

Files: ch02, Chapter 2: Investment Alternatives

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 one of the characteristics of the primary nonmarketable financial assets 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 ----- but are not-----.
- a. negotiable; liquid.
 - b. marketable; liquid.
 - c. liquid; personal
 - d. liquid; 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 ----- .
- a. money market.
 - b. capital market.
 - c. government market.
 - d. regulated market.

Ans: a

Difficulty: Easy

Ref: Money Market Securities

6. Which of the U.S. Treasury securities is always sold at a discount?
- a. Treasury bills
 - b. Treasury notes
 - c. Treasury bonds
 - d. 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?
- a. They tend to be highly marketable.
 - b. They have maturities from 1 to 3 years.
 - c. They tend to have a low probability of default.
 - d. 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. a 20-year corporate bond
 - b. a common stock
 - c. a 6-month Treasury bill
 - d. 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 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. 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. reissued as new bonds with a lower interest rate
 - c. reissued as new bonds with 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 issue that was sold 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. An investor who pays taxes at the 28% marginal tax rate would need to earn what coupon rate on a corporate bond similar in all respects other than taxes to a 5% coupon municipal bond:
- 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. semiannually
 - 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:

- 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, AAA rated bonds would have the lowest yield?

- a. corporate bond.
- b. insured municipal bond.
- c. U.S. Treasury bond.
- d. 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:

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

Ans: d

Difficulty: difficult
Ref: Equity Securities

27. ----- represent shares of foreign companies kept in banks.
- a. convertible bonds
 - b. American Depositary Receipts (ADRs)
 - c. asset-backed securities
 - 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:
- a. unpaid preferred stock dividends are paid at the end of the year
 - b. unpaid preferred stock dividends are legally binding on the corporation
 - c. unpaid preferred stock dividends must be paid in the future before common stock dividends can be paid
 - d. 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 (ASB)?
- a. They offer relatively high yields
 - b. They have relatively long maturities
 - c. They generally have low credit ratings
 - d. 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?
- a. Options are traded on exchanges whereas futures are not
 - b. Options give investors a way to manage portfolio risk while futures do not
 - c. Options can be used by speculators to profit from price fluctuations while futures cannot
 - d. Options give their holders the right to buy or sell whereas futures contract are obligations to buy or sell

Ans: d

Difficulty: Difficult

Ref: Derivative Securities

32. The premium on an option is the:
- a. par value of the option.
 - b. price of the option.
 - c. book value of the option.
 - d. 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:
- a. in the money.
 - b. at the money.
 - c. out of the money.
 - d. 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: F

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: F

Difficulty: Moderate

Ref: Nonmarketable Financial Assets

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

Ans: F

Difficulty: Moderate

Ref: Nonmarketable Financial Assets

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

Ans: F

Difficulty: Easy

Ref: Money Market Securities

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

Ans: T

Difficulty: Moderate

Ref: Money Market Securities

7. The money market security most often used a benchmark for the risk-free rate is 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: F

Difficulty: difficult

Ref: Money Market Securities

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

Ans: F

Difficulty: Moderate
Ref: Fixed-Income Securities

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

Ans: T
Difficulty: Easy
Ref: Fixed-Income Securities

11. Term bonds have a single maturity.

Ans: T
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: T
Difficulty: difficult
Ref: Fixed-Income Securities

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

Ans: F
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: T
Difficulty: difficult
Ref: Fixed-Income Securities

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

Ans: F
Difficulty: Moderate
Ref: Fixed-Income Securities

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

Ans: F
Difficulty: difficult
Ref: Fixed-Income Securities

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

Ans: F

Difficulty: Moderate

Ref: Fixed-Income Securities

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

Ans: F

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: T

Difficulty: Moderate

Ref: Fixed-Income Securities

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

Ans: F

Difficulty: Moderate

Ref: Fixed-Income Securities

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

Ans: F

Difficulty: Easy

Ref: Fixed-Income Securities

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

Ans: T

Difficulty: Easy

Ref: Equity Securities

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

Ans: F

Difficulty: Easy

Ref: Equity Securities

24. LEAPS have maturities dates up to 10 years.

Ans: F

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 whenever they choose.

Ans: T

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

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

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

Answer: $\text{Earnings retention rate} = 1 - \text{dividend payout rate}$

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, 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, options, preferred stock..

Answer: U. S. Treasury bonds, corporate bonds, preferred stock, common stock, options

Difficulty: Moderate

Ref: Fixed-Income Securities, Equity Securities, Derivative Securities

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

Answer: High yields with manageable risk.

Difficulty: Moderate

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.

Difficult: Moderate

Ref: Derivative Securities

Essay Questions

1. Do the stock options markets help stabilize or destabilize the stock markets? 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

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

Ans: Taxable equivalent yield is $0.07/(1-0.28) = 9.72\%$

Difficulty: Easy

Ref: Fixed-Income Securities

2. A corporate investor in a 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?

Ans: $10.606 \times (1.0-0.34) = 7.00$ 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 market price is \$60, the dividend per share is \$1. Calculate the dividend yield.

Ans: 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 market price is \$60, the dividend per share is \$1. Calculate the payout ratio.

Ans: 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?

Ans: Stock price per share is Earnings per share x P/E = \$6 x 15 = \$90

Difficulty: Moderate

Ref: Equity Securities