LEVEL 1: FIXED INCOME

Reading 40 (2nd out of 6): MARKETS & BOND ISSUANCE

Difficulty: **easy**

Benchmark Study Time: **2.5h**

2022

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INTENTIONALLY EMPTY

THIS E-BOOK:

- is a selective summary of the corresponding Reading in your CFA® Program Curriculum,
- provides place for your own notes,
- helps you structure your study and revision time!

How to use this e-book to maximize your knowledge retention:

1. **Print** the e-book in duplex and bind it to keep **all** important info for this Reading **in one place.**
2. **Read** this e-book, best twice, to grasp the idea of what this Reading is about.
3. **Study** the Reading from your curriculum. **Here add** your notes, examples, formulas, definitions, etc.
4. **Review** the Reading using this e-book, e.g. write your summary of key concepts or revise the formulas at the end of this e-book (if applicable).
5. **Done?** Go to your study plan and change the Reading's status to green:
   (it will make your Chance-to-Pass-Score™ grow ☺).
6. **Come back** to this e-book from time to time to **regularly review for knowledge retention!**

NOTE: While studying or reviewing this Reading, you can use the tables at the end of this e-book and mark your study/review sessions to hold yourself accountable.

CLASSIFICATIONS OF MARKETS

Classification by type of issuer

- the **government and government-related sector** (for bonds issued by governments, international organizations, e.g. the World Bank, or quasi-government entities either owned or sponsored by governments, e.g. rail services),
- the **corporate sector** (for bonds that are issued by financial or non-financial companies),
- the **structured finance (securitized) sector** (for securitized debt instruments).

Classification by credit quality

Classification according to the credit quality of bonds follows credit ratings of agencies such as Moody's Investors Service, Standard & Poor's or Fitch Ratings.

We distinguish:

- **investment grade bonds** (rating of Baa3 or above by Moody's Investors Service or BBB minus or above by Standard & Poor's and Fitch Ratings),
- **non-investment grade bonds** (rating below Baa3 or BBB minus; aka. high yield, speculative, or "junk" bonds).

Classification by maturity

We distinguish:

- **money market securities** – securities whose original maturity ranges from overnight to one year (e.g. Treasury bills),
- **capital market securities** – securities with an original maturity longer than one year.

Classification by currency denomination

Bonds issued in global markets may be denominated in different currencies (mostly in euro and U.S. dollar).

Depending on the currency a bond in denominated in, the bond's price is subject to the interest rates of the country or region where the currency is used.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

Classification by type of coupon

Depending on the interest that bonds pay on their coupons, we distinguish:

- **fixed-rate** bonds (pay stable interest),
- **floating-rate** bonds (interest paid changes).

Coupon rates of floaters are typically based on reference rates:

- **London interbank offered rate (LIBOR)** – commonly used in the Eurobond market (its U.S. dollar equivalent is used for floating-rate bonds denominated in U.S. dollars),
- **Euro interbank offered rate (Euribor)** – applied for floaters denominated in euros.

Classification by geography

- **domestic bonds** (denominated in the currency of a given country, issued and sold in that country, the issuer is from that particular country, governed by the law of this country),
- **foreign bonds** (denominated in the currency of a given country, issued and sold in that country, governed by the law of this country, the issuer is from a different country),
- **Eurobonds** (not subject to the jurisdiction of any particular country).

Other classifications of fixed-income markets

Inflation-linked bonds (aka. linkers):

- hedge against the inflation risk,
- may be issued by governments, government-related entities, and corporate issuers that have an investment-grade rating,
- the principal of such a bond is indexed to inflation (e.g. by means of the consumer price index, CPI).

Tax-exempt bonds:

- income received from municipal bonds is not taxable,
- in the United States, they are issued by local governments.

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PRIMARY VS SECONDARY BOND MARKETS

- **Primary bond markets** – markets in which bonds are sold directly after their issuance by their issuers with the aim of raising some capital.
- **Secondary bond markets** – markets in which investors trade among themselves in bonds already existing in the market.

BOND ISSUANCE

Public offerings – the bonds issued are addressed to the general public.

<u>Types of public offerings</u>:

- underwritten offerings,
- best effort offerings,
- auctions.

Private placements – only selected investors are able to engage in the purchase of the bonds issued.

Underwritten offering

When an issuer decides to issue bonds via an underwritten offering, it seeks an investment bank, which serves as an underwriter, i.e. it takes on the responsibility for the issuance of bonds and guarantees their sale at the offering price previously agreed upon with the issuer.

For larger bond issuances, syndicated offerings are rather common, which is when a group of investment banks becomes the underwriter.

Underwritten offerings are used for:

- corporate bonds,
- some local government bonds (such as U.S. municipal bonds),
- some securitized instruments (e.g. mortgage-backed securities).

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

The process of issuing bonds under an underwritten offering:

1) The issuer determines how much capital it needs to raise.
2) The issuer selects the underwriter.
3) Terms and conditions are included in the offering prospectus. Bond features such as offering price, notional principal or coupon rate are discussed.
4) The demand for the bond issue is assessed.
5) The bonds are properly priced – the underwriter will aim at a small oversubscription.
6) The underwriting agreement is signed and bonds are issued.
7) On the offering day, the underwriter buys the whole issue and resells the bonds directly or indirectly, i.e. through dealers, to investors.
8) About a fortnight later, when investors receive their bonds, the whole process ends up with the so-called closing day.

Best effort offering

In the best effort offering, the investment bank does not act as the guarantor of the whole process but serves only as a broker, i.e. it helps to sell the bonds for a commission but does not bear any responsibility if it is unable to sell any of the issued bonds.

Auction

Auctions are based on bidding:

- **competitive bidding** – when bidders themselves determine the interest rate, but if at the auction it proves too high, they will not receive any offers to buy bonds;
- **non-competitive bidding** – bidders accept the rate set at the auction and they always receive their bonds.

Single-price auctions – when all bidders pay the same price and get the same coupon rate for the same bond issue (very common in the US).

Multiple-price auctions – involve various prices and coupon rates for the same bond issue (common e.g. in Germany or Canada).

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

Shelf registration

Shelf registration – a mechanism allowing big companies that have proved themselves to be successful issuers to issue new bonds under the same prospectus.

Private placements

Private placements – only selected investors (usually large institutional investors) are able to engage in the purchase of the bonds issued.

There is no **secondary market** for bonds issued via private placements – such bonds are **issued only for selected investors** through unregistered offerings and are delivered by issuers directly to these investors.

Sometimes investment banks participate in private placements, but **such offerings are never underwritten**.

Since bonds issued via private placements are limited to certain investors only, these investors have the right to influence the bond issue in order to tailor it to their needs.

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Summarizing key concepts:

☐ Classifications of markets: by type of issuer, by credit quality, by maturity, by currency denomination, by type of coupon, by geography, other classifications

My summary:

☐ Primary vs Secondary bond markets

My summary:

☐ Bond issuance: Public offerings vs Private placements

My summary:

☐ Underwritten offering

My summary:

☐ Auctions

My summary:

☐ Shelf registration

My summary:

☐ Securities issued by: governments, supranational agencies, corporations

My summary:

☐ Bank short-term funding & repos

My summary:

Keeping myself accountable:

TABLE 1 | STUDY

When you sit down to study, you may want to **try the Pomodoro Technique** to handle your study sessions: study for 25 minutes, then take a 5-minute break. Repeat this 25+5 study-break sequence all throughout your daily study session.

✔ Tick off as you proceed.

POMODORO TIMETABLE: study-break sequences (25′ + 5′)													
date		date		date		date		date		date		date	
25′		25′		25′		25′		25′		25′		25′	
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5′		5′		5′		5′		5′		5′		5′	

TABLE 2 | REVIEW

Never ever neglect revision! Though it's not the most popular thing among CFA candidates, regular revision is what makes the difference. If you want to pass your exam, **schedule & do your review sessions.**

REVIEW TIMETABLE: When did I review this Reading?													
date		date		date		date		date		date		date	
date		date		date		date		date		date		date	