

Bond Portfolios

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1 Issues

Source of uncertainty in bond portfolios: Interest rate risk.

Main tool for measuring this: Duration. Convexity.

Passive bond management

- Immunization
- Cash flow matching

Active bond management

- Sources of profits:
 - Identification of relative mispricing.
 - Interest rate forecasting

2 Duration and convexity

2.1 Duration for a bond

Calculation of duration for a bond with T periods till maturity:

$$D = \frac{1}{P} \sum_{t=1}^T tPV(C_t)$$

where P is the current bond price and $PV(\cdot)$ is the present value operator

Modified duration

$$D^* = \frac{D}{1 + y}$$

Rules for duration:

1. The duration of a zero-coupon bond equals its time to maturity.
2. Holding maturity constant, a bond's duration is higher when the coupon rates is lower.
3. Holding the coupon rate constant, a bonds duration generally increases with its time to maturity.
Duration always increases with maturity for bonds selling at par or at a premium to par.

4. Holding other factors constant, the duration of a coupon bond is higher when the bond's yield to maturity is lower.

5. The duration of a level perpetuity is

$$\frac{(1+y)}{y}$$

where y is the yield.

6. The duration of a level annuity is equal to

$$\frac{(1+y)}{y} - \frac{T}{(1+y)^T - 1}$$

where T is the number of payments and y is the annuity's yield per payment period.

7. The duration of a coupon bond equals

$$\frac{1+y}{y} - \frac{(1+y) + T(c-y)}{c[(1+y)^T - 1] + y}$$

8. The duration of a level annuity is equal to

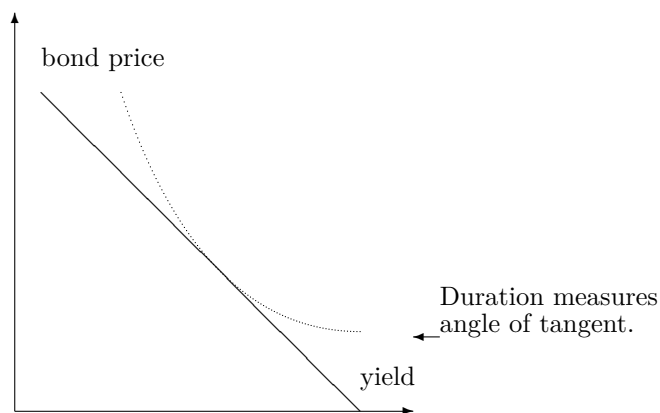
$$\frac{(1+y)}{y} - \frac{T}{(1+y)^T - 1}$$

where T is the number of payments and y is the annuity's yield per payment period.

9. The duration of a coupon bond selling at par value is

$$\frac{1+y}{y} \left[1 - \frac{1}{(1+y)^T} \right]$$

Duration is related to the change in bond price as a function of the interest rate



If we want to approximate the bond price change from a change in yield, take a Taylor expansion

$$dP = \frac{dP}{dy} dy + \frac{1}{2} \frac{d^2P}{dy^2} (dy)^2 + \text{error}$$

Duration enters into the first term.

2.2 Convexity

Recall duration – first derivative.

$$\frac{\Delta P}{P} = -D^* \Delta y$$

Only an approximation, to be more accurate also account for second order effects.

Convexity: curvature of the relationship between bond prices and interest rates.

Modify above as

$$\frac{\Delta P}{P} = -D\Delta y + \frac{1}{2} \times \text{Convexity} \times \Delta y^2$$

Calculate convexity of a bond with T periods left as:

$$\text{Convexity} = \frac{1}{P(1+r)^2} \sum_{t=1}^T (t+t^2)PV(C_t)$$

where C_t is the cash flow at time t and $PV(\cdot)$ is the present value operator.

If you want a better measure of the change in the price as a function of yield, must also use the second term. This second term is called the *convexity* of the bond.

2.3 Duration and convexity of a portfolio

Portfolio of n assets defined by weights $\{w_i\}_{i=1}^n$ that satisfies $w_i \geq 0 \forall i$ and $\sum_{i=1}^n w_i = 1$.

Both duration and convexity of portfolio can be found as weighted averages of each individual bond in the portfolio

$$D_p = \sum_{i=1}^n w_i D_i$$
$$\text{convexity} = \sum_{i=1}^n w_i \text{convexity}_i$$

Exercise 1.

Consider an equally weighted portfolio of two bonds, A and B. Bond A is a zero coupon bond with 1 year to maturity. Bond B is a zero coupon bond with 3 years to maturity. Both bonds have face values of 100. The current interest rate is 5%.

1. Determine the bond prices.
2. Your portfolio is currently worth 2000. Find the number of each bond invested.
3. Determine the duration of the portfolio.
4. Determine the convexity of your position.

3 Passive bond management

Two groups of strategies

- Indexation
- Immunization

Indexation Given an index of bond performance
Construct a bond portfolio that matches the index
Works like equity indexing – return to this in that context
Immunization

- Duration/Convexity matching
- Cash flow matching (dedication)

3.1 Liability matching

Consider a pension fund.

Typically, it has a good handle on the future cash flow obligations they are facing, since this is a function of the number of pensioners and the amount to pay each of these each month.

This is the situation for many institutional investors, they are facing a sequence of predictable liabilities.

The problem is then to create a portfolio that best serves those liabilities, by producing a sequence of cash flows covering the liabilities, at the highest possible earnings.

A number of techniques is used to do this. The first involves matching the maturity of the bond portfolio with the obligations (immunization).

3.1.1 Immunization

Suppose you have a portfolio of bonds which is meant to cover your liabilities.

Consider the price of your portfolio as a function of the yield.

If duration of the portfolio is equal to the duration of the liabilities, the portfolio is insured against parallel shifts in the yield curve.

Running an immunized portfolio assumes

- The present value of assets match the present value of liabilities.
- The duration (or interest-rate sensitivity) of the assets must match the duration of the liabilities.
- The convexity of the assets must be larger than the convexity of the liabilities.

Thus, the idea is: One *immunizes* a future payment obligation by creating a bond position with the same duration.

Exercise 2.

A company is facing a cash outflow of 1000 two years from now, which it seeks to immunize. It has identified two bonds, bond A and bond B, which is to be used in this immunization. Bond A is a zero coupon bond with one year remaining to maturity, while bond B is a three year coupon bond with 4% annual coupons. Each bond carries a face value of 100.

The following spot rates apply in the bond market: $r_1 = 2\%$, $r_2 = 3\%$, $r_3 = 4\%$ and $r_4 = 4.5\%$, where r_t is the spot interest rate for borrowing over t years, with discrete, annual compounding.

1. Using bonds A and B, find the bond portfolio that best immunizes the company's future payment obligations, based on duration.
2. How does the convexity of the bond portfolio compare to the convexity of the payment obligation? Is the payment obligation perfectly immunized?
3. Suppose that all spot rates fall by one percentage point (i.e. the spot rates change to $r_1 = 1\%$, $r_2 = 2\%$ etc.) Calculate the resultant bond price to check how well the company is protected against a decrease in interest rates.

Exercise 3.

You are working as a bond portfolio manager and is facing the following sequence of liabilities:

Year	1	2	3
Liability	10	200	400

The current term structure of interest rates is observed (with continuous compounding)

time t	1	2	3
spot rate $r(0, t)$	3%	4%	5%

Two bonds are traded: Bond A is a 3 year, 10% coupon bond. Bond B is a 2 year, 5% coupon bond. Both bonds have face values of 100.

1. Find the current bond prices.
2. Find a portfolio of these two bonds that immunizes the liability.
3. What is the convexity of the liability and the immunizing portfolio?

3.1.2 Dedicated portfolio

Suppose we are given the sequence of future liabilities as a set of needed cashflows.

One way to cover a set of future liabilities is to invest in a set of bonds that always at least produce the necessary cashflows in the future.

In theory this solves all problems, and provide for the future liabilities (cash flows).

In practice, however, run into a number of problems.

Key problems:

- Available bond maturities may not match the liabilities exactly.
- May need to buy bonds in the future

As soon as there are such mismatches, face *reinvestment risk*.

But let us illustrate the idea in a simple case

Bond selection using linear programming Generally, suppose we want to match liabilities $\{L_t\}_{t=1}^T$.

Given a set of I bonds with current prices B_i , cash flows $X_i(t)$. We want to choose the number of each bond n_i , to minimize cost, at the same time as matching the future liabilities.

The matching problem solves the following linear program

$$\min_{\{n_i\}} \sum_{i=1}^I n_i B_i$$

subject to

$$\sum_i n_i X_i(t) \geq L_t \quad \text{for all dates } t$$

Exercise 4.

A pension fund is facing the following set of future liabilities:

	Year		
	1	2	3
Liability	100	100	100

To cover this set of liabilities, the following bonds are available:

Bond no		Current Price	Cash flow in Year		
			1	2	3
1	Bond 1	100.00	10	110	0
2	Bond 2	95.00	8	8	108
3	Bond 3	105.00	12	12	112
4	Strip 1	94.3396	100		
5	Strip 2	85.7339		100	
6	Strip 3	75.1315			100

1. What are the current (continuously compounded) spot rates implied in the strip prices?
2. By investing in the three strips, find how many of each bond one need to match the liabilities.
3. What is the cost of this bond portfolio?
4. Set up the linear program for finding the cost minimizing portfolio that matches the liabilities.
5. You are given the following portfolio that solves this optimal program:

bond no	Bond	n
1	Bond 1	0.8117
2	Bond 2	0
3	Bond 3	0.8929
4	Strip 1	0.8117
5	Strip 2	0
6	Strip 3	0

What is the cost of this portfolio?

6. What does this imply about arbitrage possibilities?
7. What can explain such apparent arbitrage possibilities?

4 Active bond management

The analyst believes can create value by insights/information that leads to deviations from market valuations.

Discussion of efficient markets relevant here.

Two rough groups of strategies

4.1 Identification of relative mispricing.

Revisit the previous (linear programming) example.

In there identified a mispricing of some of the bonds. In that setting could construct long-short “arbitrage” strategies.

4.2 Interest rate forecasting

Given a forecast of where interest rates are going, position your portfolio relative to the term structure to profit from this direction.

References

Zvi Bodie, Alex Kane, and Alan J Marcus. *Investments*. McGraw Hill/Irwin, 12 edition, 2021.