

Section 10: Fixed-income investment

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Today Agenda

- ▶ **Recap**
 - ▶ Fundamental analysis of equity investment
 - ▶ How to select brokers
 - ▶ Lesson from 6th class assignment
- ▶ **What is bond?**
- ▶ **Type of debt instruments**
- ▶ **Risk and Return of debt instruments**
- ▶ **How to invest in bonds**
- ▶ **Source: www.tsi-thailand.org**

Investment style

- ▶ **Fundamental style**

- ▶ Based on the assumption that a stock's intrinsic or real value is determined by the company's future earnings

- ▶ 2 main variables: Target price (TP) and Earnings per share (EPS)

- ▶ **A value stock will be one that has some combination of:**

- ▶ Higher than average **dividend yield**

- ▶ Lower than average ratio of the stock **price to earnings** per share or of the stock price to the book value of the company's assets per share

Technical term revisited

- ▶ Dividend yield: the higher, the better if you look for investing in companies who pay dividend
- ▶ Price-to-earnings: the lower, the cheaper
- ▶ Upside = $(TP - \text{current price}) / \text{current price}$
 - ▶ The higher -> larger gap -> larger expected capital gain
- ▶ Growth in core EPS

Illustration

Stock	Dividend yield	P/E	Upside
A	2.5%	14x	15%
B	2.5%	12x	25%
C	4.5%	18x	5%
D	4.5%	16x	5%
E	3.5%	12x	25%

Let's assume that stock A – E are in the same industry. Which stock will you choose?

- If you prefer stable return 3% - 4% p.a.
- If you prefer capital gain

How to select a stock broker

Selection criteria

- ▶ An authorized brokerage firm by SEC
- ▶ You can check the list of authorized brokers in SET or SETTRADE website
- ▶ Check on integrity of its history
- ▶ Channels of sending orders: via marketing, internet, phone sales
- ▶ Quality of research paper and current news update

Selection criteria (2)

- ▶ IPO subscription
- ▶ Commission rate
- ▶ Minimum fee on daily trading value
- ▶ Necessary documents for opening an account:
 - ▶ A copy of ID card and house registration
 - ▶ A copy of previous 6 months of bank account transactions
 - ▶ ATS

Broker list

- ▶ AIRA
- ▶ BLS
- ▶ CIMB
- ▶ CGS
- ▶ CNS
- ▶ DBS Vickers
- ▶ FSS
- ▶ GLOBLEX
- ▶ MBKET
- ▶ KKS
- ▶ Kasikorn securities
- ▶ Krungsri securities
- ▶ KT ZMICO
- ▶ SCBS
- ▶ Phillips
- ▶ Thanachart
- ▶ Phatra
- ▶ Tisco
- ▶ UOBKHST

Lessons from 6th Class assignment

- ▶ What are factors for your stock selection?
- ▶ Have you considered on business model, growth, profitability and efficiency?
- ▶ Have you tried top-down approach?
- ▶ Example

Lesson from 6th class assignment (2)

- ▶ What if there is no stock you would like to acquire?
- ▶ What if you foresee a change in business landscape that will hurt a particular company? What will you do?
- ▶ What is short selling? What will you earn from short sales? When should you short sales?
- ▶ Long VS Short

What is bond?

What is bond?

▶ Debt instruments

Debt instruments are a way for markets and participants **to easily transfer the ownership of debt obligations** from one party to another. Debt obligation transferability increases liquidity and gives creditors a means of trading debt obligations on the market. Without debt instruments acting as a means to facilitate trading, debt is an obligation from one party to another.

▶ Issuers VS Debtors



Why investors buy corporate bonds

- ▶ Low risk investment alternative
- ▶ Stable income
- ▶ Diversification
- ▶ Can be used as collateral

Why corporation sell bonds

Characteristics of corporate bonds

- ▶ Corporation's written pledge to repay a specified amount of money with interest
- ▶ The face value is the dollar amount that the bondholder will receive at the bond's **maturity date**-usually \$1,000
- ▶ Bondholders receive interest payments every six months at the stated interest rate
- ▶ The legal conditions are described in a **bond indenture**
- ▶ A **trustee** is a financially independent firm that acts as the bondholder's representative

Characteristics of corporate bonds

- ▶ Par value
- ▶ Coupon rate
- ▶ Coupon frequency
- ▶ Maturity date
- ▶ Issuer
- ▶ Type of bonds
- ▶ Covenants

Why corporate issues bond

- ▶ To get funds for major purchases
- ▶ To fund ongoing business activities
- ▶ When it is difficult or impossible to sell stock
- ▶ To improve financial leverage
- ▶ Interest paid to bondholders is a tax deductible business expense that can be used to reduce the federal and state taxes corporations must pay

Type of bonds

- ▶ **Categorized by**
 - ▶ Type of issuers
 - ▶ Type of rights
 - ▶ Type of collateral
 - ▶ Type of interest payment
 - ▶ Type of features
 - ▶ Type of underlying securitization

Type of issuers

- ▶ **Government**

- ▶ Government bonds
- ▶ Bank of Thailand bonds

- ▶ **Corporation**

- ▶ Debenture: Unsecured - backed only by the reputation of the issuing company

- ▶ **Which one is safer?**

Type of rights

- ▶ Senior bond
- ▶ Junior bond/ Subordinated
 - ▶ An unsecured bond that gives bondholders a claim secondary to that of mortgage or debenture bond holders with respect to interest payments and claim on assets
- ▶ Higher rank in claiming company's asset in the event of liquidation than shareholder's equity

Type of collateral

- ▶ Secured bond: backed by asset
- ▶ Unsecured bond: not backed by any asset
- ▶ Example?

Type of interest payment

- ▶ Fixed interest payment until maturity
- ▶ Floating interest payment until maturity
- ▶ Recall from our previous classes: which one would you prefer and when?

Type of features

▶ **Convertible bond**

- ▶ A special kind of corporate bond that can be exchanged, at the owner's option, for a specified number of shares of the corporation's common stock

▶ **Callable bond**

- ▶ Corporation can call in or buy back outstanding bonds from current bondholders before the maturity date
- ▶ Most agree not to call bonds for the first 5 to 10 years after they are issued
- ▶ Bonds are typically called if their interest rate is much higher than the going rate
- ▶ Most corporate bonds are callable

▶ **Puttable bond**

Type of underlying securitization

▶ **Mortgage bond**

- ▶ A corporate bond that is secured by various assets of the issuing firm, usually real estate
 - ▶ Interest rate is lower because it is secured by the collateral and corporate assets
-
- ▶ Other asset-back securities: example?

Risk and return of debt instruments

Source of returns

- ▶ Capital gain/loss
- ▶ Interest income
- ▶ Discount
- ▶ Reinvestment rate

Factors affecting return from bonds

- ▶ Time to maturity
- ▶ Coupon rate
- ▶ Interest rate
- ▶ Credit rating

Required rate of return VS Coupon rate

	Required rate of return	Coupon rate
What is it?	Return to bondholders once he/she holds until maturity (yield to maturity)	Promised rate of return by issuers – paid in form of cash
Factors	- Investment risk - Change in interest rate	- Issuers' factors

What is the relationship between required rate of return and coupon rate?

- Premium bond
- Par bond
- Discount bond

Relationship between market interest rate and bond prices

- ▶ If the market rate is increasing
- ▶ Then, investors require higher rate of return from debt investment
- ▶ Price of bond declines
- ▶ Downward sloping? Is it linear or convexity?

Credit ratings

- ▶ Investment grade:

- ▶ AAA
- ▶ AA
- ▶ A
- ▶ BBB

- ▶ Speculative grade:

- ▶ BB
- ▶ B
- ▶ C
- ▶ D

Risks of debt investment

- ▶ Price risk, interest rate risk, market risk
- ▶ Reinvestment rate risk
- ▶ Credit risk, default risk
- ▶ Event risk
- ▶ Liquidity risk
- ▶ Inflation risk
- ▶ Exchange rate risk
- ▶ Option-embedded risk

Price risk VS Reinvestment risk

Interest rate movement	Price risk	Reinvestment rate risk
Increasing	-	+
Decreasing	+	-

How to invest in bonds

Cost-benefit analysis

- ▶ Issuer's perspective?
- ▶ Investor's perspective?

- ▶ Benefit earned = coupon interest and principal

- ▶ Recall: time value of money concept

- ▶ Example: Bond AA has 5 years held to maturity. It pays coupon 50 baht annually, 1000 baht par value. The required rate of return is 4% p.a.

Bond index

- ▶ Good proxy of tracking price movement in bond markets
- ▶ Key consideration in choosing type of debt investment
- ▶ If the interest rate decreases, then the price of bond will increase, as well as bond index.

Channels of debt investment

▶ Primary market

- ▶ Government bonds – reserved at BOT
- ▶ Corporate bonds – Private Placement (PP) and Public Offering (PO)

▶ Secondary market

- ▶ By yourself through BEX or OTC
- ▶ Through mutual fund

▶ Pros and Cons

Recommendation for beginners

- ▶ When interest rate is in downtrend
 - ▶ Choose long-term fixed-income security

- ▶ When interest rate is in uptrend
 - ▶ Choose short-term fixed-income security

Tax benefits

▶ Individual person

- ▶ Coupon interest – 15% withholding tax and exclude in calculating PIT
- ▶ Capital gain – 15% withholding tax and exclude in calculating PIT

▶ Juristic person

- ▶ Coupon interest – 1% withholding tax and include in net profit calculation
- ▶ Capital gain – no withholding tax but must include in net profit calculation