Chapter 1 — The Investment Process

1. The rate of exchange between future consumption and current consumption is
   a. the nominal risk-free rate.
   b. the coefficient of investment exchange.
   c. the pure rate of interest.
   d. the consumption/investment paradigm.
   e. the expected rate of return.

ANS: c

2. The coefficient of variation is a measure of
   a. central tendency.
   b. absolute variability.
   c. absolute dispersion.
   d. relative variability.
   e. relative return.

ANS: d

3. The nominal risk free rate of interest is a function of
   a. the real risk free rate and the investment's variance.
   b. the prime rate and the rate of inflation.
   c. the T-bill rate plus the inflation rate.
   d. the tax free rate plus the rate of inflation.
   e. the real risk free rate and the rate of inflation.

ANS: e

4. In the phrase ‘nominal risk free rate’, nominal means
   a. computed.
   b. historical.
   c. market.
   d. average.
   e. risk adverse.

ANS: c

5. If a significant change is noted in the yield of a T-bill, the change is most likely attributable to
   a. a downturn in the economy.
   b. a static economy.
   c. a change in the expected rate of inflation.
   d. a change in the real rate of interest.
   e. a change in risk aversion.

ANS: c

6. Which of the following is not a component of the risk premium?
   a. business risk
   b. financial risk
   c. liquidity risk
   d. exchange rate risk
   e. unsystematic market risk

ANS: e

7. The variability of operating earnings is associated with
    a. business risk.
    b. liquidity risk.
    c. exchange rate risk.
    d. financial risk.
    e. market risk.

ANS: a

8. What will happen to the security market line (SML) if the following events occur, other things constant: (1) inflation expectations increase, and (2) investors become more risk averse?
    a. shift up and keep the same slope
    b. shift up and have less slope
    c. shift up and have a steeper slope
    d. shift down and keep the same slope
    e. shift down and have less slope

ANS: c

9. A decrease in the expected real growth in the economy, all other things constant, will cause the security market line to
    a. shift up.
    b. shift down.
    c. have a steeper slope.
    d. have a flatter slope.
    e. remain unchanged.

ANS: b

10. Unsystematic risk refers to risk that is
    a. undiversifiable.
    b. diversifiable.
    c. due to fundamental risk factors.
    d. due to market risk.
    e. none of the above

ANS: b

11. Two factors that influence the nominal risk-free rate are
    a. the relative ease or tightness in capital markets and the expected rate of inflation.
    b. the expected rate of inflation and the set of investment opportunities available in the economy.
    c. the relative ease or tightness in capital markets and the set of investment opportunities available in the economy.
    d. time preference for income consumption and the relative ease or tightness in capital markets.
    e. time preference for income consumption and the set of investment opportunities available in the economy.

ANS: a

12. Measures of risk for an investment include
    a. variance of returns and business risk.
    b. coefficient of variation of returns and financial risk.
    c. business risk and financial risk.

d. variance of returns and coefficient of variation of returns.
e. all of the above.

ANS: d

13. Modern portfolio theory assumes that most investors are
a. risk averse.
b. risk neutral.
c. risk seekers.
d. risk tolerant.
e. none of the above.

ANS: a

14. Which of the following is not a component of the required rate of return?
a. expected rate of inflation
b. time value of money
c. risk
d. holding period return
e. all of the above are components of the required rate of return

ANS: d

15. All of the following are major sources of uncertainty EXCEPT
a. business risk.
b. financial risk.
c. default risk.
d. country risk.
e. liquidity risk.

ANS: c