

# **CHAPTER 2**

## **THE DOMESTIC AND INTERNATIONAL FINANCIAL MARKETPLACE**

### **ANSWERS TO QUESTIONS:**

1. The saving-investment cycle consists of net savers (surplus spending units) transferring funds to net investors (deficit spending units). The transfer can be made through either financial middlemen or financial intermediaries. For a given time period, actual savings equals actual investment.
2. Financial middlemen and intermediaries facilitate the transfer of funds during the saving-investment cycle. When financial middlemen aid in the transfer of funds, primary claims are issued to surplus spending units. When financial intermediaries are involved in the funds transfer process, secondary claims are issued to surplus spending units. These secondary claims are normally less risky than the primary claims received by the financial intermediaries.
3. Money markets deal in short-term securities having maturities of approximately one year or less, whereas capital markets deal in longer-term securities having maturities greater than one year. Primary markets are financial markets in which new securities are bought and sold for the first time, whereas secondary markets are financial markets in which existing securities are offered for resale.
4. Financial intermediaries:
  - Commercial banks - Sources of funds are demand and time deposits. Uses of these funds are loans to individuals, businesses (short-term credit and term loans), and governments.
  - Thrift institutions - These include savings and loan associations, mutual savings banks, and credit unions. Sources of funds are demand and time deposits. Savings and loan associations and mutual savings banks invest most of their funds in home mortgages and credit unions are engaged primarily in consumer loans.
  - Investment companies - These include mutual funds and real estate investment trusts (REIT's). Mutual funds pool the funds of many savers and invest in financial assets, such as stocks, bonds, and money market instruments. REIT's invest in commercial and residential real estate.
  - Pension funds - These intermediaries pool the contributions of employees (and/or employers) and invest these funds in both financial and real assets.
  - Insurance companies - Sources of funds are premiums (payments) from individuals and organizations (policyholders). In exchange for these premiums, the insurance companies

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agree to make certain future contractual payments, such as death and disability benefits and compensation for financial losses arising from fire, theft, accident, or illness. The premiums are used to build reserves, which are invested in various types of financial and real assets.

- Finance companies - These intermediaries obtain funds by issuing their own securities and through loans from commercial banks. The funds then are loaned to individuals and businesses.

5. Factors that should be considered when determining the optimal form of organization for a business enterprise include the control desires of owner/managers, the future growth potential and the need for external capital, the possibility of conflicts between owners and managers, the tax consequences of the organizational structure, and the desire for a limited liability exposure by the owners.

6. In primary financial markets, new securities from an issuing firm are bought and sold for the first time. Hence, firms actually raise the capital they need in the primary financial markets. In secondary markets, existing securities are offered for resale. The issuing firm does not receive any new funds when securities trade in a secondary market, such as the New York Exchange. Secondary markets provide an important service of making securities liquid, and thereby the existence of secondary markets lowers the cost of raising funds in the primary markets.

7. The New York Stock Exchange is a physical location where buyers and sellers of securities meet to exchange assets. The New York Stock Exchange works through a specialist system and complex computer linkages that match buyers and sellers and maintain an orderly market. In contrast, the over-the-counter markets are not represented by any physical place of doing business. Rather, brokerage firms around the country are linked together in a computer network which lists the securities that are for sale (or desired for purchase), by whom, and at what price. When an investor wishes to buy or sell stocks over-the-counter, that investor's broker will check the computer network to see what other broker has the desired security for sale, in what quantity, and at what price. When an agreeable match occurs, the security is bought for the investor.

8. In an efficiently functioning capital market, security prices will be bid to a level where the security's expected return just equals its required return. New information about the expected return and risk of a security will be reflected quickly, and in an unbiased fashion, in its price. In an efficient capital market, shareholders can measure the performance of a firm's managers by observing the firm's stock price. Actions that increase a firm's stock price are contributing directly to the goal of maximizing shareholder wealth.

9. It is much easier and cheaper for a firm to raise capital in the marketplace if that marketplace operates in an informationally efficient manner. When the capital markets are informationally efficient, all relevant information regarding the prospects of a firm's securities is reflected in the price of those securities. Investors can buy securities with the comfort of knowing that these securities are likely to be "fairly" priced, given their risk and return characteristics.

10. a. *A multinational corporation* is a firm that has investments in manufacturing and/or

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distribution facilities in more than one country.

- b. The *spot exchange rate* is the rate of exchange for currencies being bought and sold for immediate delivery.
- c. The *forward exchange rate* is the rate of exchange between currencies to be delivered at a future date, such as 30, 90, or 180 days from today.
- d. A *direct quote* is the home currency price of one unit of a foreign currency. An indirect quote is the foreign currency price of one unit of home currency.
- e. An *option* is a contract or security that gives the option buyer the *right, but not the obligation*, to either buy or sell a fixed amount of another good or security, such as foreign currency, at a fixed price at a time up to, or at, the expiration date of the option..
- f. The *London interbank offer rate (LIBOR)* is the interest rate at which banks in the Eurodollar market lend to each other.
- g. The *Euro* is a composite currency whose value is based on the weighted value of 17 European currencies. On January 1, 2002, the euro replaced the individual currencies of the original 11 member European countries and became a common currency of these 11 countries. Since 2002, 6 other European countries have adopted the euro as their currency.

## SOLUTIONS TO PROBLEMS:

1. Returns over the past 12 months:

- a. +6.2%
- b. +7.1%
- c. +3.6%
- d. +8.4%

2. Percentage Holding Period (HP) Return

$$= [(4400 - 4000 + 4(40))/4000] \times 100\% \\ = \mathbf{14\%}$$

Note: This problem ignores transaction costs. Also, since the stock has been sold, next year's expected price performance is irrelevant.

3. Percentage HP Return =  $[(9500 - 10,000 + 2(600))/10,000] \times 100\%$   
 $= \mathbf{7\%}$

Note: This solution ignores interest the investor may have received from reinvesting the first \$600 interest payment. The information about the common stock purchases is not relevant in computing bond returns.

4. Percentage Holding Period Return:

$$= [(\$100,000 - \$99,500)/\$99,500] \times 100\% = \mathbf{0.5025\%}$$

On an annual basis, this is slightly greater than 6%.

5. Percentage Holding Period Return:

$$= [(\$1,000 - \$975 + \$60)/\$975] \times 100\% = \mathbf{8.72\%}$$

- 6.a. *Expected* Percentage Holding Period Return =

$$[(65 - 60 + 4)/60] \times 100\% = \mathbf{15.0\%}$$

- b. *Realized* Percentage Holding Period Return =

$$[(75 - 60 + 4)/60] \times 100\% = \mathbf{31.67\%}$$

- c. *Realized* Percentage Holding Period Return =

$$[(58 - 60 + 4)/60] \times 100\% = \mathbf{3.33\%}$$

- d. *Realized* Percentage Holding Period Return =

$$[(50 - 60 + 4)/60] \times 100\% = \mathbf{-10.0\%}$$

7. Percentage Holding Period (HP) Return

$$= [(\$12,800 - \$14,000)/\$14,000] \times 100\% \\ = \mathbf{-8.57\%}$$

Note: The information about Treasury bill yields is not needed to solve this problem.

8. Percentage Holding Period (HP) Return (based on equity investment only)

$$= [(\$190,000 - \$110,000)/\$33,000] \times 100\% \\ = \mathbf{242.42\% \text{ for 6 months}}$$

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Percentage Holding Period (HP) Return (based on total original cost)  
 $= [(\$190,000 - \$110,000)/\$110,000] \times 100\%$   
 $= \mathbf{72.73\%}$

9. Percentage Holding Period Return  
 $= [(\$45 - \$35)/\$35] \times 100\% = \mathbf{28.57\%}$

The stock appears to be a good investment because the expected return exceeds the required rate of return.

Costs of Automobile

10. <u>Date</u>	<u>Exchange Rate</u>	<u>U.S. Dollar</u>	<u>Japanese Yen</u>
March 9, 2010	\$0.011113/Yen	\$20,000	1,799,694*
Feb 25, 2013	\$0.010891/Yen	<b>\$19,600**</b>	1,799,694

\*  $\$20,000 \div \$0.011113/\text{Yen} = 1,799,694 \text{ Yen}$

\*\*  $1,799,694 \text{ Yen} \times \$0.010891/\text{Yen} = \mathbf{\$19,600}$

11.	<u>Cost per watch</u>			
	<u>Exchange</u>	<u>No. of</u>	<u>U.S.</u>	<u>Swiss</u>
<u>Date</u>	<u>rate</u>	<u>watches</u>	<u>Dollar</u>	<u>Francs</u>
a. 03/09/10	\$0.9299/franc	10,000	117.17**	126.0
b. 02/25/13	\$1.0728/franc	12,000	<b>117.17†</b>	126.0

Total Cost

	<u>U. S. Dollars</u>	<u>Swiss Francs</u>
a. <b>\$1,171,674*</b>		1,260,000
b. <b>\$1,622,040††</b>		1,512,000

\*  $1,260,000 \text{ francs} \times \$0.9299/\text{franc} = \$1,171,674$

\*\*  $\$1,171,674/10,000 \text{ watches} = \$117.17/\text{watch}$

†  $126.0 \text{ francs} \times \$1.0728/\text{franc} = \$135.17/\text{watch}$

††  $\$135.17/\text{watch} \times 12,000 \text{ watches} = \$1,622,040$

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12. Exchange Rate

	<u>Country</u>	<u>Currency</u>	<u>3/9/10</u>	<u>2/25/13</u>
a.	India	Rupee	0.02193	0.01845
b.	UK	Pound	1.4995	1.5165
c.	Japan	Yen	0.011113	0.010891
d.	EuroArea	Euro	1.3600	1.3062
e.	Canada	Dollar	0.9744	0.9745

a.  $[(0.01845 - 0.02193)(100)]/0.02193 = \mathbf{-15.87\%}$

b.  $[(1.5165 - 1.4995)(100)]/1.4995 = \mathbf{+1.13\%}$

c.  $[(0.010891 - 0.011113)(100)]/0.011113 = \mathbf{-2.00\%}$

d.  $[(1.3062 - 1.3600)(100)]/1.3600 = \mathbf{-3.96\%}$

e.  $[(0.9745 - 0.9744)(100)]/0.9744 = \mathbf{+0.01\%}$

13. Holding Period Return (HPR):

$$\text{HPR} = [\$45,000 - \$15,000 - 10(\$500) - \$400] / \$15,000 = \mathbf{164\%}$$