EASY INTERMEDIATE HARD

CFA® SAMPLE QUESTION – LEVEL I

Fixed Income

Q: If the volatility of interest rates increases, which of the following will experience the smallest price increase resulting from lower rates?

CORRECT ANSWER:

Ⓒ **Callable bond.**

For a callable bond the issuer has the option to call the bond if the interest rate decreases during its call period.
The underlying logic is: the issuer will call the bond if interest rates have decreased in order to obtain cheaper financing elsewhere.
If the interest rate volatility increases the chance that it is optimal for the issuer to call the bond increases, making the call option more valuable.
Therefore, the bond price is depressed by an increase in interest rate volatility if this is a Callable Bond.

CFA Society Hong Kong
Candidate Services

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