

MALAYSIAN ASSOCIATION OF ASSET MANAGERS

Uniform Pricing for Debt Securities

- 1 This is version with accepted Tunku Afwida's comments 5 November 2002.
- 2 This is version after accepting Tunku Afwida's edits 1 above and adding my edits.

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Uniform Pricing for Debt Securities

1.Motive for developing the MAAM Bloomberg Bond Page

As a fund manager, when you are confronted by a potential bond investor's (mis) conception that bond prices will never fall, that begs the question for an appropriate method to value debt securities. With a proper method to value debt securities, this will clear the misconception, as bond prices, like share prices move up and down according to the bond market's volatility.

We notice that there are several methods being practiced in the marketplace to value debt securities. One fund manager might choose to value it using the accrual method, one can opt for the cost method and the other can use last done prices. These non-uniform pricing methods have caused confusion for bond investors, as they are unable to ascertain whether they are buying into a fairly valued bond fund.

This leads us to ask: how should the price of debt securities be arrived at? Which price to use: last-done price (which might be three months ago), cost price or accrual basis? These liberal practices prompted MAAM, in 2001, to develop practical and transparent methods of pricing debt securities. MAAM consulted the AIMR- Global Investment Performance (GIPS) for guidance on pricing methods for debt securities in particular. Other sources, which are currently in comment evaluation stages, include the Malaysian Accounting Standards Board Exposure Draft 35 (www.masb.org.my) and the International Accounting Standard Board's Exposure Draft 39 (first exposure and its revision). This article is written from an advocacy stance and reflects the recommendations that MAAM has made to these comment invitations. (MAAM welcomes comments from investors, investment committees and market participants at our website www.maam.org.my)

As a result of comprehensive in-house exposures and comment periods, we wrote “*Guidelines for the Portfolio Valuation of Debt Securities*” in August 2001. This was the first step MAAM took to encourage some form of daily marked-to-market pricing of debt securities for all MAAM members. To further encourage the uniform pricing of debt securities across the whole investment industry, we are working with Bloomberg to develop the MAAM Bloomberg Bond Page, as well as other debt market participants to help expand uniform pricing for all debt securities and encourage bonds as an asset class.

2. Why do we need a uniform pricing method for debt securities?

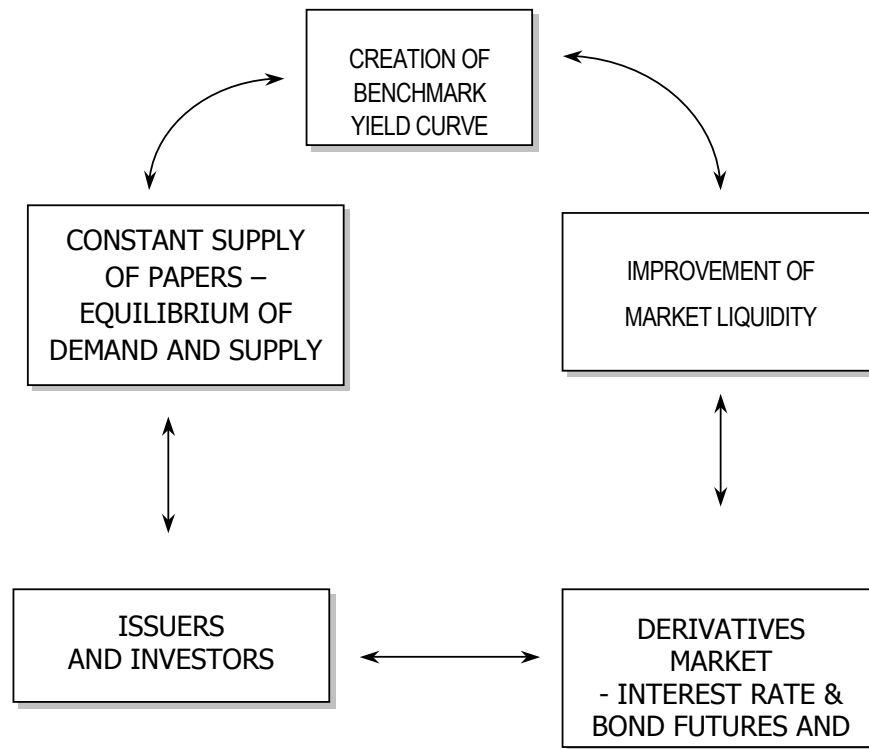
First of all, we have to understand the structure of the Malaysian Debt Capital Markets and how we can help to further develop the market from here.

Development of the debt capital market needs to have the following **ingredients**:

- Demand/supply dynamics in the form of issuers and investors,
- Liquidity,
- Transparent Price Discovery,
- Benchmark Yield Curve,
- Derivatives Market Development.

Without one of the above, the loop will fall apart and may lead to the development of an inefficient debt capital market.

Figure 1 STRUCTURE OF DEBT CAPITAL MARKET



With good market liquidity, prices of bonds will be transparent and readily available to all investors. One will ask, why do we need bond prices to be transparent? With transparent bond prices, debt securities can then be valued more correctly. Uniformity of debt securities valuation will emerge!

Uniform pricing method for debt securities will lead to a more transparent price discovery process, which will in turn make the bond market more efficient. Market liquidity should then improve due to a more efficient bond market. With that, we can then easily price most bonds and the creation of a benchmark yield curve would then be a natural consequence.

3. Needs and benefits for uniform pricing of fixed income instruments

For shares, we use daily closing prices quoted in KLSE to value all shares portfolio. For debt securities, all bonds are quoted over-the-counter and quoting of bond prices can vary from one bank/broker to another. So, how can one be certain of the actual daily closing prices of each bond? On top of that, due to the low market liquidity of bonds, some bonds might not be traded at all for a long period of time. This has led us to initiate the project to ensure that prices of bonds will be made available to fund managers, so that they can value their bond portfolios daily.

The pricing methods for bonds vary across fund managers. It can be either based on last done prices, accrual basis, cost basis, average of bid or ask quotes, some monthly, some as and when, very few daily. This has led to a situation where fund managers' bond portfolio performances cannot be evaluated in the same light due to the non-uniform pricing method. Clients are then unable to assess the true performance of their fund managers, as prices used to value bond portfolios could be different for each fund manager; even though they may be holding the same bonds.

As for bond unit trust funds, investors cannot compare the true performance of bond unit trust funds, as not all these funds are marked-to-market daily. Investors might end up buying a mispriced bond fund, which in actual fact might be lower in terms of unit price on a Net Asset Value (NAV) basis. (All bond fund units are priced on NAV).

Only with a proper pricing method for bonds, can one then measure the performance of fund managers correctly. And, only with a proper pricing method for bonds, can one then safely buy into any bond fund with a correctly priced unit price based on NAV.

4.MAAM methodology in deriving the uniform pricing of debt securities

Currently, as a best practice, we advocate the use of least three bid quotes from financial institutions, brokers or any other reliable sources. The bid quotes are averaged to derive the price for each bond. Why the use of average bid quotes? Due to the low market liquidity for debt securities, bonds should be priced where there is a ready buyer, for example, the readily disposable value, especially to match redemptions (which can be highly unpredictable) in an open-ended bond fund. Later on, with the completion of the Bloomberg Bond project in conjunction with MAAM, all bond prices will be shown in the MAAM Bloomberg Bond page in order that investors can use the uniform price, as a basis, to conduct the daily mark-to-market valuation of debt securities.

5.Description of the MAAM Bloomberg Bond Page

The universe will attempt to cover the majority of bonds in the market. There will be three sub-universes as described below.

- MAAM1 - shows Today's fixings where 3 or more prices are available.
- MAAM2 - shows Today's fixings where two prices are available.
- MAAM3 - shows list of securities based on last done prices

At a later stage, we plan to show in MAAM3, an interpolation of indicative bond prices rather than last done prices. This will enable the MAAM Bloomberg bond page to cover the whole universe.

Below is how one of the pages would look like.

| Send | | Help | | Warning: Function is under test - Not formally released !! | | | | | | Corp | MAAM |
|-----------------------------------------------|-------------|--------------|--------|------------------------------------------------------------|-------|------|-------|--|--|-------------|------|
| 17:37 MALAYSIAN BOND FIXING RATES | | | | | | | | | | PAGE 2 / 10 | |
| DESCRIPTION | RAM RATINGS | MARC RATINGS | PRICE | | YIELD | | TIME | | | | |
| | | | BID | ASK | BID | ASK | | | | | |
| 1) PNHMK 6.85 10/05 | NA | AAid | 106.52 | 107.10 | 4.50 | 4.30 | 17:15 | | | | |
| 2) PNHMK 7.9 10/10 | NA | AAid | 115.35 | 115.35 | 5.50 | 5.50 | 17:15 | | | | |
| 3) ALBKMB 7 ³ / ₄ 06/11 | A3 | NA | 98.84 | 98.84 | 9.51 | 9.51 | 17:15 | | | | |
| 4) PUTRAJ 5 07/04 | NA | AAAid | 102.88 | 103.04 | 3.25 | 3.15 | 17:15 | | | | |
| 5) PUTRAJ 6 ¹ / ₄ 07/08 | NA | AAAid | 109.49 | 110.55 | 4.35 | 4.15 | 17:15 | | | | |
| 6) PUTRAJ 6 ¹ / ₂ 07/09 | NA | AAAid | 110.22 | 111.43 | 4.70 | 4.50 | 17:15 | | | | |
| 7) PUTRAJ 6.6 07/10 | NA | AAAid | 110.12 | 111.82 | 5.00 | 4.75 | 17:15 | | | | |
| 8) PUTRAJ 6 ³ / ₄ 07/11 | NA | AAAid | 111.48 | 111.48 | 5.10 | 5.10 | 17:15 | | | | |
| 9) PUTRAJ 6.85 07/12 | NA | AAAid | 111.23 | 112.85 | 5.35 | 5.15 | 17:15 | | | | |
| 10) SILKMK 0 08/16 | NA | Aid | 26.52 | 26.52 | 9.82 | 9.82 | 17:15 | | | | |
| 11) SILKMK 0 08/17 | NA | Aid | 23.97 | 23.97 | 9.86 | 9.86 | 17:15 | | | | |
| 12) SILKMK 0 08/18 | NA | Aid | 21.65 | 21.65 | 9.89 | 9.89 | 17:15 | | | | |
| 13) SILKMK 0 08/19 | NA | Aid | 19.53 | 19.53 | 9.94 | 9.94 | 17:15 | | | | |
| 14) SILKMK 0 08/20 | NA | Aid | 17.61 | 17.61 | 9.97 | 9.97 | 17:15 | | | | |

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This page is expected to allow Bloomberg subscribers to download all information to spreadsheets to price the bond portfolio. Clients of fund managers could then ask for printed Bloomberg pages, which display prices of the respective bonds in their portfolios.

We hope that with this, all fund managers will be able to use a uniform and consistent source of pricing to value their bond portfolios daily. This exercise will also ensure that performances of bond funds can be evaluated in the same light.

AMMB Asset Management Sdn Bhd, a Member of the Malaysian Association of Asset Managers