shorts**

DMO: Under 7 Years to redemption

Press: Under 5 Years to redemption

**Mediums**

DMO: 7-15 Years to redemption

Press: 5-15 Years to redemption

**Longs**

15 Years + to redemption

**Index-Linked Gilts**

Both Coupon and Nominal Value **increase & decrease** in line with RPI (CIPH from 2030)

3 Month time lag.

**Repo Market**

Sale and buy-back agreement.

Can sell gilt to 3rd party and buy back on agree day.

Creates liquidity.

**Strips Market**

Gilts stripped down to individual components and sold.

If someone wants a bond with no coupon.

Only allowed with certain gilts.

**Credit Ratings for Corporate Bonds**

Credit ratings for companies more changeable than for countries.

**Liquidity for Corporate Bonds**

Varies widely depending on size of firm/ credit rating.

Wide Spread: difference between buying/selling price.

**What is a debenture?**

Secured corporate bond.

Provide security if company goes insolvent.

**Secured Corporate Bond: Fixed charge vs Floating charge**

Fixed charge: Specific Asset e.g. building

Floating charge: General charge on firms assets

**Unsecured Corporate Bonds**

Same rights as normal creditors.

Higher Risk = Higher Coupon.

**Floating Rate Notes**

Coupon linked to SONIA/ EURIBOR

Nominal Value = Clean price as interest fluctuates.