Monthly analysis – July

Let's price in the 15/B!

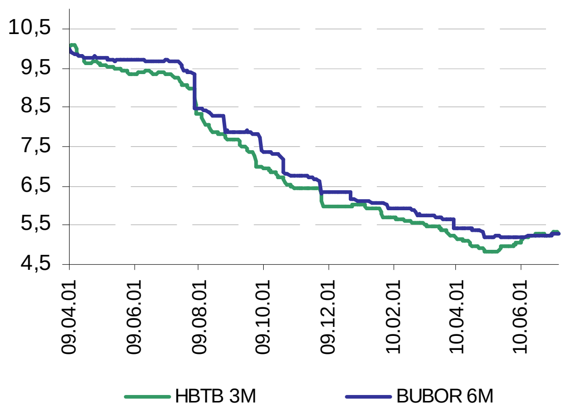
The result of the 15/B auction on 1 July took some market players by surprise. Previously the bond, which pays variable interest twice yearly and matures in 2015, was typically quoted at a price of above 99; indeed, the average price was around 100 at the first auction in March. However, at the latest issue the average price was only 98.06, while the lowest accepted offer was 95.5. The difference between the average price and the lowest accepted offer was unusually large, as was the discrepancy compared with the result of the previous auction.

The time has come for us to price in this bond properly!

One of the most useful methods for characterizing floating-rate bonds is the discount margin, which is the numerical expression of the expected premium above fixing. Generally we do not need to calculate the rate of conversion between the price and the discount margin as Bloomberg or Reuters does it for us, but in this instance we need to solve the problem without their help as neither service provider has a 15/B yield calculator. For this reason, we determine what discount factor is implied by the market price taking the most recently fixed coupon at the time of the next payment into account. If we compare the discount factor to the coupon, we get the value of the premium above the priced-in fixing (here the average of the last three 3-month Discount Treasury Bill / DTB auctions).

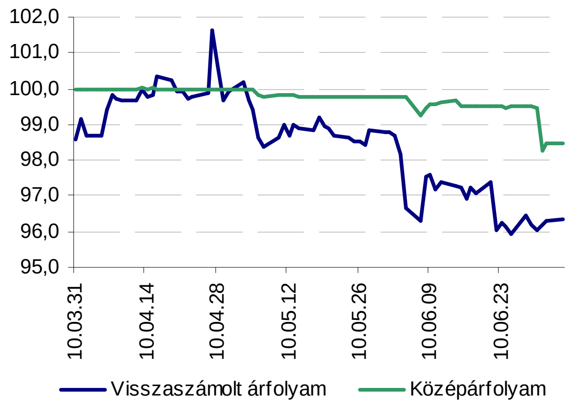
How great might this expected premium be in the case of 15/B? We're looking for a premium whose value we know, where a close correlation with the expected 15/B premium can be assumed. As regards the term to maturity, 16/C is closest to 15/B. In order to be able to compare bonds of variable and fixed interest, we use a 5-year swap in place of the fixed 16/C payments. The analogy works quite well as with the 16/C + interest swap combination we get a cash-flow that pays variable interest twice yearly until around the end of 2015. The comparison is nevertheless imperfect for two reasons: on the one hand, 16/C pays interest annually, while 15/B pays every six months; and on the other hand, the value of the asset-swap premium is to be understood as being above the 6-month BUBOR, and not tied to the result of the 3-month DTB auction.

Average of last three 3-month auctions and the 6-month BUBOR



Source: Bloomberg

Subscribed and back-calculated price of 15/B



Source: AEGON Global Asset Management / AAM CEE

These two distinctions are not really important, however. Examining a longer period (from 1 April 2009), the correlation between the average of the 3-month DKJ auctions and the 6-month BUBOR is higher than 0.99, while the average deviation is 26 basis points. The average difference from 1 June 2010 is only 0.2 basis points, so that the distortion due to the discrepancy between fixings at the time of the auction is only small. For this reason, the price determined on the basis of the 16/C asset swap premium above BUBOR can be regarded as authoritative when evaluating 15/B. Given that the margin between BUBOR and DKJ is positive, this method actually slightly overestimates the real price of 15/B.

Disregarding a number of outlier values since the bond’s issue, the fair price back-calculated using the method described above is significantly lower than the market price, which was quoted for a long time at close to face value following the first issue. If the price of a security paying variable interest matches the face value, this means that its yield matches the value of the coupon. The discount margin is then zero and contains no maturity, illiquidity or non-payment premium, which in the case of fixed securities is reflected in the asset-swap margin. The market has thus priced the bond more or less as if it were a security with a six-month term to maturity, and not as a five-year instrument with a six-month interest risk.

If we look upon the bond in this way, then its realistic value on the date of the most recent auction may have been around 96, below the average auction price and only a little above the lowest accepted offer. The result of the auction could not, then, have come as any great surprise. And although the price quotation has since slipped lower, we would not gladly buy 15/B even at the current level.

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