

CHAPTER 2: THE DOMESTIC AND INTERNATIONAL FINANCIAL MARKETPLACE

1. A multinational firm_____.
 - a. has direct investments in manufacturing facilities in more than one country
 - b. exports finished goods for sale in another country
 - c. imports raw materials from another country
 - d. has a manufacturing representative in another country

ANSWER: a

2. The difference between merchandise exports and imports is known as the_____.
 - a. transaction exposure
 - b. difference in purchasing power
 - c. goods and services trade balance
 - d. import/export reserve

ANSWER: c

3. The interest rate at which banks in the Eurocurrency market lend to each other is known as the_____.
 - a. Eurocurrency currency rate (ECR)
 - b. London interbank offer rate
 - c. exchange rate
 - d. interest rate parity

ANSWER: b

4. An exchange rate quoted as \$1.47 per British pound is known as a_____quote.
 - a. hedge
 - b. direct
 - c. futures
 - d. indirect

ANSWER: b

5. If Japanese yen are deposited in a bank in Paris, the deposits would be called_____.
 - a. Eurofrancs
 - b. European Currency Unit
 - c. Eurobond
 - d. Euroyen

ANSWER: d

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6. If the spot rate for Swiss francs is \$0.6658/franc and the 180-day forward rate is \$0.6637, the market is indicating that the Swiss franc is expected to
- strengthen relative to the dollar
 - weaken relative to the ECU
 - lose value relative to the dollar over the next 6 months
 - gain value relative to the dollar over the next 6 months

ANSWER: c

7. Which of the following is not a correct statement about foreign currency futures?
- futures contracts have a standardized maturity date
 - futures contracts are an exchange-traded agreement
 - futures contracts are not liquid
 - futures contracts are "marked to market" daily

ANSWER: c

8. The most important foreign currency futures market in the United States is the_____.
- Chicago Board of Trade
 - New York Mercantile Exchange
 - Commodity Exchange
 - Chicago Mercantile Exchange

ANSWER: d

9. The buyer of a foreign currency call option has the_____ a fixed amount of a foreign currency.
- right to sell
 - right but not the obligation to buy
 - obligation to buy, only at expiration,
 - obligation to buy

ANSWER: b

10. Eurodollars are U.S. dollars that have been deposited in
- foreign banks
 - foreign branches of U.S. banks
 - foreign subsidiaries
 - foreign banks and foreign branches of U.S. banks

ANSWER: d

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11. If the exchange rate from U.S. dollars to Canadian dollars is \$0.80/Canadian dollar, then the exchange rate from Canadian dollars to U.S. dollars is
- 0.80 Canadian \$/US dollar
 - \$1.25 Canadian \$/US dollar
 - \$1.20 Canadian \$/US dollar
 - \$8.00 Canadian \$/US dollar

ANSWER: b

12. If the exchange rate from U.S. dollars to Swiss francs is \$0.20/franc, then the exchange rate from francs to dollars is
- 0.20 francs/dollar
 - 0.80 francs/dollar
 - 5.0 francs/dollar
 - 2.0 francs/dollar

ANSWER: c

13. If the spot rate (in U.S. dollars) for Japanese Yen is 0.00703 and the 180 day forward rate is 0.00717, then the Yen is trading at a(n)___.
- expected gain
 - premium
 - reciprocal
 - discount

ANSWER: b

14. If the forward (direct quote) exchange rate is lower than the spot rate, then the currency is said to be trading at a ____.
- forward premium
 - forward gain
 - forward discount
 - forward loss

ANSWER: c

15. Financial middlemen include
- securities brokers
 - securities dealers
 - investment bankers
 - all of these

ANSWER: d

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16. The following are listed security exchanges in the United States:

- a. New York Stock Exchange
- b. Pacific Exchange
- c. Cincinnati Exchange
- d. All of these are listed exchanges

ANSWER: d

17. The Standard and Poor's 500 Stock Price Index is a _____ index.

- a. price weighted
- b. market value weighted
- c. price average
- d. none of these answers is correct

ANSWER: b

18. Securities not listed on exchanges are said to be traded

- a. on the AMEX
- b. as composite transactions
- c. over the counter
- d. on the regional exchanges

ANSWER: c

19. Financial intermediaries include

- a. securities brokers
- b. commercial banks
- c. securities dealers
- d. all of these

ANSWER: b

20. _____ markets deal in long-term securities having maturities greater than one year.

- a. Credit
- b. Money
- c. Commodity futures
- d. Capital

ANSWER: d

21. _____ markets deal in short-term securities having maturities of one year or less.

- a. Credit
- b. Money
- c. Capital
- d. Capital and credit

ANSWER: b

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22. Which of the following (if any) are *not* financial intermediaries?

- a. commercial bank
- b. thrift institution
- c. securities broker
- d. all are financial intermediaries

ANSWER: c

23. In the _____ market, the firm receives the proceeds from the sale of its securities.

- a. over-the-counter
- b. secondary
- c. fully integrated
- d. primary

ANSWER: d

24. A savings and loan association is an example of which type of financial intermediary?

- a. commercial bank
- b. investment company
- c. finance company
- d. thrift institution

ANSWER: d

25. In any economy as a whole, the actual savings for a given period of time must _____ the actual investments.

- a. be greater than
- b. be unrelated to
- c. equal
- d. be less than

ANSWER: c

26. Financial intermediaries

- a. issue secondary claims to the lender
- b. are compensated for their services by fixed fees
- c. include both brokers and dealers
- d. issue primary claims to the lender

ANSWER: a

27. The main purpose of an economy's financial system is to facilitate the transfer of funds from

- a. financial middlemen to financial intermediaries
- b. surplus spending units to deficit spending units
- c. primary claimholders to secondary claimholders
- d. lenders to financial intermediaries

ANSWER: b

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28. Money markets deal in securities having maturities of _____; capital market securities have maturities _____.
- less than 18 months, greater than 18 months
 - one year or less, greater than one year
 - less than 9 months, greater than 9 months
 - less than 6 months, greater than 6 months

ANSWER: b

29. Commercial banks are an important source of
- mortgage loans
 - equity loans
 - real estate loans
 - short-term loans and term loans

ANSWER: d

30. Finance companies obtain a significant amount of their funds by
- issuing their own equity securities
 - accepting both demand and time deposits
 - issuing their own debt securities
 - pooling funds

ANSWER: c

31. When an investor purchases shares in a no-load common stock mutual fund, she is using a(n)
- primary intermediary
 - financial intermediary
 - over-the-counter market
 - broker

ANSWER: b

32. The interest rate in the Eurodollar market is related to
- the DOW
 - the stock market
 - the LIBOR
 - interest rates in the United States

ANSWER: c

33. Capital markets in financially sophisticated economies are not perfectly efficient because of
- anomalous events
 - the Sun Spot theory
 - irrational investor behavior
 - anomalous events and irrational investor behavior

ANSWER: d

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34. Commercial banks are a major source of term loans. These loans are best used for:
- financing the expansion of the business.
 - financing the establishment of overseas operations.
 - financing current assets like inventory and accounts receivable.
 - financing the payment of dividends.

ANSWER: c

35. The Dow Jones Industrial Average is calculated using the
- total market value of 30 stocks
 - price of 30 stocks
 - a weighted index of 30 stocks
 - industrial, railroad, financial, and utility stocks

ANSWER: b

36. Insider trading is defined as
- an individual using proper trading rules
 - an individual buying or selling using non-SEC disclosure rules
 - an individual buying or selling on the basis of material nonpublic information
 - a zero-plus game

ANSWER: c

37. The U.S. financial markets are said to be highly informationally efficient. This means
- they process stock trades accurately and quickly
 - the market provides quick access to a firm's financial statements
 - they quickly reflect information relevant to determining stock value
 - accurate stock quotes are quickly available to all investors

ANSWER: c

38. Ex post returns differ from _____ returns in that they represent _____ values rather than _____ values.
- ex ante; estimated; actual
 - ex post; accounting; economic
 - ex ante; actual; estimated
 - ex ante; economic; accounting

ANSWER: c

39. The fact that no investor can expect to earn excess returns based on an investment strategy using only historical stock price or return information is an example of market efficiency.
- strong-form
 - weak-form
 - semiweak-form
 - semistrong-form

ANSWER: b

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40. With semistrong-form market efficiency, no investor can expect to earn excess returns based on an investment strategy using any_____information.
- a. past market price
 - b. market value
 - c. publicly available
 - d. private

ANSWER: c

41. In an efficient capital market, all security investments will have:
- a. a required rate of return that exceeds the cost of capital
 - b. a positive NPV
 - c. a required rate of return that is zero
 - d. a NPV of zero

ANSWER: d

42. In an efficient capital market, corporate diversification is_____.
- a. unnecessary
 - b. inexpensive
 - c. of benefit to corporate managers
 - d. of great benefit

ANSWER: a

43. The barriers to the free flow of capital among the major world capital markets include all of the following except:
- a. low transaction costs
 - b. taxation policies
 - c. foreign exchange risks
 - d. legal restrictions

ANSWER: a

44. For the financial manager, taxes have important implications for
- a. dividend policy
 - b. financial restructurings
 - c. capital structure policy
 - d. all of these

ANSWER: d

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45. Changes in the tax code that slow down depreciation, _____ the present value of investment cash flows and, therefore, make the investment _____ desirable.
- decrease, more
 - decrease, less
 - increase, more
 - increase, less

ANSWER: b

46. In an efficient capital market
- required returns equal expected returns
 - investors will have holding period returns equal to zero
 - purchase of any security yields zero profit
 - purchasing stocks is no better than gambling

ANSWER: a

47. If the spot rate for the British pound is \$1.5077 and the 180-day forward rate is \$1.4934, what is the annualized premium (discount)?
- premium of 1.90%
 - premium of 0.97%
 - discount of (-)1.90%
 - discount of (-)0.97%

ANSWER: c

RATIONALE: Solution: $[(\$1.4934 - \$1.5077)/(\$1.5077)](12/6)(100\%) = -1.897\%$

48. If the spot rate for the Japanese yen is \$0.009204 and the 90-day forward rate is \$0.009227, what is the annualized premium (discount)?
- premium of 1.00%
 - premium of 0.50%
 - discount of -0.99%
 - premium of 0.25%

ANSWER: a

RATIONALE: Solution: $[(.009227 - .009204)/(.009204)](12/3)(100\%) = 0.9996\%$

49. Christy purchased 100 shares of Good Idea stock for \$48 last year. Yesterday she sold the stock for \$45. If she received \$4 in dividends during the time she held the security, what is her holding period return?
- 2.08%
 - 8.30%
 - 6.30%
 - 14.60%

ANSWER: a

RATIONALE: Solution: $(\$45 - \$48 + \$4)/\$48 = 0.0208$ or 2.08%

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50. If an investor purchased 100 shares of Biggee stock for \$30 per share, 6 months ago, and then sold the stock today for \$33 per share, what was the investor's holding period return if a total of \$1 per share in dividends was received over the 6 month period?
- a. 10%
 - b. 27.1%
 - c. 17.1%
 - d. 13.3%

ANSWER: d

RATIONALE: Solution: $HPR = (\$33 - \$30 + \$1)/\$30 = 13.3\%$

51. What is the holding period return to an investor who bought 100 shares of Oil Slick stock nine months ago for \$36 per share, received two \$50 dividend checks, and sold the stock today at \$38 a share.
- a. 5.56%
 - b. 8.33%
 - c. 11.11%
 - d. 6.94%

ANSWER: b

RATIONALE: Solution: $(\$38 + \$1 - \$36)/\$36 = 0.0833$ or 8.33%

52. If a treasury bond can be purchased for \$9,450 today and the bond holder will receive \$850 in interest and the \$10,000 face value at maturity, what is the percentage holding period return?
- a. 14.8%
 - b. 5.8%
 - c. 6.7%
 - d. 12.6%

ANSWER: a

RATIONALE: Solution: $(\$10,000 - \$9,450 + \$850)/\$9,450 = 0.148$ or 14.8%

53. You bought 100 shares of Risky Venture stock six months ago for \$14 per share and sold it yesterday for \$12. The company paid a total of \$0.24 per share in dividends to you during the time you held the stock. What was your holding period return?
- a. -25.14%
 - b. -16.67%
 - c. -12.57%
 - d. 16.00%

ANSWER: c

RATIONALE: Solution: $HPR = (\$12 - \$14 + \$0.24)/\$14 = -0.1257$ or -12.57%

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54. Maher purchased 100 shares of Chill Pill Pharmaceuticals at \$30 per share last spring and sold them in six months for \$36 per share. The stock paid no dividend. What was Maher's holding period return?
- 40%
 - 20%
 - 10%
 - 5%

ANSWER: b

RATIONALE: Solution: $HPR = (3600 - 3000)/3000 \times 100\% = 20\%$

55. Two years ago you bought 100 shares of Big Bubba convertible preferred stock at \$25 per share. The preferred stock had an annual dividend of \$2.125 per share, and a total of \$3.19 in dividends per share have been paid so far. Today the company announced that the stock is redeemable for \$26.70 plus accrued and unpaid dividends, for a total of \$27.76. Alternatively, holders may convert their shares of preferred stock at a conversion rate of 1.6393 shares of Big Bubba common stock for each share of preferred stock. If the closing price of Big Bubba common stock is \$27.50, what is your holding period return?
- 93.08%
 - 23.80%
 - 80.32%
 - 64.60%

ANSWER: a

RATIONALE: Solution: Ending price = $\$27.50(1.6393) = \45.08
 $HPR = (\$45.08 - \$25 + \$3.19)/\$25 = 0.9308$ or 93.08%

56. If the spot rate (in U.S. dollars) for Japanese Yen is 0.00703 and the 180 day forward rate is 0.00717, then the Yen is trading at an annualized
- premium of 4.04%
 - premium of 3.98%
 - premium of 3.91%
 - discount of 3.89%

ANSWER: b

RATIONALE: Solution: Premium = $[(0.00717 - 0.00703)/0.00703](12/6) = 0.0398$

57. Lear purchased 100 shares of Quitcha Twitchin Anti-inch Cream stock at \$30 per share last year and sold them eleven months later for \$24 per share. The shares split 2 for 1 shortly after Lear purchased the stock. If the stock paid \$0.25 per share in dividends last year, what is Lear's holding period return?
- 61.67%
 - 19.17%
 - 21.67%
 - 6.17%

ANSWER: a

RATIONALE: Solution: $HPR = [2400 - 1500 + .25(100)]/1500 \times 100\% = 61.67\%$

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58. Which of the following reflect (reflects) the implications of income taxes for financial managers:

- I. Interest payments on debt incurred by the firm are not tax deductible for the firm.*
 - II. Preferred stock and common stock dividends are tax deductible for the firm and are used as often as possible to raise capital.*
- a. Only statement I is correct.
 - b. Only statement II is correct.
 - c. Both statements I and II are correct.
 - d. Neither statement I nor II is correct.

ANSWER: d

59. Savings and loan associations are considered:

- a. commercial banks
- b. investment companies
- c. thrift institutions
- d. loan sharks

ANSWER: c

60. Which of the following is correct regarding the forms of market efficiency?

- I. In an efficient capital market stock prices provide an unbiased estimate of the true value of an enterprise.*
 - II. In an efficient capital market, stock prices reflect the present value of the firm's expected cash flows.*
- a. Only statement I is correct
 - b. Only statement II is correct
 - c. Both statements I and II are correct
 - d. Neither statement I nor II is correct

ANSWER: c

61. Which of the following statements is/are correct about financial intermediaries?

- I. Financial intermediaries primarily operate within the secondary market.*
 - II. Examples of financial intermediaries are: commercial banks, thrift companies and the internal revenue service.*
- a. Only statement I is correct.
 - b. Only statement II is correct.
 - c. Both statements I and II are correct.
 - d. Neither statement I nor II is correct.

ANSWER: d

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62. There are three forms of market efficiency. All of the following statements are correct EXCEPT:
- The weak form efficiency states that no investor can earn excess returns based on historical price information.
 - The strong form of efficiency states that no investor can consistently earn excess returns since all public and private information is reflected in stock prices.
 - The semi-strong form of efficiency states that no investor can earn excess returns based on an investment strategy using public information.
 - Market efficiency is a hard and fast rule that has been verified in real-world situations.

ANSWER: d

63. There are highly publicized hedge fund problems, for example Julian Robertson's Tiger fund or Long Term Capital Management. The impact that this has had on hedge funds is:
- minimal. They have continued to grow in size and number.
 - huge. Hedge funds are being discontinued.
 - being felt in the overall reallocation of hedge funds into bonds.
 - inconsequential and irrelevant. Investors may rely on the due diligence of the fund managers for safe investing.

ANSWER: a

64. An example of a financial middleman is a:
- commercial bank
 - stock broker
 - insurance company
 - thrift institution

ANSWER: b

65. An example of a listed security exchange within the secondary market is:
- OTC
 - NYSE
 - NASDAQ
 - Automated quotations

ANSWER: b

66. As a group, net savers are:
- businesses
 - households
 - government
 - partnerships

ANSWER: b

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67. Trading on the NYSE is conducted by members of the exchange. The members that execute orders and act as agents on behalf of their clients are:
- Floor Brokers
 - Exchange Runners
 - Designated Market Makers
 - SEC Agents

ANSWER: a

68. The difference between the bid price and the ask price on a security is the:
- spread
 - value
 - asset factor
 - commission

ANSWER: a

69. There are many reasons why there was a financial crisis in 2007. The most significant event closely associated with this crisis is:
- the stock market crash
 - the real estate bubble
 - government overspending
 - the use of financial hedging

ANSWER: b

70. In the financial crisis of 2007 there was cheap money coming from emerging markets. Examples of emerging markets are all of the following EXCEPT:
- South Korea
 - Australia
 - India
 - China

ANSWER: b

71. Although there was a financial crisis in 2007-2010, some firms were able to weather the crisis. These firms had all of the following characteristics which were directly responsible for their ability to survive the crisis EXCEPT:
- Tight control over fixed and variable costs
 - Low business risk
 - A business model which encouraged risk taking by management that paid off
 - Low product pricing

ANSWER: c

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72. What are the differences between the primary and secondary markets?

ANSWER: The primary market allows the investor to purchase new securities. Net proceeds from such sales go to the issuing corporation.

The secondary market allows the investor to purchase securities that are already in circulation. These are purchased through an organized security exchange, for example NYSE, or in the over-the-counter market, and none of the proceeds go to the issuing corporation.

73. What is the purpose and importance of the stock market indexes?

ANSWER: Stock market indexes give a broad indication of how the stock market or a segment of it performed during a particular day. The most known index is the Dow Jones Industrial Average (DJIA), which is composed of 30 stocks. The index gives an overview of how well stocks are doing, the overall health of the economy, and the anticipated marketability of securities.

74. Explain the degrees of market efficiency and their applicability to the stock market.

ANSWER:

1. Weak form market efficiency: No investor can earn excess returns based on historical price information or past return information.
2. Semi-strong market efficiency: No investor can earn excess returns based on an investment strategy using any public information. Stock prices consistently incorporate any new information about the stock or the issuing company.
3. Strong market efficiency: No investor can consistently earn excess returns based on any public or private information. Stock prices reflect all information, both public and private.

The number of investors who have traded with insider knowledge provides graphic evidence that the strong form efficiency does not hold.

75. Define the differences between the capital market and the money market. Give examples of the kinds of securities found in each category.

ANSWER: Money market securities are short-term and liquid with maturities under one year. There is minimal risk in the money market and money market securities generally pay interest that is guaranteed. Types of money market securities are: cash and cash equivalents, commercial paper, treasury bills, government securities, and certificates of deposit.

Capital market securities are long-term and illiquid with maturities greater than one year. There is significant risk involved and capital market securities earn a rate of return that is not guaranteed. Types of capital market securities are: preferred stocks, common stocks and bonds.

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76. List the types of disclosure forms required by the SEC and explain what information is contained in each form.

ANSWER: The various SEC forms listed in the text are:

1. 10-K. This is the firm's annual report to the SEC required from firms with publicly held securities.
2. 10-Q. This form contains quarterly information which updates the 10-K.
3. 14-A filing or Proxy Statement. This form is submitted prior to annual shareholder meetings detailing matters to be discussed and voted upon by the stockholders.

77. List changes that have occurred within financial markets regulation as a result of the passage of the Sarbanes-Oxley Act of 2002.

ANSWER: The significant changes that have occurred are:

1. Top management is directly responsible for the accuracy of their firm's financial statements. They must personally certify to the accuracy of the financial statements and internal control systems.
2. The act strengthens the independence and accountability of the audit committee of the firm's internal control system.
3. The act creates the Public Company Accounting Standards Board to oversee the auditing industry to improve the independence and credibility of auditors and the auditing function.
4. The act requires that auditors now certify a firm's financial control system and report any material weaknesses.
5. The act creates structural separation between financial analysts and investment bankers working for the same firm.
6. The act institutes new rules to ensure independence of financial analysts.

78. How did the mortgage market provide the impetus for the financial crisis of 2007-2010?

ANSWER: Mortgage markets in the US evolved to take advantage of easy money flowing in from around the world.

Mortgages became securitized. Banks, in the past, were very cautious with regard to who they lent to and ensured that borrowers had sufficient income and collateral to repay their loans to the bank.

Beginning in 1980, this changed. Banks and mortgage brokers and lenders would originate the loans and then resell them to other financial institutions. These institutions would bundle the mortgages into a mortgage-backed security or bond and sell them to investors around the world. These bonds were perceived to be very safe. But in the early 2000's the demand exceeded the supply and investment banks found a way to expand supply by reaching into more risky mortgages (known as subprime). As long as real estate prices were going up and the economy and employment levels were high, these derivative securities enjoyed a great deal of popularity and the default risk on these bonds was very low. The increase in home prices was unsustainable and in the end the owners of these derivatives suffered huge losses. There arose fear of lending money between banks which eventually led to a liquidity crisis which resulted in banks and financial institutions being liquidated or taken over by a stronger financial institution.

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79. The difference between puts and calls is:
- a. a call is an option to buy
 - b. a put allows the purchase of extra stock
 - c. a call cannot be resold
 - d. a put requires that the owner of the put must sell on a specific date

ANSWER: a

80. Foreign currency forward and future options are contracts that reflect _____:
- a. an obligation
 - b. a choice
 - c. a delivery date of the product
 - d. a specific requirement

ANSWER: b

81. Foreign currency forward and future options provide a means for firms to control _____
- a. foreign government intervention
 - b. foreign political problems
 - c. foreign exchange risk
 - d. the foreign transport of the goods

ANSWER: c

82. An investor decides to sell his stock based on information he received about some internal audit revealing that the company has severe financial problems. Trading on this information is called:
- a. private trading
 - b. insider trading
 - c. options trading
 - d. information trading

ANSWER: b

83. _____ finance seeks to identify why some investors react irrationally when confronted with unexpected ups and downs in the market
- a. Systematic
 - b. Weak-form
 - c. Asset Evaluation
 - d. Behavioral

ANSWER: d

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84. All of the following are anomalies that have impacted the financial market in the past EXCEPT:

- a. the real estate market
- b. the purchase and subsequent sale of internet stock
- c. the run up of gold prices
- d. investing in blue chip stock

ANSWER: d

85. All of the following contributed to the financial crisis of 2007-2010 EXCEPT:

- a. the Gulf War
- b. the securitization of mortgage loans
- c. very low interest rates
- d. foreign investment in the bond market

ANSWER: a

86. All of the following have tax implications as it concerns financial management decisions EXCEPT:

- a. Capital structure
- b. Dividend policy
- c. Inventory control
- d. Leasing

ANSWER: c

87. Financial intermediaries are compensated for their services by

- a. the interest rate spread.
- b. salary.
- c. stock options
- d. preferred stock certificates

ANSWER: a

88. Financial assets are all of the following EXCEPT:

- a. money
- b. debt securities
- c. equity securities
- d. inventory

ANSWER: d