

Multiple Choice Questions

1. The largest single institutional owner of common stocks is:
- a. mutual funds.
 - b. insurance companies.
 - c. pension funds.
 - d. commercial banks.

Ans: c

Difficulty: Moderate

Ref: Organizing Financial Assets

2. Which of the following is not a characteristic of the primary nonmarketable financial asset owned by most individuals?
- a. High liquidity
 - b. High return
 - c. Often issued by the U.S. government
 - d. Low risk

Ans: b

Difficulty: Moderate

Ref: Nonmarketable Financial Assets

3. Savings accounts are:
- a. negotiable but are not liquid.
 - b. marketable but are not liquid.
 - c. liquid but are not personal.
 - d. liquid but are not marketable.

Ans: d

Difficulty: Difficult

Ref: Nonmarketable Financial Assets

4. Nonmarketable financial assets that protect against inflation include:
- a. nonnegotiable certificates of deposit (CDs).
 - b. money market deposit accounts (MMDAs).
 - c. Series EE US government savings bonds.
 - d. US government savings bonds, I bonds.

Ans: d
Difficulty: Moderate
Ref: Nonmarketable Financial Assets

5. Treasury bills are traded in the:
- money market.
 - capital market.
 - government market.
 - regulated market.

Ans: a
Difficulty: Easy
Ref: Money Market Securities

6. Which of the U.S. Treasury securities is always sold at a discount?
- Treasury bills
 - Treasury notes
 - Treasury bonds
 - Treasury inflation protected securities (TIPS)

Ans: a
Difficulty: Moderate
Ref: Money Market Securities

7. Which of the following statements regarding money market instruments is *not* true?
- They tend to be highly marketable.
 - They have maturities from 1 to 3 years.
 - They tend to have a low probability of default.
 - Their rates tend to move together.

Ans: b
Difficulty: Moderate
Ref: Money Market Securities

8. Which of the following would *not* be considered a capital market security?
- A 20-year corporate bond
 - A common stock
 - A 6-month Treasury bill
 - A mutual fund share

Ans: c
Difficulty: Moderate
Ref: Capital Market Securities

9. The coupon rate is another name for the:

- a. market interest rate.
- b. current yield.
- c. stated interest rate.
- d. yield to maturity.

Ans: c

Difficulty: Easy

Ref: Fixed-Income Securities

10. Zero-coupon bonds are similar to Treasury bills in that both:

- a. are issued exclusively by the U.S. Treasury.
- b. are money-market securities.
- c. are capital-market securities.
- d. are sold at less than par.

Ans: d

Difficulty: Moderate

Ref: Fixed-Income Securities

11. Each point on a corporate bond quote represents:

- a. \$100.
- b. 1 percent of \$100.
- c. 1 percent of \$1000.
- d. \$1000.

Ans: c

Difficulty: Difficult

Ref: Fixed-Income Securities

12. Treasury STRIPS are most similar to which type of corporate security?

- a. Preferred stock
- b. Premium bond
- c. High-yield bond
- d. Zero-coupon bond

Ans: d

Difficulty: Moderate

Ref: Fixed-Income Securities

13. Bonds trade on an accrual interest basis. This means an investor:
- a. can sell a bond at any time without losing the interest that has accrued.
 - b. can buy a bond at any time and gain the interest accrued from the time of the last payment.
 - c. can sell a bond at any time and retain the interest portion of the bond.
 - d. can buy a bond at any time and receive an immediate interest check.

Ans: a

Difficulty: Moderate

Ref: Fixed-Income Securities

14. Bonds called in are likely to be:
- a. bonds already in default.
 - b. replaced with new bonds that have a lower interest rate.
 - c. replaced with new bonds that have a higher interest rate.
 - d. junk bonds.

Ans: b

Difficulty: Moderate

Ref: Fixed-Income Securities

15. What will a bond be worth on the day it matures?
- a. \$0
 - b. \$100
 - c. Its face value (plus remaining coupon, if applicable)
 - d. Its remaining coupon, if applicable

Ans: c

Difficulty: Moderate

Ref: Fixed-Income Securities

16. Which of the following statements is true regarding an investment in mortgage-backed securities?
- a. There is little default risk.
 - b. The stated maturity is generally 10 years.
 - c. They receive a fixed payment per month.
 - d. They are not subject to prepayment.

Ans: a

Difficulty: Moderate

Ref: Fixed-Income Securities

17. A municipal bond issued to finance a toll bridge would most likely be a:
- a. general obligation bond.
 - b. revenue bond.
 - c. special assessment bond.
 - d. zero-coupon bond.

Ans: b

Difficulty: Easy

Ref: Fixed-Income Securities

18. What is the major difference between municipal bonds and other types of bonds?
- a. Municipal bonds are always insured; other bonds are not.
 - b. Unlike other bonds, municipal bonds sell at a discount.
 - c. Municipal bond interest is tax-exempt; interest on other bonds is not.
 - d. There is no brokerage commission on municipal bonds unlike other bonds.

Ans: c

Difficulty: Moderate

Ref: Fixed-Income Securities

19. For an investor with a 28% marginal tax rate, what return would a corporate bond have to pay to provide the same after-tax return as a municipal bond paying 5%?
- a. 1.40%
 - b. 2.50%
 - c. 5.00%
 - d. 6.94%

Ans: d

Difficulty: Moderate

Ref: Fixed-Income Securities

20. Interest on bonds is typically paid:
- a. monthly.
 - b. quarterly.
 - c. semi-annually.
 - d. annually.

Ans: c

Difficulty: Moderate

Ref: Fixed-Income Securities

21. Treasury bonds generally have maturities of:

- a. 5 to 15 years.
- b. 5 to 30 years.
- c. 10 to 20 years.
- d. 10 to 30 years.

Ans: d

Difficulty: Easy

Ref: Fixed-Income Securities

22. A corporate bond with a rating of BBB- is considered to be which of the following?

- a. Non-investment grade
- b. Investment grade
- c. Speculative grade
- d. Junk or high-yield

Ans: b

Difficulty: Difficult

Ref: Fixed-Income Securities

23. An unsecured bond is known as a(n):

- a. debenture.
- b. indenture.
- c. mortgage bond.
- d. junk bond.

Ans: a

Difficulty: Moderate

Ref: Fixed-Income Securities

24. Which of the following 10-year bonds would have the lowest yield?

- a. AAA-rated corporate bond
- b. AAA-rated insured municipal bond
- c. U.S. Treasury bond
- d. AAA-rated mortgage-backed bond

Ans: b

Difficulty: Difficult

Ref: Fixed-Income Securities

25. For U.S. companies, dividends are typically paid:

- a. monthly.
- b. quarterly.
- c. semi-annually.
- d. yearly.

Ans: b

Difficulty: Easy

Ref: Equity Securities

26. If an investor states that Intel is overvalued at 65 times, he is referring to Intel's:

- a. earnings per share.
- b. dividend yield.
- c. book value.
- d. P/E ratio.

Ans: d

Difficulty: Difficult

Ref: Equity Securities

27. Which of the following is a security that represents shares of a foreign company, which are held in a bank?

- a. Convertible bond
- b. American Depository Receipt (ADR)
- c. Asset-backed security
- d. LEAPS

Ans: b

Difficulty: Easy

Ref: Equity Securities

28. Which of the following statements regarding common stocks is true?

- a. The par value of common stock is usually \$100.
- b. The market value of common stock is equal to its book value.
- c. Dividends on common stock are at the discretion of the company.
- d. Common stock has a senior claim on company assets.

Ans: c

Difficulty: Moderate

Ref: Equity Securities

29. If a preferred stock issue is cumulative, this means:
- unpaid preferred stock dividends are paid at the end of the year.
 - unpaid preferred stock dividends are legally binding on the corporation.
 - unpaid preferred stock dividends must be paid in the future before common stock dividends can be paid.
 - unpaid preferred stock dividends are never repaid.

Ans: c

Difficulty: Moderate

Ref: Equity Securities

30. Which of the following statements is true regarding asset-backed securities?
- They offer relatively high yields.
 - They have relatively long maturities.
 - They generally have low credit ratings.
 - Each tranche has the same risk.

Ans: a

Difficulty: Moderate

Ref: Asset Backed Securities

31. What is the biggest difference between an option and a futures contract?
- Options are traded on exchanges, whereas futures are not.
 - Options give investors a way to manage portfolio risk, while futures do not.
 - Options can be used by speculators to profit from price fluctuations, while futures cannot.
 - Options give their holders the right to buy or sell, whereas futures contracts are obligations to buy or sell.

Ans: d

Difficulty: Difficult

Ref: Derivative Securities

32. The premium on an option is the:
- par value of the option.
 - price of the option.
 - book value of the option.
 - price at which a security may be bought or sold using the option.

Ans: b

Difficulty: Moderate

Ref: Derivative Securities

33. If a call option has a \$10 strike price, and the underlying stock is trading at \$11, then the option is considered:
- in the money.
 - at the money.
 - out of the money.
 - worthless.

Ans: a

Difficulty: Easy

Ref: Derivative Securities

True-False Questions

1. Direct investing involves trades made by directly purchasing shares of a financial intermediary.

Ans: False

Difficulty: Moderate

Ref: Organizing Financial Assets

2. An example of indirect investing would be buying shares in a mutual fund.

Ans: True

Difficulty: Easy

Ref: Organizing Financial Assets

3. Nonmarketable investments would include savings accounts at banks and Treasury bills.

Ans: False

Difficulty: Moderate

Ref: Nonmarketable Financial Assets

4. Marketable securities all fall into the category of capital market securities.

Ans: False

Difficulty: Moderate

Ref: Nonmarketable Financial Assets

5. All U. S. government securities are considered marketable securities.

Ans: False

Difficulty: Easy

Ref: Money Market Securities

6. Money market securities generally carry a low chance of default.

Ans: True

Difficulty: Moderate

Ref: Money Market Securities

7. The money market rate most often used as a benchmark for the risk-free rate is the money market deposit account rate.

Ans: False

Difficulty: Easy

Ref: Money Market Securities

8. The rate spreads between the different money market securities of the same term tend to be quite large.

Ans: False

Difficulty: Difficult

Ref: Money Market Securities

9. Treasury notes represent the nontraded debt of the U.S. government.

Ans: False

Difficulty: Moderate

Ref: Fixed-Income Securities

10. The capital market includes both fixed-income and equity securities.

Ans: True

Difficulty: Easy

Ref: Fixed-Income Securities

11. Term bonds have a single maturity.

Ans: True

Difficulty: Easy

Ref: Fixed-Income Securities

12. The return on a zero-coupon bond is derived from the difference between the purchase price of the bond and its par value.

Ans: True

Difficulty: Difficult

Ref: Fixed-Income Securities

13. The deeper the discount on a zero-coupon bond, the lower the effective return.

Ans: False

Difficulty: Moderate

Ref: Fixed-Income Securities

14. If a bond has a coupon greater than the current market yield, it should be selling at a premium.

Ans: True

Difficulty: Difficult

Ref: Fixed-Income Securities

15. Callable bonds attract investors because they can be redeemed early.

Ans: False

Difficulty: Moderate

Ref: Fixed-Income Securities

16. TIPS adjust for inflation by adjusting the rate of interest paid on the bond.

Ans: False

Difficulty: Difficult

Ref: Fixed-Income Securities

17. The major attraction of municipal bonds is their extremely low risk.

Ans: False

Difficulty: Moderate

Ref: Fixed-Income Securities

18. Investors in high tax brackets would be unlikely to invest in municipal bonds.

Ans: False

Difficulty: Moderate

Ref: Fixed-Income Securities

19. In the case of a corporate bankruptcy, bondholders are paid before any distributions are paid to preferred or common stockholders.

Ans: True

Difficulty: Moderate

Ref: Fixed-Income Securities

20. Bond ratings are primarily used to assess interest rate risk.

Ans: False

Difficulty: Moderate

Ref: Fixed-Income Securities

21. The major bond rating service is Dun & Bradstreet.

Ans: False

Difficulty: Easy

Ref: Fixed-Income Securities

22. The earnings retention rate is calculated as $1 - \text{dividend yield}$.

Ans: False

Difficulty: Easy

Ref: Equity Securities

23. The par value on common stock sets the value that stockholders will receive in case of bankruptcy.

Ans: False

Difficulty: Easy

Ref: Equity Securities

24. LEAPS have maturity dates up to 10 years.

Ans: False

Difficulty: Easy

Ref: Equity Securities

25. Most futures contracts are not exercised.

Ans: T

Difficulty: Moderate

Ref: Equity Securities

26. Convertible bonds give their investors the right to convert the bond into common stock at their discretion.

Ans: True

Difficulty: Easy

Ref: Fixed-Income Securities

Short-Answer Questions

1. Distinguish between direct and indirect investing.

Answer: Direct investing – buy bonds and stocks; Indirect investing – buy mutual funds, contribute to pension plans, buy life insurance policies.

Difficulty: Easy

Ref: Organizing Financial Assets

2. Compare the cash flows an investor expects from coupon bonds, zero-coupon bonds, and preferred stock.

Answer: Coupon bonds – annuity of interest payments plus lump sum of principal at maturity
Zero-coupon bonds – principal at maturity
Preferred stock – annuity ad infinitum (perpetuity)

Difficulty: Moderate

Ref: Fixed-Income Securities

3. How is the earnings retention rate related to the dividend payout rate?

Answer: Earnings retention rate = 1 - dividend payout rate

Difficulty: Moderate

Ref: Equity Securities

4. How is the total book value of equity affected by stock splits?

Answer: Stock splits do not affect total value of equity or the individual accounts, other than the number of shares outstanding and the par value.

Difficulty: Moderate

Ref: Equity Securities

5. In what sense is a stock selling for 12 times earnings “cheaper” than a stock with a P/E ratio of 20?

Answer: If a stock is trading at 12 times earnings, it is cheaper than the one trading at 20 times earnings in the sense investors get \$1 of earnings for only a \$12 investment in buying the stock.

Difficulty: Moderate

Ref: Equity Securities

6. What are two direct and one indirect method for individuals to invest in foreign stocks?

Answer: Buy securities directly through exchanges or as American depository receipts and indirectly through mutual funds.

Difficulty: Moderate

Ref: Organizing Financial Assets, Equity Securities

7. Explain how writing option contracts (both puts and calls) can generate income for owners of the underlying stock.

Answer: The writer keeps the option premium regardless of whether or not the option is exercised.

Difficulty: Moderate

Ref: Derivative Securities

8. Rank (lowest to highest) the following securities in terms of the risk-expected return tradeoff from the investors' viewpoint: common stock, corporate bonds, U.S. Treasury bonds, preferred stock.

Answer: U.S. Treasury bonds, corporate bonds, preferred stock, common stock
Difficulty: Moderate
Ref: Fixed-Income Securities, Equity Securities

9. What are some advantages of asset-backed securities to investors?

Answer: High yields with manageable risk.
Difficulty: Moderate
Ref: Fixed-Income Securities

10. Who benefits from a futures contract, a call contract, and a put contract, if prices fall?

Answer: The seller of the futures contract, the writer of the call contract, and the buyer of the put contract.
Difficulty: Moderate
Ref: Derivative Securities

Essay Questions

1. Does the options market help stabilize or destabilize the stock market? Explain.

Answer: Options should be a stabilizing force if options are used to hedge stock positions. Options might be destabilizing if used for speculation.
Difficulty: Difficult
Ref: Equity Securities, Derivative Securities

2. How do asset-backed securities improve the flow of funds from savers to borrowers?

Answer: Asset-backed securities can be sold to a broader market of investors than the underlying securities.
Difficulty: Moderate
Ref: Fixed-Income Securities

Problems

1. What rate would a taxable corporate bond have to pay to be comparable to a municipal bond with a coupon rate of 7 percent if the investor is in the 28 percent tax bracket?

Answer: Taxable equivalent yield is $0.07/(1-0.28) = 9.72\%$
Difficulty: Easy
Ref: Fixed-Income Securities

2. A corporate investor in the 34% marginal income tax bracket can buy bonds issued by a petroleum exploration company yielding 10.606%. The investor should be willing to buy tax-exempt municipal bonds of similar quality yielding what percent or higher?

Answer: $10.606 \times (1.0 - 0.34) = 7.00$ percent

Difficulty: Easy

Ref: Fixed-Income Securities

3. The par value of Blaze, Inc. common stock is \$0.50, the earnings per share is \$4, the stock price is \$60, and the dividend per share is \$1. Calculate the dividend yield.

Answer: Dividend yield = $\$1/\$60 = 0.0167 = 1.67\%$

Difficulty: Moderate

Ref: Equity Securities

4. The par value of Blaze, Inc. common stock is \$0.50, the earnings per share is \$4, the stock price is \$60, and the dividend per share is \$1. Calculate the payout ratio.

Answer: Payout rate = $\$1/\$4 = 0.25 = 25\%$

Difficulty: Moderate

Ref: Equity Securities

5. The par value of Inferno, Inc. common stock is \$0.50, the earnings per share is \$6, and it trades at a P/E of 15. What is Inferno, Inc.'s stock price?

Answer: Stock price is $EPS \times P/E = \$6 \times 15 = \90

Difficulty: Moderate

Ref: Equity Securities