4.9: Key Takeaways

Key Takeaways

Valuation is a fundamental concept in finance that is based on the present value of the future cash flows which a security will generate. Because of their structure, a fixed cash flow stream over a finite time horizon, bonds provide a reasonably straightforward security in which to initially apply valuation analysis. As demonstrated above, the value of a bond moves inversely to the market rate of interest so that as interest rates fall, bond prices rise and vice-versa. Also, given the current price of a bond, the expected return of that bond, either the yield-to-maturity or yield-to-call, can be calculated. The required return on bonds is a primarily a function of anticipated inflation over the life of the bond and the risk of the bond. The primary risk factor is default risk which is approximated through bond ratings.