How are Bonds Priced?

When evaluating a bond's price, investors must consider several influencing factors. The relationship between bond prices and yields is foundational, maintaining an inverse relationship. As yields fall, the price of outstanding bond issues will rise (and vice versa).

Bond Pricing

One of the most common methods to pricing a bond is to discount future cash flows to the present, which include both the periodic interest payments and the principal repayment at maturity. Quite simply, this formula determines today's equivalent value of an income stream to be paid at future dates.

Yield spreads

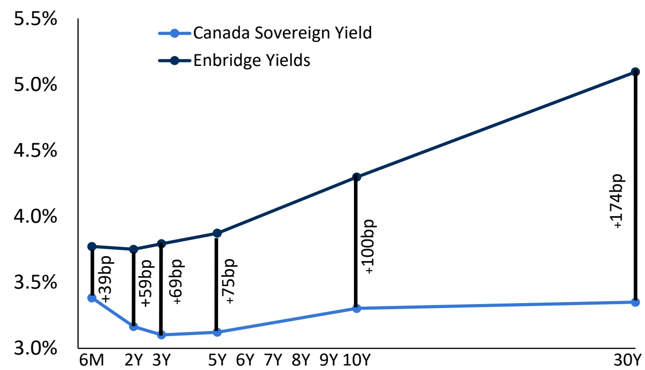
Yields to different maturities are influenced differently; short-end yields tend to more closely follow interest rates, whereas longer-dated securities build in a number of additional assumptions. These extra factors shape the benchmark curve (usually made up of low to no risk assets like sovereign bonds).

A bond's yield in relation to the yield of its benchmark is referred to as the spread. In the fixed-income market, especially between traders and institutional investors, bonds are frequently described based on their yield and spread rather than their nominal price. The price is then derived from the yield. This yield spread serves as a critical mechanism for both pricing and comparative analysis among bonds of similar characteristics and maturities.

For instance, if a bond is quoted as being 113 basis points (bps) above the benchmark, this indicates that it yields 1.13% more than the benchmark bond. The spread provides investors with a clear metric to evaluate the relative attractiveness of different bonds. For example, a wider spread may suggest that a bond is undervalued relative to its peers, presenting an opportunity for enhanced yield. Conversely, a narrower spread could indicate that a bond is overvalued.

The spread can also reflect broader market sentiment and/or perceived creditworthiness of the bond's issuer. A significant increase in a bond's spread may signal heightened risk perceptions among investors, prompting them to demand a higher yield for taking on additional credit risk. Conversely, a tightening spread may indicate improved confidence in the issuer's creditworthiness. Thus, it is important to determine why a security is yielding more than a comparative name, especially if the difference is wide or has changed meaningfully in a short period of time.

Corporate Bonds Trade at a Spread Over the Benchmark



Source: FactSet; Raymond James Ltd.; Data as of November 18, 2024.

Special Features

Bonds may also carry unique features, such as call options, or may be backed by an asset. Terms of a bond can often alter its relative attractiveness and should also be considered when pricing a fixed income investment.

An understanding of the key contributors to a bond's price is essential for successful fixed-income investing. By comprehending the relationships between interest rates, cash flows, and the influence of market dynamics, investors are better informed to make decisions that align with their financial goals.