[Frequently Asked Questions]

[Bond Management (part-2)]

Subject:	Business Economics
Course:	B.A., 5th Semester, Undergraduate
Paper No. & Title:	Paper – 511 Investment Management
Unit No. & Title:	Unit - 1 Bond Management
Lecture No. & Title:	2: Bond Management (part-2)

Frequently Asked Questions

1. **State the two variables of Bonds for price changes**

   The two major variables of bonds which are important in assessing price changes are:

   i. The coupon and

   ii. The maturity.

   To receive the maximum impact from an expected change in interest rates, investors should purchase low coupon, long maturity bonds.

2. **What does theorem 2 states of bond valuation**

   It says that "The longer the maturity of a bond, the more sensitive is its price to a change in interest rates."

3. **Explain interest rate risk briefly.**

   Under the interest rate risk, the interest rate is inversely related to bond price. Thus, as interest rate decreases the price of bonds trading in the marketplace generally increases. On the contrary, when interest rate rises, the price of bonds tends to fall.

4. **Explain default risk briefly.**

A bond is nothing but a certificate of debt, that ensures the investor that he will get his principle amount plus interest on it on a specific date – maturity date. But many investors fails to realize that corporate bonds doesn't have such guarantee, instead they trade on the company's good will hence the returns are dependent on the corporation's ability to repay that debt. As an investor it is one's duty to calculate the probability and possibility of default, based on which the investment decision should be taken. Thus, the calculated risk that an investor faces in an investment is known as Default Risk.

5. **What is risk structure of interest rates**

   The relationship between interest rates on bonds with the same term to maturity is called the risk structure of interest rates. It is generally calculate by calculating the risk premiums.

6. **Explain zero coupon bond.**

   A bond which pays directly on its maturity that is duration is equal to its time to maturity.

7. **Explain Vanilla bond.**

   It is different than zero-coupon bond, the dividends are paid at regular intervals and lumpsum amount on the maturity date. Thus, Duration will always be less than its time to maturity.

8. **State difference between zero coupon bond and vanilla bond.**

   The only difference between zero-coupon bond and vanilla bond is that in zero-coupon bond we get the lump-sum amount on the maturity whereas in vanilla bond we receive dividends at every interval pre-fixed.

9. **Explain Modified duration.**

Modified duration is a formula that expresses the measurable change in the value of a security in response to a change in interest rates.

10. **What is bond Convexity?**

For a given bond, a graph of the relationship between price and yield is convex. This means that the graph forms a curve rather than a straight-line, what we call a linear curve. The degree to which the graph is curved shows how much a bond's yield changes in response to a change in price. Thus, this change in the yield is known as bond convexity.