



Bachelor of Economics
THAMMASAT UNIVERSITY

FN 211 Financial Markets

Class 3: Interest Rates and their Roles in Valuation

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Today's Outline

1. Time Value of Money (Review)

2. Equity Valuation

3. Bond Valuation

- Price-Yield Relationship
- Duration
- Convexity

Time Value of Money and Interest Rates

Present Value of a Single Cash Flow

$$PV = \frac{FV}{(1 + r)^t}$$

where:

PV = present value

FV = future value (lump sum) received in t years

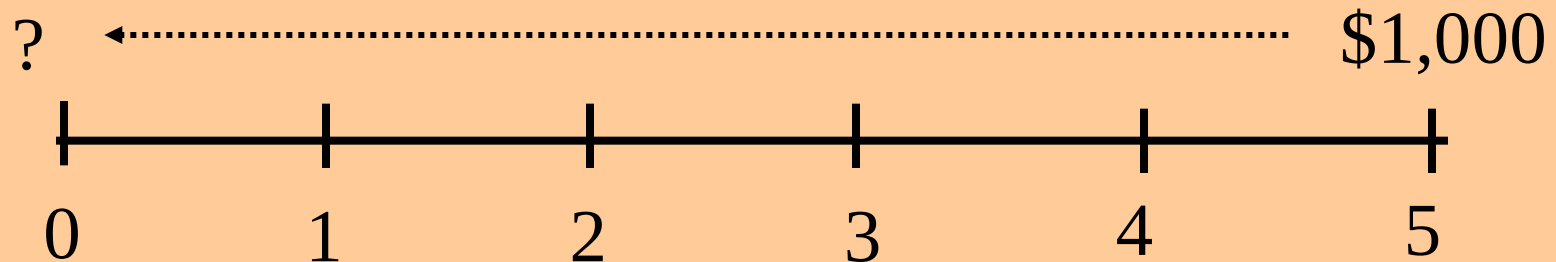
r = simple interest rate earned per period

t = total number of compounding periods

Time Value of Money and Interest Rates

Present Value of a Single Cash Flow

Find PV of a \$1,000 cash flow to be received in five years, given a discount rate of 9%.



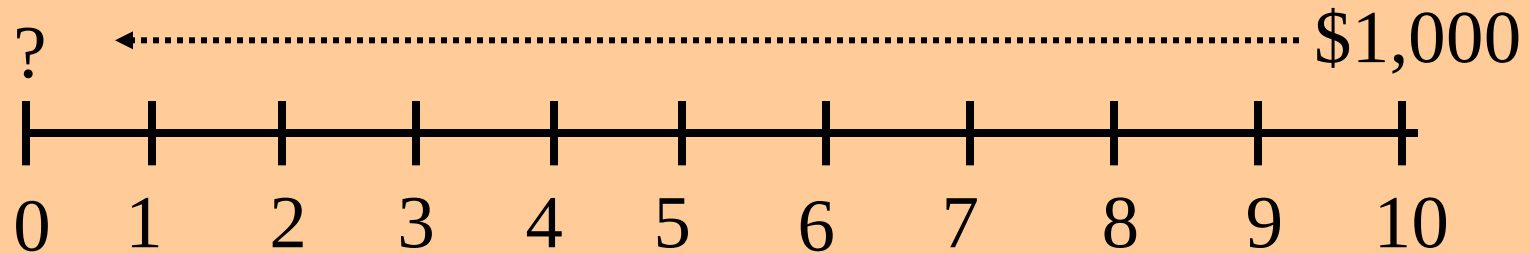
$$PV = \frac{1,000}{(1 + 0.09)^5} = 649.93$$

INPUT	5	9	0	1,000
	N	I/Y	PV	FV
OUTPUT	-649.93			

Time Value of Money and Interest Rates

PV of a Single Cash Flow: Semiannual Compounding

Find PV of a \$1,000 cash flow to be received in five years, given a discount rate of 9%, semiannual compounding.



INPUT

N

I/Y

PV

PMT

FV

OUTPUT

Time Value of Money and Interest Rates

Future Value of a Single Cash Flow

$$FV = PV * (1 + r)^t$$

where:

PV = present value

FV = future value (lump sum) received in t years

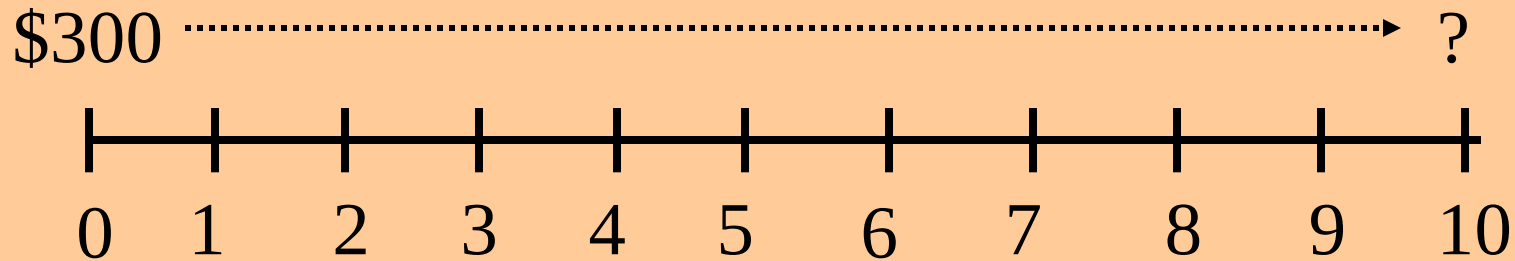
r = periodic rate earned on investments

t = total number of compounding periods

Time Value of Money and Interest Rates

Future Value of a Single Cash Flow

Find FV of a \$300 investment, given you can earn a compound rate of return of 8% over a 10 year period of time.



INPUT

N

I/Y

PV

PMT

FV

OUTPUT

Time Value of Money and Interest Rates

Annuity is a stream of equal cash flows that occur at equal intervals over a period of time.

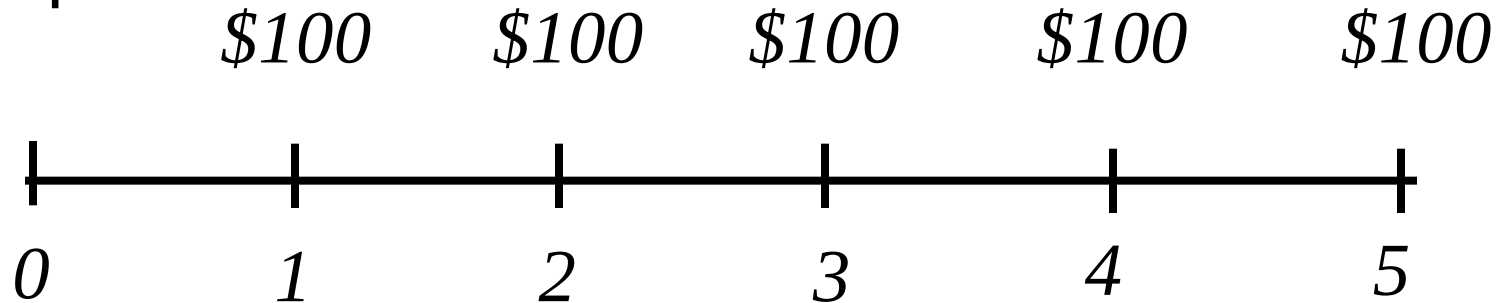
- Receiving \$100 per year at the end of each year of the next eight years is an example of an annuity.

There are 2 types of annuities.

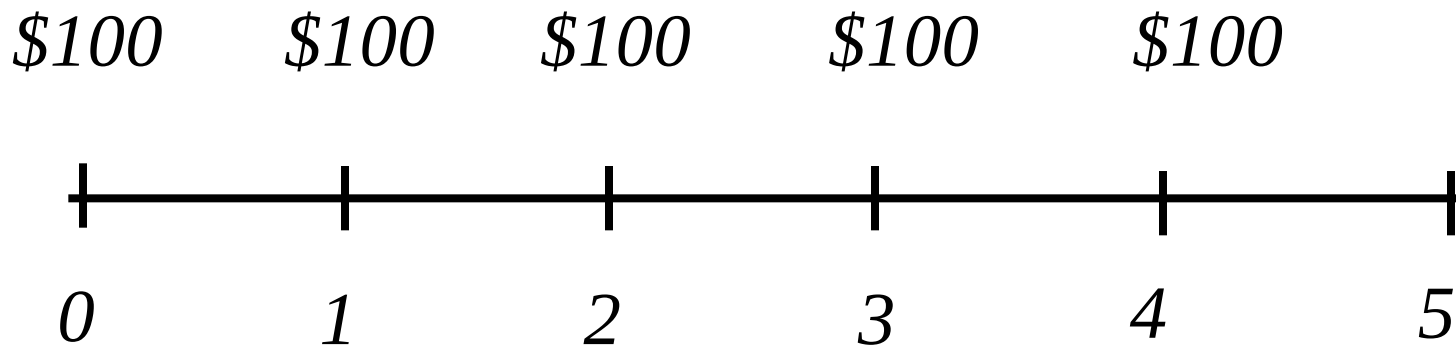
1. **Ordinary Annuity** – cash flows occur at the end of each period.
2. **Annuity Due** – cash flows occur at the beginning of each period.

Time Value of Money and Interest Rates

1. Ordinary Annuity – cash flows occur at the end of each period.



2. Annuity Due – cash flows occur at the beginning of each period.



Time Value of Money and Interest Rates

PV an Ordinary Annuity

$$PV = PMT * \left(1 - \frac{1}{(1+r)^t} \right) * \frac{1}{r}$$

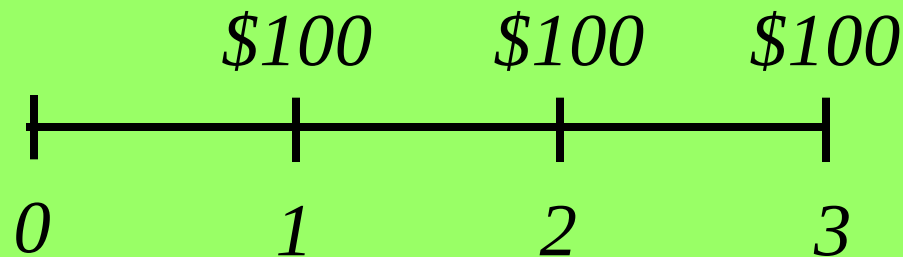
PV an Annuity Due

$$PV = PMT + PMT * \left(1 - \frac{1}{(1+r)^{t-1}} \right) * \frac{1}{r}$$

Time Value of Money and Interest Rates

Present Value of an Ordinary Annuity

What is the PV of an annuity that will pay \$100 per year at the end of each of the next 3 years given a 10% rate of return?



Time Value of Money and Interest Rates

Present Value of an Ordinary Annuity

What is the PV of an annuity that will pay \$100 per year at the end of each of the next 3 years given a 10% rate of return?

INPUT

N

I/Y

PV

PMT

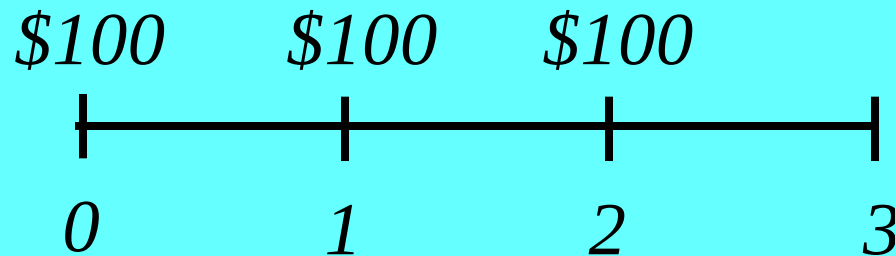
FV

OUTPUT

Time Value of Money and Interest Rates

Present Value of an Annuity Due

What is the PV of an annuity that will pay \$100 per year at the beginning of each of the next 3 years given a 10% rate of return?



Time Value of Money and Interest Rates

Present Value of an Annuity Due

What is the PV of an annuity that will pay \$100 per year at the beginning of each of the next 3 years given a 10% rate of return?

INPUT



******At BEGIN mode******

OUTPUT

Time Value of Money and Interest Rates

To set your calculator for BEGIN mode

2nd

PMT

2nd

ENTER

2nd

CPT

To go back to END mode, simply repeat the same sequence

2nd

PMT

2nd

ENTER

2nd

CPT

Time Value of Money and Interest Rates

FV of an Ordinary Annuity

$$FV = PMT * \left[(1 + r)^t - 1 \right] * \frac{1}{r}$$

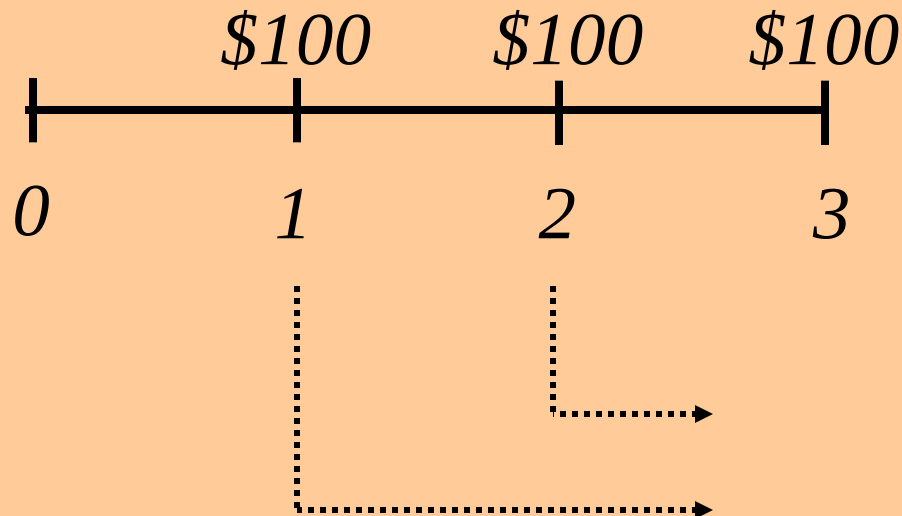
FV of an Annuity Due

$$FV = \left[PMT * \left[(1 + r)^{t+1} - 1 \right] * \frac{1}{r} \right] - PMT$$

Time Value of Money and Interest Rates

Future Value of an Ordinary Annuity

What is the FV of an annuity that will pay \$100 per year at the end of each of the next 3 years given a 10% rate of return?



Time Value of Money and Interest Rates

Future Value of an Ordinary Annuity

What is the FV of an annuity that will pay \$100 per year at the end of each of the next 3 years given a 10% rate of return?

INPUT

N

I/Y

PV

PMT

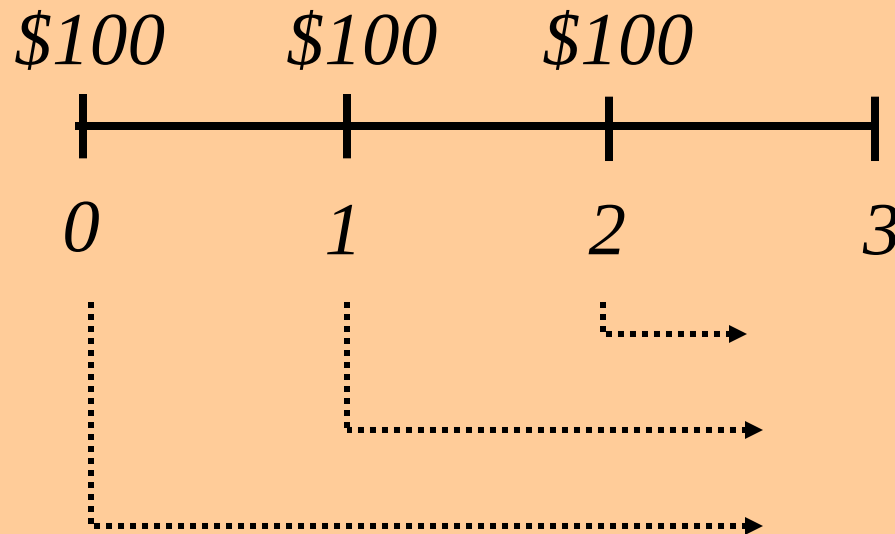
FV

OUTPUT

Time Value of Money and Interest Rates

Future Value of an Annuity Due

What is the FV of an annuity that will pay \$100 per year at the beginning of each of the next 3 years given a 10% rate of return?



Time Value of Money and Interest Rates

Future Value of an Annuity Due

What is the FV of an annuity that will pay \$100 per year at the beginning of each of the next 3 years given a 10% rate of return?

INPUT



****At BEGIN mode****

OUTPUT

Net Present Value (NPV)

A NPV analysis includes the following steps:

1. Estimate the cash flows (inflows and outflows)
2. Determine the cost of capital(i.e. discount rate).
3. Discount the cash flows at the cost of capital
4. Sum up the discounted cash flows to determine the project's NPV.

$$NPV = CF_0 + \frac{CF_1}{(1+k)^1} + \frac{CF_2}{(1+k)^2} + \dots + \frac{CF_n}{(1+k)^n} = \sum_{t=0}^n \frac{CF_t}{(1+k)^t}$$

Internal Rate of Return (IRR)

- **Internal rate of return (IRR)** is the discount rate that sets the net present value equal to zero:

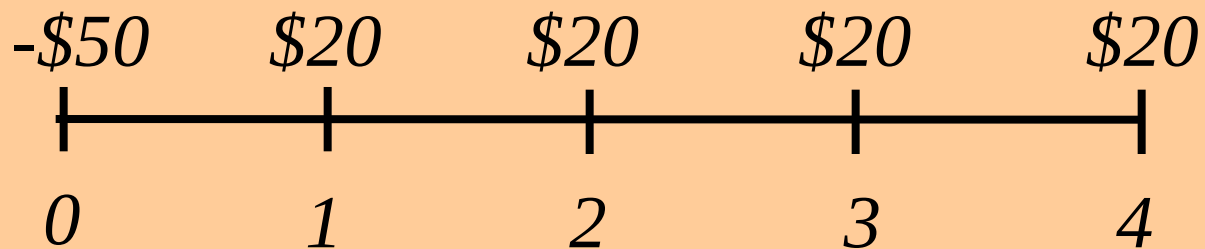
$$NPV = CF_0 + \frac{CF_1}{(1 + IRR)^1} + \frac{CF_2}{(1 + IRR)^2} + \dots + \frac{CF_n}{(1 + IRR)^n} = 0$$

- Alternatively, the IRR is defined as the discount rate that equals the present value of cash inflows to the present value of investment costs.
PV (Investment costs) = PV (Cash Inflows)
- The IRR on a project is its **expected rate of return**.
 - If the IRR **exceeds** the cost of capital, a surplus remains after paying for the capital and thus increases shareholder value.
 - If the IRR is **less** than the cost of capital, taking on the project destructs shareholders value.

NPV vs. IRR

NPV and IRR of a Project

What is the NPV and IRR of a project that requires \$50 initial investment and generates \$20 cash flows for 4 years, given a 10% discount rate?



NPV vs. IRR

NPV and IRR of a Project

What is the NPV and IRR of a project that requires \$50 initial investment and generates \$20 cash flows for 4 years, given a 10% discount rate?

Mortgage Loan Schedule

Home Mortgage Interest Rate

- Each monthly payment of a *home mortgage* loan first covers in full the monthly interest on the outstanding principal. The remainder is then applied to the principal of the loan, such that the amount owed is reduced progressively.

Mortgage Loan Schedule

Home Mortgage Interest Rate

You agree to take out a 3,000,000 Baht loan for 10 years at an interest rate of 6% per year to buy your new home. Calculate the monthly payment and construct a mortgage table.

INPUT	10x12=120	6/12=0.5	3,000,000		0
	N	I/Y	PV	PMT	FV
OUTPUT				-33,306.15	

Mortgage Loan Schedule

Total monthly payment = interest + principal repayment

1st Month Payment:

Interest = beginning balance x interest rate per month
= 3,000,000 x 0.005
= 15,000

Principal = total monthly payment – interest
= 33,306.15 – 15,000
= 18,306.15

Monthly payment = 15,000 + 18,306.15
= 33,306.15

Mortgage Loan Schedule

Total monthly payment = interest + principal repayment

2nd Month Payment:

Interest = beginning balance x interest rate per month
=
=
=

Principal = total monthly payment – interest
=
=

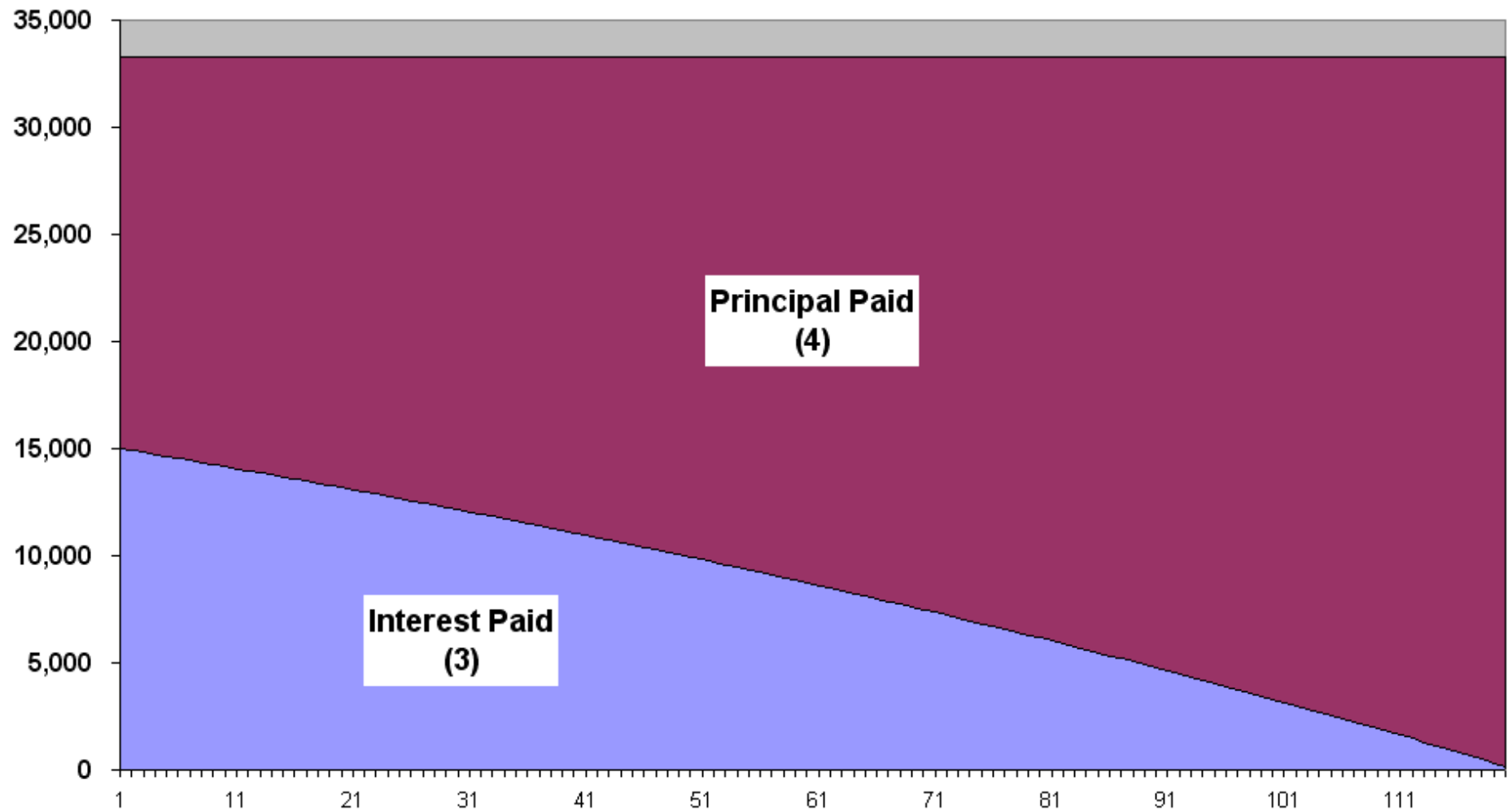
Monthly payment =
=

Mortgage Loan Schedule

Month	Beginning Balance (1)	Monthly Payment (2) = (3) + (4)	Interest Paid (3)	Principal Paid (4)	Ending Balance (5) = (1) - (4)	Effective Rate (6) = [(3)/(1)]*12
1	3,000,000	33,306.15				
2						
3						
4						
5						

Mortgage Loan Schedule

Mortgage Loan Schedule



Car Loan Schedule

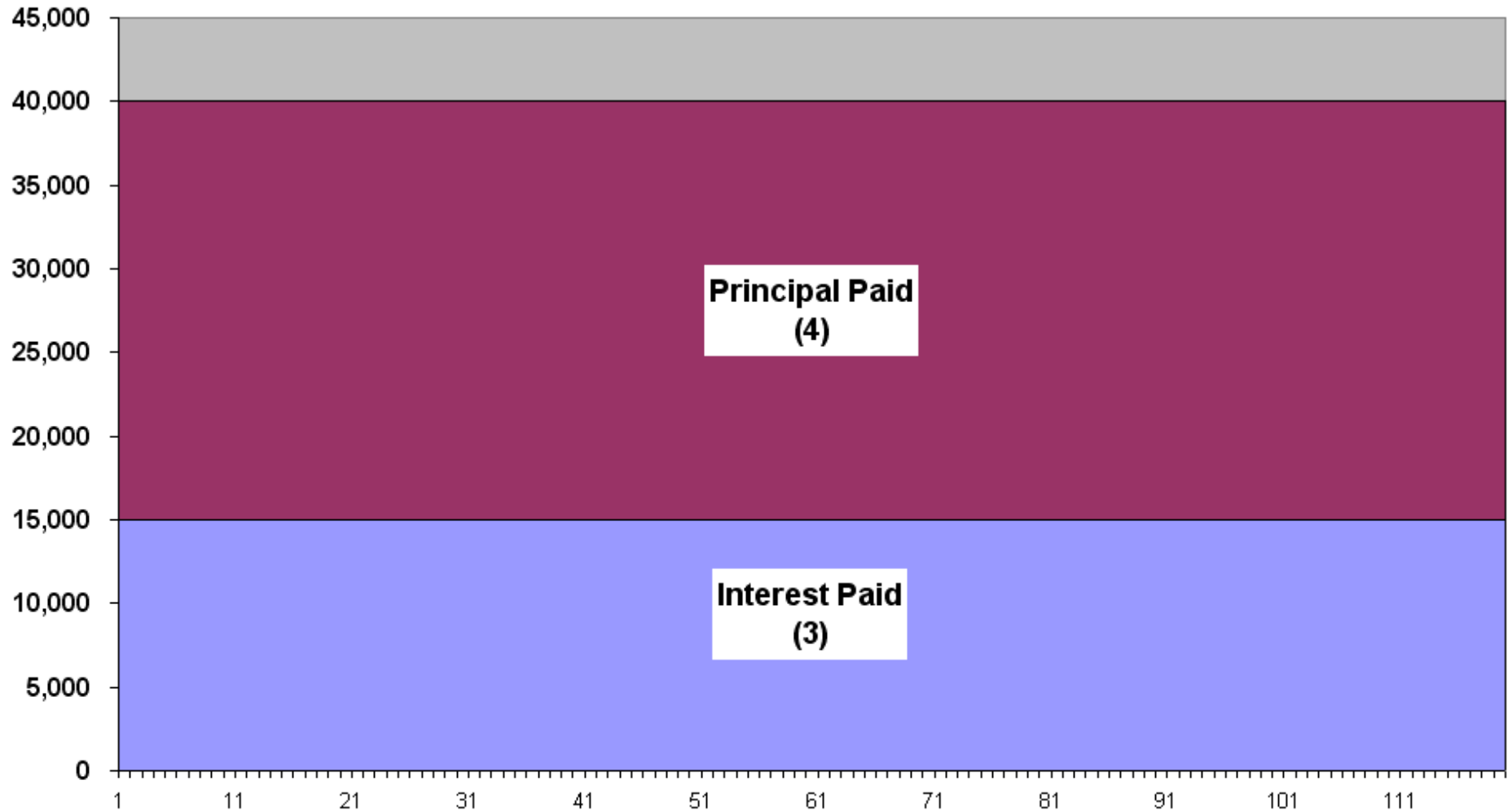
Car Loan: Principal = 3,000,000 Baht, Interest Rate = 6% per year, Maturity = 10 years, Down Payment = 0

Monthly Payment = 40,000 Baht

Month	Beginning Balance	Monthly Payment	Interest Paid	Principal Paid	Ending Balance	Effective Rate per year
	(1)	(2)	(3)	(4)	(5) = (1) - (4)	(6) = [(3)/(1)]*12
1	3,000,000.00	40,000.00	15,000.00	25,000.00	2,975,000.00	6.00%
2	2,975,000.00	40,000.00	15,000.00	25,000.00	2,950,000.00	6.05%
3	2,950,000.00	40,000.00	15,000.00	25,000.00	2,925,000.00	6.10%
4	2,925,000.00	40,000.00	15,000.00	25,000.00	2,900,000.00	6.15%
5	2,900,000.00	40,000.00	15,000.00	25,000.00	2,875,000.00	6.21%
118	75,000.00	40,000.00	15,000.00	25,000.00	50,000.00	240.00%
119	50,000.00	40,000.00	15,000.00	25,000.00	25,000.00	360.00%
120	25,000.00	40,000.00	15,000.00	25,000.00	0.00	720.00%

Car Loan Schedule

Car Loan Schedule



Today's Outline

1. Time Value of Money (Review)

2. Equity Valuation

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- Price-Yield Relationship
- Duration
- Convexity

Equity Valuation:

How much is an Apple worth? As of September 2012

Apple Inc. (AAPL) - NasdaqGS

+ Add to Portfolio

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8.4k

694.09 ↑ 11.11 (1.63%) 9:48AM EDT - Nasdaq Real Time Price

Prev Close:	682.98	Day's Range:	687.89 - 694.10
Open:	689.97	52wk Range:	354.24 - 685.50
Bid:	688.75 x 100	Volume:	3,309,402
Ask:	688.91 x 200	Avg Vol (3m):	13,869,200
1y Target Est:	756.07	Market Cap:	645.75B
Beta:	0.88	P/E (ttm):	16.19
Next Earnings Date:	15-Oct-12	EPS (ttm):	42.55
		Div & Yield:	10.60 (1.60%)



People viewing AAPL also viewed:
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Apple (NASDAQ: [AAPL](#)) was once the most valuable company in history in terms of market capitalization. The company had a market-cap of over \$648 billion.

That was twice the size of Thailand's GDP!

Equity Valuation:

How much is an Apple worth? **As of August 2013**



The stock price of Apple (NASDAQ: [AAPL](#)) dropped from the peak of US\$700 to around \$450.

The company has lost 200 billion dollar worth of market cap during the past year.

Equity Valuation: The Basics

Estimated Value vs. Market Price

- Estimated value > market price => undervalued
- Estimated value = market price => fairly valued
- Estimated value < market price => overvalued

Equity Valuation Models

1. **Present Value** – PV of expected future cash flows
 - *DDM, FCFE*
2. **Multiplier Model** – intrinsic value based on multiple of some fundamental variable:
 - *P/E, P/S, EV/EBITDA*
3. **Asset-based Valuation** – based on estimated value of assets - liabilities
 - *Book Value*

Equity Valuation:

Dividend Discount Model (DDM)

DDM

- Intrinsic value of a share is the PV of expected future dividends/cash flows.
- The issuing company is assumed to be a going concern.

$$P_0 = \frac{D_1}{(1+k)} + \frac{D_2}{(1+k)^2} + \dots + \frac{D_\infty}{(1+k)^\infty}$$
$$= \sum_{t=1}^n \frac{D_t}{(1+k)^t}$$

$$P_0 = \frac{FCFE_1}{(1+k)} + \frac{FCFE_2}{(1+k)^2} + \dots + \frac{FCFE_\infty}{(1+k)^\infty}$$
$$= \sum_{t=1}^n \frac{FCFE_t}{(1+k)^t}$$

where:

P_0 = value of common stock

D_t = dividend during time period t

k = required rate of return on stock

FCFE = Free Cash Flow for Equity = CFO – FCInv + Net borrowing

Equity Valuation:

Dividend Discount Model (DDM)

The N-Period Model

- If the stock is held for only N period, e.g. 2 years, and a sale at the end of year 2 would imply:

$$P_0 = \frac{D_1}{(1+k)} + \frac{D_2}{(1+k)^2} + \frac{SP_2}{(1+k)^2}$$

- The expected selling price, SP_2 , of stock at the end of Year 2 is crucial, which is in fact the present value of future expected dividends

Example - A stock just paid \$10 dividend. dividend will grow 10% each year. The stock is expected to be sold at \$150 at the end of year 2. $k = 20\%$.

Equity Valuation:

Gordon Growth Model

- Given the constant growth rate, the earlier formula can be reduced to:

$$P_0 = \frac{D_1}{k - g}$$

$$\frac{P_0}{E_1} = \frac{D_1 / E_1}{k - g} = \frac{\text{Payout}}{k - g}$$

Assumptions of DDM:

- Dividends grow at a constant rate
- The constant growth rate will continue for an infinite period
- The required rate of return (k) is greater than the infinite growth rate (g)

Example: Apple Inc. has just paid a dividend of \$10. An analyst expects that dividends will rise at 5% a year forever. The required rate of return on the stock is 23%. Calculate the intrinsic value of Apple Inc.

Equity Valuation:

Multistage Dividend Discount Model

- **Information:** A stock has just paid \$10 dividend.
 - Dividends will grow at 30% for year 1 and year 2, 15% for years 3 to 5, and then 5% from year 6.
- **Solution:**
 - The present value of the 1st stage supernormal growth:

$$V_1 = + \frac{\$10(1 + .3)}{(1 + .1)^1} + \frac{\$10(1 + .3)^2}{(1 + .1)^2} = \$25.8$$

- The present value of the 2nd stage supernormal growth:

$$V_2 = \frac{\$10(1 + .3)^2(1 + .15)}{(1 + .1)^3} + \frac{\$10(1 + .3)^2(1 + .15)^2}{(1 + .1)^4} + \frac{\$10(1 + .3)^2(1 + .15)^3}{(1 + .1)^5} = \$45.9$$

Equity Valuation:

Multistage Dividend Discount Model

- The terminal value of constant growth at the end of the 5th year:

$$\text{Terminal Value} = \frac{\$10(1 + .3)^2(1 + .15)^3(1 + 0.05)}{10\% - 5\%} = \$539.8$$

- The present value of constant growth:

$$V = \frac{\$539.8}{(1 + 0.1)^5} = \$335.3$$

- The total value of the stock: $\$25.8 + \$45.9 + \$335.3 = \407

Equity Valuation: Multiplier Models

- **Price to earnings (P/E)**

- Better use forward P/E (predict future earnings) than trailing P/E
- can only be used to value stocks with positive EPS
- EPS can be manipulated

Example: Dora has estimated that earnings per share (EPS) of Apple Inc. for the year 2013 will be \$45. Based on her research, an average P/E ratio of stocks in the same industry is 12 times. Based on the information provided, the intrinsic value of Apple Inc. is closest to ...

Equity Valuation:

Preferred Stock Valuation

- The value is simply the stated annual dividend divided by the required rate of return on preferred stock (k_p)

$$P_0 = \frac{\text{Dividend}}{k_p}$$

- Assume a preferred stock has a \$100 par value and a dividend of \$8 a year and a required rate of return of 9 percent

Today's Outline

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2. Equity Valuation

3. Bond Valuation

- Price-Yield Relationship
- Duration
- Convexity

Bond Valuation:

The Basics

- **Maturity**: the length of time until the loan agreement (or the bond contract) expires, essentially the remaining life of the bond.
- **Par value**: the amount that the borrower promises to pay on or before the maturity date on the issue, also known as the redemption or face value.
 - If the market interest rates move above the coupon rate, the bond will sell below par value (at **discount**).
 - If the rates move below the coupon rate, the bond will sell above par value (at **premium**).

Bond Valuation:

The Basics

Interest Rates for Bonds

- The *coupon rate* of a bond is the promised interest rate that the security issuer agrees to pay at the time the security is issued.
 - *Example: A bond with a par value of \$1000 and a coupon rate of 9% pays an annual coupon of \$90.*
- The *current yield* of a bond is the ratio of the annual coupon interest generated by the asset to its market value.
 - *Example: The current yield of a bond selling for 900 Baht in the market and paying an annual coupon of 30 Baht to the bondholder is $30/900 = 3.33\%$.*

Bond Valuation:

The Basics

Interest Rates for Bonds

- The *yield to maturity* (YTM) is the rate of interest that the market is prepared to pay today for a bond.
- It is the rate that equates the purchase price (P) with the present value of all the expected annual net cash flows (CF) from the bond.

$$P = \frac{CF_1}{(1 + YTM)^1} + \frac{CF_2}{(1 + YTM)^2} + \dots + \frac{CF_n}{(1 + YTM)^n}$$

Bond Valuation:

The Basics

Interest Rates for Bonds

- A bond trades at a *discount from par* if its price is less than its par value, i.e. if its current yield to maturity is higher than its coupon rate.
- A bond trades at a *premium over par* if its price is more than its par value, i.e. if its current yield to maturity is lower than its coupon rate.
- A bond trades *at par* if its price equals its par value, i.e. if the current market interest rate on comparable securities equals its coupon rate.

Bond Valuation:

The Basics

Interest Rates for Bonds

- ‘YTM’ or ‘Yield’ represents market interest rate for bonds.
- Bond Dealers usually quote *two* yields for a bond. (*Dealers in the US quote price instead of ‘yield’.*)
 - The lower *ask* yield (higher price) is the dealer’s selling price, while the higher *bid* yield (lower price) is the dealer’s buying price.
- The difference between the bid and ask prices – known as the *spread* – provides the dealer’s return for creating a market for the security.

Bond Valuation:

The Basics

- All bonds are priced according to the present value of their future cash flows. There are 3 steps in bond valuation.

*(Throughout our course, bonds are assumed to be **non-callable**, which means the issuer has no right to redeem the bond before its maturity. Therefore, it is assumed that the amount and timing of a bond's future cash flow are known with certainty.)*

1. Estimate the **cash flows**: coupon payments and repayment of principal at maturity
2. Determine the appropriate **discount rate** which is the bond's yield to maturity
3. Calculate the **present value**:

Bond Valuation:

Pure Discount Bonds

Pure Discount Bonds

- Also called **Zero Coupon Bonds**
- are bonds that do not pay interest and are sold at discount from their par values.
- They then increase in value over time, and appreciate to their par values at maturity.

Bond Valuation:

Pure Discount Bonds



Present value of a pure discount bond at time 0:

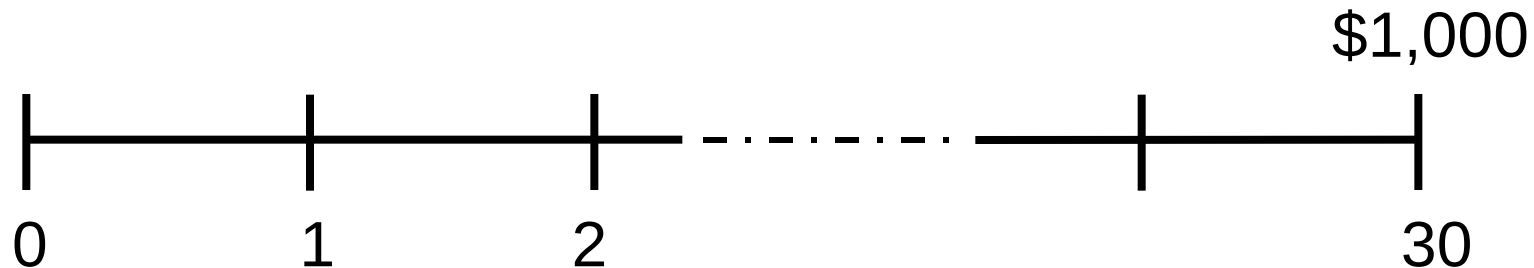
$$PV = \frac{F}{(1+r)^T}$$

Bond Valuation:

Pure Discount Bonds

Pure Discount Bonds

Find the value of a 30-year zero-coupon bond with a \$1,000 par value and a YTM of 6%.



$$PV = \frac{F}{(1+r)^T} = \frac{\$1,000}{(1.06)^{30}} = \$174.11$$

INPUT 30 6 0 1,000

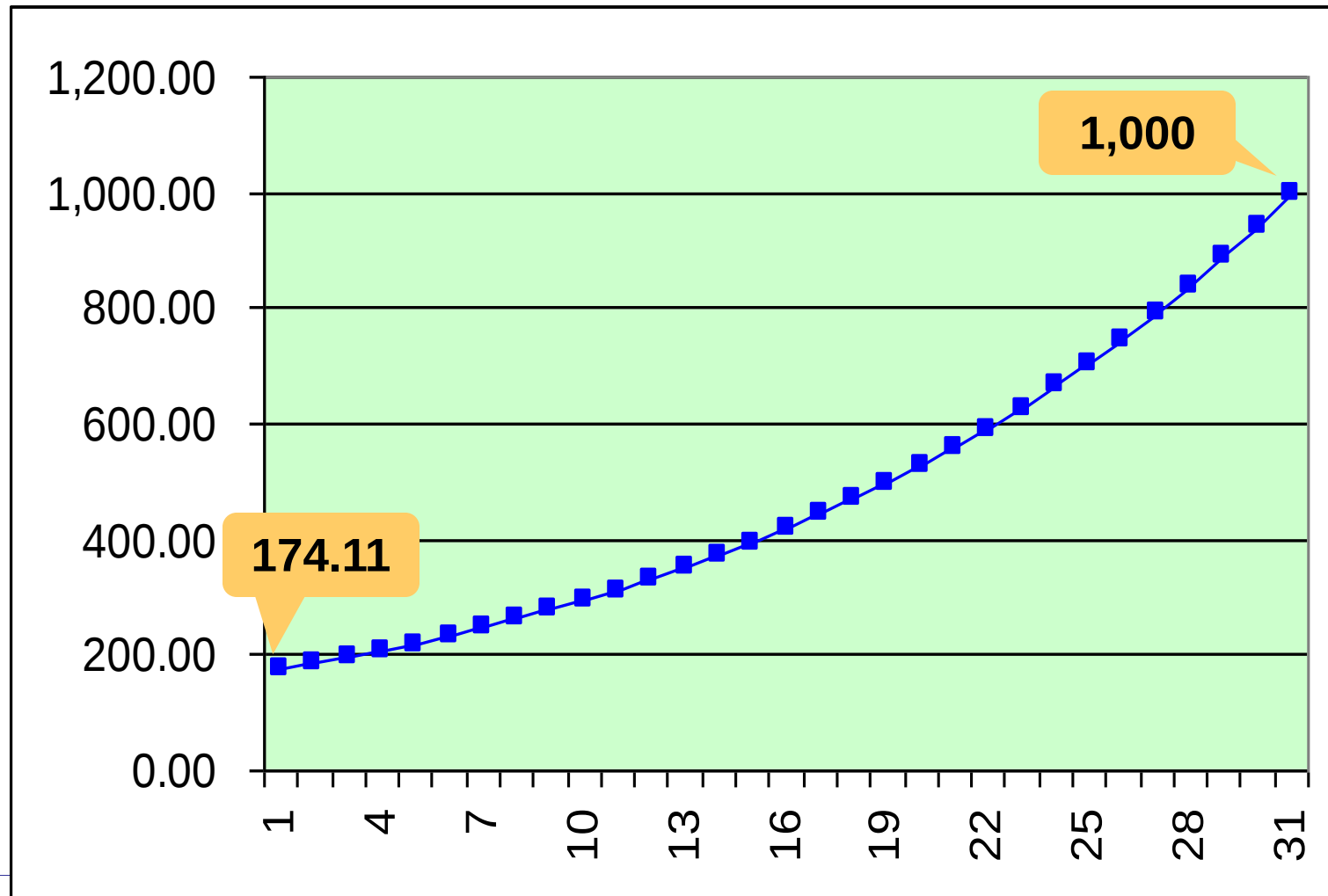
N I/Y PV PMT FV

OUTPUT -174.11

Bond Valuation:

Pure Discount Bonds

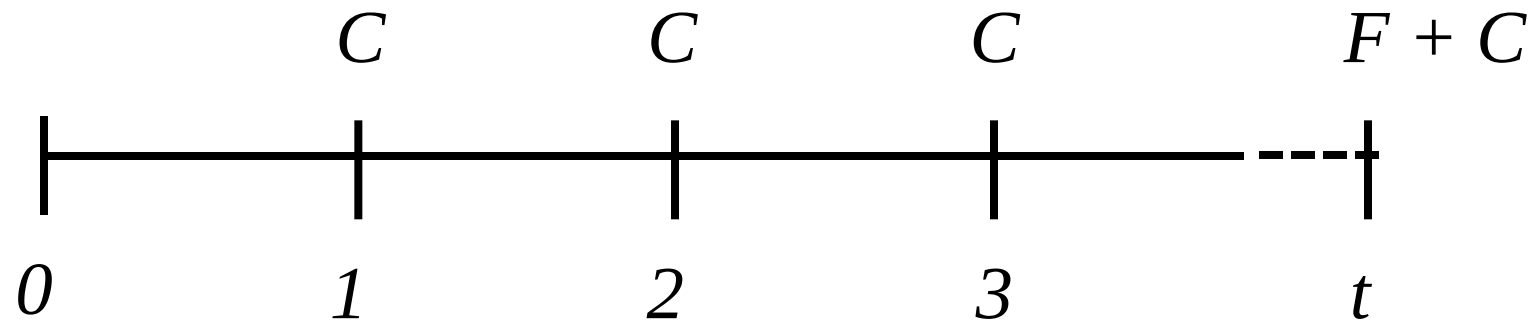
Pure Discount Bonds: Value increases over time



Bond Valuation:

Coupon Bonds

Coupon Bonds



PV = PV of coupons + PV of par

$$PV = C * \left(1 - \frac{1}{(1+r)^t} \right) \left(\frac{1}{r} \right) + \frac{F}{(1+r)^t}$$

Where: F = par value

C = coupon payment for each period

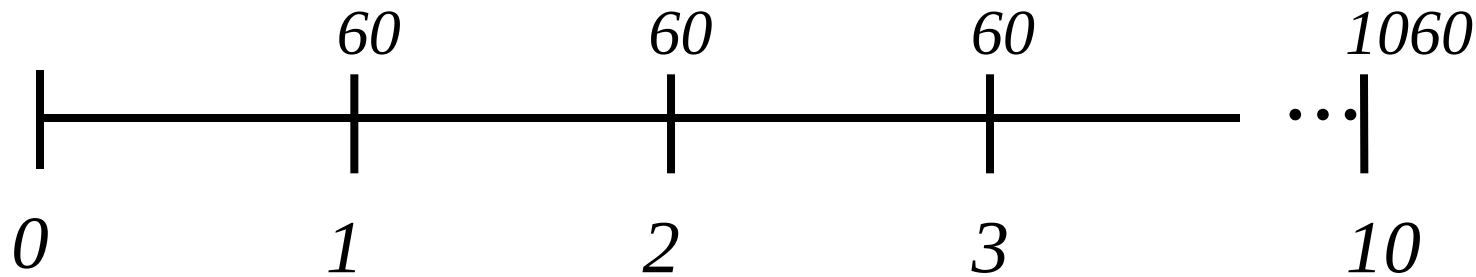
r = the bond's Yield to Maturity

t = number of time periods to maturity

Bond Valuation:

Coupon Bonds

Suppose there is a 10-year, B1,000 par value, 6% annual-pay coupon bond. What is the bond value, given YTM = 8%?



$$PV = 60 * \left(1 - \frac{1}{(1 + 0.08)^{10}} \right) \left(\frac{1}{0.08} \right) + \frac{1000}{(1 + 0.08)^{10}} = 865.80$$

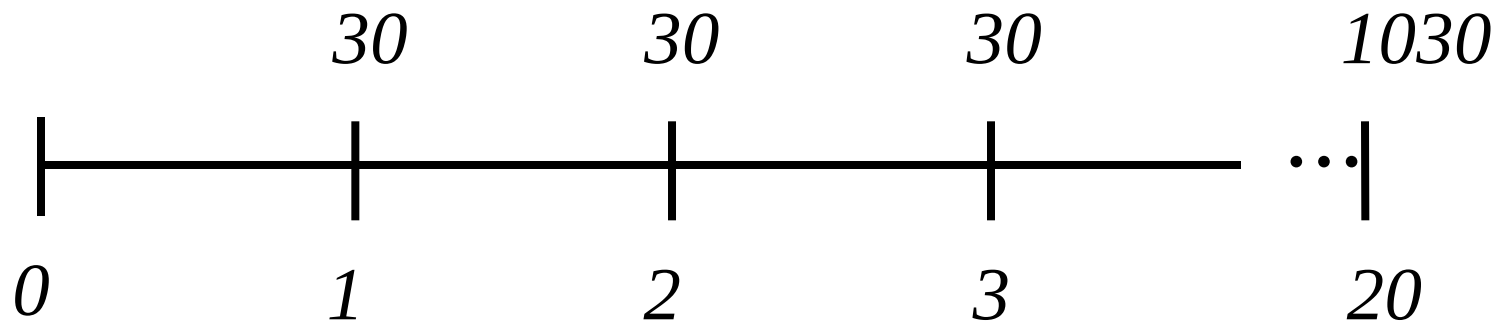
INPUT	10	8	60	1,000
	N	I/Y	PMT	FV

OUTPUT **-865.80**

Bond Valuation:

Coupon Bonds

Suppose there is a 10-year, B1,000 par value, 6% coupon bond. The coupons are paid semiannually. What is the bond value, given $YTM = 8\%$?



INPUT

N

I/Y

PV

PMT

FV

OUTPUT

Bond Valuation:

Price-Yield Relationship

- Over the life of a bond, cash flows (coupons and face value) will not change while market yield (YTM) can change dramatically.
- Therefore, the market price of the bond must change to reflect any change in market yield.
- Basically, the price of a bond will **move inversely** with its market yield: bond prices go up when the yield goes down, and vice versa.

Bond Valuation:

Price-Yield Relationship

Suppose there is a 30-year bond issued 20 years ago and now has 10 years to maturity. The bond pays 10% coupon semiannually. Calculate the bond price today given YTM of 7%, 10% and 13%

YTM = 7%

INPUT

N

I/Y

PV

PMT

FV

OUTPUT

YTM = 10%

INPUT

N

I/Y

PV

PMT

FV

OUTPUT

YTM = 13%

INPUT

N

I/Y

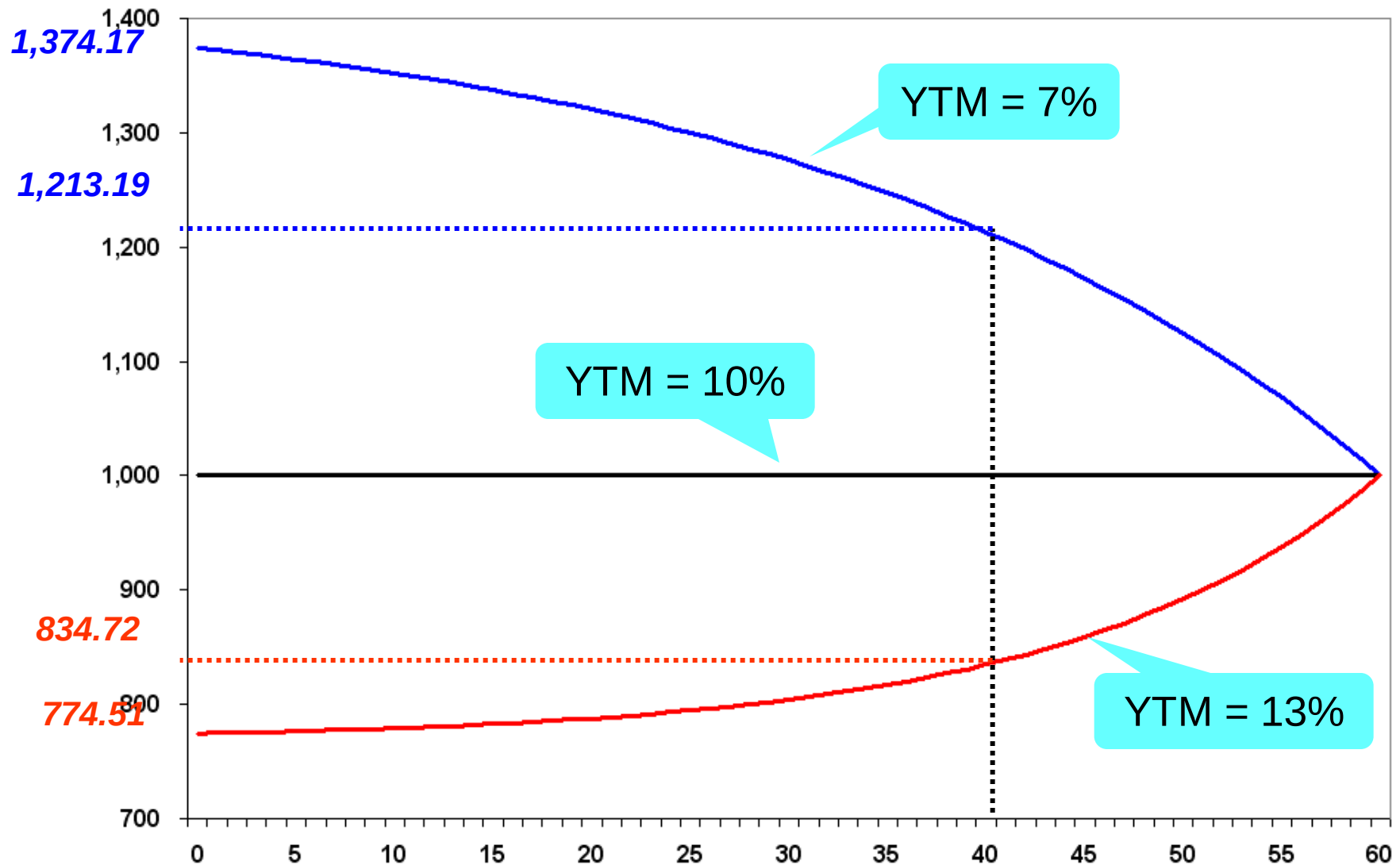
PV

PMT

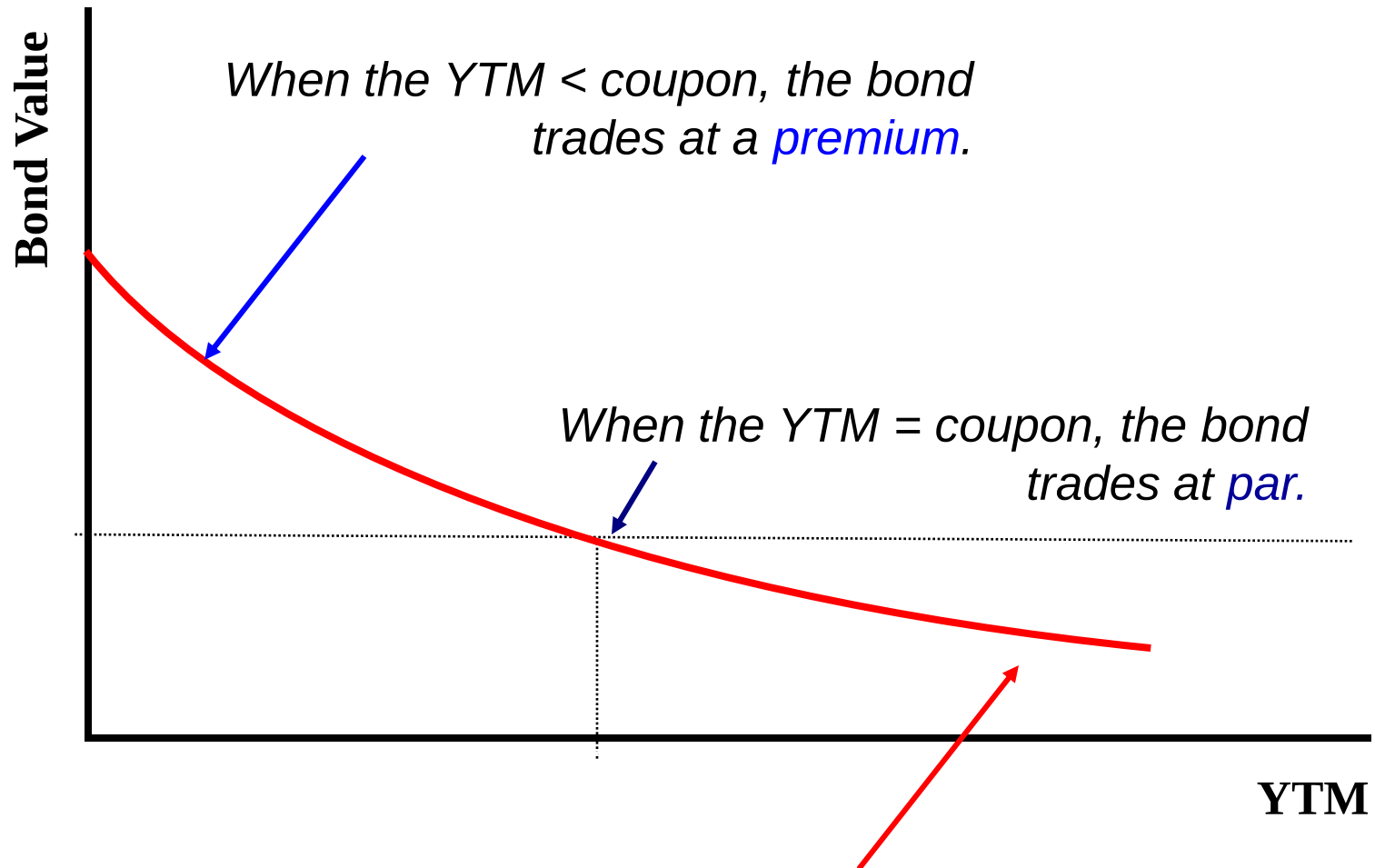
FV

OUTPUT

Bond Valuation: Price-Yield Relationship



Bond Valuation: Price-Yield Relationship



When the YTM > coupon, the bond trades at a *discount*.

Bond Valuation:

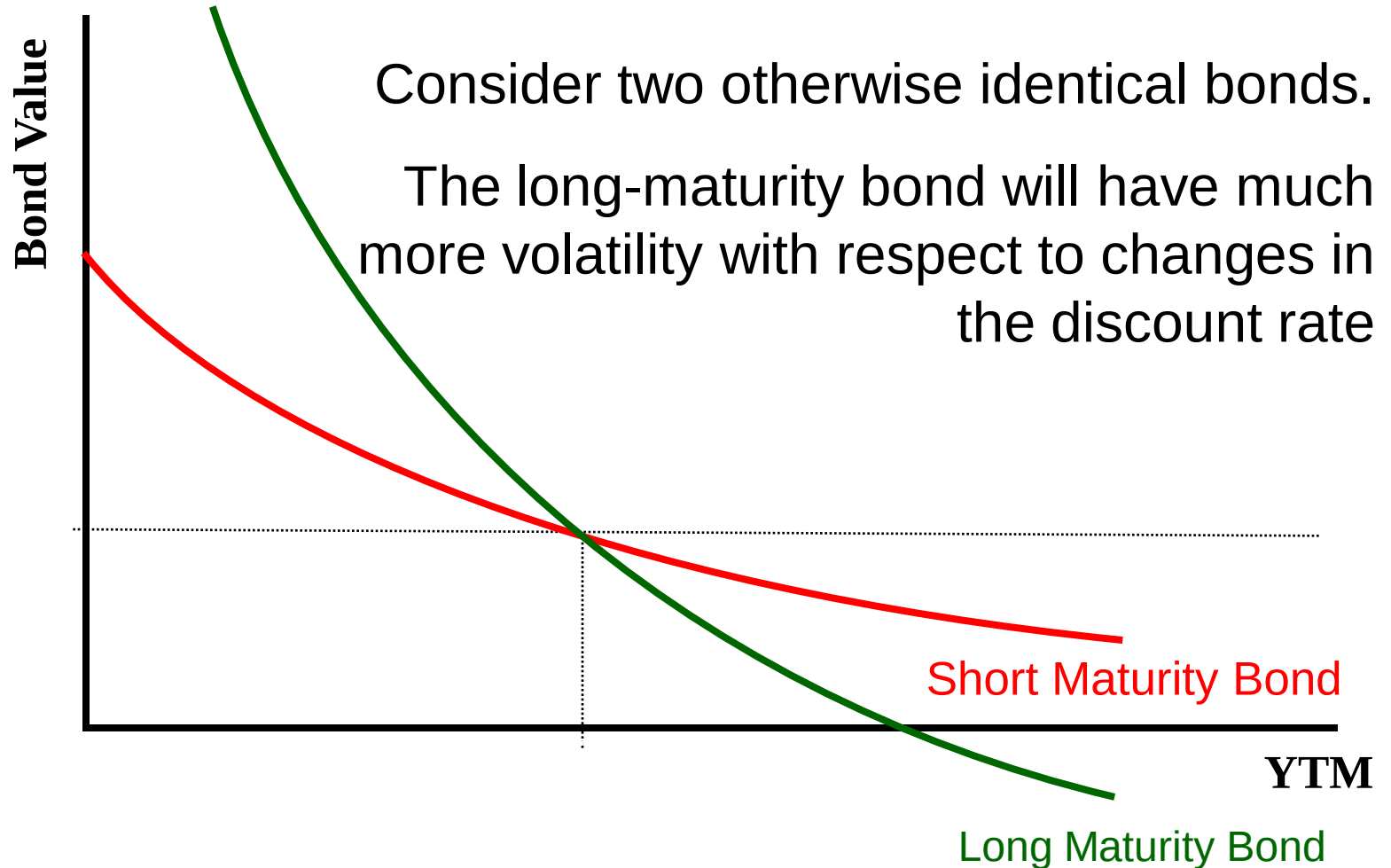
Maturity and Bond Price Volatility

Compute the value of a B1,000 par value bond, with 3-year, 2-year and 1-year life, paying 6% semiannual coupons to an investor with a required rate of return of 5%, 6% and 7%.

Notice that a bond with longer maturity has higher relative (%) price change than one with shorter maturity when interest rate (YTM) changes. So, the prices of long-term bonds are more volatile than the prices of short-term bonds. All other features are identical.

Bond Valuation:

Maturity and Bond Price Volatility



Bond Valuation:

Coupon Rate and Bond Price Volatility

Compute the value of a B1,000 par value bond, with a 3-year life, paying 8%, 6% and 4% semiannual coupons to an investor with a required rate of return of 5%, 6% and 7%.

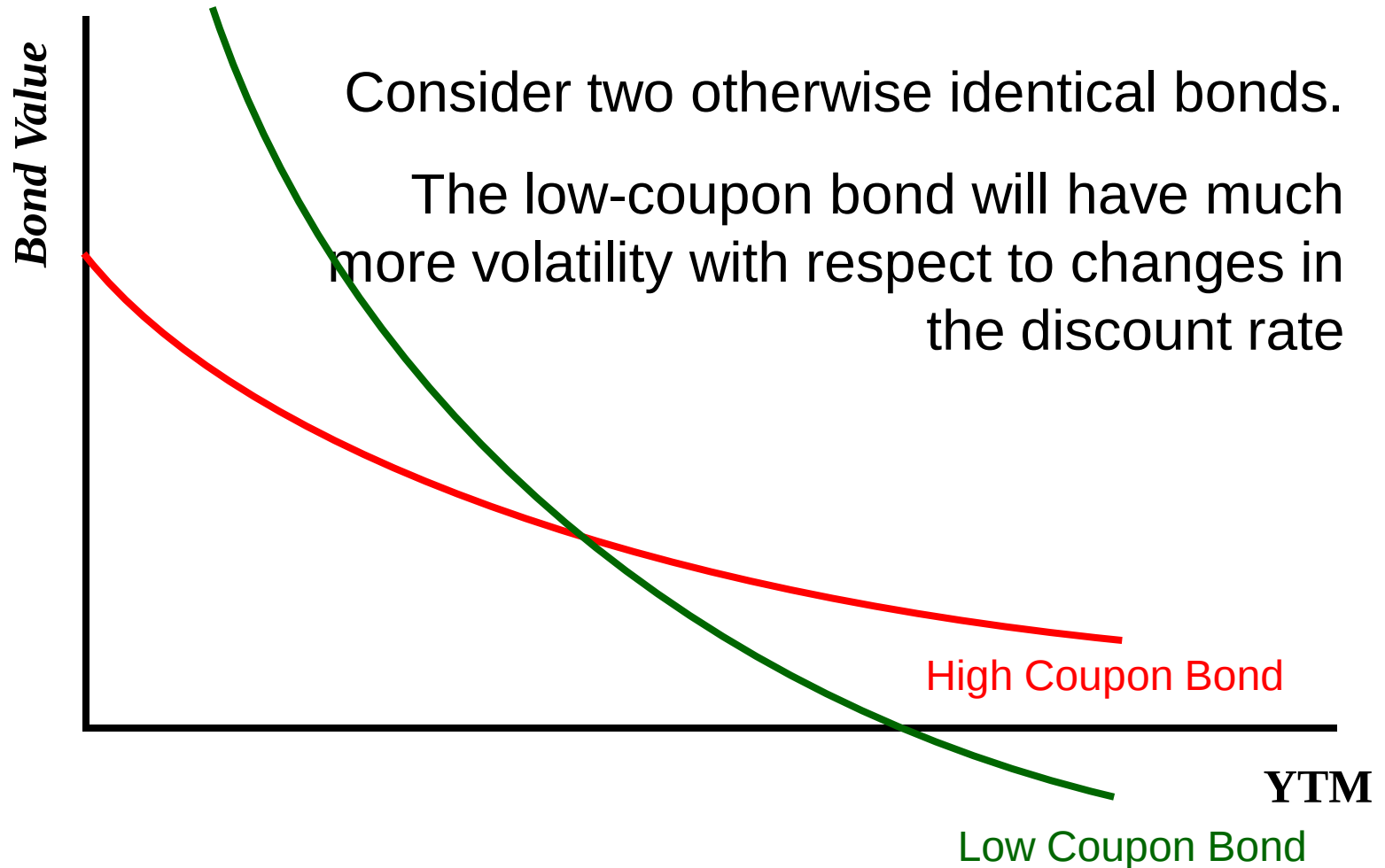
Bond Valuation:

Coupon Rate and Bond Price Volatility

Notice that a lower coupon bond has a higher relative price change than a higher coupon bond when YTM changes. So, prices of bonds that pay low coupon are more volatile than those that pay high coupon. All other features are identical.

Bond Valuation:

Coupon Rate and Bond Price Volatility



Bond Valuation:

Macauley Duration

- Macauley Duration measures the average maturity of a bond's total cash flows – coupons as well as principal.
- The average is weighted by the present value dollars paid in each period.

$$\text{Macauley Duration} = \frac{\sum_{t=1}^n \frac{C_t(t)}{(1+r)^t}}{\sum_{t=1}^n \frac{C_t}{(1+r)^t}}$$

- t = time in which the cash flow (coupon or par value) occurs
- C_t = cash flows (interest or principal payment) that occurs in period t
- r = the yield to maturity (YTM) on the bond

Bond Valuation:

Macauley Duration

$$\text{Macauley Duration} = \frac{\sum_{t=1}^n \frac{C_t(t)}{(1+r)^t}}{\sum_{t=1}^n \frac{C_t}{(1+r)^t}}$$

- The *denominator* is the PV of all cash flows, which is essentially the price of bond.
- The *numerator* is the time to maturity of each cash flow weighted according to the PV of the cash flow.

Bond Valuation:

Macauley Duration

1. Estimate the cash flows: coupon payments and repayment of principal at maturity
2. Calculate the present value of the cash flows series
3. Calculate the sum of the above PVs
4. Multiply each of PVs in #2 with time period
5. Calculate the sum of #4 PVs.
6. Duration is the result of #5 divided by that of #3

Notice: #2 and #3 - the **denominator** of the formula
#4 and #5 - the **numerator** of the formula

Bond Valuation:

Macauley Duration

Suppose there is a 5-year, B1,000 par value, 9% annual pay bond. What is the bond's duration, given YTM = 9%?

Period	Cash Flow	PV of CF	t x PV
1	90	82.57	82.57
2	90	75.75	151.50
3	90	69.50	208.49
4	90	63.76	255.03
5	1,090	708.43	3,542.13
		1,000.00	4,239.72
Duration 4.2397 years			

Notice that... Time to maturity = 5 years
 Macauley Duration = 4.2397 years

Bond Valuation:

Macaulay Duration

Suppose the 5-year bond above pays semi-annually. What is the bond's duration, given $YTM = 9\%$?

Notice that... Time to maturity = 5 years
 Macaulay Duration = years

Bond Valuation:

Macaulay Duration

Duration and coupon interest

- Macaulay duration of a bond with coupon payments always will be less than its term to maturity because duration gives weight to these interim interest payments.
- The higher the coupon payment, the lower the bond's duration
- Duration of discount (or zero-coupon) bond is equal to its time to maturity.

Duration and yield to maturity

- the higher the yield to maturity, the lower the bond's duration

Bond Valuation:

Macauley Duration

Duration and maturity

- duration increases with maturity at a decreasing rate
- Given the same maturity, a **callable bond** has shorter duration than a non-callable bond because there is a chance that the issuer exercise the right to call the bond (repay the loan) early.

Bond Valuation:

Modified Duration

- For option-free bond, modified duration can provide an **approximation** to the interest rate sensitivity of a bond.
- Modified Duration equals Macaulay Duration divided by 1 plus the current yield to maturity divided by the number of payments in a year.

$$\text{Modified Duration} = \frac{\text{Macaulay Duration}}{\left(1 + \frac{YTM}{m}\right)}$$

- From previous example, a 5-year, 9% semiannual-pay coupon bond with a Macaulay duration of 4.1344 years, YTM of 9% ...

$$\begin{aligned}\text{Modified Duration} &= \frac{4.1344}{\left(1 + \frac{0.09}{2}\right)} \\ &= 3.96\end{aligned}$$

Bond Valuation:

Modified Duration

Modified duration can be used to see how the price of a bond will respond to a specific change in yield.

Approximate change in price due to duration
= (-) (Modified duration) (Change in yield in decimal term)

Bond Valuation:

Modified Duration

Suppose there is a 5-year, B1,000 par value, 9% semiannual pay bond. The bond's YTM = 9% and we have calculated that modified duration is 3.96.

If YTM falls by 1% (or 100 basis points) from 9% to 8%, the approximate change in price of the 5-year bond is

$$= (-)(3.96)(-0.01)$$

$$= 0.0396$$

Estimated price

$$= (1+0.0396)(1,000)$$

$$= 1,039.60$$

Actual Price (can be calculated using financial calculator)

$$= 1,040.55$$

**Current bond price,
not par value!!!**

Bond Valuation:

Modified Duration

Suppose there is a 5-year, B1,000 par value, 9% semiannual pay bond. The bond's YTM = 9% and we have calculated that modified duration is 3.96.

If YTM rises by 1% (or 100 basis points) from 9% to 10%, the approximate change in price of the 5-year bond is

Bond Valuation:

Effective Duration

- **Modified Duration** has one limitation. It assumes that, when interest rates change, cash flows of bond do not change.
- This is a problem when measuring the exposure of bonds with embedded options (e.g., callable bonds, mortgage-back securities, etc.) to changes in interest rates.
- **Effective Duration**, in contrast, takes changes in cash flows into account and thus, is the appropriate measure for bonds with embedded options.
- For bonds without embedded options, **Modified Duration** and **Effective Duration** produce the same duration value so both can be used.

Bond Valuation:

Effective Duration

$$\text{Effective Duration} = \frac{BV_- - BV_+}{2(BV_0)(\Delta y)}$$

BV_- is bond value when yield falls

BV_+ is bond value when yield rises

BV_0 is bond value when yield stays the same

Δy is change in yield in decimal term

$\Delta y = 0.01$ for 1% change in yield

$\Delta y = 0.005$ for 0.5% change in yield

Notice that, since BV_- is always greater than BV_+ for option-free bonds, you will always get duration in positive term.

Bond Valuation:

Effective Duration

Suppose there is a 5-year, B1,000 par value, 9% semiannual pay bond. The bond's YTM = 9%. Determine effective duration given 1% change in yield.

$$\begin{aligned}\text{Effective Duration} &= \frac{1040.55 - 961.39}{2(1,000)(0.01)} \\ &= \frac{79.1587}{20} \\ &= 3.96\end{aligned}$$

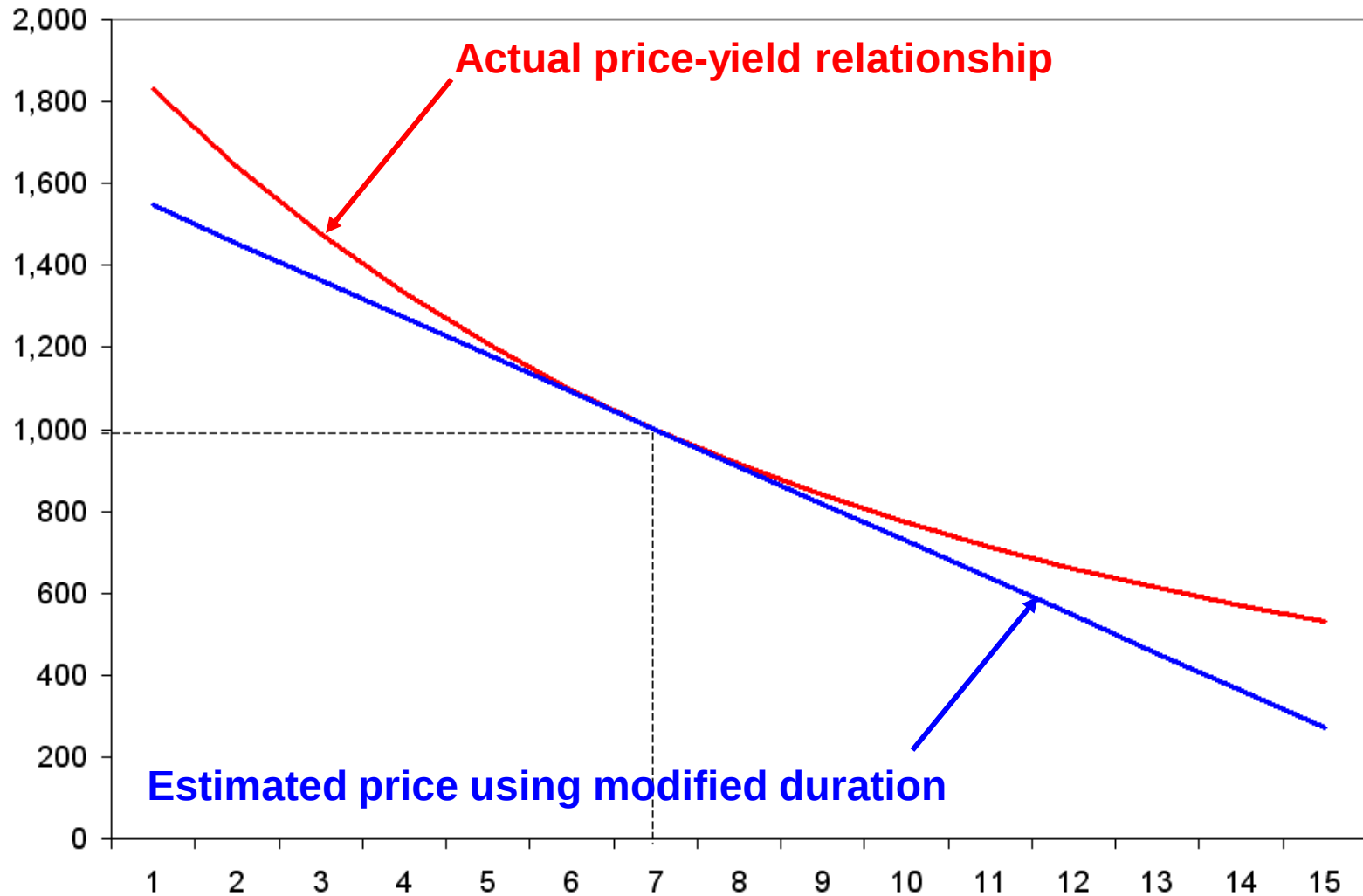
Notice that **Modified Duration** and **Effective Duration** produce the same duration value of 3.96. Since our example is a bond without embedded option, both duration measures will produce the same duration number and both can be used to estimate bond price.

Bond Valuation:

Convexity

- Modified duration allows us to estimate bond price changes for a change in interest rates.
- However, estimated price using duration is accurate only for very small changes in market yields.
- This is because modified duration is a **linear** approximation of a bond price.
- However, the actual price-yield relationship is a **convex** function.

Bond Valuation: Convexity



Bond Valuation:

Convexity

- Convexity is a measure of how much a bond's price-yield curve **deviates** from the linear approximation of that curve.
- Convexity is always a positive number, implying that the price-yield curve lies above the modified-duration line.
- Mathematically, convexity is the **second derivative** of price with respect to yield. (Duration is the first derivative)
- *Modified duration is the percentage change in **price** for a given change in yield.*
- *Convexity is the percentage change in **duration** for a given change in yield.*

Bond Valuation:

Convexity

- As yield increases, the rate at which the price of the bond declines becomes slower.
- When yield declines, the rate at which the price of the bond increases becomes faster.
- The estimate using only modified duration will **underestimate** the actual price increase caused by yield decline and **overestimate** the actual price decline caused by an increase in yields.

Bond Valuation:

Convexity

$$\text{Convexity} = \frac{BV_{-} + BV_{+} - 2(BV_0)}{2(BV_0)(\Delta y)^2}$$

BV_{-} is bond value when yield falls

BV_{+} is bond value when yield rises

BV_0 is bond value when yield stays the same

Δy is change in yield in decimal term

$\Delta y = 0.01$ for 1% change in yield

$\Delta y = 0.005$ for 0.5% change in yield

Bond Valuation:

Convexity

Continued with the previous 5-year, B1,000 par value, 9% semiannual pay bond. The bond's YTM = 9%. We have calculated that modified duration = 3.96. Determine the bond's convexity given 1% change in yield.

$$\begin{aligned}\text{Convexity} &= \frac{BV_- + BV_+ - 2(BV_0)}{2(BV_0)(\Delta y)^2} \\ &= \frac{1,040.55 + 961.39 - 2(1,000)}{2(1,000)(0.01)^2} \\ &= \frac{1.94}{0.2} \\ &= 9.7\end{aligned}$$

Bond Valuation:

Convexity

Convexity can be used to improve the estimation by modified duration to see how the price of a bond will respond to a specific change in yield.

Approximate change in price using convexity

$$= (\text{convexity}) \times (\text{change in yield in decimal term})^2$$

$$= (9.7)(0.01)^2$$

$$= 0.00097$$

Bond Valuation:

Using Modified Duration Only

Suppose there is a 5-year, B1,000 par value, 9% semiannual pay bond. The bond's YTM = 9% and we have calculated that modified duration is 3.96.

If YTM falls by 1% (or 100 basis points) from 9% to 8%, the approximate change in price of the 5-year bond is

$$= (-)(3.96)(-0.01)$$

$$= 0.0396$$

Estimated price

$$= (1+0.0396)(1,000)$$

$$= 1,039.60$$

Actual Price (can be calculated using financial calculator)

$$= 1,040.55$$

Current bond price,
not par value!!!

Bond Valuation:

Using Both Modified Duration + Convexity

Suppose there is a 5-year, B1,000 par value, 9% semiannual pay bond. The bond's YTM = 9%. We have calculated that modified duration is 3.96 and convexity is 9.7

If YTM falls by 1%, the approximate change in price is

$$= (-)(3.96)(-0.01) + (9.7)(-0.01)^2$$

$$= 0.0396 + 0.00097$$

$$= 0.04057$$

Estimated price

$$= (1 + 0.04057)(1,000)$$

$$= 1,040.57$$

Actual Price (can be calculated using financial calculator)

$$= 1,040.55$$

Bond Valuation:

Using Both Modified Duration + Convexity

Suppose there is a 5-year, B1,000 par value, 9% semiannual pay bond. The bond's YTM = 9%. We have calculated that modified duration is 3.96 and convexity is 9.7

If YTM rises by 1%, the approximate change in price is

Bond Valuation:

Duration of a Portfolio

Duration of a portfolio is simply the **weighted average** of the duration of the bonds in the portfolio. The average is **weighted by market value** of bonds within the portfolio.

For example, if a portfolio worth 5 million Baht has 2 bonds

- The previous 5-year bonds, B1,000 par value, 9% semiannual pay bond. The bond's YTM = 9%. It's modified duration is 3.96 with total market value of 2,000,000 Baht
- 15-year, B1,000 par value, 7% annual pay bonds, YTM = 7% with modified duration of 9.11 and total market value of 3,000,000

$$\begin{aligned}\text{Portfolio Duration} &= \frac{3.96(2,000,000) + 9.11(3,000,000)}{5,000,000} \\ &= 7.05\end{aligned}$$

Bond Valuation:

Duration of a Portfolio

Given portfolio's modified duration of 7.05, If YTM rises by 1% across the board, the approximate change in price of the portfolio is

$$\begin{aligned} &= (-)(7.05)(+0.01) \\ &= -0.0705 \end{aligned}$$

Estimated portfolio value after YTM rises by 1%

$$\begin{aligned} &= (1-0.0705)(5,000,000) \\ &= 4,647,500 \end{aligned}$$

Bond Valuation:

Duration of a Portfolio

Given portfolio's modified duration of 7.05, If YTM falls by 1% across the board, the approximate change in price of the portfolio is

Estimated portfolio value after YTM rises by 1%

Bond Valuation:

PV01

PV01 = Price Value of One Basis Point Change. It is the change in value (in Baht or Dollar terms) per one million nominal value, given 1 basis point change in yield

Example: Suppose our previous 5-year bond has 9% semiannual coupon, YTM of 9%, market price of 1,000, modified duration of 3.96.

The estimated bond price change given 1 bp Δ in yield
= (MD) x (Change in Yield Decimal Term) x (Bond Price)
= (3.96) x (0.0001) x (1,000)
= 0.396 Baht.

So, bond price will change by 0.396 Baht given 1bp Δ in yield.

Bond Valuation:

PV01

Notice that the price change of 0.396 Baht above is per one unit of bond.

Since PV01 is defined as 'change in value per one million Baht nominal value and since Thai Baht Bond par value is B1,000; one million Baht nominal value translate to 1,000 units of bonds. Therefore, we need to multiply 1,000 to the above calculation to achieve PV01 formula...

$$PV01 = MD \times 0.0001 \times \text{Bond Price} \times 1,000$$

Bond Valuation:

PV01

Example: Suppose our previous 5-year bond has 9% semiannual coupon, YTM of 9%, market price of 1,000, modified duration of 3.96. Calculate PV01

$$\begin{aligned}\text{PV01} &= \text{MD} \times 0.0001 \times \text{Bond Price} \times 1,000 \\ &= 3.96 \times 0.0001 \times 1,000 \times 1,000 \\ &= 396 \text{ Baht}\end{aligned}$$

- So, we can predict that, if yield change by 1 basis point, the value of this bond, with 1 million Baht nominal, will change by 396 Baht.*
- You can check this prediction by calculating that, if yield change by 1 basis point from 9% to 9.01%, the actual value will change by 395.54 Baht*

Bond Valuation:

PV01 : Exercise

A 5-year bond has 5% annual coupon, YTM of 4%, market price of 1,044.52, modified duration of 4.38. Calculate PV01

Bond Valuation:

PV01

- **Position PV01** = PV01 x nominal value in million Baht
- **Position PV01 of a portfolio** is the sum of total Position PV01 of the bonds in the portfolio.
- For example, if a portfolio with 50 million nominal has 2 bonds

Issue	Bond Price	Modified Duration	PV01	Nominal (million Baht)	Position PV01
5 years	1,000.00	3.96	396.00	15.00	5,940
15 years	1,000.00	9.11	911.20	35.00	31,892
Position PV01 of Portfolio =					37,832

This means, given 1 basis point change in yield, the value of this portfolio will change by 37,832 baht