FIN 366: INVESTMENTS
BRIEFING

Chapters 10: Bond Prices and Yields

A **bond** is a security that requires an issuer (the borrower) to make specified payments to the bondholder (the lender) over a period of time. The borrower generally pays the **par** or **face value** of the bond at maturity and may make **coupon** payments during the life of the bond to the lender or holder. The **indenture** is a contract describing the terms of the bond. **Convertible bonds** allow the holder of the bond to convert the bond into shares of common stock of the firm. **Callable bonds** may be repurchased by the borrower during the life of the bond and retired. **Puttable bonds** allow the lender, at their discretion, to extend the bond past the maturity date. When valuing bonds, the **coupon rate** is used to determine the coupon payments, while the **discount rate** is used to determine the rate at which the coupon payments are discounted to the present. A bond's **yield to maturity** is the bond's compound annual rate of return over the life of the bond and to maturity, assuming it is purchased at its price and coupon payments are reinvested. **Premium bonds** have a bond price greater than par, while **discount bonds** have a price less than par. The **current yield** is the total of the bond's coupons paid over a year, divided by its current price. The **yield to call** is similar to the yield to maturity, but it considers the date at which the bond may be *called* rather than the bond's maturity date as the date the bond is "retired". The **holding period return** is the rate of return an investor realizes for purchasing a bond, collecting coupons, and selling the bond prior to the bond's maturity and par value payment. **Investment grade bonds** are higher quality bonds issued by safe companies and governments while **speculative grade bonds** are issued by riskier firms. **Collateral** is a specific asset pledged against possible default on the bond. **Debentures** are bonds not backed by collateral. **Subordination** on bonds implies that some debtholders are paid first in the event of bankruptcy before others.