Chapter 01

The Investment Environment

Multiple Choice Questions

1. The material wealth of a society is a function of

   A. all financial assets.

   B. all real assets.

   C. all financial and real assets.

   D. all physical assets.

2. _______ are real assets.

   A. Land

   B. Machines

   C. Stocks and bonds

   D. Knowledge

   E. Land, machines, and knowledge

3. The means by which individuals hold their claims on real assets in a well-developed economy are

A. investment assets.

B. depository assets.

C. derivative assets.

D. financial assets.

E. exchange-driven assets.

4. _______ are financial assets.

A. Bonds

B. Machines

C. Stocks

D. Bonds and stocks

E. Bonds, machines, and stocks

5. _________ financial asset(s).

A. Buildings are

B. Land is a

C. Derivatives are

D. U.S. agency bonds are

E. Derivatives and U.S. agency bonds are

6. Financial assets

A. directly contribute to the country's productive capacity.

B. indirectly contribute to the country's productive capacity.

C. contribute to the country's productive capacity both directly and indirectly.

D. do not contribute to the country's productive capacity either directly or indirectly.

E. are of no value to anyone.

7. In 2012, ___________ was the most significant real asset of U.S. households in terms of total value.

A. consumer durables

B. automobiles

C. real estate

D. mutual fund shares

E. bank loans

8. In 2012, ___________ was the least significant financial asset of U.S. households in terms of total value.

A. real estate

B. mutual fund shares

C. debt securities

D. life insurance reserves

E. pension reserves

9. In 2012, ___________ was the most significant financial asset of U.S. households in terms of total value.

A. real estate

B. mutual fund shares

C. debt securities

D. life insurance reserves

E. pension reserves

10. In 2012, ___________ was the most significant asset of U.S. households in terms of total value.

A. real estate

B. mutual fund shares

C. debt securities

D. life insurance reserves

E. pension reserves

11. In 2012, ___________ was the most significant liability of U.S. households in terms of total value.

A. credit cards

B. mortgages

C. bank loans

D. student loans

E. other debt

12. Which of the following financial assets made up the greatest proportion of the financial assets held by U.S. households?

A. Pension reserves

B. Life insurance reserves

C. Mutual fund shares

D. Debt securities

E. Personal trusts

13. In 2012 _______ of the assets of U.S. households were financial assets as opposed to tangible assets.

A. 20.4%

B. 34.2%

C. 68.8%

D. 71.7%

E. 82.5%

14. The largest component of domestic net worth in 2012 was

A. nonresidential real estate.

B. residential real estate.

C. inventories.

D. consumer durables.

E. equipment and software.

15. The smallest component of domestic net worth in 2012 was

A. nonresidential real estate.

B. residential real estate.

C. inventories.

D. consumer durables.

E. equipment and software.

16. The national net worth of the U.S. in 2012 was

A. $15.411 trillion.

B. $26.431 trillion.

C. $42.669 trillion.

D. $48.616 trillion.

E. $70.983 trillion.

17. A fixed-income security pays

A. a fixed level of income for the life of the owner.

B. a fixed stream of income or a stream of income that is determined according to a specified formula for the life of the security.

C. a variable level of income for owners on a fixed income.

D. a fixed or variable income stream at the option of the owner.

18. A debt security pays

A. a fixed level of income for the life of the owner.

B. a variable level of income for owners on a fixed income.

C. a fixed or variable income stream at the option of the owner.

D. a fixed stream of income or a stream of income that is determined according to a specified formula for the life of the security.

19. Money market securities

A. are short term.

B. are highly marketable.

C. are generally very low risk.

D. are highly marketable and are generally very low risk.

E. All of the options

20. An example of a derivative security is

A. a common share of Microsoft.

B. a call option on Intel stock.

C. a commodity futures contract.

D. a call option on Intel stock and a commodity futures contract.

E. a common share of Microsoft and a call option on Intel stock.

21. The value of a derivative security

A. depends on the value of the related security.

B. is unable to be calculated.

C. is unrelated to the value of the related security.

D. has been enhanced due to the recent misuse and negative publicity regarding these instruments.

E. is worthless today.

22. Although derivatives can be used as speculative instruments, businesses most often use them to

A. attract customers.

B. appease stockholders.

C. offset debt.

D. hedge risks.

E. enhance their balance sheets.

23. Financial assets permit all of the following except

A. consumption timing.

B. allocation of risk.

C. separation of ownership and control.

D. elimination of risk.

24. The ___________ refers to the potential conflict between management and shareholders.

A. agency problem

B. diversification problem

C. liquidity problem

D. solvency problem

E. regulatory problem

25. A disadvantage of using stock options to compensate managers is that

A. it encourages managers to undertake projects that will increase stock price.

B. it encourages managers to engage in empire building.

C. it can create an incentive for managers to manipulate information to prop up a stock price temporarily, giving them a chance to cash out before the price returns to a level reflective of the firm's true prospects.

D. All of the options

26. Which of the following are mechanisms that have evolved to mitigate potential agency problems?

I) Using the firm's stock options for compensation

II) Hiring bickering family members as corporate spies

III) Boards of directors forcing out underperforming management

IV) Security analysts monitoring the firm closely

V) Takeover threats

A. II and V

B. I, III, and IV

C. I, III, IV, and V

D. III, IV, and V

E. I, III, and V

27. Corporate shareholders are best protected from incompetent management decisions by

A. the ability to engage in proxy fights.

B. management's control of pecuniary rewards.

C. the ability to call shareholder meetings.

D. the threat of takeover by other firms.

E. one-share/one-vote election rules.

28. Theoretically, takeovers should result in

A. improved management.

B. increased stock price.

C. increased benefits to existing management of taken-over firm.

D. improved management and increased stock price.

E. All of the options

29. During the period between 2000 and 2002, a large number of scandals were uncovered. Most of these scandals were related to

I) manipulation of financial data to misrepresent the actual condition of the firm.

II) misleading and overly optimistic research reports produced by analysts.

III) allocating IPOs to executives as a quid pro quo for personal favors.

IV) greenmail.

A. II, III, and IV

B. I, II, and IV

C. II and IV

D. I, III, and IV

E. I, II, and III

30. The Sarbanes-Oxley Act

A. requires corporations to have more independent directors.

B. requires the firm's CFO to personally vouch for the firm's accounting statements.

C. prohibits auditing firms from providing other services to clients.

D. requires corporations to have more independent directors and requires the firm's CFO to personally vouch for the firm's accounting statements.

E. All of the options

31. Asset allocation refers to

A. choosing which securities to hold based on their valuation.

B. investing only in "safe" securities.

C. the allocation of assets into broad asset classes.

D. bottom-up analysis.

32. Security selection refers to

A. choosing which securities to hold based on their valuation.

B. investing only in "safe" securities.

C. the allocation of assets into broad asset classes.

D. top-down analysis.

33. Which of the following portfolio construction methods starts with security analysis?

A. Top-down

B. Bottom-up

C. Middle-out

D. Buy and hold

E. Asset allocation

34. Which of the following portfolio construction methods starts with asset allocation?

A. Top-down

B. Bottom-up

C. Middle-out

D. Buy and hold

E. Asset allocation

35. _______ are examples of financial intermediaries.

A. Commercial banks

B. Insurance companies

C. Investment companies

D. Credit unions

E. All of the options

36. Financial intermediaries exist because small investors cannot efficiently

A. diversify their portfolios.

B. assess credit risk of borrowers.

C. advertise for needed investments.

D. diversify their portfolios and assess credit risk of borrowers.

E. All of the options

37. ________ specialize in helping companies raise capital by selling securities.

A. Commercial bankers

B. Investment bankers

C. Investment issuers

D. Credit raters

38. Commercial banks differ from other businesses in that both their assets and their liabilities are mostly

A. illiquid.

B. financial.

C. real.

D. owned by the government.

E. regulated.

39. In 2012, ___________ was(were) the most significant financial asset(s) of U.S. commercial banks in terms of total value.

A. loans and leases

B. cash

C. real estate

D. deposits

E. investment securities

40. In 2012, ___________ was(were) the most significant liability(ies) of U.S. commercial banks in terms of total value.

A. loans and leases

B. cash

C. real estate

D. deposits

E. investment securities

41. In 2012, ___________ was(were) the most significant real asset(s) of U.S. nonfinancial businesses in terms of total value.

A. equipment and software

B. inventory

C. real estate

D. trade credit

E. marketable securities

42. In 2012, ___________ was(were) the least significant real asset(s) of U.S. nonfinancial businesses in terms of total value.

A. equipment and software

B. inventory

C. real estate

D. trade credit

E. marketable securities

43. In 2012, ___________ was(were) the least significant liability(ies) of U.S. nonfinancial businesses in terms of total value.

A. bonds and mortgages

B. bank loans

C. inventories

D. trade debt

E. marketable securities

44. In terms of total value, the most significant liability(ies) of U.S. nonfinancial businesses in 2012 was(were)

A. bank loans.

B. bonds and mortgages.

C. trade debt.

D. other loans.

E. marketable securities.

45. In 2012, ___________ was(were) the least significant financial asset(s) of U.S. nonfinancial businesses in terms of total value.

A. cash and deposits

B. trade credit

C. trade debt

D. inventory

E. marketable securities

46. New issues of securities are sold in the _______ market(s).

A. primary

B. secondary

C. over-the-counter

D. primary and secondary

47. Investors trade previously issued securities in the _______ market(s).

A. primary

B. secondary

C. primary and secondary

D. derivatives

48. Investment bankers perform which of the following role(s)?

A. Market new stock and bond issues for firms

B. Provide advice to the firms as to market conditions, price, etc.

C. Design securities with desirable properties

D. All of the options

E. None of the options

49. Until 1999, the ________ Act(s) prohibited banks in the United States from both accepting deposits and underwriting securities.

A. Sarbanes-Oxley

B. Glass-Steagall

C. SEC

D. Sarbanes-Oxley and SEC

E. None of the options

50. The spread between the LIBOR and the Treasury-bill rate is called the

A. term spread.

B. T-bill spread.

C. LIBOR spread.

D. TED spread.

51. Mortgage-backed securities were created when ________ began buying mortgage loans from originators and bundling them into large pools that could be traded like any other financial asset.

A. GNMA

B. FNMA

C. FHLMC

D. FNMA and FHLMC

E. GNMA and FNMA

52. The sale of a mortgage portfolio by setting up mortgage pass-through securities is an example of

A. credit enhancement.

B. securitization.

C. unbundling.

D. derivatives.

53. Which of the following is true about mortgage-backed securities?

I) They aggregate individual home mortgages into homogeneous pools.

II) The purchaser receives monthly interest and principal payments received from payments made on the pool.

III) The banks that originated the mortgages maintain ownership of them.

IV) The banks that originated the mortgages continue to service them.

A. II, III, and IV

B. I, II, and IV

C. II and IV

D. I, III, and IV

E. I, II, III, and IV

54. ________ were designed to concentrate the credit risk of a bundle of loans on one class of investor, leaving the other investors in the pool relatively protected from that risk.

A. Stocks

B. Bonds

C. Derivatives

D. Collateralized debt obligations

E. All of the options

55. ________ are in essence an insurance contract against the default of one or more borrowers.

A. Credit default swaps

B. CMOs

C. ETFs

D. Collateralized debt obligations

E. All of the options

Short Answer Questions

56. Discuss the agency problem in detail.

57. Discuss the similarities and differences between real and financial assets.

58. Discuss securitization as it relates to the field of investments.

Chapter 01 The Investment Environment Answer Key

Multiple Choice Questions

1. The material wealth of a society is a function of

A. all financial assets.

B. all real assets.

C. all financial and real assets.

D. all physical assets.

The material wealth of a society is a function of all real assets.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Assets

2. _______ are real assets.

A. Land

B. Machines

C. Stocks and bonds

D. Knowledge

E. Land, machines, and knowledge

Land, machines and knowledge are real assets; stocks and bonds are financial assets.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Assets

3. The means by which individuals hold their claims on real assets in a well-developed economy are

A. investment assets.

B. depository assets.

C. derivative assets.

D. financial assets.

E. exchange-driven assets.

Financial assets allocate the wealth of the economy. Example: it is easier for an individual to own shares of an auto company than to own an auto company directly.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Assets

4. _______ are financial assets.

A. Bonds

B. Machines

C. Stocks

D. Bonds and stocks

E. Bonds, machines, and stocks

Machines are real assets; stocks and bonds are financial assets.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Assets

5. _________ financial asset(s).

A. Buildings are

B. Land is a

C. Derivatives are

D. U.S. agency bonds are

E. Derivatives and U.S. agency bonds are

Buildings and land are real assets.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Assets

6. Financial assets

A. directly contribute to the country's productive capacity.

B. indirectly contribute to the country's productive capacity.

C. contribute to the country's productive capacity both directly and indirectly.

D. do not contribute to the country's productive capacity either directly or indirectly.

E. are of no value to anyone.

Financial assets indirectly contribute to the country's productive capacity because these assets permit individuals to invest in firms and governments. This in turn allows firms and governments to increase productive capacity.

AACSB: Analytic
Blooms: Understand
Difficulty: Basic
Topic: Assets

7. In 2012, ___________ was the most significant real asset of U.S. households in terms of total value.

A. consumer durables

B. automobiles

C. real estate

D. mutual fund shares

E. bank loans

See Table 1.1.

AACSB: Analytic
Blooms: Remember
Difficulty: Basic

Topic: Assets

8. In 2012, ___________ was the least significant financial asset of U.S. households in terms of total value.

A. real estate

B. mutual fund shares

C. debt securities

D. life insurance reserves

E. pension reserves

See Table 1.1.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Assets

9. In 2012, ___________ was the most significant financial asset of U.S. households in terms of total value.

A. real estate

B. mutual fund shares

C. debt securities

D. life insurance reserves

E. pension reserves

See Table 1.1.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Assets

10. In 2012, ___________ was the most significant asset of U.S. households in terms of total value.

<u>A.</u> real estate
B. mutual fund shares
C. debt securities
D. life insurance reserves
E. pension reserves

See Table 1.1.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Assets

11. In 2012, ___________ was the most significant liability of U.S. households in terms of total value.

A. credit cards
<u>B.</u> mortgages
C. bank loans
D. student loans
E. other debt

See Table 1.1.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Assets

12. Which of the following financial assets made up the greatest proportion of the financial assets held by U.S. households?

<u>A.</u> Pension reserves

B. Life insurance reserves

C. Mutual fund shares

D. Debt securities

E. Personal trusts

See Table 1.1.

AACSB: Analytic

Blooms: Remember

Difficulty: Intermediate

Topic: Assets

13. In 2012 _______ of the assets of U.S. households were financial assets as opposed to tangible assets.

A. 20.4%

B. 34.2%

C. 68.8%

D. 71.7%

E. 82.5%

See Table 1.1.

AACSB: Analytic

Blooms: Remember

Difficulty: Intermediate

Topic: Assets

14. The largest component of domestic net worth in 2012 was

A. nonresidential real estate.

B. residential real estate.

C. inventories.

D. consumer durables.

E. equipment and software.

See Table 1.2.

AACSB: Analytic

Blooms: Remember

Difficulty: Intermediate

Topic: Assets

15. The smallest component of domestic net worth in 2012 was

A. nonresidential real estate.

B. residential real estate.

C. inventories.

D. consumer durables.

E. equipment and software.

See Table 1.2.

AACSB: Analytic

Blooms: Remember

Difficulty: Intermediate

Topic: Assets

16. The national net worth of the U.S. in 2012 was

A. \$15.411 trillion.

B. \$26.431 trillion.

C. \$42.669 trillion.

D. \$48.616 trillion.

E. \$70.983 trillion.

See Table 1.2.

AACSB: Analytic

Blooms: Remember

Difficulty: Intermediate

Topic: Assets

17. A fixed-income security pays

A. a fixed level of income for the life of the owner.

B. a fixed stream of income or a stream of income that is determined according to a specified formula for the life of the security.

C. a variable level of income for owners on a fixed income.

D. a fixed or variable income stream at the option of the owner.

A fixed-income security pays a fixed stream of income or a stream of income that is determined according to a specified formula for the life of the security.

AACSB: Analytic
Blooms: Remember
Difficulty: Basic
Topic: Asset Types

18. A debt security pays

A. a fixed level of income for the life of the owner.

B. a variable level of income for owners on a fixed income.

C. a fixed or variable income stream at the option of the owner.

D. a fixed stream of income or a stream of income that is determined according to a specified formula for the life of the security.

A debt security pays a fixed stream of income or a stream of income that is determined according to a specified formula for the life of the security.

AACSB: Analytic
Blooms: Remember
Difficulty: Basic
Topic: Asset Types

19. Money market securities

A. are short term.

B. are highly marketable.

C. are generally very low risk.

D. are highly marketable and are generally very low risk.

E. All of the options

All answers are correct.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Asset Types

20. An example of a derivative security is

A. a common share of Microsoft.

B. a call option on Intel stock.

C. a commodity futures contract.

D. a call option on Intel stock and a commodity futures contract.

E. a common share of Microsoft and a call option on Intel stock.

The values of a call option on Intel stock and a commodity futures contract are derived from that of an underlying asset; the value of a common share of Microsoft is based on the value of the firm only.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Asset Types

21. The value of a derivative security

A. depends on the value of the related security.

B. is unable to be calculated.

C. is unrelated to the value of the related security.

D. has been enhanced due to the recent misuse and negative publicity regarding these instruments.

E. is worthless today.

Of the factors cited above, only the value of the related security affects the value of the derivative and/or is a true statement.

AACSB: Analytic
Blooms: Understand
Difficulty: Basic
Topic: Asset Types

22. Although derivatives can be used as speculative instruments, businesses most often use them to

A. attract customers.

B. appease stockholders.

C. offset debt.

D. hedge risks.

E. enhance their balance sheets.

Firms may use forward contracts and futures to protect against currency fluctuations or changes in commodity prices. Interest-rate options help companies control financing costs.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Asset Types

23. Financial assets permit all of the following except

A. consumption timing.

B. allocation of risk.

C. separation of ownership and control.

D. elimination of risk.

Financial assets do not allow risk to be eliminated. However, they do permit allocation of risk, consumption timing, and separation of ownership and control.

AACSB: Analytic

Blooms: Remember

Difficulty: Intermediate

Topic: Assets

24. The ___________ refers to the potential conflict between management and shareholders.

A. agency problem
B. diversification problem
C. liquidity problem
D. solvency problem
E. regulatory problem

The agency problem describes potential conflict between management and shareholders. The other problems are those of firm management only.

AACSB: Analytic
Blooms: Remember
Difficulty: Basic
Topic: Financial Management

25. A disadvantage of using stock options to compensate managers is that

A. it encourages managers to undertake projects that will increase stock price.

B. it encourages managers to engage in empire building.

C. it can create an incentive for managers to manipulate information to prop up a stock price temporarily, giving them a chance to cash out before the price returns to a level reflective of the firm's true prospects.

D. All of the options

Encouraging managers to undertake projects that will increase stock price is a desired characteristic. Encouraging managers to engage in empire building is not necessarily a good or bad thing in and of itself. Creating an incentive for managers to manipulate information to prop up a stock price temporarily creates an agency problem.

AACSB: Analytic

Blooms: Understand

Difficulty: Basic

Topic: Financial Management

26. Which of the following are mechanisms that have evolved to mitigate potential agency problems?

I) Using the firm's stock options for compensation

II) Hiring bickering family members as corporate spies

III) Boards of directors forcing out underperforming management

IV) Security analysts monitoring the firm closely

V) Takeover threats

A. II and V

B. I, III, and IV

C. I, III, IV, and V

D. III, IV, and V

E. I, III, and V

All the options except hiring bickering family members as corporate spies have been used to try to limit agency problems.

AACSB: Analytic

Blooms: Understand

Difficulty: Intermediate

Topic: Financial Management

27. Corporate shareholders are best protected from incompetent management decisions by

A. the ability to engage in proxy fights.

B. management's control of pecuniary rewards.

C. the ability to call shareholder meetings.

D. the threat of takeover by other firms.

E. one-share/one-vote election rules.

Proxy fights are expensive and seldom successful, and management may often control the board or own significant shares. It is the threat of takeover of underperforming firms that has the strongest ability to keep management on their toes.

AACSB: Analytic
Blooms: Understand
Difficulty: Intermediate
Topic: Financial Management

28. Theoretically, takeovers should result in

A. improved management.

B. increased stock price.

C. increased benefits to existing management of taken-over firm.

D. improved management and increased stock price.

E. All of the options

Theoretically, when firms are taken over, better managers come in and thus increase the price of the stock; existing management often must either leave the firm, be demoted, or suffer a loss of existing benefits.

AACSB: Analytic
Blooms: Remember

Difficulty: Basic
Topic: Financial Management

29. During the period between 2000 and 2002, a large number of scandals were uncovered. Most of these scandals were related to

I) manipulation of financial data to misrepresent the actual condition of the firm.
II) misleading and overly optimistic research reports produced by analysts.
III) allocating IPOs to executives as a quid pro quo for personal favors.
IV) greenmail.

A. II, III, and IV
B. I, II, and IV
C. II and IV
D. I, III, and IV
E. I, II, and III

I, II, and III are all mentioned as causes of recent scandals.

AACSB: Analytic
Blooms: Understand
Difficulty: Intermediate
Topic: Financial Management

30. The Sarbanes-Oxley Act

A. requires corporations to have more independent directors.

B. requires the firm's CFO to personally vouch for the firm's accounting statements.

C. prohibits auditing firms from providing other services to clients.

D. requires corporations to have more independent directors and requires the firm's CFO to personally vouch for the firm's accounting statements.

<u>E.</u> All of the options

The Sarbanes-Oxley Act does all of the above.

AACSB: Analytic
Blooms: Remember
Difficulty: Intermediate
Topic: Regulation

31. Asset allocation refers to

A. choosing which securities to hold based on their valuation.

B. investing only in "safe" securities.

<u>C.</u> the allocation of assets into broad asset classes.

D. bottom-up analysis.

Asset allocation refers to the allocation of assets into broad asset classes.

AACSB: Analytic
Blooms: Remember
Difficulty: Intermediate
Topic: Financial Management

32. Security selection refers to

A. choosing which securities to hold based on their valuation.

B. investing only in "safe" securities.

C. the allocation of assets into broad asset classes.

D. top-down analysis.

Security selection refers to choosing which securities to hold based on their valuation.

AACSB: Analytic

Blooms: Remember

Difficulty: Intermediate

Topic: Financial Management

33. Which of the following portfolio construction methods starts with security analysis?

A. Top-down

B. Bottom-up

C. Middle-out

D. Buy and hold

E. Asset allocation

Bottom-up refers to using security analysis to find securities that are attractively priced.

Top-down refers to using asset allocation as a starting point.

AACSB: Analytic

Blooms: Remember

Difficulty: Intermediate

Topic: Portfolios

34. Which of the following portfolio construction methods starts with asset allocation?

A. Top-down

B. Bottom-up

C. Middle-out

D. Buy and hold

E. Asset allocation

Bottom-up refers to using security analysis to find securities that are attractively priced.

AACSB: Analytic

Blooms: Remember

Difficulty: Intermediate

Topic: Portfolios

35. _______ are examples of financial intermediaries.

A. Commercial banks

B. Insurance companies

C. Investment companies

D. Credit unions

E. All of the options

All are institutions that bring borrowers and lenders together.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Financial Institutions

36. Financial intermediaries exist because small investors cannot efficiently

A. diversify their portfolios.

B. assess credit risk of borrowers.

C. advertise for needed investments.

D. diversify their portfolios and assess credit risk of borrowers.

E. All of the options

The individual investor cannot efficiently and effectively perform any of the tasks above without more time and knowledge than that available to most individual investors.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Financial Institutions

37. ________ specialize in helping companies raise capital by selling securities.

A. Commercial bankers

B. Investment bankers

C. Investment issuers

D. Credit raters

An important role of investment banking is to act as middlemen in helping firms place new issues in the market.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Financial Institutions

38. Commercial banks differ from other businesses in that both their assets and their liabilities are mostly

A. illiquid.

B. financial.

C. real.

D. owned by the government.

E. regulated.

See Table 1.3.

AACSB: Analytic

Blooms: Understand

Difficulty: Basic

Topic: Financial Institutions

39. In 2012, ___________ was(were) the most significant financial asset(s) of U.S. commercial banks in terms of total value.

A. loans and leases

B. cash

C. real estate

D. deposits

E. investment securities

See Table 1.3.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Financial Institutions

40. In 2012, ___________ was(were) the most significant liability(ies) of U.S. commercial banks in terms of total value.

A. loans and leases

B. cash

C. real estate

D. deposits

E. investment securities

See Table 1.3.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Financial Institutions

41. In 2012, ___________ was(were) the most significant real asset(s) of U.S. nonfinancial businesses in terms of total value.

A. equipment and software

B. inventory

C. real estate

D. trade credit

E. marketable securities

See Table 1.4.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Financial Institutions

42. In 2012, ___________ was(were) the least significant real asset(s) of U.S. nonfinancial businesses in terms of total value.

A. equipment and software

<u>B.</u> inventory

C. real estate

D. trade credit

E. marketable securities

See Table 1.4.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Financial Institutions

43. In 2012, ___________ was(were) the least significant liability(ies) of U.S. nonfinancial businesses in terms of total value.

A. bonds and mortgages

<u>B.</u> bank loans

C. inventories

D. trade debt

E. marketable securities

See Table 1.4.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Financial Institutions

44. In terms of total value, the most significant liability(ies) of U.S. nonfinancial businesses in 2012 was(were)

A. bank loans.

B. bonds and mortgages.

C. trade debt.

D. other loans.

E. marketable securities.

See Table 1.4.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Financial Institutions

45. In 2012, ___________ was(were) the least significant financial asset(s) of U.S. nonfinancial businesses in terms of total value.

A. cash and deposits

B. trade credit

C. trade debt

D. inventory

E. marketable securities

See Table 1.4.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Financial Institutions

46. New issues of securities are sold in the ________ market(s).

A. primary

B. secondary

C. over-the-counter

D. primary and secondary

New issues of securities are sold in the primary market.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Financial Markets

47. Investors trade previously issued securities in the ________ market(s).

A. primary

B. secondary

C. primary and secondary

D. derivatives

Investors trade previously issued securities in the secondary market.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Financial Markets

48. Investment bankers perform which of the following role(s)?

A. Market new stock and bond issues for firms

B. Provide advice to the firms as to market conditions, price, etc.

C. Design securities with desirable properties

D. All of the options

E. None of the options

Investment bankers perform all of the roles described above for their clients.

AACSB: Analytic

Blooms: Understand

Difficulty: Basic

Topic: Financial Markets

49. Until 1999, the ________ Act(s) prohibited banks in the United States from both accepting deposits and underwriting securities.

A. Sarbanes-Oxley

B. Glass-Steagall

C. SEC

D. Sarbanes-Oxley and SEC

E. None of the options

Until 1999, the Glass-Steagall Act prohibited banks in the United States from both accepting deposits and underwriting securities.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Regulation

50. The spread between the LIBOR and the Treasury-bill rate is called the

A. term spread.

B. T-bill spread.

C. LIBOR spread.

D. TED spread.

The spread between the LIBOR and the Treasury-bill rate is called the TED spread.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Financial Markets

51. Mortgage-backed securities were created when ________ began buying mortgage loans from originators and bundling them into large pools that could be traded like any other financial asset.

A. GNMA

B. FNMA

C. FHLMC

D. FNMA and FHLMC

E. GNMA and FNMA

Mortgage-backed securities were created when FNMA and FHLMC began buying mortgage loans from originators and bundling them into large pools that could be traded like any other financial asset.

AACSB: Analytic

Blooms: Remember

Difficulty: Basic

Topic: Securities

52. The sale of a mortgage portfolio by setting up mortgage pass-through securities is an example of

A. credit enhancement.

B. securitization.

C. unbundling.

D. derivatives.

The financial asset is secured by the mortgages backing the instrument.

AACSB: Analytic

Blooms: Understand

Difficulty: Basic

Topic: Securities

53. Which of the following is true about mortgage-backed securities?

I) They aggregate individual home mortgages into homogeneous pools.

II) The purchaser receives monthly interest and principal payments received from payments made on the pool.

III) The banks that originated the mortgages maintain ownership of them.

IV) The banks that originated the mortgages continue to service them.

A. II, III, and IV

B. I, II, and IV

C. II and IV

D. I, III, and IV

E. I, II, III, and IV

III is not correct because the bank no longer owns the mortgage investments.

AACSB: Analytic

Blooms: Understand

Difficulty: Intermediate

Topic: Securities

54. ________ were designed to concentrate the credit risk of a bundle of loans on one class of investor, leaving the other investors in the pool relatively protected from that risk.

A. Stocks

B. Bonds

C. Derivatives

D. Collateralized debt obligations

E. All of the options

Collateralized debt obligations were designed to concentrate the credit risk of a bundle of loans on one class of investor, leaving the other investors in the pool relatively protected from that risk.

AACSB: Analytic

Blooms: Understand

Difficulty: Basic

Topic: Securities

55. ________ are in essence an insurance contract against the default of one or more borrowers.

A. Credit default swaps
B. CMOs
C. ETFs
D. Collateralized debt obligations
E. All of the options

Credit default swaps are in essence an insurance contract against the default of one or more borrowers.

AACSB: Analytic
Blooms: Understand
Difficulty: Basic
Topic: Securities

Short Answer Questions

56. Discuss the agency problem in detail.

Managers are the agents of the shareholders and should act on their behalf to maximize shareholder wealth (the value of the stock). A conflict (the agency conflict) arises when managers take self-interested actions to the detriment of shareholders. The roles of the board of directors selected by the shareholders are to oversee management and to minimize agency problems. However, often these boards are figureheads, and individual shareholders do not own large enough blocks of the shares to override management actions. One potential resolution of an agency problem occurs when inefficient management actions cause the price of the stock to be depressed. The firm may then become a takeover target. If the acquisition is successful, managers may be replaced and, potentially, stockholders benefit.

Feedback: The question is designed to ascertain that the student understands the corporate relationships between shareholders, management, and the board of directors. In addition, this problem has been addressed extensively in recent years, both in the popular financial press during the mergers and acquisitions mania of the 1980s and in the academic literature as agency theory.

AACSB: Reflective Thinking
Blooms: Analyze
Difficulty: Intermediate
Topic: Financial Management

57. Discuss the similarities and differences between real and financial assets.

Real assets represent the productive capacity of the firm and appear as assets on the firm's balance sheet. Financial assets are claims against the firm and thus appear as liabilities on the firm's balance sheet. On the other hand, financial assets are listed on the asset side of the balance sheet of the individuals who own them. Thus, when financial statements are aggregated across the economy, the financial assets cancel out, leaving only the real assets, which directly contribute to the productive capacity of the economy. Financial assets contribute indirectly only.

Feedback: The purpose of this question is to ascertain if the student understands the difference between real and financial assets, both in the aggregate balance sheet context and the relative contribution of the two types of assets to the productive capacity of the economy.

AACSB: Reflective Thinking

Blooms: Analyze

Difficulty: Intermediate

Topic: Assets

58. Discuss securitization as it relates to the field of investments.

Securitization refers to aggregating underlying financial assets, such as mortgages, into pools and then offering a security that represents a claim on these underlying assets. An example is mortgage-backed securities. Securitization allows investors to hold partial ownership in financial assets that would otherwise be beyond their reach (e.g., mortgages).

Financial engineering involves bundling or unbundling. Bundling involves combining separate securities.

Feedback: The purpose of this question is to ascertain if the student understands the importance of securitization and the impact it has on the field of investments.

AACSB: Reflective Thinking
Blooms: Analyze
Difficulty: Intermediate
Topic: Securities