

# Hot Bonds

## Trading fixed-income securities like stocks

By OSLEC LOPEZ

Unknown to many local investors, interest-bearing securities like government-issued bonds and bills, provide earning opportunities just like stocks traded on the exchange and gains from foreign exchange trading.

In fact, most banks attribute much of their trading income year in and year out to healthy trading positions in these so-called fixed-income securities. Banks hardly hold on to these Treasury bills and bonds until they mature as they continually buy and sell them to maximize yields.

More often than not, it is individual investors and large insurance companies that buy bonds with the intention of holding on to them until they mature. They patiently collect regular interest payments or wait for the lump sum amount, in the process forgoing possible trading gains along the way.

Lately, however, foreign private bankers have been aggressively wooing individual investors and a few have been introduced to the opportunity of enhancing their earning potential through active trading of fixed-income securities.

Private bankers give their clients regular advice on when to buy or sell their portfolio of T-bills and T-bonds, much like the investment advice stockbrokers provide investors in stocks. Their goal is to increase investors' incomes beyond just the given bond yield as the demand for them increases after they are bought. Insurance companies, too, have begun to actively trade their fixed-income portfolio as most have merged or are allied with foreign partners who are experienced in the practice of trading bonds.

Bond trading becomes even more timely and important now as government and the private sector are strongly endorsing the creation of a local bond exchange. This will allow a more transparent and accessible venue for trading interest-bearing securities.

Pretty soon we will have a swarm of brokers peddling T-bonds, T-bills, and corporate IOUs, and not just the usual shares of stocks we are currently accustomed to. Bonds will soon be traded on the local bourse, too!

Just how does an investor profit from bond trading?

First, he or she should be comfortable with the concept of trading bonds in terms of price and not yield (or the expected interest rate, also called the coupon rate). Local bond dealers have found it difficult to change the Philippine market practice of trading using interest rates as basis instead of price, so one need not start asking his/her banker to quote in terms of price instead of yield. What an investor should know, however, is that price is a function of yield, and vice versa.

For example, assume you invested in both T-bills and fixed-rate treasury notes (FXTN) with your friendly banker. For simplicity we will exclude taxes involved and assume no interest has accrued upon purchase. You will receive a sale confirmation that will have more or less the details shown in Example 1.

The price of your two investments in our example is simply the purchase price. Notice we used PhP100 (\$1.92 at PhP51.982=\$1) as the investments' face or maturity values. This may seem a negligible amount but the purpose is to align the example with the trading practice worldwide of using "price per hundred" quotes. For people who watch business news, this should make you familiar with the way Bloomberg, CNBC, and other financial information providers quote the prices of bonds traded globally.

Let us say then that one day after you invested your funds, the Bangko Sentral ng Pilipinas (Central Bank of the Philippines, or BSP) unexpectedly lowered its benchmark interest rates by half a percentage point. Consequently, when you called your banker to find out the yield of a 363-day T-bill and a 10-year FXTN, you were told it is now trading at 9.5% and 14.5%, respectively.

Had another investor bought the same securities from you, he/she will receive a confirmation notice with the details shown in Example 2.

Theoretically, if you sold the securities to the new investor, you would have gained from the transaction even after only a day as their prices have already appreciated. You would have earned PhP2.23 per hundred from your FXTN investment (i.e. 102.23 - 100) and PhP0.35 from your T-bills (i.e. 93.00 - 92.65).

More importantly, instead of earning 15.0% and 10.0% for holding on to the securities until they matured, you actually earned one-day return equal to an annualized rate of 802.80% from your PhP100.00 FXTN investment and 136% from your PhP92.65 T-bills investment.

Your one-day holding period rate of return is computed as follows:

#### Fixed-Rate Treasury Notes

$$[(2.23/100) \times (360/1)] \times 100 = 802.80\%$$

#### Treasury Bills

$$[(0.35/92.65) \times (360/1)] \times 100 = 135.99\%$$

The same premise holds when investing in stocks or trading foreign exchange -- the investor buys at a low price and sells at a high.

However, as the investor may be more accustomed to investing in bills and bonds in terms of yield, the reverse holds true -- you buy at a high interest rate and sell at a low interest rate. This is how banks or government securities dealers make money. They buy the bonds and bills

Example 1	Fixed-Rate Treasury Notes	Treasury Bills
Coupon Rate:	15.00%	N/A
Yield/Interest Rate:	15.00%	10%
Term:	10 years	364 days
Maturity Date:	xx/xx/xx	xx/xx/xx
Face/Maturity Value:	P100.00	P100.00
Purchase Price/Cost:	P100.00	P92.65
Example 2	Fixed-Rate Treasury Notes	Treasury Bills
Coupon Rate:	15.00%	N/A
Yield/Interest Rate:	14.50%	9.5%
Term:	10 years less one day	363 days
Maturity Date:	xx/xx/xx	xx/xx/xx
Face/Maturity Value:	P100.00	P100.00
Purchase Price/Cost:	P102.23	P93.00

when interest rates are high. They will hold on to their government securities for days or months then sell them to their individual and corporate clients when interest rates go down.

In our example, you might have noticed that the price of the bonds depends on interest rate movements (specifically BSP's benchmark rates). Because of this, factors affecting the bonds' interest rates should be the investor's main concern. Just as a listed company's earning capacity and stability affect its stock price, a bond issuer's credit rating, inflation and monetary policy will likewise affect a bond's price or yield.

Notice also that the gain from the 10-year FXTN was relatively bigger than the one-year T-bills. This is because the tenor (or the duration of the life) of a fixed-income instrument has a major effect on its price. A single factor like a BSP rate adjustment will have a bigger impact on the price of a longer bond than that of a shorter one. Thus, there is more "price risk" in T-bonds than T-bills.

An optimist might see this as an opportunity for higher returns but the fact remains that T-bonds are more volatile in terms of price swings than T-bills.

Note also that an investor can gain only from a favorable downward interest rate movement. One can lose money if interest rates rise after the investment was made. Again, just like your investment in stocks and foreign exchange, you can have paper losses. The main difference is, your investment in bonds will continue to earn interest. If you hold on to it until maturity, you get back your full investment plus the interest. It is only when you insist on selling it now that you take the loss.

Does an average investor have to wait then for the local bond exchange to open before availing of this investment opportunity? Definitely not, because some banks already provide clients the opportunity to trade their bond portfolio.

Some banks regularly give their clients what is commonly known in financial markets as a "two-way price" -- that is, a price for both buying and selling a T-bond or T-bill. The key is looking for the right banker. Unfortunately, there are only a few at the moment, as most would rather have their clients' buy bonds than sell them.

Do you need tons of cash for this? Not exactly. T-bonds and T-bills are very liquid instruments, so banks accept volumes as low as PhP100,000. The National Government even issues retail series bonds through some financial institutions with minimum purchase amounts of only PhP5,000.

Before you pick up that phone to call your banker, however, please remember that just like stocks, your investment decisions are not to be made by the seat of your pants. One has to brush up on basic economics and be more aware of the effects of regularly published economic data on interest rates.

Ask your banker for subscriptions on daily journals or write-ups about interest rates and currencies to help you "read" the interest rate market. Do some "shadow trading," that is, try to build a portfolio of bonds without really investing your cash but diligently monitoring its value over time. Your banker should be able to provide you calculators and formulas for computing bond prices.

If you feel you've got the hang of it, then go and have a happy and profitable time trading!

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