Zero Coupon Bonds

By: Rolando D. Esguerra

The latest buzzword in the local financial circles, made popular during the confirmation hearings of Finance Secretary Lito Camacho is zero coupon bonds. In the extravaganza that followed all the related hearings, the man on the street may now be asking: “What on earth are zero coupon bonds? How different are they from the usual bonds we read or hear about?”

With the now-confirmed Finance Chief’s announcement that government will continue to issue new long-term zero coupons in the coming months, we need to understand this instrument better.

First, let us deal with bond basics. Think of a bond in the context of a loan we need to borrow to put up a business, to buy a car, or a house. Governments and large corporations also need to borrow for a wide range of reasons, except that government and giant corporations, unlike you and me, find it difficult to borrow their huge funding needs from the banking system. To solve this, government and large corporations issue bonds to the general public, where thousands lend capital to the issuer (the government or the giant corporation), until the desired amount is raised.

As in borrowing money from a bank, bonds are obligations of the issuer to the lender, and must carry a pre-specified period of time of repayment, or maturity date, usually from 10-30 years.

As in loans, a bonded debt is not usually free. The borrower must pay a pre-stated premium or “coupon” in exchange for using the money, at a pre-determined interest rate, usually paid every three or six months, until the bond matures.

It is in this interest, or coupon feature, that zero coupon bonds differ from ordinary bonds, and it is this feature that has to be better understood.

When investing in a conventional bond being issued for the first time, the investor usually pays up front an amount equal to the face value of his investment. As long as he owns the bond, he receives regular interest payments and then collects his initial investment when the bond matures.

Thus, an investor buying a 10-year conventional bond with a face amount of P 100,000 and a coupon rate of 6% per annum paid semi-annually, pays out P 100,000 on investment date, and receives P 3,000 for each of next 20 semi-annual periods, plus his original investments of P 100,000 at the end of 10 years. In this example, his yield on the bond is equal to the coupon rate of 6%.

However, the some bondholder may want to get a better yield, say, 7% on a bond that carries a coupon rate of 6%. In which case, he will have to buy the bond at a discount such that his yield-to-maturity is 7%, or 1% more than the bond’s coupon rate.
On the other hand, when he buys a “zero” or “stripped” bond, the investor pays at a discount from the face value and the issuer makes no interest payments during the life of the security. On maturity, the issuer pays the investor the face amount of the bond. Unlike a coupon bond investor then, an investor in zeros gets no stream of regular cash flows, and gets to recover his face value on maturity.

In this case, the same investor investing into a 10-year zero coupon bond, will pay P 55,800 for a bond with a face value of P100,000. When the bond matures, he receives the full face amount of P100,000, the P 44,200 difference is equal to his accumulated compound interest, calculated on the basis of 6% rate of return on his initial P55,800.

Since the bonds are sold at a discount to their face value, the investor also benefits from having to shell out a lower amount up front, an advantage to those who have more modest amounts to invest.

But while a lower upfront investment provides the investor the advantage over coupon bonds, contemplating an investment in zero coupon bonds in one’s portfolio deserves a good second look. Yields on zero involve greater analysis in order to account for the absence of individual regular cash flows associated with regular coupon bonds. Coupon bonds give you regular income, and you can further reinvest these regular cash flows if you wish. With zeros there is no regular cash flow to re-invest.

Devoid of this opportunity to manage reinvestment risk in the case of zeros, then it follows that investing in the latter instrument, especially for as long as 20-30 years, is a trickier, and certainly, riskier proposition. At the very least, because they don’t pay interest until maturity, their prices are more likely to fluctuate if they have to be resold to other investors.

This should be something to watch and confirm as more of these zeros are issued in the coming months.

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