The Journal of
FIXED INCOME

VOLUME 14, NUMBER 2   SEPTEMBER 2004

In the summer of 2003, the fixed income markets were extremely volatile. Much of this volatility was exacerbated by mortgage related hedging activity. Since rates have declined significantly this summer, we begin this issue of *The Journal of Fixed Income* with an article by Goodman and Ho on measuring the mortgage market's convexity needs. They examine the demand over time by investors, servicers, and originators and demonstrate the increase in convexity hedging. In the next article, Professor Rendleman considers the effect of the delivery option on the price of Treasury bond and note futures contracts. He shows that the proper hedging quantity may differ significantly from a more standard duration–based quantity that ignores the option to switch delivery to a more optimal bond.

A methodology for constructing an optimal portfolio of fixed income managers is put forth in the next article by Frederick Dopfel. The portfolio structure optimizes across managers deviations from benchmark risks in terms of style biases, tactical bets, and security selection alpha. Then a choice among efficient portfolios of managers is made.

In the next article, Lucas, Goodman, and Fabozzi scrutinize the rating agency methodologies for estimating default rates on structured finance products (e.g., asset-backed securities, commercial mortgage-backed securities, and residential mortgage-backed securities) and compare them to that of corporate debt. They also emphasize the importance of estimating future default rates rather than past default rates. Next, Hamilton and Cantor demonstrate that past credit rating actions and current rating outlooks are systematically related to the future probability of a rating change or default. However, rating outlook is a nearly sufficient statistic of rating transition probability, but rating history may matter for some categories when predicting default.

Next, Professors Liu and Wu tackle the difficult problem of introducing the effect of personal taxes on credit spreads. They show that ignoring the interactive effects of taxes and default results in an underestimation of yield spreads and an upward biased estimate of default probability. Finally, Professors Hong and Warga provide empirical evidence on transactions costs for municipal bond trading. The bid/ask spreads associated with retail-sized trades are generally three to five times as large as institutional trades.

We hope you enjoy this issue of *The Journal of Fixed Income*. Your continued support of the Journal is greatly appreciated.

Stanley J. Kon
Editor