CHAPTER 1: FIXED INCOME VALUATION

LESSON 2: PRICE VOLATILITY

Question 1

Brian Kormack and Andrea Fitch, candidates in the CFA Level 1 exam, are discussing the valuation of a 5.8% annual pay corporate bond with a face value of €1,000 and 15 years to maturity. The bond is trading at par.

Kormack makes the following statement: the market currently requires a 5.8% return on the bond. If required returns were to increase by 50 bps, the bond price would drop by €47.62. Fitch adds: in that case, a 50 bps fall in the required rate of return would cause the bond price to increase to €1,047.62.

With respect to the statements made by Kormack and Fitch:

A Both Kormack and Fitch are correct.

B Kormack is correct with regard to the change in the bond price given a 50 bps increase in the rate of return but incorrect with regard to the returns currently required by investors.

C Fitch is correct with regard to the direction of the price change but incorrect with regard to the new price level.

The following information relates to questions 2 and 3

The following information is available for three annual-pay coupon bonds:

Bond	Coupon	Maturity
X	5%	4 years
Y	8%	4 years
Z	8%	8 years

The required market rate of return on all three bonds is currently 4%.

Question 2

Relative to bond X, given a 250 basis point increase in the rate of return required by market participants, bond Y will most likely experience a(n):

A lower percentage price change.

B greater percentage price change.

C equal percentage price change.

Question 3

Relative to bond Z, given a 250 basis point decrease in the rate of return required by market participants, bond Y will most likely experience a(n):

A lower percentage price change.

B greater percentage price change.

C equal percentage price change.