Chapter 7 Summary

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A bond is a form of fixed income security that pays a regular income to its holder. It is a form of loan granted by the holder to its issuer. In this type of loan, the lender can take money back by selling the bond to some other party. The two key kinds of bonds are coupon bonds and zero-coupon bonds. The annual payment of interest made to the bondholder till the date its maturity is generally referred as coupons, defined by the rate of coupon. There is a difference amongst a regular coupon bond and a zero-coupon bond, the first one pays regular coupon payments to its holders while the second does not pay regular interest payments.

The zero-coupon bondholders only obtain the stated value of the bond when it touches maturity, on the other hand, holders of a regular bond get stated value in addition to the coupon payments that they receive over the life of the bond. The holders of the zero-coupon bonds generally pay a price less than the face value and receive face value at the end and the difference of both the values is the earning of the bondholder. The rate of zero-coupon bond grows the price to the face value until maturity, and these bonds can be short-term and long-term as well. On the other hand, the regular coupon bonds have the following features. Such as they can be convertible i.e. the face value can be converted to the common shares, allows early redemption of the bond and may have a variable coupon.

Bond yields are affected by many factors such as real interest rates, default risk, liquidity, inflation and maturity preference. The Expectation theory tells that the yield on bonds is determined by an expectation of monetary policy and the rate of inflation. According to the maturity preference theory also known as liquidity preference theory, the bond investors favor shorter maturities and issuers have to pay higher interest rates to compensate for this preference.