



# ATRAM Academy

## Fixed Income

# What is **Fixed Income**

*A fixed-income security is an instrument that allows governments, companies, and other types of issuers to borrow money from investors.*

*- CFA Institute*

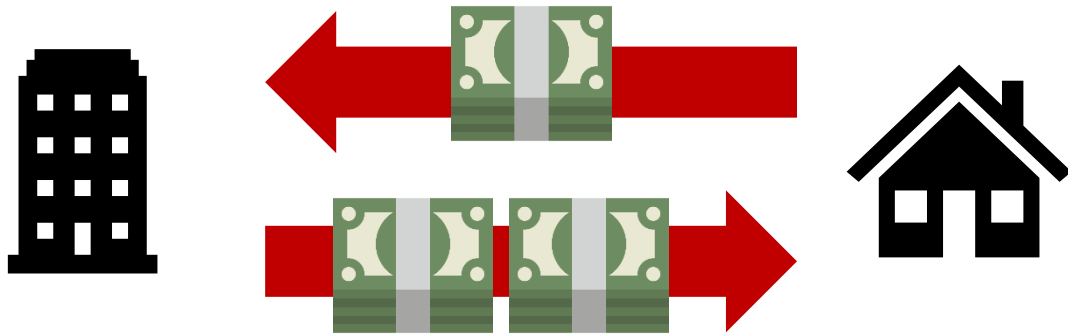
## Characteristics of Fixed Income Securities

Bondholders have no ownership rights

Fixed income securities take precedence over payment to shareholders upon bankruptcy

Fixed income securities are, in theory, less risky than common shares

# The Role of Fixed Income



Entities, Businesses, and Governments are able to finance their projects

Creditors are rewarded by interest on money lent

- Riskier projects will require much more compensation than less risky ones

# Different Types of Fixed Income



TIME DEPOSITS



GOVERNMENT  
SECURITIES



CORPORATE  
SECURITIES



NOTES, LOANS AND  
DEBENTURES



MANDATORILY  
REDEEMABLE  
PREFERRED SHARES

# Bond Terminology

**Issuer** – entity who is offering bonds for sale to investors (e.g. government entities and corporations)

**Term** – period of time during which the debt instrument is outstanding

**Maturity** - the date on which a debt becomes due for payment

**Principal** – amount to be repaid to the investor at maturity

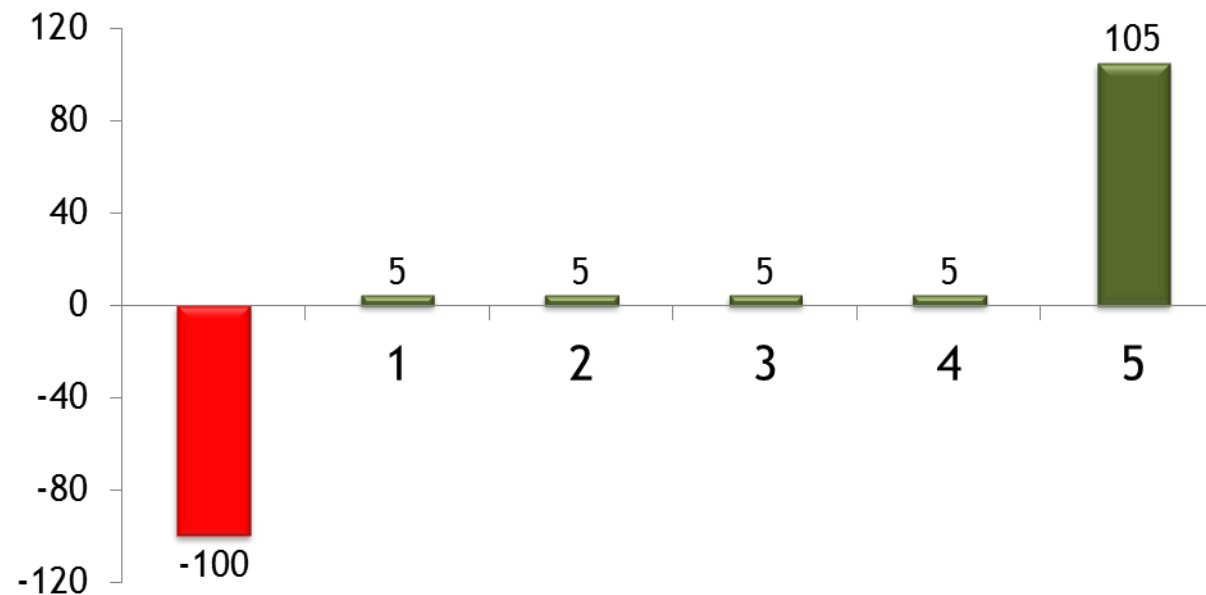
**Coupon** – periodic interest payment made to the bondholder during the life of the bond

# The Coupon Rate – Obvious Source of Income

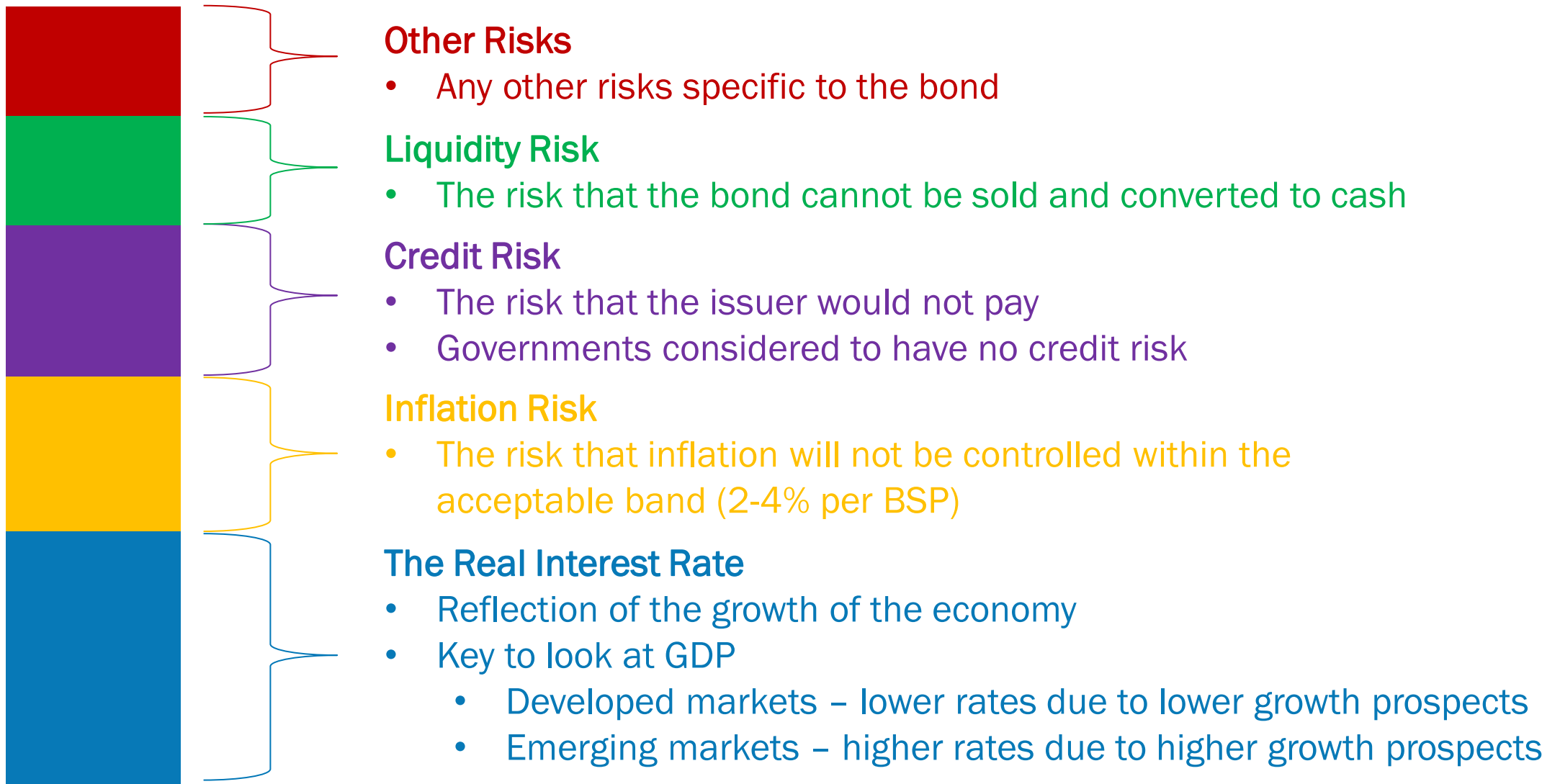
## What is the coupon?

Percentage of the face amount paid at regular intervals

Example: investment in a bond with a face amount of 100 and a 5% coupon



# The Interest Rate – Compensation for Certainty



# The Price – Relative Attractiveness

When interest rates fall, bond prices rise...

interest rates



bond prices

interest rates



bond prices

...when interest rates rise, bond prices fall



# Duration – Measurement of Interest Rate Risk

## Technical Definition

- Approximate % change in price due to a 100 basis point change in yield
- Sensitivity of a bond's full price to changes in YTM or benchmark interest rates

## Practical Definition

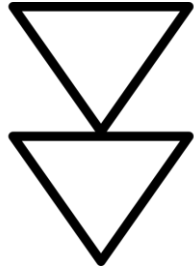
- Average period in receiving all cash flows
- The longer the duration, the riskier

# The Different Forms of Credit Risk



## default risk

risk that a borrow fails to meet its obligations to make timely/full payments on interest and principal



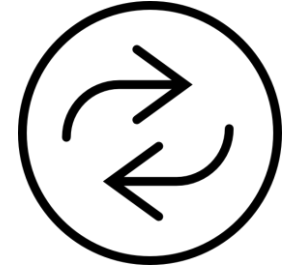
## downgrade risk

risk that a borrower's creditworthiness weakens. investors will see the issue as having more risk and therefore will decline in value



## credit spread risk

risk that spreads against "risk-free" instruments widen due to decline in creditworthiness or increase in market liquidity risk



## market liquidity risk

risk that the price at which investors transact with each other will be different from an instrument's intrinsic value

# Credit Ratings

Three internationally recognized rating agencies include:  
Moody's Investor Service, Standard & Poor's Corporation, and Fitch Ratings

		Moody's	S&P	Fitch
Investment Grade	High-Quality Grade	Aaa	AAA	AAA
		Aa1	AA+	AA+
		Aa2	AA	AA
		Aa3	AA-	AA-
	Upper-Medium Grade	A1	A+	A+
		A2	A	A
		A3	A-	A-
	Low-Medium Grade	Baa1	BBB+	BBB+
		Baa2	BBB	BBB
		Baa3	BBB-	BBB-

		Moody's	S&P	Fitch
Speculative Grade ("Junk" or "High Yield")	Low Grade or Speculative Grade	Ba1	BB+	BB+
		Ba2	BB	BB
		Ba3	BB-	BB-
		B1	B+	B+
		B2	B	B
		B3	B-	B-
		Caa1	CCC+	CCC+
		Caa2	CCC	CCC
		Caa3	CCC-	CCC-
		Ca	CC	CC
	C	C	C	
	Default	C	D	D

# Other Common Corporate Bonds



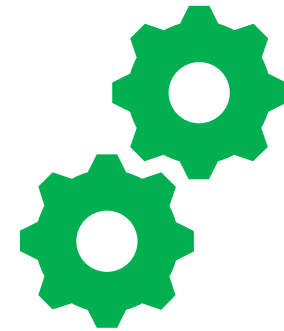
## Callable

Issuer has the right to prepay the bond



## Puttable

Holder has the right to force the issuer to repay the bond



## Convertible/Exchangeable

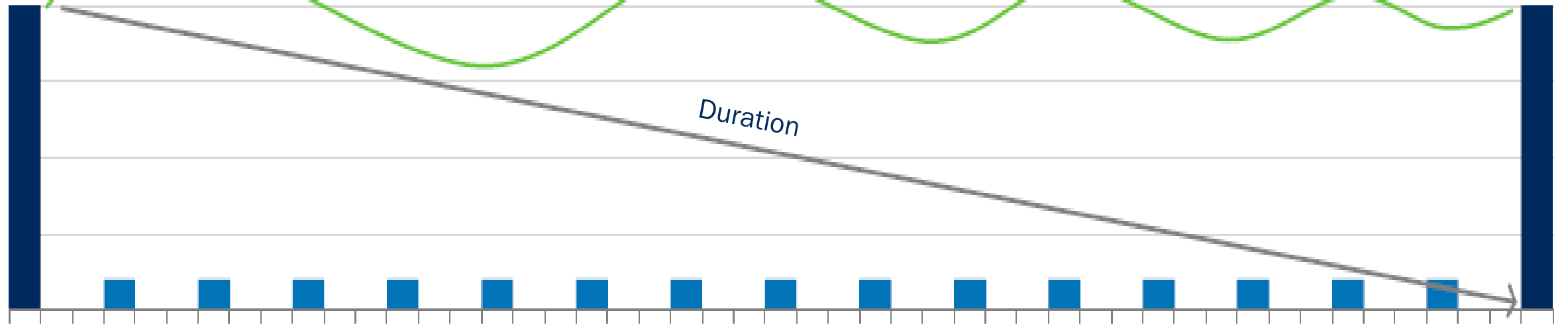
Holder has the right to swap the bonds for stocks

# How Fixed Income Works

Initial investment

Bond Value

Principal payout



Duration

■ Coupon    ■ Capital

Bond purchase

Bond maturity →

# How to Earn Through **Fixed Income**



coupon payments

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promised **periodic interest payments** for the borrowed funds as well as the eventual payment of the **principal**



capital gains/losses

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gains/losses on **sale of the bond** prior to maturity



reinvestment income

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income realized from **reinvestment of coupon payments** to other financial instruments

# Why Fixed Income

## Why invest in bonds?

- ✓ Income payments
- ✓ Slow and steady predictable returns

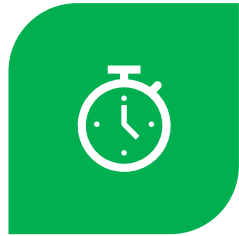
## How to earn in bonds

- ✓ Through bond coupons
- ✓ Through trading of bonds



# Different Types of Fixed Income Revisited

Cash or  
Money Market



TIME DEPOSITS

Rates or  
Duration  
Products



GOVERNMENT  
SECURITIES

Spread or Credit Products



CORPORATE  
SECURITIES



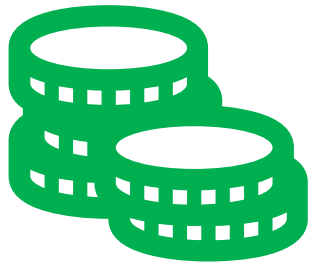
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# Different Types of Fixed Income Funds



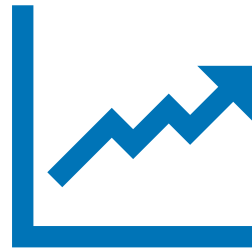
Money Market

Cash or  
Money Market



Short to  
Medium Term  
bond funds

Rates or Duration Products

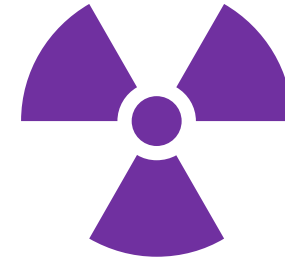


Index/  
Long-term  
bond funds



Investment  
Grade bond  
funds

Spread or Credit Products



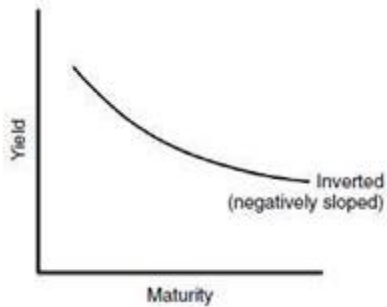
High Yield  
bond funds



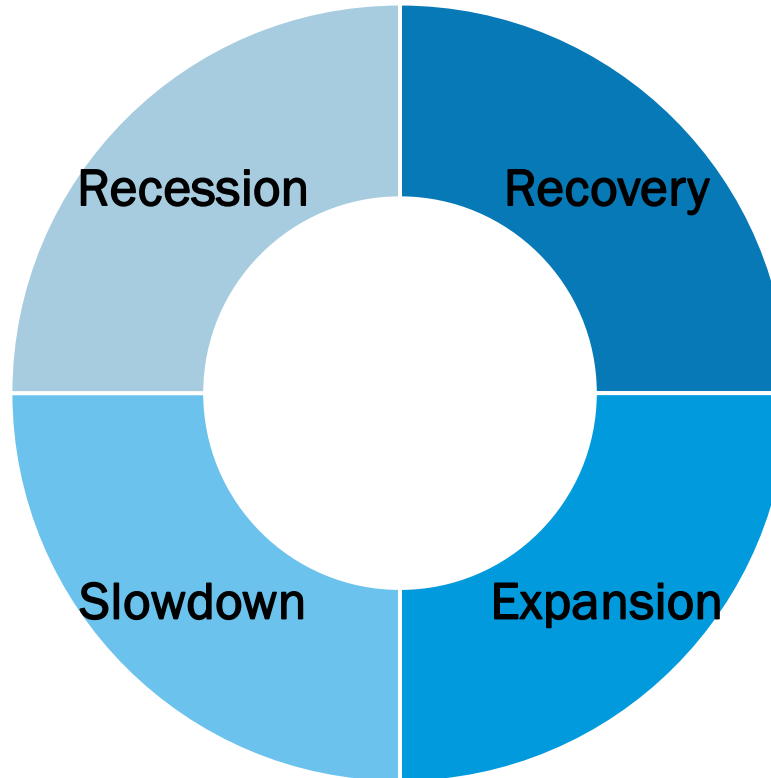
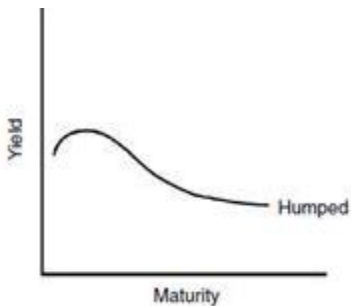
Total Return  
bond funds

# Yield Curve and the Economy

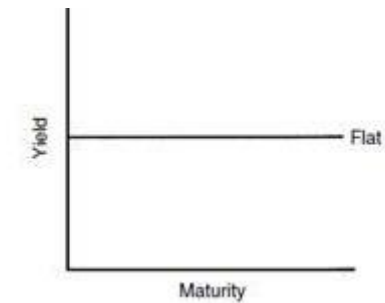
Production decline  
Slowing inflation



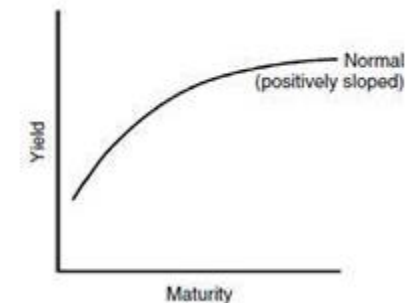
Profitability slowing down  
Peaking inflation  
Rate cuts on monetary policy



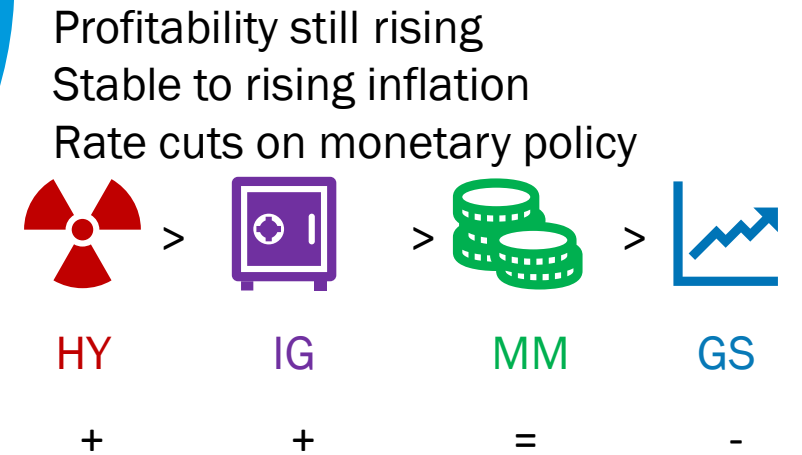
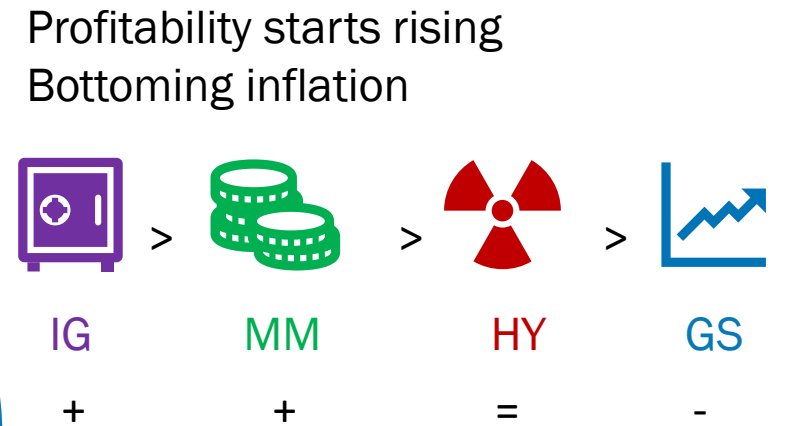
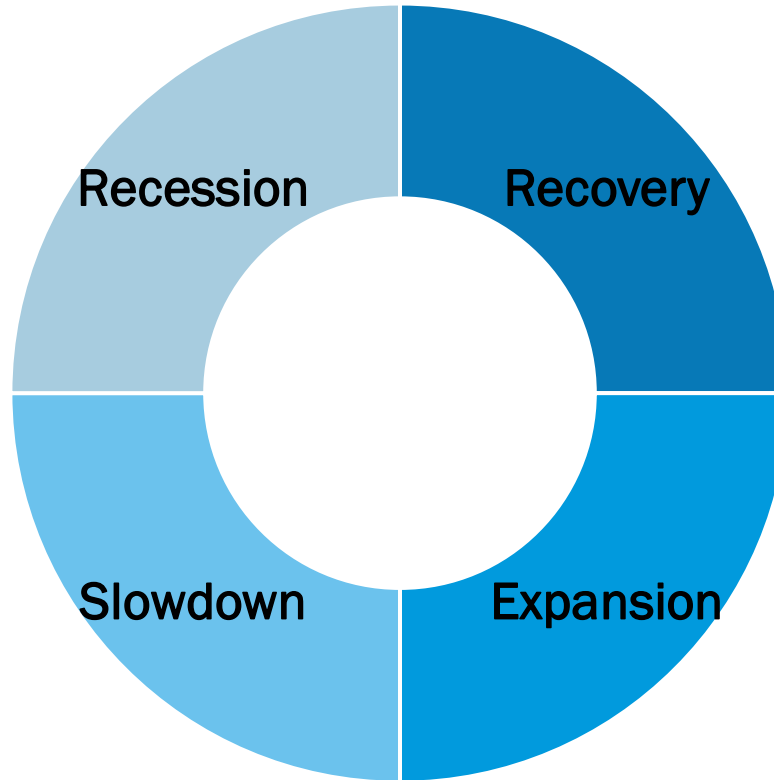
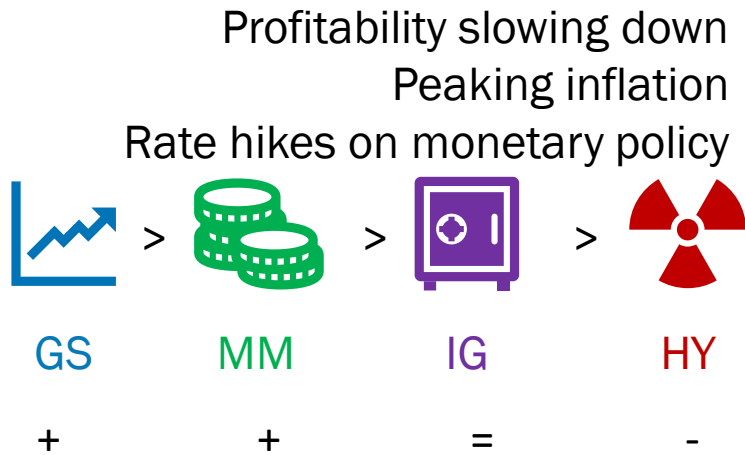
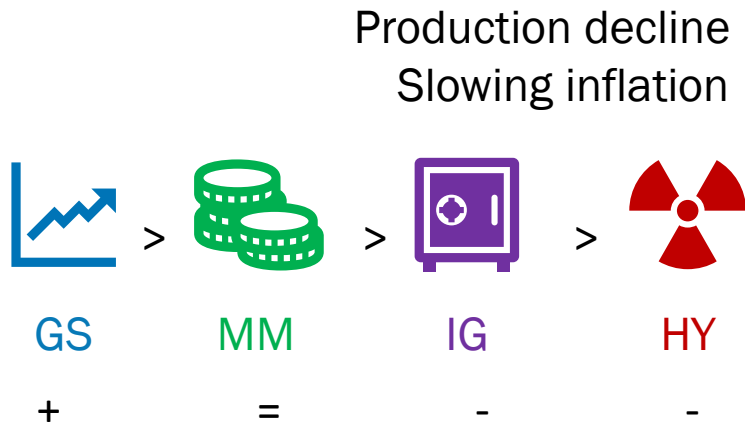
Profitability starts rising  
Bottoming inflation



Profitability still rising  
Stable to rising inflation  
Rate hikes on monetary policy



# Fixed Income and the Economy



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