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 Depository 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 traunche 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
Difficutly: 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 – 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: Earnings retention rate = 1 - dividend payout rate
Difficulty: Moderate
Ref: Equity Securities

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

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

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

Answer: If a stock is trading at 12 times earnings, 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 x (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