

# Contents

<b>Acknowledgments</b>	<b>xi</b>
<b>CHAPTER 1</b>	
<b>An Overview of the Fixed Income Securities Market</b>	<b>1</b>
Recent Rise in Popularity of Bonds	1
Debt versus Equity	2
Characteristics of Fixed Income Securities	4
Components of Fixed Income Securities	10
The Basics of Price	11
Factors Affecting Bond Prices	12
Are Today's Bond Yields High or Low?—A History Lesson	14
Sorting Out Fact from Fiction	17
Investment Strategies—Buy-and-Hold versus Market Timing	22
<b>CHAPTER 2</b>	
<b>The Basics of Debt Instruments</b>	<b>26</b>
Coupon Rate	26
Zero Coupon	27
Maturity and Par	28
Basics of Bond Pricing and Market Yield	30
Key Properties of Fixed Income Securities	34
Embedded Options	37
Macaulay Duration	39
Modified Duration and Convexity	43
<b>CHAPTER 3</b>	
<b>Bond Pricing Concepts</b>	<b>52</b>
Time Value of Money	52
Price of a Bond	64
Understanding Yield	69
<b>CHAPTER 4</b>	
<b>Risks Associated with Bonds</b>	<b>81</b>
What Is Risk?	81
Interest Rate Risk	81

Credit or Default Risk	82
Reinvestment Risk	84
Early Redemption or Call/Sink Risk	84
Prepayment Risk	86
Liquidity Risk	88
Exchange Rate or Currency Risk	89
Political or Country Risk	90
Event Risk	90
<b>CHAPTER 5</b>	
<b>Macroeconomics and the Bond Market</b>	<b>92</b>
Economics 101	92
Bond Yields and the Macroeconomy	103
The Twin Deficits: Budget and Trade	104
Fiscal Policy Matters, But Far Less than the Market Believes	106
Monetary Policy or, More Correctly, Fed Interest Rate Policy	107
Investing Strategy (Managing a Bond Portfolio in a Period of Financial Adversity)	118
<b>CHAPTER 6</b>	
<b>Using Economic Variables to Forecast Interest Rates and the Bond Market</b>	<b>120</b>
Historical Patterns	121
Forecasting Reliability	122
Trading Range	123
Key Economic Indicators	125
Commodity Prices Can Serve as Guide to Market-Timing Bond Investing	153
Forecasting Inflation Psychology	155
Forecasting and Recognizing Shifts in Interest Rate Trends	155
Investing with the Interest Rate Cycle	158
Putting It All Together	159
Glossary	162
<b>CHAPTER 7</b>	
<b>The Yield Curve</b>	<b>171</b>
Yield Curve and Its Structures	171
Analyzing the Shape of the Yield Curve	176
Uses of the Yield Curve	178

**CHAPTER 8****Money Market Instruments**

Federal Funds Markets	180
Repurchase Agreements	181
Eurodollar Deposits	182
U.S. Treasury Bills (T-Bills)	183
Government-Sponsored Enterprises/ Federal Agency Securities	185
Commercial Paper	187
Certificates of Deposit	195
Banker's Acceptances	200
Municipal Notes	202
Auction Rate Securities	203
Variable Rate Demand Bonds (Lower Floaters)	206
Conclusion	207

**CHAPTER 9****U.S. Treasury and Government Agency Securities**

U.S. Treasury Securities	209
U.S. Treasury Bond Auctions	213
Treasury STRIPS	214
Government Agency Securities	216
A Little History	217
Agency Debt Structures	227
Callable Agencies	233
Valuation of Callable Agency Securities	237
Trading Ideas in Callable Agencies	242

**CHAPTER 10****Municipal Bonds**

General Obligation Bonds	248
Revenue Bonds	250
Prerefunded Bonds (Tax-Free Treasuries)	253
Types of Revenue Bonds	256
Who Are the Players in the Municipal Market?	275
Rating Agencies	276
Insured Municipal Bonds	279
Zero Coupon (Capital Appreciation) Municipal Bonds	281
Put Bonds	284
Callable Bonds	285
High Yield Municipal Bonds (Junk Bonds)	287
Certificates of Participation (COPs)	288

Liberty Bonds	288
Tobacco Bonds	288
Buying Bonds—The Primary Market, the Secondary Market	290
Tax Treatment of Municipal Bonds	294
Three Debacles: New York City, Washington Public Power Supply System, and Orange County, California	298
Municipal Bond Price Transparency	302

**CHAPTER 11****Corporate Bonds 305**

What Is a Corporate Bond?	305
Why Do Corporations Issue Bonds?	307
Role of the Trustee	308
Why Do Investors Purchase Bonds?	308
How Corporate Bond Prices Are Quoted in the Market	311
Types of Corporate Bonds	314
Medium-Term Notes	317
Variable Rate Notes	318
Original Issue Discounts	320
Bonds with Embedded Options	321
Rating Agencies	329
High Yield (“Junk”) Bonds	330
Senior Floating Rate Loans	331
Inflation-Linked Corporate Notes	333
The Internet and Price Transparency	334

**CHAPTER 12****Emerging Markets 335**

Origins of a Structured Trading Market: The Brady Plan	336
Characteristics of Brady Bonds: Confusion and Complexity Abound	338
Roller Coaster Growth of the Asset Class	338
Defining Traits of an Emerging Market Country	338
Understanding Today’s Market	339
Look Out Below: Important Statistics to Know Before Investing in Emerging Markets	342
Two Wild Cards: Multilateral Aid and Political Uncertainty	350

It Gets Negative Headlines But Investors Are Happy: Emerging Markets Returns versus Other High-Risk Investments	353
A Popular Trade in a Low Interest Rate Environment: The Carry Trade	355
Summary: Emerging Markets Reward the Prepared Investor (Most of the Time)	360
<b>CHAPTER 13</b>	
<b>Distressed Debt Securities</b>	<b>361</b>
Which Is Sexier? Vulture versus Venture	364
Uncertain Trend of Default Rates	364
Main Characteristics of a Distressed Security	366
A Note on Recovery Rates	369
Case Study: Corporación Durango	369
<b>CHAPTER 14</b>	
<b>Mortgage-Backed Securities</b>	<b>374</b>
Building Blocks of MBS—Mortgages	375
What Are Mortgage-Backed Securities?	377
What Are the Attractions of MBS?	377
Types of Mortgage-Backed Securities	379
Pass-Through MBS (Agency Pass-Throughs)	379
Issuing Agencies	381
Terminology	382
Types of Underlying Loans	384
Agency Pass-Through Trading	386
Prepayment Risk and Analysis	389
OAS Analysis and MBS	392
Collateralized Mortgage Obligations	393
How Best to Purchase Mortgage-Backed Securities	405
<b>CHAPTER 15</b>	
<b>Asset-Backed Securities</b>	<b>406</b>
Asset-Backed Securities Defined	407
How Are ABS Created?	408
Structure of ABS	408
Credit Quality, Credit Enhancement, and the Rating Agencies	413
ABS Collateral Types	421
Collateralized Debt Obligation (CDO) Market Overview	432
Benefits of Investing in ABS	436

<b>CHAPTER 16</b>	
<b>Preferred Stock</b>	<b>439</b>
Perpetual Preferred Stock	440
Cumulative Preferred Stock	443
Convertible Preferred Stock	444
Call Features	445
Voting Rights	446
Sinking Funds	446
Foreign Issues	446
Real Estate Investment Trusts (REITs)	448
Other \$25 Par Investments	448
Anticipating the Risks	449
The Secondary Market	451
Conclusion	452
<b>CHAPTER 17</b>	
<b>Fixed Income Derivatives: Products and Applications</b>	<b>453</b>
Interest Rate Swaps	454
Fixed Income Options: A Strategy to Suit Every Outlook	459
Credit Derivatives: Definitions, Growth, and Applications	463
<b>CHAPTER 18</b>	
<b>Managing a Fixed Income Portfolio</b>	<b>480</b>
The Economy	482
Tax Consequences	482
Mechanics of the Bond Market	484
Selecting a Bond Broker	487
Structuring and Managing a Fixed Income Portfolio	489
Market Timing versus Buy and Hold	490
Managing Credit Risk	492
Managing Interest Rate Risk	494
Strategies to Enhance Portfolio Returns	496
Do It Like the Pros	501
Conclusion	502
<b>About the Co-Writers</b>	<b>503</b>
<b>Notes</b>	<b>505</b>
<b>Index</b>	<b>507</b>