NPTEL

Course Name: Security Analysis and Portfolio Management

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Session 36: Bond Portfolio Management Strategies-II

1. What is Active Bond Portfolio Management Strategies?
Ans.

Active Bond Portfolio Management Strategies includes following five aspects:

I. Interest Rate Anticipation:

- Reduce the portfolio duration when interest arte rate is expected to increase and vice versa.
- Increase the investment in long duration bonds when interest rates are expected to decline
- Move into shorter duration bonds if interest rate is going to be declined

II. Valuation Analysis:

- Select the bonds on the basis of their intrinsic values
- Identification of major factors that affect the bond's intrinsic values.
- Bond's rating, call feature etc.
- Buy the undervalued bonds and sell the overvalued bonds

III. Credit Analysis

- It involves detailed analysis of the bond issuer to determine expected changes in its default risk
- Identification of internal and external factors which affect the credit rating of the company.
- Explanation of credit analysis model

IV. Yield Spread Analysis:

- Yield spread can give investors ideas for potential investment opportunities. In other words it is the difference between yields on differing debt instruments that share a common time to maturity.
- Factors affecting yield spread: Business cycle, Volatility in the market interest rate
- The higher the yield spread better the investment investment opportunity

V. Bond Swaps:

- It involves liquidating a current position and simultaneously buying a different issue in its place with similar attributes but having a chance for improved return.
- The main purpose of the bond swap is portfolio improvement.
- Different types of bond swaps: Pure Yield Pickup Swap, Substitution Swap, Tax Swap

2. What is the meaning of Bond Swap? Explain the concept of Pure Yield Pickup Swap.
Ans.

Meaning of Bond Swap: It involves liquidating a current position and simultaneously buying a different issue in its place with similar attributes but having a chance for improved return. The main purpose of the bond swap is portfolio improvement.

Different Types of Bond Swap: Pure Yield Pickup Swap,Substitution Swap, Tax Swap

Pure Yield Pickup Swap:

- It involves swapping out of a low-coupon bond into a comparable higher coupon bond to realize an automatic and instantaneous increase in current yield and yield to maturity.
- Advantages:
    - No need for interest rate speculation
    - No need to analyze prices or overvaluation or under valuation
    - No specific work-out period needed because the investor is assumed to hold new bond to maturity
- Disadvantages:
    - Increased risk of call in the event interest rate decline
    - Reinvestment risk is greater with higher coupon bonds.

3. Write a short note on Substitution Swap.
Ans.

Substitution Swap:

- It is generally short-term, It relies heavily on interest rate expectations and subject to more risky than pure yield pickup swaps
- The procedure assumes a short-term imbalance in yield spreads between issues that are perfect substitutes
- The imbalance in yield spread is expected to be corrected in near future
- Advantage:
    - Realization of Capital Gain by switching out of your current position into higher yielding obligation
- Disadvantages:
    - Yield spread thought to be temporary in fact be permanent thus reducing capital gains advantages.The market rate may change adversely.

4. What are the factors to be considered for a Global Fixed-Income Investment Strategy?
Ans.

Factors to consider for a Global Fixed-Income Investment Strategy

- The local economy in each country including the effects of domestic and international demand
- The impact of total demand and domestic monetary policy on inflation and interest rates

- The effect of the economy, inflation, and interest rates on the exchange rates among countries