Chapter 02
Financial Markets and Institutions

True / False Questions

1. The reinvestment of cash back into the firm's operations is an example of a flow of savings to investment.
True False

2. Smaller businesses are especially dependent upon internally generated funds.
True False

3. An individual can save and invest in a corporation only by lending money to it or by purchasing additional shares.
True False

4. Apple Computer is well known for its product innovations. Access to financing was not vital to Apple's growth and profitability.
True False

5. Hedge fund managers, unlike mutual fund managers, do not receive fund-performance-related fees.
True False

6. In the United States, banks are the most important source of long-term financing for businesses.
True False

7. A financial intermediary invests in financial assets rather than real assets.
True False

8. Only small companies can go through financial markets to obtain financing.
True False

9. Previously issued securities are traded among investors in the secondary markets.
True False

10. Only the IPOs for large corporations are sold in primary markets.
True False

11. The markets for long-term debt and equity are called capital markets.
True False

12. The stocks of major corporations trade in many markets throughout the world on a continuous or near-continuous basis.
True False

13. The derivative market is also a source of financing.
True False

14. Households hold more than half of U.S. corporate equities.
True False

15. The key to the banks' ability to make illiquid loans is their ability to pool liquid deposits from thousands of depositors.
True False

16. For corporate bonds, the higher the credit quality of an issuer, the higher the interest rate.
True False

17. The cost of capital is the interest rate paid on a loan from a bank or some other financial institution.
True False

18. Like public companies, private companies can also use their stock price as a measure of performance.
True False

19. The opportunity cost of capital is the expected rate of return that shareholders can obtain in the financial markets on investments with the same risk as the firm's capital investments.
True False

20. Whenever there is uncertainty, investors might be interested in trading, either to speculate or to lay off their risks, and a market may rise to meet the trading demand.
True False

21. Financial markets and intermediaries allow investors and businesses to reduce and reallocate risk.
True False

22. The cost of capital is the minimum acceptable rate of return for capital investment.
True False

23. The rates of return on investments outside the corporation set the minimum return for investment projects inside the corporation.
True False

24. Financing for public corporations must flow through financial markets.
True False

25. Financing for private corporations must flow through financial intermediaries.
True False

26. Almost all foreign exchange trading occurs on the floors of the FOREX exchanges in New York and London.
True False

27. During the Financial Crisis of 2007-2009, the U.S. government bailed out all firms in danger of failing.
True False

28. From June 2001 to June 2006, housing prices in the United States doubled.
True False

29. The effects of the financial crisis of 2007-2009 were confined to the U.S. and domestic companies.
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30. One root of the financial crisis of 2007-2009 was the strict money policies promoted by the U.S. Federal Reserve and other central banks after the technology bubble burst (i.e., money was relatively expensive during this time).
True False

Multiple Choice Questions

31. Corporate financing comes ultimately from:
A. savings by households and foreign investors.
B. cash generated from the firm's operations.
C. the financial markets and intermediaries.
D. the issue of shares in the firm.

32. A company can pay for its expansion in all the following ways *except*:
A. by using the earnings generated from its sale of obsolete equipment.
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C. by purchasing bonds in the secondary market.
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33. "Reinvestment" means:
A. new investment in new operations.
B. additional investment in existing operations.
C. new investment by new shareholders.
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34. Excess cash held by a firm should be:
A. reinvested by the firm in projects offering the highest rate of return.
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C. reinvested by the firm in the financial markets.
D. distributed to bondholders in the form of extra coupon payments.

35. A financial intermediary provides financing for:
A. individuals.
B. companies.
C. other organizations.
D. all of these.

36. Which of the following statements is *not* characteristic of mutual funds?
A. They are financial institutions.
B. They raise money by selling shares to investors.
C. They pool the savings of many investors.
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37. Compared to buying stocks and bonds directly, what are the advantages of investing in a mutual fund?
A. Mutual funds are efficiently diversified and professionally managed.
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38. "Balanced" mutual funds:
A. offer mixtures of stocks and bonds.
B. spread their investments equally over a specified geographic area.
C. spread their investments equally over various industries.
D. charge a management fee that is proportionate to the investment return.

39. Which of the following mutual funds have a tax advantage?
A. Balanced funds
B. Pension funds
C. Bond funds
D. Funds that invest in foreign countries

40. Banks cover the costs of the service they provide primarily via:
A. a management fee.
B. a service charge.
C. an interest rate differential.
D. an operating fee.

41. Which of the following financial intermediaries has shown a preference for investing in *long-term* financial assets?
A. Commercial banks
B. Insurance companies
C. Finance companies
D. Savings banks

42. Which of the following financial intermediaries can loan money directly to businesses?
A. Mutual funds
B. Pension funds
C. Insurance companies
D. All of these

43. Insurance companies can usually cover the claims of policyholders because:
A. the incidence of claims normally averages out.
B. they issue thousands of insurance policies.
C. the cost of paying for claims has already been factored into the price of the policies.
D. all of these.

44. Which of the following is *not* typically considered a function of financial intermediaries?
A. Providing a payment mechanism
B. Investing in real assets
C. Accumulating funds from smaller investors
D. Spreading, or pooling risk among individuals

45. U.S. bonds and other debt securities are mostly held by:
A. institutional investors.
B. households.
C. foreign investors.
D. state and local governments.

46. Liquidity is important to a mutual fund because:
A. a fund that is less liquid will attract more investors.
B. the fund's shareholders may want to redeem their shares at any time.
C. the fund's managers need liquidity to trade actively.
D. the fund needs to distribute payouts to its shareholders and managers periodically.

47. Property insurance companies protect themselves against the extensive damage caused by hurricanes and earthquakes by:
A. selling thousands of policies to different homeowners.
B. factoring the cost into the price of the policies.
C. buying reinsurance against such catastrophes.
D. declaring bankruptcy when the need arises.

48. Financing for public corporations flows through:
A. the financial markets only.
B. financial intermediaries only.
C. derivatives markets.
D. the financial markets, financial intermediaries, or both.

49. When corporations need to raise funds through stock issues, they rely on the:
A. primary market.
B. secondary market.
C. tertiary market.
D. centralized NASDAQ exchange.

50. A primary market would be utilized when:
A. investors buy or sell existing securities.
B. shares of common stock are exchanged.
C. securities are initially issued.
D. a commission must be paid on the transaction.

51. The primary distinction between securities sold in the primary and secondary markets is the:
A. riskiness of the securities.
B. price of the securities.
C. previous issuance of the securities.
D. profitability of the issuing corporation.

52. Which of the following are both a financial intermediary and a financial institution?
A. Mutual funds
B. Pension funds
C. Insurance companies
D. Hedge funds

53. A share of IBM stock is purchased by an individual investor for $75 and later sold to another investor for $125. Who profits from this sale?
A. IBM.
B. The first investor.
C. The second investor.
D. Profit is split between IBM and the investor.

54. Which of the following financial assets might be *least* likely to have an active secondary market?
A. Common stock of a large firm
B. Bank loans made to smaller firms
C. Bonds of a major, multinational corporation
D. Debt issued by the U.S. Treasury

55. When Patricia sells her General Motors common stock at the same time that Brian purchases the same amount of GM stock, GM receives:
A. the dollar value of the transaction.
B. the dollar amount of the transaction, less brokerage fees.
C. only the par value of the common stock.
D. nothing.

56. Which of the following financial markets is in one centralized location?
A. NYSE
B. NASDAQ
C. The over-the-counter market
D. The European Monetary Union

57. Which of the following financial markets is *not* located in one centralized location?
A. NYSE
B. LSE
C. NASDAQ
D. CBOT

58. Corporate debt instruments are most commonly traded:
A. on the NYSE.
B. on NASDAQ.
C. in the money market.
D. in the over-the-counter market.

59. A bond differs from a share of stock in that:
A. a bond represents a claim on the firm.
B. a bond has more risk.
C. a bond has guaranteed returns.
D. a bond has a maturity date.

60. Short-term financing decisions commonly occur in the:
A. primary markets.
B. secondary markets.
C. capital markets.
D. money markets.

61. Long-term financing decisions commonly occur in the:
A. option markets.
B. secondary markets.
C. capital markets.
D. money markets.

62. You can buy silver in the:
A. capital markets.
B. foreign exchange markets.
C. commodities markets.
D. option markets.

63. Commodity and derivative markets:
A. are sources of financing.
B. enable the financial manager to adjust the firm's exposure to various business risks.
C. are always over-the-counter markets.
D. all of these.

64. A financial institution:
A. is a kind of financial intermediary.
B. simply pools and invests savings.
C. raises financing by selling shares or policies.
D. invests primarily in commodities.

65. U.S. corporate equities are mostly held by:
A. insurance companies.
B. households.
C. foreign investors.
D. state and local governments.

66. In 2010, U.S. corporate and foreign bonds totaled:
A. less than $500 billion.
B. about $3 trillion.
C. about $7 trillion.
D. more than $11 trillion.

67. In 2010, U.S. corporate equities totaled:
A. less than $6 trillion.
B. about $10 trillion.
C. about $16 trillion.
D. more than $20 trillion.

68. An example of how financial intermediaries can assist in shifting an individual's consumption to the future is:
A. lending money to the individual.
B. providing a checking account.
C. opening a savings account.
D. requiring purchases to be in cash.

69. An example of how financial intermediaries can assist in shifting an individual's consumption forward in time is:
A. providing a line of credit.
B. opening a passbook account.
C. starting a life insurance policy.
D. starting an auto insurance policy.

70. One reason suggesting that banks may be better than individuals at matching lenders to borrowers is that banks:
A. can shift loan risk to their deposit customers.
B. are motivated by the potential for profit.
C. do not have any income tax liability.
D. have information to evaluate creditworthiness.

71. Which of the following is *least* liquid?
A. Foreign currency
B. U.S. Treasury bonds
C. Rare coins
D. Savings deposit

72. Financial markets and intermediaries:
A. channel savings to real investment.
B. enable investors and businesses to reduce risk.
C. provide liquidity.
D. all of these.

73. Which of the following functions does *not* require financial markets?
A. Transporting of cash across time
B. Provision of liquidity
C. Risk reduction by investment in diversified portfolios
D. Provision of trade information

74. For the consumer, a credit card:
A. transports money forward in time.
B. provides liquidity.
C. is a convenient way to pay.
D. all of these.

75. Which of the following actions does *not* help reduce risk?
A. Extending the service warranty for your notebook
B. Converting your money market account to a mutual fund account
C. Contracting to sell your farm produce to the neighborhood grocery
D. Buying Japanese yen now when you plan to study in Japan next year

76. Which of the following information is *not* provided by the financial markets?
A. The price of six ounces of gold
B. The cost of borrowing $500,000 for 5 years
C. Microsoft's earnings in 2002
D. The cost of wiring one million yen to Japan

77. The opportunity cost of capital:
A. is the interest rate that the firm pays on a loan from a financial institution.
B. is the maximum acceptable rate of return on a project.
C. is the minimum acceptable rate of return on a project.
D. is always less than 10%.

78. Who was responsible for the financial crisis of 2007-2009?
A. The U.S. Federal Reserve, for its policy of easy money
B. The U.S. government, for pushing banks to expand credit for low-income housing
C. Bankers, who aggressively promoted and resold subprime mortgages
D. All of these

79. A capital investment that generates a 10% rate of return is worthwhile if:
A. corporate bonds of similar risk offer 8% rates of return.
B. corporate bonds of similar risk offer 10% rates of return.
C. top-quality corporate bonds offer 10% rates of return.
D. the expected rate of return on the stock market is 12%.

80. The cost of capital:
A. is the expected rate of return on capital investment.
B. is an opportunity cost determined by the risk-free rate of return.
C. is the interest rate that the firm pays on a loan from a bank or insurance company.
D. for risky investments is normally higher than the firm's borrowing rate.

81. In the context of housing, what is an ARM?
A. A mortgage with high initial payments, offset by significantly lower payments later
B. A mortgage with low initial payments, offset by significantly higher payments later
C. A mortgage with no initial payments, offset by significantly high payments later
D. A mortgage with equal payments per period

82. During the Financial Crisis of 2007-2009, the U.S. government bailed out the following firms *except:*
A. AIG.
B. Fannie Mae.
C. Lehman Brothers.
D. all of these.

Essay Questions

83. How can an individual save and invest in a corporation?

84. What are the advantages of investing indirectly in stocks and bonds via mutual funds and pension funds?

85. What are the key differences between a financial intermediary and a financial institution?

86. What are the largest institutional investors in bonds? In stocks?

87. Why are secondary market transactions of importance to corporations?

88. What is meant by over-the-counter trading?

89. Describe the distinguishing characteristics of the major financial markets.

90. What are the functions of financial markets?

91. Why do nonfinancial corporations need modern financial markets and institutions?

92. Rhonda and Reggie Hotspur are working hard to save for their children's college education. They don't need more cash for current consumption but will face big tuition bills in 2020. Should they therefore avoid investing in stocks that pay generous current cash dividends? Explain briefly.

93. What is an exchange traded fund? What are some popular choices of exchange traded funds?

94. How can the financial manager identify the cost of the capital raised by a corporation?

95. How was the role of many bankers in the Financial Crisis of 2007-2009 an example of an agency problem?

96. Investing $100,000 in additional raw materials today—mostly in palladium—should allow Cryogenic Concepts to increase production and earn an additional $112,000 next year. This payoff would cover the investment today, plus a 12% return. Palladium is traded in commodity markets. The CFO has studied the history of returns on investments in palladium and believes that investors in that precious metal can reasonably expect a 15% return. Is Cryogenic's investment in palladium a good idea? Why or why not?

97. Healthy Fish, Inc. is considering the purchase of a batch of experimental fish fry for $10,000. The fry will mature and be ready for the market in a year. A government agency guarantees the hardiness of the new breed—it will make a one-for-one same-size replacement if any fish should die of infections during the first year when reared according to clearly specified instructions. Healthy Fish expects to spend another $42,000 to raise the fish. Suppose that Healthy Fish can enter into a futures contract to sell the entire batch of fish for $60,000, the contract will cost $3,000. What is the opportunity cost of capital for this investment? Should Healthy Fish make the investment? If Healthy Fish cannot set up a futures contract, what is its opportunity cost of capital? Should it invest in this case? Assume that the current interest rate on AAA corporate bonds is 6.25%, and that the historical rate of return on the stock exchange is 10%.

98. What are subprime mortgages and how were they a part of the Financial Crisis of 2007-2009?

Chapter 02 Financial Markets and Institutions Answer Key

True / False Questions

1. The reinvestment of cash back into the firm's operations is an example of a flow of savings to investment.
TRUE

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 1 Easy
Learning Objective: 02-01 Understand how financial markets and institutions channel savings to corporate investment.
Topic: The Importance of Financial Markets and Institutions

2. Smaller businesses are especially dependent upon internally generated funds.
TRUE

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Difficulty: 3 Hard
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3. An individual can save and invest in a corporation only by lending money to it or by purchasing additional shares.
FALSE

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4. Apple Computer is well known for its product innovations. Access to financing was not vital to Apple's growth and profitability.
FALSE

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5. Hedge fund managers, unlike mutual fund managers, do not receive fund-performance-related fees.
FALSE

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Topic: The Crisis of 2007-2009

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C. an interest rate differential.
D. an operating fee.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the basic structure of mutual funds; pension funds; banks; and insurance companies.
Topic: The Flow of Savings to Corporations

41. Which of the following financial intermediaries has shown a preference for investing in *long-term* financial assets?
A. Commercial banks
B. Insurance companies
C. Finance companies
D. Savings banks

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the basic structure of mutual funds; pension funds; banks; and insurance companies.
Topic: The Flow of Savings to Corporations

42. Which of the following financial intermediaries can loan money directly to businesses?
A. Mutual funds
B. Pension funds
C. Insurance companies
D. All of these

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 1 Easy
Learning Objective: 02-02 Understand the basic structure of mutual funds; pension funds; banks; and insurance companies.
Topic: The Flow of Savings to Corporations

43. Insurance companies can usually cover the claims of policyholders because:
A. the incidence of claims normally averages out.
B. they issue thousands of insurance policies.
C. the cost of paying for claims has already been factored into the price of the policies.
D. all of these.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the basic structure of mutual funds; pension funds; banks; and insurance companies.
Topic: The Flow of Savings to Corporations

44. Which of the following is *not* typically considered a function of financial intermediaries?
A. Providing a payment mechanism
B. Investing in real assets
C. Accumulating funds from smaller investors
D. Spreading, or pooling risk among individuals

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the basic structure of mutual funds; pension funds; banks; and insurance companies.
Topic: The Flow of Savings to Corporations

45. U.S. bonds and other debt securities are mostly held by:
A. institutional investors.
B. households.
C. foreign investors.
D. state and local governments.

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the basic structure of mutual funds; pension funds; banks; and insurance companies.
Topic: The Flow of Savings to Corporations

46. Liquidity is important to a mutual fund because:
A. a fund that is less liquid will attract more investors.
B. the fund's shareholders may want to redeem their shares at any time.
C. the fund's managers need liquidity to trade actively.
D. the fund needs to distribute payouts to its shareholders and managers periodically.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 3 Hard
Learning Objective: 02-02 Understand the basic structure of mutual funds; pension funds; banks; and insurance companies.
Topic: The Flow of Savings to Corporations

47. Property insurance companies protect themselves against the extensive damage caused by hurricanes and earthquakes by:
A. selling thousands of policies to different homeowners.
B. factoring the cost into the price of the policies.
C. buying reinsurance against such catastrophes.
D. declaring bankruptcy when the need arises.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 3 Hard
Learning Objective: 02-02 Understand the basic structure of mutual funds; pension funds; banks; and insurance companies.
Topic: Functions of Financial Markets and Intermediaries

48. Financing for public corporations flows through:
A. the financial markets only.
B. financial intermediaries only.
C. derivatives markets.
D. the financial markets, financial intermediaries, or both.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 1 Easy
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

49. When corporations need to raise funds through stock issues, they rely on the:
A. primary market.
B. secondary market.
C. tertiary market.
D. centralized NASDAQ exchange.

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

50. A primary market would be utilized when:
A. investors buy or sell existing securities.
B. shares of common stock are exchanged.
C. securities are initially issued.
D. a commission must be paid on the transaction.

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 1 Easy
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

51. The primary distinction between securities sold in the primary and secondary markets is the:
A. riskiness of the securities.
B. price of the securities.
C. previous issuance of the securities.
D. profitability of the issuing corporation.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

52. Which of the following are both a financial intermediary and a financial institution?
A. Mutual funds
B. Pension funds
C. Insurance companies
D. Hedge funds

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: Functions of Financial Markets and Intermediaries

53. A share of IBM stock is purchased by an individual investor for $75 and later sold to another investor for $125. Who profits from this sale?
A. IBM.
B. The first investor.
C. The second investor.
D. Profit is split between IBM and the investor.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

54. Which of the following financial assets might be *least* likely to have an active secondary market?
A. Common stock of a large firm
B. Bank loans made to smaller firms
C. Bonds of a major, multinational corporation
D. Debt issued by the U.S. Treasury

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 3 Hard
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

55. When Patricia sells her General Motors common stock at the same time that Brian purchases the same amount of GM stock, GM receives:
A. the dollar value of the transaction.
B. the dollar amount of the transaction, less brokerage fees.
C. only the par value of the common stock.
D. nothing.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 3 Hard
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

56. Which of the following financial markets is in one centralized location?
A. NYSE
B. NASDAQ
C. The over-the-counter market
D. The European Monetary Union

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

57. Which of the following financial markets is *not* located in one centralized location?
A. NYSE
B. LSE
C. NASDAQ
D. CBOT

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

58. Corporate debt instruments are most commonly traded:
A. on the NYSE.
B. on NASDAQ.
C. in the money market.
D. in the over-the-counter market.

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

59. A bond differs from a share of stock in that:
A. a bond represents a claim on the firm.
B. a bond has more risk.
C. a bond has guaranteed returns.
D. a bond has a maturity date.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

60. Short-term financing decisions commonly occur in the:
A. primary markets.
B. secondary markets.
C. capital markets.
D. money markets.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 1 Easy
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

61. Long-term financing decisions commonly occur in the:
A. option markets.
B. secondary markets.
C. capital markets.
D. money markets.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 1 Easy
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

62. You can buy silver in the:
A. capital markets.
B. foreign exchange markets.
C. commodities markets.
D. option markets.

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 1 Easy
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

63. Commodity and derivative markets:
A. are sources of financing.
B. enable the financial manager to adjust the firm's exposure to various business risks.
C. are always over-the-counter markets.
D. all of these.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 3 Hard
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

64. A financial institution:
A. is a kind of financial intermediary.
B. simply pools and invests savings.
C. raises financing by selling shares or policies.
D. invests primarily in commodities.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 3 Hard
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

65. U.S. corporate equities are mostly held by:
A. insurance companies.
B. households.
C. foreign investors.
D. state and local governments.

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

66. In 2010, U.S. corporate and foreign bonds totaled:
A. less than $500 billion.
B. about $3 trillion.
C. about $7 trillion.
D. more than $11 trillion.

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

67. In 2010, U.S. corporate equities totaled:
A. less than $6 trillion.
B. about $10 trillion.
C. about $16 trillion.
D. more than $20 trillion.

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

68. An example of how financial intermediaries can assist in shifting an individual's consumption to the future is:
A. lending money to the individual.
B. providing a checking account.
C. opening a savings account.
D. requiring purchases to be in cash.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 3 Hard
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

69. An example of how financial intermediaries can assist in shifting an individual's consumption forward in time is:
A. providing a line of credit.
B. opening a passbook account.
C. starting a life insurance policy.
D. starting an auto insurance policy.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

70. One reason suggesting that banks may be better than individuals at matching lenders to borrowers is that banks:
A. can shift loan risk to their deposit customers.
B. are motivated by the potential for profit.
C. do not have any income tax liability.
D. have information to evaluate creditworthiness.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

71. Which of the following is *least* liquid?
A. Foreign currency
B. U.S. Treasury bonds
C. Rare coins
D. Savings deposit

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

72. Financial markets and intermediaries:
A. channel savings to real investment.
B. enable investors and businesses to reduce risk.
C. provide liquidity.
D. all of these.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 1 Easy
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

73. Which of the following functions does *not* require financial markets?
A. Transporting of cash across time
B. Provision of liquidity
C. Risk reduction by investment in diversified portfolios
D. Provision of trade information

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: Functions of Financial Markets and Intermediaries

74. For the consumer, a credit card:
A. transports money forward in time.
B. provides liquidity.
C. is a convenient way to pay.
D. all of these.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: Functions of Financial Markets and Intermediaries

75. Which of the following actions does *not* help reduce risk?
A. Extending the service warranty for your notebook
B. Converting your money market account to a mutual fund account
C. Contracting to sell your farm produce to the neighborhood grocery
D. Buying Japanese yen now when you plan to study in Japan next year

AACSB: Reflective Thinking Skills
Blooms: Application
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: Functions of Financial Markets and Intermediaries

76. Which of the following information is *not* provided by the financial markets?
A. The price of six ounces of gold
B. The cost of borrowing $500,000 for 5 years
C. Microsoft's earnings in 2002
D. The cost of wiring one million yen to Japan

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: Functions of Financial Markets and Intermediaries

77. The opportunity cost of capital:
A. is the interest rate that the firm pays on a loan from a financial institution.
B. is the maximum acceptable rate of return on a project.
C. is the minimum acceptable rate of return on a project.
D. is always less than 10%.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: Functions of Financial Markets and Intermediaries

78. Who was responsible for the financial crisis of 2007-2009?
A. The U.S. Federal Reserve, for its policy of easy money
B. The U.S. government, for pushing banks to expand credit for low-income housing
C. Bankers, who aggressively promoted and resold subprime mortgages
D. All of these

AACSB: Communication Abilities
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009.
Topic: The Crisis of 2007-2009

79. A capital investment that generates a 10% rate of return is worthwhile if:
A. corporate bonds of similar risk offer 8% rates of return.
B. corporate bonds of similar risk offer 10% rates of return.
C. top-quality corporate bonds offer 10% rates of return.
D. the expected rate of return on the stock market is 12%.

AACSB: Reflective Thinking Skills
Blooms: Application
Difficulty: 1 Easy
Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009.
Topic: Functions of Financial Markets and Intermediaries

80. The cost of capital:
A. is the expected rate of return on capital investment.
B. is an opportunity cost determined by the risk-free rate of return.
C. is the interest rate that the firm pays on a loan from a bank or insurance company.
D. for risky investments is normally higher than the firm's borrowing rate.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 3 Hard
Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009.
Topic: Functions of Financial Markets and Intermediaries

81. In the context of housing, what is an ARM?
A. A mortgage with high initial payments, offset by significantly lower payments later
B. A mortgage with low initial payments, offset by significantly higher payments later
C. A mortgage with no initial payments, offset by significantly high payments later
D. A mortgage with equal payments per period

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009.
Topic: The Crisis of 2007-2009

82. During the Financial Crisis of 2007-2009, the U.S. government bailed out the following firms *except:*
A. AIG.
B. Fannie Mae.
C. Lehman Brothers.
D. all of these.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009.
Topic: The Crisis of 2007-2009

Essay Questions

83. How can an individual save and invest in a corporation?

Households and foreign investors provide most of the savings for corporate financing; financial markets and institutions provide the process and contracts to channel funds from savers to corporations (financial investment) for real investment. Figures 2-1 and 2-2 are excellent graphics for this discussion. Individuals can save and invest in a corporation by lending to, or buying shares in, the financial markets or a financial intermediary such as a bank or mutual fund that subsequently invests in the corporation. When the corporation retains cash and reinvests in the firm's operations, that cash is saved and invested on behalf of the firm's shareholders. The reinvested cash could have been paid out to the shareholders. By not taking the cash, these investors have also reinvested their savings in the corporation.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 1 Easy
Learning Objective: 02-01 Understand how financial markets and institutions channel savings to corporate investment.
Topic: The Flow of Savings to Corporations

84. What are the advantages of investing indirectly in stocks and bonds via mutual funds and pension funds?

Mutual funds pool savings from many individual investors and then invest in a diversified portfolio of securities. Each individual investor then owns a proportionate share of the mutual fund's portfolio. The advantages of mutual funds for individuals are diversification, professional investment management, and record keeping. In particular, an individual can achieve a widely diversified portfolio at a reasonable cost even when the investment amount is very small. Pension funds are also pooled investments, but are set up by an employer to provide for employees' retirement. Pension funds offer efficient diversification and professional management, too. Additionally, they offer a tax advantage because investment returns are not taxed until withdrawn from the fund.

AACSB: Analytical Skills
Blooms: Analysis
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the basic structure of mutual funds; pension funds; banks; and insurance companies.
Topic: The Flow of Savings to Corporations

85. What are the key differences between a financial intermediary and a financial institution?

Financial intermediaries such as mutual funds and pension funds pool and invest savings in financial assets. Financial institutions such as banks or insurance companies raise money in various ways—for example, by accepting deposits or selling insurance policies. They not only invest in securities but also lend directly to businesses. They also provide various other financial services such as payment and risk management services.

AACSB: Analytical Skills
Blooms: Analysis
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the basic structure of mutual funds; pension funds; banks; and insurance companies.
Topic: The Flow of Savings to Corporations

86. What are the largest institutional investors in bonds? In stocks?

The largest institutional investors in bonds are insurance companies. Other major institutional investors in bonds are pension funds, mutual funds, and banks and other savings institutions. The largest institutional investors in shares are pension funds, mutual funds, and insurance companies.

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 1 Easy
Learning Objective: 02-02 Understand the basic structure of mutual funds; pension funds; banks; and insurance companies.
Topic: The Flow of Savings to Corporations

87. Why are secondary market transactions of importance to corporations?

Although corporations do not generate cash flows from secondary market transactions (other than those they initiate), it is the existence of secondary markets that made many investors comfortable enough to invest in their primary market offerings. In other words, if investors felt there would not be an organized, convenient market in which to alter their portfolio of securities, their original investment decisions might be quite different. Also, the secondary market acts as a form of "scorecard" for the decisions of management and the general prospects of the firm. Market values are, in most instances, much more important than book values, thus values in the secondary market give investors and analysts alike the ability to evaluate a firm. These evaluations will also affect future primary market offerings.

AACSB: Analytical Skills
Blooms: Analysis
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

88. What is meant by over-the-counter trading?

"Over the counter" refers to trading that does not take place on a centralized exchange such as the New York Stock Exchange. For example, trading of securities on NASDAQ is over the counter because NASDAQ is a network of security dealers linked by computers. Although some corporate bonds are traded on the NYSE, most corporate bonds are traded over the counter, as are all U.S. Treasury securities. Foreign exchange trading is also over the counter.

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 1 Easy
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

89. Describe the distinguishing characteristics of the major financial markets.

The stock market, or equity market, is the market where the stocks of corporations are issued and traded. Most trading in the shares of large corporations takes place on centralized stock exchanges such as the NYSE. A corporation may also list its shares on several stock exchanges simultaneously. There is also a thriving over-the-counter market in shares. The fixed-income market is the market for bonds and other debt securities. A few corporate debt securities are traded on stock exchanges, but most corporate debt securities and government debt are traded over the counter. The foreign exchange market is the market where different currencies are traded. Most trading takes place in over-the-counter transactions between the major international banks. Another major market is the commodities market, where agricultural commodities, fuels (including crude oil and natural gas), and metals (such as gold, silver, and platinum) are traded on organized exchanges. In addition to these, there are also markets for options and other derivatives, which derive their value from the price of other underlying securities such as stocks or commodities.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: The Flow of Savings to Corporations

90. What are the functions of financial markets?

Financial markets allow for many necessary and important functions including providing the abilities to transport cash across time, transfer risk, provide liquidity, and allow for greater diversification in investing. Financial markets help channel savings to corporate investment, matching borrowers and lenders. Trading in financial markets provides a wealth of useful information for the financial manager.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: Functions of Financial Markets and Intermediaries

91. Why do nonfinancial corporations need modern financial markets and institutions?

The reason is straightforward: Corporations need access to financing in order to innovate and grow. A modern financial system offers different types of financing, depending on a corporation's age and the nature of its business. A high-tech startup will seek venture capital financing, for example. A mature firm will rely more on bond markets.

AACSB: Analytical Skills
Blooms: Analysis
Difficulty: 1 Easy
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: Functions of Financial Markets and Intermediaries

92. Rhonda and Reggie Hotspur are working hard to save for their children's college education. They don't need more cash for current consumption but will face big tuition bills in 2020. Should they therefore avoid investing in stocks that pay generous current cash dividends? Explain briefly.

Rhonda and Reggie need not avoid high-dividend stocks. They can reinvest the dividends and keep reinvesting until it's time to pay the tuition bills. They will have to pay taxes on the dividends, however, which could affect their investment strategy.

AACSB: Analytical Skills
Blooms: Analysis
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: Functions of Financial Markets and Intermediaries

93. What is an exchange traded fund? What are some popular choices of exchange traded funds?

Exchange traded funds (ETFs) are portfolios of stocks that can be bought or sold in a single trade. These include Standard & Poor's Depository Receipts (SPDRs, or "spiders"), which are portfolios matching Standard & Poor's stock market indexes. The total amount invested in the spider tracking the benchmark S&P 500 index was about $94 billion by early 2011. You can also buy DIAMONDS, which track the Dow Jones Industrial Average; QUBES or QQQQs, which track the NASDAQ 100 index; and Vanguard ETFs, which track the Vanguard Total Stock Market index, a basket of almost all the stocks traded in the United States. You can also buy ETFs that track foreign stock markets, bonds, or commodities.

AACSB: Communication Abilities
Blooms: Knowledge
Difficulty: 2 Medium
Learning Objective: 02-03 Explain the functions of financial markets and institutions.
Topic: Functions of Financial Markets and Intermediaries

94. How can the financial manager identify the cost of the capital raised by a corporation?

The cost of capital is the minimum acceptable rate of return on capital investment. It is an opportunity cost, that is, a rate of return that investors could earn in financial markets. For a safe capital investment, the opportunity cost is the interest rate on safe debt securities, such as high-grade corporate bonds. For riskier capital investments, the opportunity cost is the expected rate of return on risky securities, such as investments in the stock market.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 2 Medium
Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009.
Topic: Functions of Financial Markets and Intermediaries

95. How was the role of many bankers in the Financial Crisis of 2007-2009 an example of an agency problem?

An agency problem is a failure for an agent (the banker) to work in the best interest of his or her principals (the bank's shareholders). Typically a result of a poor incentive structure, agency problems played a role in the Financial Crisis of 2007-2009. Bonuses and promotions provided the incentive to promote the sale and resale of subprime mortgages and mortgage-backed securities. As suggested in the last chapter, managers were probably aware that a strategy of originating massive amounts of subprime debt was likely to end badly.

AACSB: Analytical Skills
Blooms: Analysis
Difficulty: 3 Hard
Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009.
Topic: The Crisis of 2007-2009

96. Investing $100,000 in additional raw materials today—mostly in palladium—should allow Cryogenic Concepts to increase production and earn an additional $112,000 next year. This payoff would cover the investment today, plus a 12% return. Palladium is traded in commodity markets. The CFO has studied the history of returns on investments in palladium and believes that investors in that precious metal can reasonably expect a 15% return. Is Cryogenic's investment in palladium a good idea? Why or why not?

This would not be a good investment, as the opportunity cost of capital in this situation (15%) is greater than the expected return (12%). The investment should be made only if the expected return on the project is greater than the opportunity cost of capital.

AACSB: Analytical Skills
Blooms: Analysis
Difficulty: 2 Medium
Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009.
Topic: Functions of Financial Markets and Intermediaries

97. Healthy Fish, Inc. is considering the purchase of a batch of experimental fish fry for $10,000. The fry will mature and be ready for the market in a year. A government agency guarantees the hardiness of the new breed—it will make a one-for-one same-size replacement if any fish should die of infections during the first year when reared according to clearly specified instructions. Healthy Fish expects to spend another $42,000 to raise the fish. Suppose that Healthy Fish can enter into a futures contract to sell the entire batch of fish for $60,000, the contract will cost $3,000. What is the opportunity cost of capital for this investment? Should Healthy Fish make the investment? If Healthy Fish cannot set up a futures contract, what is its opportunity cost of capital? Should it invest in this case? Assume that the current interest rate on AAA corporate bonds is 6.25%, and that the historical rate of return on the stock exchange is 10%.

When Healthy Fish can enter into a futures contract, the capital outlay required = $10,000 + $42,000 + $3,000 = $55,000. So the rate of return = ($60,000 - $55,000)/$55,000 = 9.09%. Since the government agency and futures contract guarantee the payoff for the investment, the opportunity cost of capital is the rate of return on safe investments, such as top-quality (AAA) corporate debt issues (i.e., 6.25%). Since the investment return of 9.09% is higher than the opportunity cost of capital, Healthy Fish should invest in the experimental fish fry. When Healthy Fish cannot set up a futures contract, the capital outlay required = $10,000 + $42,000 = $52,000. So the expected rate of return = ($60,000 - $52,000)/$52,000 = 15.38%. Since the expected selling price is not guaranteed, the opportunity cost of capital is the rate of return on risky securities, such as investments in the stock market (i.e., 10%). Since the expected investment return of 15.38% is higher than the opportunity cost of capital, Healthy Fish should still invest in the experimental fish fry. In fact, even when Healthy Fish can set up a futures contract, it should consider whether the contract is worthwhile given the company's risk-return preferences and risk characteristics (such as value-at-risk).

AACSB: Analytical Skills
Blooms: Evaluation
Difficulty: 3 Hard
Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009.
Topic: Functions of Financial Markets and Intermediaries

98. What are subprime mortgages and how were they a part of the Financial Crisis of 2007-2009?

In the early twenty-first century, central banks promoted a policy of cheap money (low interest rates). Banks took advantage of this cheap money to expand the supply of *subprime mortgages* to low-income borrowers. Subprime mortgages are mortgages given to people with a higher probability of default than a typical home buyer. Many banks tempted would-be home buyers with low initial payments, offset by significantly higher payments later. Most subprime mortgages were then bundled with other mortgages into mortgage-backed securities that could be resold. But, instead of selling these securities to investors who could best bear the risk, many banks kept large quantities of the loans on their own books or sold them to other banks. When housing prices began to decline and mortgage default rates began to rise, owners of the mortgage-backed securities began to report massive losses and many teetered on the brink of bankruptcy.

AACSB: Reflective Thinking Skills
Blooms: Understanding
Difficulty: 3 Hard
Learning Objective: 02-04 Understand the main events behind the financial crisis of 2007-2009.
Topic: The Crisis of 2007-2009