

# BOND PRICES AND YIELDS

In the previous chapters on risk and return relationships, we have treated securities at a high level of abstraction.

We have assumed implicitly that a prior, detailed analysis of each security already has been performed, and that its risk and return features have been assessed.

We turn now to specific analyses of particular security markets. We examine valuation principles, determinants of risk and return, and portfolio strategies commonly used within and across the various markets.

We begin by analyzing **fixed-income securities**. A fixed-income security is a claim on a specified periodic stream of income. Fixed-income securities have the advantage of being relatively easy to understand because the level of payments is fixed in advance. Risk considerations are minimal as long as the issuer of the security is sufficiently creditworthy. That makes these securities a convenient starting point for our analysis of the universe of potential investment vehicles. The bond is the basic fixed-income security, and this chapter reviews the principles of bond pricing. We show how bond prices are set in accordance with market interest rates, and why bond prices change with those rates. After examining the Canada bond market, where default risk may be ignored, we move to the corporate bond sector. Here, we look at the determinants of credit risk and the default premium built into bond yields. We examine the impact of call and convertibility provisions on prices and yields. Finally, we discuss certain tax rules that apply to fixed-income investments and show how to calculate after-tax returns.

