INTRODUCTION TO BOND TRADING

Capademy Tutorial Series

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A bond is an instrument of indebtedness of the bond issuer to the holders. It is a debt investment in which an investor loans money to an entity (corporate or governmental) that borrows the funds for a defined period of time at a fixed interest rate.

Bonds are used by companies, municipalities, states and U.S. and foreign governments to finance a variety of projects and activities.

Most of the daily trading volume in the cash market for bonds takes place between broker-dealers and large institutions in a decentralized, over-the-counter (OTC) market. Bond Futures and options are often traded on financial exchanges and can also be traded on OTC markets, by individuals and institutions alike.

The main bond products are government bonds - US treasury bonds, German Bunds and Schatz, Japanese Government Bonds, UK Gilts and some other government bonds. However, a small number of bonds, primarily corporate, are also listed on exchanges.

Companies and governments issue bonds to finance their day to day operations or finance specific projects. In exchange, the borrower promises to pay you interest every year and to return your principal at "maturity," when the loan comes due, or at "call" if the bond is of the type that can be called earlier than its maturity. The length of time to maturity is called the "term."

A bond's face value, or price at issue, is known as its "par value." Its interest payment is known as its "coupon." The prices of bonds fluctuate throughout the trading day as, of course, do their yields (coupon rate/price = yield).But the coupon payments stay the same.

The majority of cash bond trading is done through institutions. As an example, a client of a brokerage may ask them to buy them a bond. The brokerage would then call an institution such as broker-dealer or an investment bank or some other qualified dealer in such instruments, and tell them they had an order for XYZ bond. This institution would either look for that bond from another institution or they may have this bond in their own bond inventory.

A price would be quoted for that particular bond and the investor would then choose whether or not they wanted the bond at the quoted price. Depending on the number of bonds being bought, sometimes the price can be negotiated.

On the other hand, if the client came to the broker asking to sell a bond, the same process would be followed in reverse. The broker would call an institution and tell them they had an XYZ bond to sell and they would either buy it for their own inventory or contact other institutions to see if someone else wanted to buy the bond. Then, the broker/their client would be quoted a price they would receive for selling the bond.

The above mentioned detailed process of transacting in bonds applies to the buying in cash/selling for cash of bonds.

The trading of bond futures and options is a highly simplified process, where no actual delivery of cash/bonds is mandated, and it rarely ever occurs. Instead, the transacting parties place a security deposit (premium in the case of options), each, at the financial exchange/clearinghouse, which facilitates the trade. After the trade has been closed out, the facilitator credits/debits each account with the relevant profit/loss on the transaction net of all commissions and charges.

Bonds are often called “fixed income” investments because the amount of money you receive and the dates on which you receive payments are specified in advance, or “fixed.” They are regarded as having less risk than stocks.

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