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|---------|-----------|--------|
| Index: | 23,516.26 | 9.420% |
| Cap: | N5.34trn | 9.42% |
| Volume: | 1.46 bn | -6.4% |
| Value: | N10.41 | -9.47% |



I never hesitate to tell a man that I am bullish or bearish. But I do not tell people to buy or sell any particular stock. In a bear market all stocks go down and in a bull market they go up – Jesse Livermore

Zero Coupon Bonds: What are they?

When you think of bonds, the first thing that comes to your mind is the interest that they pay. One common term among bond investors is "coupon" which refers to interest paid on bonds. However, not all bonds pay interest. The most well known non-interest bearing bond is the Zero Coupon Bond (also known as zeros).

The "zero coupons" means "no interest". Zero coupon bonds do not pay interest to the investor while they are maturing. The interest accrues and the value of the bond increases. The investor can then sell it for the face value once it matures.

In essence, Zero coupon bonds or zeros don't make regular interest payments like other bonds do. Investors receive all the interest in one lump sum when the bond matures.

Another distinguishing factor of Zeros is that it is sold at a deep discount to its face value, and matures at its face value. This means that the bond is sold to investors at a price much lower than the face or par value. For instance, a Zero Coupon Bond having N10,000 as face value worth could be sold to investors at N7,500 or less depending on the tenor and expected yield rate. By implication, the amount at which the bond is sold today represents the net present value which would yield the face value of the bond at a future date when it matures. Hence, investors would pay less (discounted value) today for the bond that would worth more (Par value) at maturity. The difference between the discounted value and the par value becomes what investors earn as return on their investment. When a zero is purchased, the investor is promised a fixed rate of return for the life of security called the yield to maturity. If the investor holds the zero until maturity, the investor receives the maturity (face) value.

Zero coupon bonds are issued by municipalities, the federal government, and corporations. Like with all bonds, they issue these so that investors can loan them money for immediate use and the investors are then later repaid. The amount loaned is called the "principal."

In Nigeria, the Federal Government Treasury Bills are offered as discounted instruments. They are similar to zero-coupon bonds in that the payment of interest is not received before maturity. Instead, the T-Bills are marketed at a discount on the face value in order to produce a yield to maturity.

For example, a N10,000 Treasury bill can be bought at N9,300 and redeemed for its full value after a specified time, usually 90 days. Treasury bills are auctioned by the Central Bank.

Also, the bulk of the debt raised to finance the Tinapa Business Resort in Cross River State was by way of zero-coupon bonds guaranteed by the Federal Government of Nigeria.

Factors Influencing Price of Zeros

The price of zero Coupon bonds can be influenced by the following factors: quality of the bond, the length of time to maturity,

State Bonds Issued in the last 10 years

| Year | Amount | State | Purpose |
|------|--------|-------------|---|
| 1999 | N1bn | Edo | Housing |
| 2000 | N3.5bn | Delta | Various Projects |
| 2001 | N2.5bn | Yobe | Various Projects |
| 2002 | N4bn | Ekiti | Various Projects |
| 2002 | N15bn | Lagos | Various Projects |
| 2003 | N4bn | Cross River | Tourism (Obudu Ranch) |
| 2004 | N6bn | Akwa Ibom | Various Projects |
| 2006 | N2.5bn | Kebbi | State University and irrigation project |
| 2008 | N275bn | Lagos | Roads etc |

“Zero coupon bonds also offer investors predictability for the long-term. Though they are volatile investments they still provide a predictable return for investors who want a lump sum of money paid by a specific date.”

the call provision, market interest rate as well as the percentage yield.

According to Esme Faerber in 'All About Bonds and Bond Mutual Funds' the quality of the Zero-coupon bond is important since the return depends on: one, the issuer's ability to redeem the bonds at maturity; and two – the investor's to sell them before maturity at a price higher than the purchase price.

A zero-coupon bondholder has more to lose in the event of default than the holder of a conventional bond. With the latter, the bondholder would have received some

interest payment which could have been reinvested.

The quality of a zero is an assessment of the issuer's ability to pay off the bondholder at maturity. A good quality zero-coupon bond has less risk of default than a speculative, low quality one, hence the need for rating of issuers by reputable rating agencies to determine the quality of bonds issued by them. In Nigeria, Treasury Bills are considered the most risk-free investment.

Also, the price of these bonds is inversely related to the yield and length of time to maturity. For example, while 5-year zero-coupon bond of N1,000 par value would be sold at N644 if the yield was 9% per annum, the same bond would be sold at N744 if the yield is 6% per annum. Likewise, the same bond with a 10-year maturity time would sell for N415 at 9% yield and N554 at 6% yield. This indicates that the higher the time it takes for the bond to mature, the higher the price difference between the discounted value and the face value of the bond.

Advantages

1. Zero coupon bonds offer investors one more way to invest in bonds and they do have advantages. For those who understand them, they provide an excellent way of investing for the long-term.

2. Zero coupon bonds have some really attractive features to them. One is that you buy zero coupon bonds at a deep discount. This means that you pay much less than the bond's par value, the amount it is worth at maturity. As the bond matures, the interest is accrued and the bond increases in value.

3. Zero coupon bonds also offer investors predictability for the long-term. Though they are volatile investments they still provide a predictable return for investors who want a lump sum of money paid by a specific date.

4. Another advantage of zero coupon bonds is that they also benefit whoever issues them. Because they don't pay periodic interest, they allow corporations, municipalities, and the government to continue using the loan amount without having to pay back interest.

5. A zero-coupon bond has the important advantage of being free of reinvestment risk, though the downside is that there is no opportunity to enjoy the effects of a rise in market interest rates. Also, such bonds tend to be very sensitive to changes in interest rates, since there are no coupon payments to reduce the impact of interest rate changes.

Disadvantages

1. Zero coupon bonds also have a few drawbacks. The first big drawback is that they are extremely volatile investments. Interest rates changes can swing the price of the bond in either direction. This means that if you want to sell it before it matures, you are not guaranteed to make a profit. However, if you hold it until maturity, you would not have to worry about this. As with stocks, long-term investing in zero coupon bonds is the best way to go.

2. Another drawback to investing in zeroes is that they are callable. What this means is that the issuer can say that they want to repay the bonds before maturity at a certain percentage rate.

3. Unlike other types of bonds which make periodic interest payments, zero-coupons bonds do not provide a steady flow of income to investors. Instead of making regular interest payments, the value of the bond accrues each year by the interest until the zero matures at face value providing the investor holds the bond until maturity.

4. The current value of a zero before it matures will fluctuate according to fluctuations in the interest rate. The bond value is inversely related to interest rates. This means, as interest rates rise, the value of the bond will fall and as interest rates fall, the value of the bond will increase.

Risks of Zero Coupon Bonds

Zero-Coupon Bonds are subject to risk of default as well as interest rate risks. The risk of default depends on the financial position of the issuer and should be of great importance to the bondholder. This is because the principal and interest is paid back in a single payment at maturity and if the issuer is not able to make a single payment, the bond holder would have lost everything. With regular bonds, the holder would have received some interest payments.

Interest rate risk come to play in that when the market interest rates fall or rise, zero-coupon bonds, like regular bonds, rise or fall. However, the price of zeros tends to be more volatile than conventional bonds.