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 a characteristic of the primary nonmarketable financial asset 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:

a. negotiable but are not liquid.
b. marketable but are not liquid.
c. liquid but are not personal.
d. liquid but are not 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 corporate 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. can 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. replaced with new bonds that have a lower interest rate.
c. replaced with new bonds that have 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 issued 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. For an investor with a 28% marginal tax rate, what return would a corporate bond have to pay to provide the same after-tax return as a municipal bond paying 5%?

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. semi-annually.
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(n):

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 bonds would have the lowest yield?

a. AAA-rated corporate bond
b. AAA-rated insured municipal bond
c. U.S. Treasury bond
d. AAA-rated 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 Intel's:

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

Ans: d
Difficulty: Difficult
Ref: Equity Securities

27. Which of the following is a security that represents shares of a foreign company, which are held in a bank?

a. Convertible bond
b. American Depository Receipt (ADR)
c. Asset-backed security
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?

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 contracts are obligations to buy or sell.

Ans: d
Difficulty: Difficult
Ref: Derivative Securities

32. The premium on an option is the:

a. par value of the option.
b. price of the option.
c. book value of the option.
d. price at which a security may be bought or sold using the option.

Ans: b
Difficulty: Moderate
Ref: Derivative Securities

33. If a call option has a $10 strike price, and the underlying stock is trading at $11, then the option is considered:

a. in the money.
b. at the money.
c. out of the money.
d. worthless.

Ans: a
Difficulty: Easy
Ref: Derivative Securities

True-False Questions

1. Direct investing involves trades made by directly purchasing shares of a financial intermediary.

Ans: False
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: False
Difficulty: Moderate
Ref: Nonmarketable Financial Assets

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

Ans: False
Difficulty: Moderate
Ref: Nonmarketable Financial Assets

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

Ans: False
Difficulty: Easy
Ref: Money Market Securities

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

Ans: True
Difficulty: Moderate
Ref: Money Market Securities

7. The money market rate most often used as a benchmark for the risk-free rate is the 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: False
Difficulty: Difficult
Ref: Money Market Securities

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

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

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

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

11. Term bonds have a single maturity.

Ans: True
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: True
Difficulty: Difficult
Ref: Fixed-Income Securities

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

Ans: False
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: True
Difficulty: Difficult
Ref: Fixed-Income Securities

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

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

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

Ans: False
Difficulty: Difficult
Ref: Fixed-Income Securities

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

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

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

Ans: False
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: True
Difficulty: Moderate
Ref: Fixed-Income Securities

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

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

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

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

22. The earnings retention rate is calculated as 1 – dividend yield.

Ans: False
Difficulty: Easy
Ref: Equity Securities

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

Ans: False
Difficulty: Easy
Ref: Equity Securities

24. LEAPS have maturity dates up to 10 years.

Ans: False
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 at their discretion.

Ans: True
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
Ref: Organizing Financial Assets

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
Ref: Fixed-Income Securities

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, it 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, preferred stock.

Answer: U.S. Treasury bonds, corporate bonds, preferred stock, common stock
Difficulty: Moderate
Ref: Fixed-Income Securities, Equity Securities

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

Answer: High yields with manageable risk.
Difficulty: Moderate
Ref: Fixed-Income Securities

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. Does the options market help stabilize or destabilize the stock market? 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

Problems

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

Answer: Taxable equivalent yield is $0.07/(1-0.28) = 9.72\%$
Difficulty: Easy
Ref: Fixed-Income Securities

2. A corporate investor in the 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?

Answer: 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 stock price is $60, and the dividend per share is $1. Calculate the dividend yield.

Answer: 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 stock price is $60, and the dividend per share is $1. Calculate the payout ratio.

Answer: 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?

Answer: Stock price is EPS x P/E = $6 x 15 = $90
Difficulty: Moderate
Ref: Equity Securities