1. The substitution swap is an exchange of one bond for nearly identical substitute.

The substituted bonds should be one of essentially equal coupon, maturity, quality, call features, sinking fund provisions, & so on.

A substitution swap would be motivated by a belief that the market has temporarily mispriced the two bonds, with a discrepancy representing a profit opportunity.

An example of a substitution swap would be a sale of a 20-year maturity, 9% coupon Ford bond callable after five years at $1,050 that is priced to provide a yield to maturity of 9.05% coupled with purchase of a 9% coupon General Motors bond with the same call provision & time to maturity that yields 9.15%.

If the bond have about the same credit rating, there is no apparent reason for the GM bonds to provide a higher yield.

Therefore, the higher yield actually available in the market makes the GM bond seem relatively attractive.

Of course, the equality of credit risk is an important condition. If the GM bond is in fact riskier, then its higher yield does not represent a bargain.

2. The inter-market spread swap is an exchange of two bonds from different sectors of the bond market.

It is pursued when an investor believes the yield spread between two sectors of the bond market is temporarily out of line.

For example, if the yield spread between 10-year Treasury bond & 10-year Baa-rated corporate bonds is now 3%, & the historical spread has been only 2%, an investor might consider selling holding of Treasury bonds & replacing them with corporate.

If the yield spread eventually narrows, the Baa-rated corporate bond will outperform the Treasury bonds.

Of course, the investor must consider carefully whether there is good reason that the yield spread seems out of alignment.

For example, the default premium on corporate bonds might have increased because the market is expecting a severe recession. In this case, the wider spread would not represent attractive pricing of corporate relative to Treasuries, but would simply be an adjustment for a perceived increase in credit risk.

3. The rate anticipation swap is an exchange of bonds with different maturities.

It is pegged to interest rate forecasting.

Investors who believe rates will fall will swap into bonds of longer duration.

For example, the investor might sell a five-year maturity Treasury bond, replacing it with 25-year maturity Treasury bond.

The new bond has the same lack of credit risk as the old one, but it has longer duration.

4. The pure yield pickup swap is an exchange of a shorter duration bond for a longer duration bond.

This swap is pursued not in response to perceived mispricing but as a means of increasing return by holding higher yielding, longer maturity bonds.

The investor is willing to bear the interest rate risk this strategy entails.

A yield pickup swap can be illustrated using the Treasury bond listings in Figure 9.1 from the last chapter.

You can see from that table that a Treasury note maturing in February 2010 yields 4.53%, while one maturing in February 2029 yields 5.59%.

The investor who swaps the shorter term bond for the longer one will earn a higher rate of return as long as the yield curve does not shift upward during the holding period. Of course, if it does, the longer duration bond will suffer a greater capital loss.
5. We can add a fifth swap, called a **tax swap** to this list. This simply refers to a swap to exploit some tax advantage.

For example, an investor may swap from one bond that has decreased in price to another similar bond if realization of capital losses is advantageous for tax purpose.