

Fixed Income Securities: Tools for Today's Markets

By Bruce Tuckman, Angel Serrat

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Fixed income practitioners need to understand the conceptual frameworks of their field; to master its quantitative tool-kit; and to be well-versed in its cash-flow and pricing conventions. *Fixed Income Securities, Third Edition* by Bruce Tuckman and Angel Serrat is designed to balance these three objectives. The book presents theory without unnecessary abstraction; quantitative techniques with a minimum of mathematics; and conventions at a useful level of detail.

The book begins with an overview of global fixed income markets and continues with the fundamentals, namely, arbitrage pricing, interest rates, risk metrics, and term structure models to price contingent claims. Subsequent chapters cover individual markets and securities: repo, rate and bond forwards and futures, interest rate and basis swaps, credit markets, fixed income options, and mortgage-backed-securities.

Fixed Income Securities, Third Edition is full of examples, applications, and case studies. Practically every quantitative concept is illustrated through real market data. This practice-oriented approach makes the book particularly useful for the working professional.

This third edition is a considerable revision and expansion of the second. Most examples have been updated. The chapters on fixed income options and mortgage-backed securities have been considerably expanded to include a broader range of securities and valuation methodologies. Also, three new chapters have been added: the global overview of fixed income markets; a chapter on corporate bonds and credit default swaps; and a chapter on discounting with bases, which is the foundation for the relatively recent practice of discounting swap cash flows with curves based on money market rates.

This university edition includes problems which students can use to test and enhance their understanding of the text.

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Editorial Review

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From the Authors: Five Ways to Deepen Your Knowledge of Fixed Income Markets in the Wake of the Financial Crisis
By Bruce Tuckman and Angel Serrat

1. **Get to know the 'big picture' of markets and institutions.** When markets are calm, you can get away with focusing on your products, your markets, and your customers or trading partners. During a crisis, however, everyone and everything reacts to the same macro forces. To take one example from the '07-'09 crisis, the deterioration of the housing market put stress on structured mortgage products and on the balance sheets of financial institutions, which, in turn, led to the collapse of a seemingly unrelated market, namely that for municipal auction rate securities. Weakened financial institutions were not in a position to support the auctions, which were failing as investors abandoned nearly all short-term investments in structured products.

2. **Understand financing.** Financial businesses lose money by bets on some market going bad, but they most often fail because they lose their financing. For example, at the start of the financial crisis, many hedge funds that invested exclusively in mortgage-backed securities on a levered basis were forced to unwind and cease operations. This was in part due to portfolio losses, but mostly due to depletion of capital from having to post more and more collateral in support of their borrowing. An even more important example, of course, was the threat to broker-dealers during the crisis, whose repo and commercial paper funding evaporated.

3. **Be aware of money market spreads, basis swaps, and credit risk.** Perhaps the single most telling icon of the financial crisis is the graph of the three-month LIBOR-OIS spread. This spread, which can be thought of as the cost of locking up funds for three months relative to borrowing at the overnight fed funds rate, became a key metric of financial stress during the crisis. From 2005 to 2007, the average of the USD and EUR LIBOR-OIS spreads were about eight and six basis points, respectively; at the height of the crisis, these spreads peaked at about 365 and 200 basis points, respectively. Of course, locking in the fed funds rate plus the LIBOR-OIS spread is achieved by borrowing at LIBOR and paying LIBOR vs. OIS in a basis swap. More broadly speaking, this all means that credit risk, even at short maturities and even for historically solid counterparties, can no longer be assumed away.

4. **Learn how the practice of discounting has changed.** Until relatively recently, the cash flows of swaps were discounted at rates derived from par swap rates. This was never a perfectly sound methodology in theory, but so long as LIBOR was not too different from the cost of funding, the methodology was good enough. During the crisis, however, when LIBOR rose way above the cost of funding, discounting at par swap rates gave significantly misleading results. As a result, the most sophisticated practitioners completed their conversion to a two-curve pricing methodology, and, in June 2010, LCH Clearnet converted to OIS discounting.

5. **Follow regulatory changes to derivatives markets.** The Dodd-Frank law and other regulatory initiatives

set out to require that certain swaps be cleared and that others be subject to new rules and capital requirements. Despite the significant passage of time, however, many of the details of the new regulatory regime, including the criteria for mandated clearing and the extent of capital requirements for non-cleared swaps, remain in flux. As a result, significant uncertainties exist with respect to the costs of using and of making markets in swaps.

Fixed Income Securities: Tools for Today's Markets, Third Edition, was revised, among other reasons, to discuss these and other issues that have assumed greater importance as a result of the financial crisis.

From the Back Cover

Praise For *Fixed Income Securities*

"*Fixed Income Securities* is excellent, seamlessly combining theory and experience to make the global fixed-income markets come alive for students and practitioners. It is obvious that the authors not only understand and articulate theory with ease, but also enjoy its application to myriad simple and complicated instruments."
—**Myron Scholes**, 1997 Nobel Laureate in Economics; **Frank E. Buck**, Professor of Finance, Emeritus, Graduate School of Business, Stanford University

"It takes authors who have both insight into financial economics and a thorough understanding of how markets function to write a book that integrates theory and practice so effortlessly. As market turmoil forces us to revisit historical relationships, the book's setting of applications and data in the context of sound theory is particularly useful."
—**Ravi Mattu**, Managing Director and Head of Analytics, PIMCO

"*Fixed Income Securities* conveys intuition, is full of examples, and is comprehensive in its coverage. Professionals will find valuable insights in the authors' treatment of advanced topics; students will value the careful organization and presentation of ideas. I recommend it very highly indeed.
—**Krishna Ramaswamy**, Edward Hopkinson, Jr., Professor of Investment Banking, The Wharton School, University of Pennsylvania

"This is a great reference book for fixed income students and practitioners alike, which seamlessly combines mathematical concepts with practical applications."
—**Kostas Pantazopoulos**, Global Head of Interest Rate Products, Goldman Sachs

About the Author

Bruce Tuckman holds a PhD in economics from MIT and began his career as a professor of finance at New York University's Stern School of Business. Moving to the industry, he became a managing director at Salomon Brothers' Fixed Income Proprietary Trading Group; ran research groups at Credit Suisse and Lehman Brothers; and, for the Prime Services Division at Barclays Capital, was global head of research and an executive committee member. He is now the Director of Financial Markets Research at the Center for Financial Stability, a think tank in New York.

Angel Serrat holds a PhD in finance from MIT. Prior to joining the industry, he was a member of the finance faculty at The University of Chicago's Graduate School of Business. He has published in journals including The Review of Economic Studies, The Review of Financial Studies, and Econometrica. He was an executive director of strategy groups at Goldman Sachs and Credit Suisse, and later became a managing director at JPMorgan's global proprietary positioning business as a portfolio manager and head of strategy. He is currently a partner at Capula Investment Management, a fixed income asset management firm.

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