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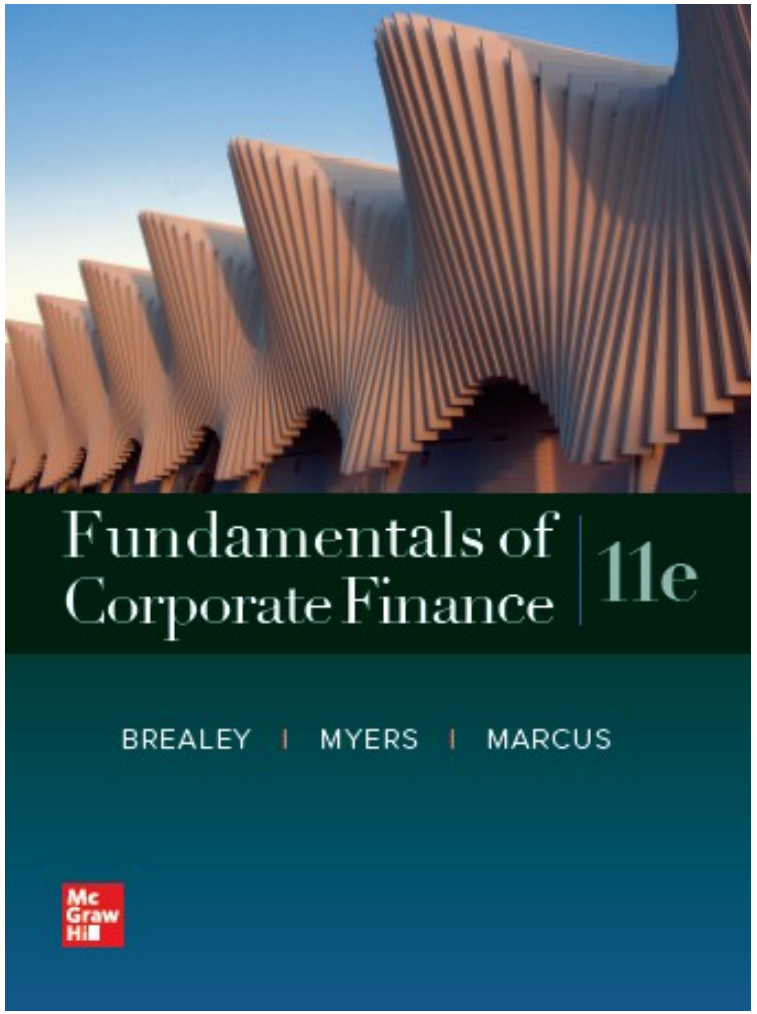
Fundamentals of Corporate Finance, 11th Edition

CHAPTER 6: Valuing Bonds



Bond Rates of Return [1]

Rate of Return.

- Total income per period per dollar invested.

$$\text{Rate of return} = \frac{\text{total income}}{\text{investment}} = \frac{\text{coupon income + price change}}{\text{investment}}$$

Bond Rates of Return 2

Example.

A bond increases in price from $963.80 to $1,380.50 and pays a coupon of $21.875 during the same period. What is the rate of return?

$$\text{Rate of return} = \frac{\$21.875 + (\$1{,}380.50 - 963.80)}{\$963.80} = .455, \text{ or } 45.5\%$$

Bond Rates of Return 2

Example.

See White Board for another example

Nominal and Real Rates of Interest [1]

In the presence of inflation, an investor's real interest rate is always less than the nominal interest rate.

$$1 + \text{real rate} = \frac{1 + \text{ nominal rate}}{1 + \text{ inflation rate}}$$

Nominal and Real Rates of Interest 2

Example.

If you invest in a security that pays 8% interest annually and inflation is 4%, what is your real interest rate? (How much additional Purchasing Power do you have?)

$$1 + \text{real rate} = \frac{1.08}{1.04}$$

$$\text{Real interest rate} = .0385 \text{ or } 3.85\%$$

First Half Review/Exam Preview

Chapters 5 & 6; Exam One discussion

See Review Document