



**LET'S TALK ABOUT...**

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

## Bond Risk

**(Part Two)** The *rating*, that is the reliability assessment for a given bond issuer, as it is evaluated and published by some specialized institutions (see the descriptive part of our Financial Glossary for details), may then be viewed as the most traditional measure of risk within the fixed income area. The scale ranges from AAA (highest reliability) down to D (default level), with all its intermediate steps, both investment graded and non-investment graded (that is not allowed to be purchased by most pension funds, mutual funds and similar institutions). However such risk indication currently is much less reputed than it used to be, due to its indefiniteness and several recent events, which showed how high ratings were not effective proves of financial solidity under stressed and difficult market conditions.

The *spread*, as the yield differential between a certain bond and a comparable one or a risk free benchmark (in the form of a short term government issue for instance), may be a better risk indicator. It may be useful to remind that a bond's yield is related to its coupon, the time to expiration, hence its duration, the purchasing price and the issuer's features and instrument's characteristics: all other things being equal the higher the yield, the weaker the issuer in terms of financial solidity, that is the greater the overall risk which the investor is facing.

But the last frontier in risk measurement is the value of CDS-*Credit Default Swaps*. Such instruments are complex and multi-functional, but within our need we can consider them as representative of the insurance premium which an investor pays for the guarantee of receiving the bond's par value at its natural expiration date.

Such value is constantly assessed by market participants and expressed in base points. If the value of the CDS for a given government bond is 80 and 540 for a corporate issue, then the latter is much more riskier. The investor or manager may monitor the evolution of CDS day by day, so effectively and continuously feeling the pulse of the fixed income market. *(end)* GLT

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**(Part One)** Financial evolutions and sliding interest rates towards historical lows, combined with the absence of inflative worries, by now at least, have made fixed income investments particularly attractive for many. In the hottest phases of the current financial turmoil, the diffused flight to quality has particularly benefited government issues. Many high quality corporates, both coming in the primary market and already traded in the secondary one, have also lured many savers. But the fixed income market itself is far from being safe. Many huge amounts of debts are coming to expiration in the next months, and the many bailouts and support plans which governments are implementing inevitably weight on their public balance sheets, and will require massive issues for their financing. Moreover those companies which can not turn to the equity markets for getting new funds, due to unfavourable market or own corporate conditions, are compelled to turn to the bond market, so adding new pressures on the supply side. That is the reason of the uncertainty and discomfort now affecting the fixed income area, the worry of likely defaults and other "accidents" possibly striking corporate or even government issuers. Indeed the current risk premiums are reflecting such negative scenario. What are the indicators and the instruments the investor can use in order to assess and select issuers and a fixed income instruments ? First of all extreme caution and short maturities are the two main points to consider. After that, the three ways one can use for the purpose are the following: the issuer's rating, the bond's spread, that is the yield differential from a reference benchmark, a similar risk free security for instance, or the gap between a comparable investment in terms of quality and duration. The third one is new, the CDS-Credit Default Swap, a derivative which is used for hedging purposes but may be also seen as an indicator of default risk for a given issuer, both government and corporate. We will consider these point in more detail. *(to be continued)* GLT

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