

Quarterly Report No. 1 '04



SWX BONDS

## SWX Bonds Quarterly Report

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Dear Reader

This article is about bondholder value. The purpose of bondholder value is to provide better protection and more transparency for bondholders. The capitalisation of the global bond market amounts to about USD 45 trillion, which is considerably more than all the world's GDPs combined and even exceeds share capitalisation. In investment portfolios, bonds operate as cushions, among other things, by protecting investors from excessive performance drops in times of high volatility on the equity markets. The stability of this protective function of bonds for investment portfolios depends largely on the creditworthiness of bond issuers.

### Bondholder Value

There has been a rapid increase in the securitisation of credit by means of bonds. Securitisation allows banks to offer large-capital seekers an alternative to syndicated loans. The problem, however, is that securitisation involves the breaking-up of the creditor position due to the large number of involved parties (compared to a bank loan). Furthermore, the creditors and their interests remain anonymous. The individual investor is faced with the question of how credit checks, which are associated with agency costs, should be carried out. Neither in theory (textbooks, science) nor in practice (issuers, financial institutions) has there been enough emphasis on the interests of bondholders, which is surprising considering the importance of bondholders and the tremendous volume of the market.

The aggressive and almost mechanical implementation of the shareholder value model in the 1990s gave a substantial, almost uncontrolled boost to efforts to procure outside capital and at the same time caused the interests of other stakeholders to be neglected to a sometimes irresponsible degree. The emphasis was on expected share yields, while too little attention was given to risk. Shareholders were given top priority. A certain recklessness, combined with unbridled optimism, led to economic overcapacity and hence to the recent stock-market slump. Companies which previously had used outside financing to make overpriced acquisitions or carry out risky expansions were severely punished. So were companies that considered it expedient to repay capital to shareholders at the end of the economic cycle.

Various major bond obligors collapsed due to bad strategies, which, on the bond market, resulted in high default rates and extraordinarily low recovery rates for bondholders. Specifically, both the default volume (2002) and the number of bankrupt bond obligors (2001) reached all-time highs. The demand for transparency was met only in part by applicable accounting standards. All this was a clear indication that something had gone wrong.

In principle, shareholder value is based on the possibility that a going concern will continue its activities in perpetuity. Capital increases, for example, are simply not discussed in textbooks on shareholder value. During the Internet hype, shareholders were filled with a mortal fear of capital increases. This is not the case with bondholder value, where professional risk management is of key importance. In principle, capital increases are useful for increasing the survival probability of companies in financially difficult times. They result in added liquidity and hence a stronger own-capital base. Because of this, various banks and insurance companies decided just in time to carry out capital increases during the great slump of 2000 until March 2003 in order to ensure their survival and avoid a systemic crisis.

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### Definition of Bondholder Value®

I

Bond Issuers creating Bondholder Value® reduce or stabilize the default risk through a variety of measures, thus protecting the bondholders.

II

Bond Issuers do not wait until default threatens before they take the necessary precautions to prevent the recovery rate from deteriorating at the bondholders' expense.

III

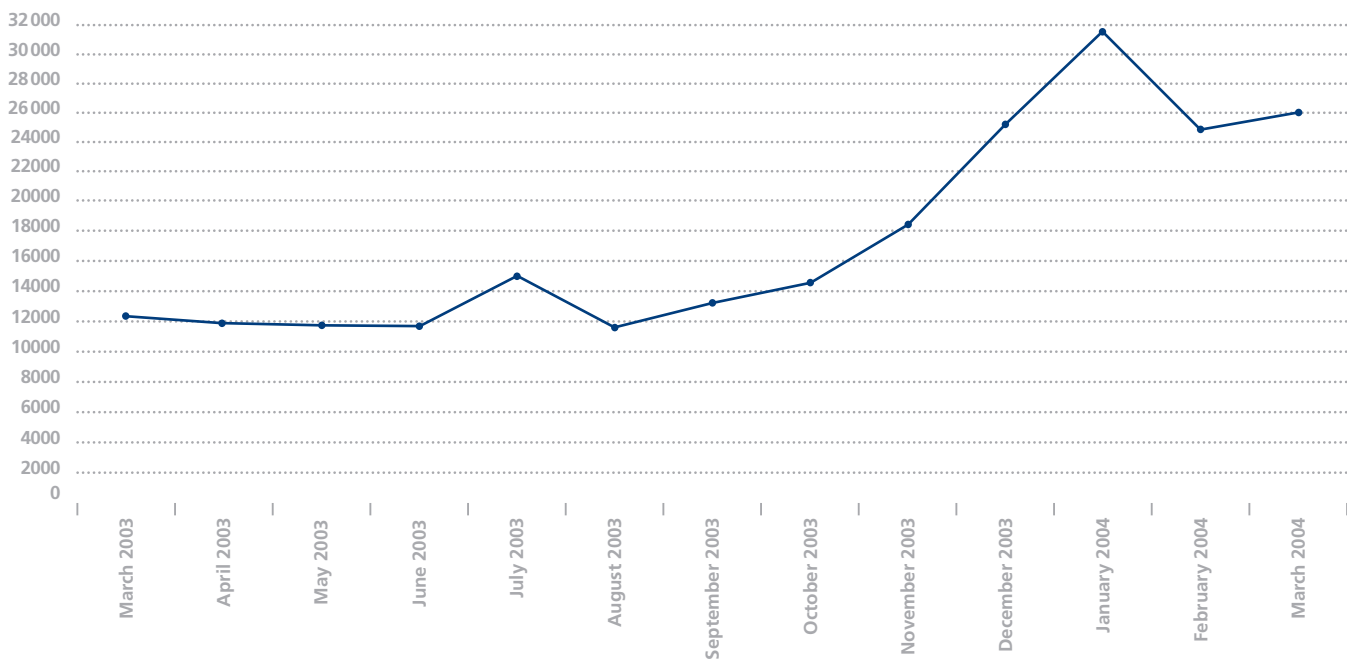
Bond Issuers communicate openly. Information provided to the bondholders is transparent and comprehensive.

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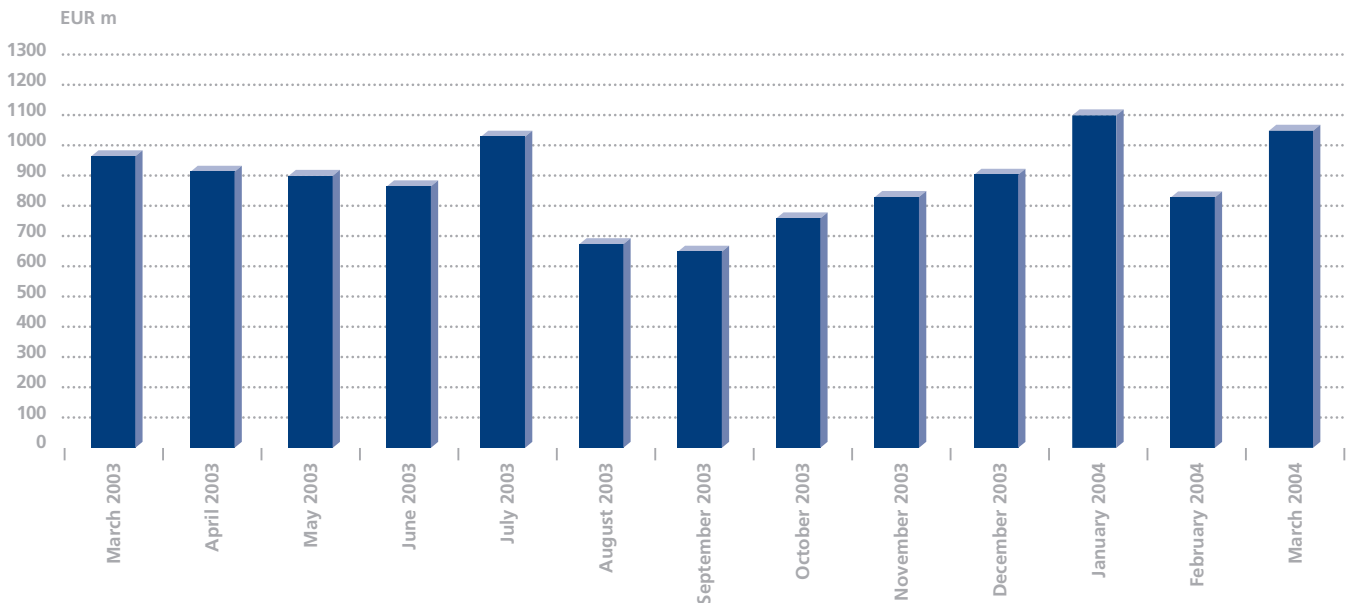
## 1 International Bonds

	Turnover in m								Number of trades								Total
	USD	CAD	AUD	NZD	EUR	GBP	NOK	SEK	USD	CAD	AUD	NZD	EUR	GBP	NOK	SEK	
March '03	777,49				961,24	10,29			4 310				7 607	309			12 226
April '03	646,07				910,59	12,85			3 347				8 000	388			11 735
May '03	689,88				886,90	10,40			3 728				7 654	306			11 688
June '03	626,42				857,45	17,65			3 652				7 324	482			11 458
July '03	792,22				1 047,24	9,04			4 118				9 999	328			14 445
Aug '03	699,58				691,67	10,67			3 702				7 024	345			11 071
Sep '03	539,31	11,21	26,07	17,83	640,16	27,50	165,53		4 004	68	275	106	7 816	704	280		13 253
Oct '03	641,00	18,01	39,22	32,89	772,00	35,55	120,49		4 611	213	424	357	9 297	832	288		16 022
Nov '03	610,78	22,98	22,62	21,43	859,51	37,27	81,34	73,04	4 823	373	430	386	11 800	923	214	110	19 059
Dec '03	713,69	20,17	18,91	20,70	917,04	60,15	61,40	87,00	6 947	377	457	404	14 843	1 932	221	182	25 324
Jan '04	848,36	27,09	30,87	18,87	1 099,71	64,59	169,44	73,12	8 975	414	704	425	17 923	2 186	488	317	31 432
Feb '04	690,51	28,93	24,29	23,98	871,99	55,98	151,40	61,32	7 327	352	477	546	13 238	1 640	457	183	24 220
March '04	673,67	28,12	31,45	22,97	1 058,17	74,97	168,82	99,08	6 666	319	686	486	15 550	2 111	417	218	26 453

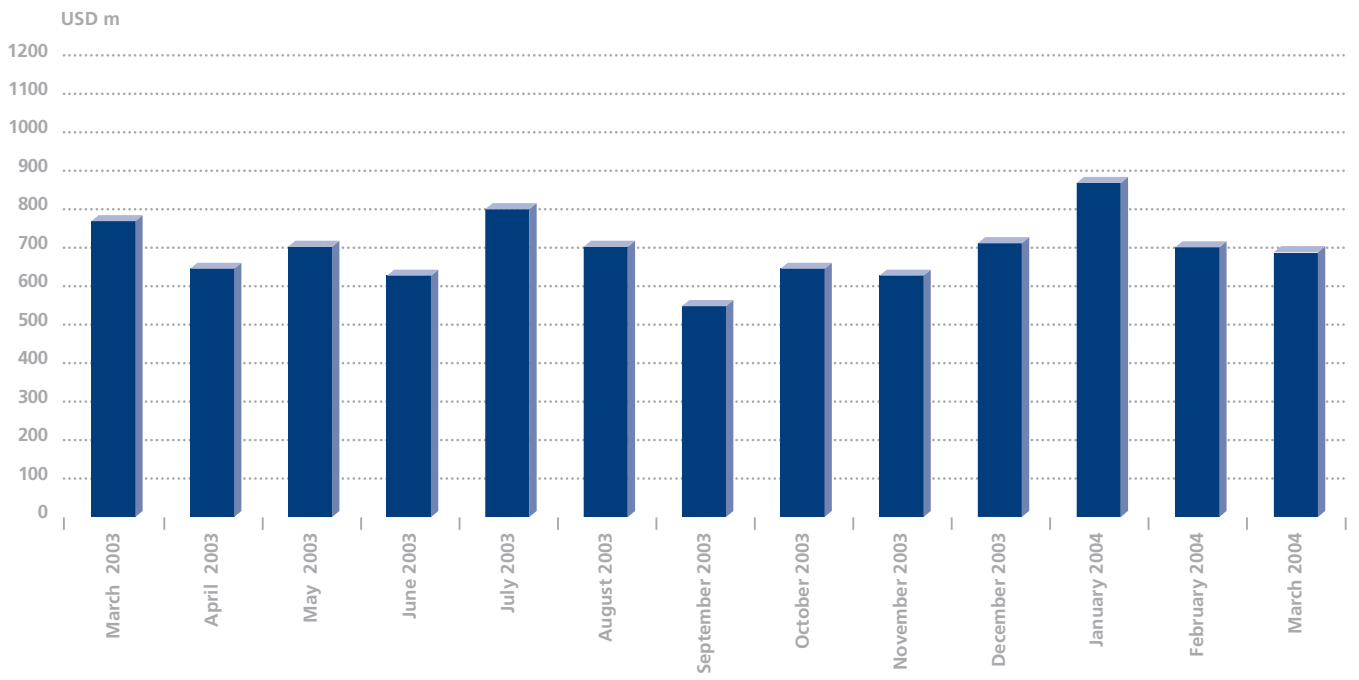
## 2 Trades



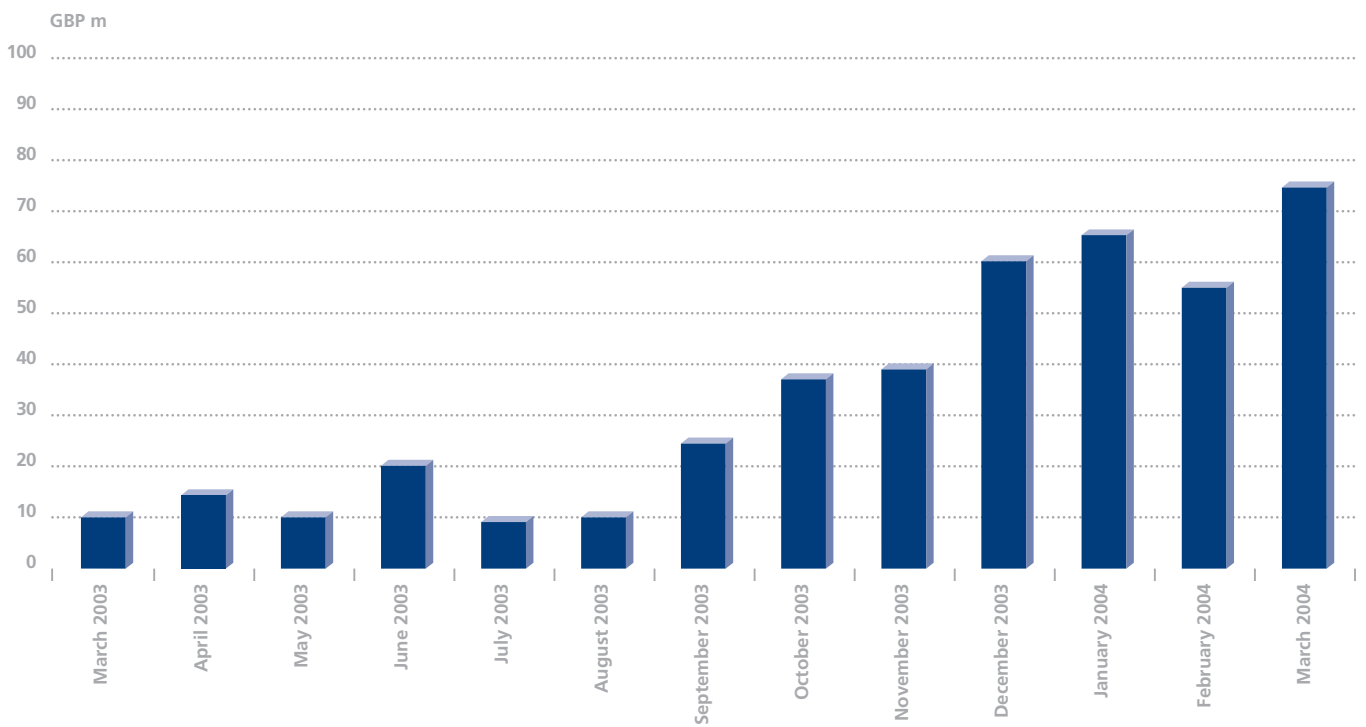
### 2.1 Turnover EUR



## 2.2 Turnover USD



## 2.3 Turnover GBP



It is important to understand that the interests of bondholders are different from those of shareholders – in particular with regard to a number of key issues. The question often arises of whether these two groups of investors do not, in fact, have the same long-term objectives. Ideally, yes – both bondholders and shareholders should be interested in sustainable company development and the involvement of other stakeholders. In practice, the situation is rather more complex. There are often significant informational asymmetries to the disadvantage of bondholders. Managements often have strong incentives to take fairly large risks, due, for example, to significant stock-option plans in connection with compensation packages. As is shown by various concrete examples, there is a risk of putting off insolvency problems. One of the reasons for doing this is that the management has its human capital invested in the debtor. For creditors, this means extremely low recovery rates.

The purpose of the concept of bondholder value is (a) to promote the interests of bondholders, (b) to provide better protection for bondholders and (c) to increase transparency. It acts preventively. Progressive issuers who are interested in having a broad and diversified bondholder base take the three key elements of bondholder value into consideration when drawing up their financing strategies (see definition). Companies that seek close and enduring relationships with their bondholders (bondholder and creditor relations are not, however, PR activities) create stability and a strong basis for acquiring new investors. Bondholder value is of strategic importance and therefore a task that should be taken up by top-level management.

Today's bond obligors have access to expert risk management. The purpose of the concept of bondholder value is not to unnecessarily limit operational freedom and thereby prevent satisfyingly rapid and healthy growth. Professional bondholders, however, will take greater care not to be put at an undue disadvantage compared to shareholders and creditor banks. They will, in fact, bring all their influence to bear in order to prevent this.

Not all issuers are equally viable from the point of view of their bondholders. Corporate business models are subject to ever shorter cycles, management composition is changing at an ever faster rate, and the same applies to the return-risk profiles of bond obligors. The challenge in buying bonds today is not just choosing from among creditors with and without credit ratings. Experienced and emancipated investors

are considerably more selective nowadays because of such negative examples as SAir Group, WorldCom, Enron, Parmalat and Argentina. They react more sensitively and quickly to unexpected events. Large institutional investors have the power to trigger significant price changes. With their voting rights, they can even prevent recapitalisations in the context of restructurings. As was shown very clearly by the recent stock-market slump, the pressure from creditors on management increases almost exponentially the worse off the debtor is. In some cases, therefore, the bondholders even take over the majority of the equities by means of debt-equity swaps in the context of restructurings. Easy access to the capital market and a fair return are of great importance to companies and public organisations. The overall cost of capital can only be optimised when all stakeholders pull in the same direction. The question for issuers, then, is this: how important is it to you to promote the interests of bondholders? The market for bondholder protection and care is enormous, and the first steps have already been taken. For example, the revised OECD version of the "Principles of Corporate Governance" will put more emphasis on bondholders and creditor rights. If you think bonds, you should also think bondholder value.

Gion Reto Capaul, developer of the concept of bondholder value\*, Visual Finance, contact: [mail@visualfinance.ch](mailto:mail@visualfinance.ch)

\*In order to avoid the risk of dilution and prevent wrong interpretations of the concept, we protected the term "bondholder value" under trademark law in 2001. Gion Reto Capaul published a first article on bondholder value as early as 1997. Mr Capaul is a leading bond activist.

## Pfandbriefe via SWX Bonds

Pfandbriefe were admitted to trading on SWX Bonds on 13 April 2004.

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### Data vendors

Real-time prices of SWX Bonds are available on:

**Reuters SWX.CH/Telekurs [ISIN or Valoren#], 4/Bloomberg/Datastream and others**

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