Reading 51

FIXED-INCOME ISSUANCE & TRADING

1. (B) Long-term, investment-grade securities.

Explanation

Insurance companies have to ensure that they have the funds needed to pay claims as they come due. Investment-grade securities are deemed the safest by rating agencies, and while the yields are relatively low, they do provide a stable stream of income. Long-term investments align with the reality that claims are ongoing for insurance companies**.**

(Module 51.1, LOS 51.a)

2. (B) 15 basis points lower.

Explanation

For an older, less liquid bond traded on the secondary market, the spread between the bid (lower) and the ask (higher) will be greater than it would be for newer, more liquid bonds, often with a spread of up to 1020 basis points. Newer, more liquid bonds may have a spread of less than a basis point.

(Module 51.1, LOS 51.c)

3. (B) higher.

Explanation

Bonds have maturity dates (unlike equities), and new bonds are issued regularly relative to equities. So, the turnover (removal and replacement of constituents) is higher for fixedincome indices versus equity indices.

(Module 51.1, LOS 51.b)

4. (A) Financial sector bonds.

Explanation

Corporate bonds are frequently classified by issuer as financial or non-financial. Floating rate bonds are a classification by coupon structure. Money market securities are a classification by original maturities.

(Module 51.1, LOS 51.a)

5. (C) A private placement, debut issuer.

Explanation

Because this bond is only available to specific investors, it is considered a private placement rather than a public offering. An issuer that is offering its first-ever bond is referred to as a debut issuer. In this case, because the underwriter has guaranteed the bond issue price, it will be an "underwritten offering" (not best-efforts offering). A shelf registration allows bonds to be issued over time, and there is no indication that this is the intention here.

(Module 51.1, LOS 51.c)

6. (A) Shelf registration.

Explanation

Through a shelf registration, a bond issue is registered in aggregate with securities regulators. The bonds are then issued over a period of time, dependent upon when the issuer needs to raise the funds. This will accommodate the CFO's desire to add debt over a period of years. Best-efforts offerings are when intermediaries do not guarantee the issue price. In an underwritten offering, financial intermediaries guarantee the bond issue.

(Module 51.1, LOS 51.c)

7. (B) An S&P rating of BB+.

Explanation

Investment-grade bonds are the safest investments, aside from "default risk free," which means they will have the lowest yields. S&P ratings ranging from AAA to BBB– are investment grade, as are Moody's ratings ranging from Aaa to Baa3. An S&P rating of BB+ is considered non-investment grade and will carry greater risk. Because this investor is interested in high-yield bonds and is willing to take on more risk, BB+ is the most likely rating found in his portfolio.

(Module 51.1, LOS 51.a)

8. (C) low credit rating, high risk, high yield.

Explanation

Distressed debt is the debt of an issuer that is either in bankruptcy already or is expected to be there in the near future. This debt (and the issuer themselves) will likely carry a low credit rating, and because of the financial state they are in, these bonds are considered high risk. Because investors will naturally expect to earn high returns on higher risk investments, the yields will be high—if the issuer makes the interest and principal payments as they come due!

(Module 51.1, LOS 51.c)

9. (C) **Credit quality.**

Explanation

An index used as a benchmark for a bond fund should match the exposure of the fund in terms of credit quality, sector focus, and maturity. Duration and volatility are not specifically identified as exposures that need to be matched by an index fund benchmark.

(Module 51.1, LOS 51.b)

10. (C) **short term and investment grade.**

Explanation

ABCP is commercial paper that has a maturity of less than a year (thereby making it short term) and collateralized by financial assets, such as receivables. Regular commercial paper is only eligible to be issued by high credit rating corporations, and ABCP is even more secure because it is collateralized. The high ratings make it investment grade, so it would not be high yield (associated with non-investment grade). It would not, however, be default free.

(Module 51.1, LOS 51.a)

11. (A) **Geography.**

Explanation

If a fixed-income index uses a narrower focus, the focus may be on geography, credit quality, sector, or maturity. Coupon rate ranges and equity correlations are unlikely to be a focus in the development of a fixed-income index.

(Module 51.1, LOS 51.b).

12. (C) **Bonds included come from many sectors and currencies.**

Explanation

An aggregate index like the Bloomberg Barclays Aggregate Index will include a broad selection of bonds from many sectors and currencies (the Bloomberg Barclays Aggregate Index has bonds across 28 currencies). There are minimum size thresholds for bonds to be included in the index, and high-yield and unrated bond issuances are excluded.

(Module 51.1, LOS 51.b)

13. (A) **private placement.**

Explanation

In a private placement, an entire bond issue is sold to a single investor or a small group of investors, rather than being offered to the public.

(Module 51.1, LOS 51.c)

14. (A) uses sampling to minimize transaction complexity.

Explanation

A bond tracker fund will use sampling techniques because fixed-income indices have many more constituents than equity indices, and sampling will keep the transaction complexity reasonable.

(Module 51.1, LOS 51.b)

15. (B) 1 year to 10 years.

Explanation

The Federal Reserve Bank is a central bank, and the monetary policy tool it is using to reduce the money supply is the sale of intermediate-term (1 to 10-year) Treasury notes.

(Module 51.1, LOS 51.a)

16. (A) its liquidity, but not its credit quality.

Explanation

Bond dealers' bid-ask spreads depend primarily on the liquidity of an issue. Spreads are narrower for highly liquid issues and wider for less liquid issues. Credit quality and liquidity are both reflected in yield spreads.

(Module 51.1, LOS 51.c)

17. (B) have large weights in sovereign bonds.

Explanation

Aggregate indexes contain a broad selection of bonds across sectors and currencies. Because sovereign governments are the largest issuers of bonds, they typically have the largest weight in broad bond indexes. Because bonds mature, they must be replaced in indexes more frequently than equities.

(Module 51.1, LOS 51.b)

18. (A) debut issue.

Explanation

Debut issues are new and often require a significant amount of time for underwriters to market the issuance to investors through roadshows. A shelf registration is used for a bond that will be issued over a period of time rather than all at once. A repeat issue will not typically require months of roadshows and marketing efforts to investors.

(Module 51.1, LOS 51.c)

19. (A) fallen angels.

Explanation

Fallen angels is the term for bonds associated with issuers that previously held investment-grade ratings, that have since been downgraded to below investment grade. Neither of the other terms are used to describe these bonds. Yields would increase as the bond is downgraded to below investment grade**.**

(Module 51.1, LOS 51.a)

20. (C) Sovereign.

Explanation

Many national governments use auctions to issue sovereign bonds. Corporate bonds are typically issued in an underwriting or private placement process while municipal bonds are typically issued in a negotiated or underwritten process.

(Module 51.1, LOS 51.c)

21. (C) relatively illiquid.

Explanation

The spread between the bid and ask prices is one-half percent of par, which most likely reflects an illiquid market for this bond. Bonds with liquid secondary markets typically have bid-ask spreads of approximately 10 to 12 basis points.

(Module 51.1, LOS 51.c)