

Investments Analysis and Management 14th edition
Jones Test Bank

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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 are:

- a. issued exclusively by the U.S. Treasury.
- b. money-market securities.
- c. capital-market securities.
- d. sold on a discount basis.

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 original 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 20 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 Depositary 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 that unpaid preferred stock dividends:
- a. are paid at the end of the year.
 - b. are legally binding on the corporation.
 - c. must be paid in the future before common stock dividends can be paid.
 - d. 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 tranche 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

34. American Depositary Receipts (ADRs) are attractive investments for U.S. investors because they:
- a. eliminate foreign currency exchange risk.
 - b. are purchased on a U.S. exchange with U.S. dollars.
 - c. pay dividends that are exempt from income taxes.
 - d. are less risky than the typical U.S. stock.

Ans: b

Difficulty: Moderate

Ref: Investing Globally in Equities

35. Which of the following is a capital market, fixed-income security?
- a. An American Depositary Receipt (ADR)
 - b. Commercial paper
 - c. Shares in a mutual fund
 - d. Corporate bond

Ans: d

Difficulty: Easy

Ref: Fixed-Income Securities

36. Which of the following characteristics is true of municipal bonds?
- a. They general have higher rates than corporate bonds of equal risk.
 - b. Capital gains on municipal bonds are exempt from federal taxation.
 - c. They pay interest income that is exempt from federal taxation.
 - d. They are default free.

Ans: c

Difficulty: Easy

Ref: Types of Bonds

37. Which of the following is a money market security that has a weak secondary market?
- a. preferred stock
 - b. banker's acceptance
 - c. repurchase agreement
 - d. commercial paper

Ans: d

Difficulty: Moderate

Ref: Money Market Securities

38. Which of the following is a money market security that pays income that is exempt from state and local income taxes?
- a. municipal bond
 - b. repurchase agreement
 - c. banker's acceptance
 - d. T-bill

Ans: d

Difficulty: Moderate

Ref: Money Market Securities

39. TL Bank is planning to purchase a T-bill with a \$100,000 face value. The T-bill is quoted at a bank discount of 2.2% and has 300 days to maturity. What is the T-bill's bond equivalent yield (BEY)?
- a. 2.21%
 - b. 2.23%
 - c. 2.25%
 - d. 2.27%

Ans: d

Difficulty: Moderate

Ref: Money Market Securities

40. Which of the following is a money market security that is insured by the FDIC?
- a. Commercial paper
 - b. Banker's acceptance
 - c. Certificate of deposit
 - d. T-bill

Ans: c

Difficulty: Easy

Ref: Money Market Securities

41. Ted is considering a State of Nebraska bond that pays 3.40% and a comparable risk bond issued by Verizon that pays 5.25%. Ted is in the 37% marginal tax bracket. Relative to the Verizon bond, Ted should conclude that the taxable equivalent yield (TEY) on the Nebraska bond is approximately:
- a. 9 basis points higher.
 - b. 15 basis points higher.
 - c. 9 basis points lower.
 - d. 15 basis points lower.

Ans: b

Difficulty: Moderate

Ref: Types of Bonds

42. The money market security that sells with the lowest denomination is a:
- a. negotiable CD and the amount is \$100,000.
 - b. municipal bond and the amount is \$1,000.
 - c. repurchase agreement and the amount is \$5,000.
 - d. T-bill and the amount is \$10,000.

Ans: d

Difficulty: Moderate

Ref: Money Market Securities

43. TR Bank is planning to purchase a T-bill with a \$100,000 face value. The T-bill is quoted at a bank discount of 2.1% and has 220 days to maturity. What is the T-bill's effective annual yield (EAY)?
- a. 2.15%
 - b. 2.17%
 - c. 2.19%
 - d. 2.21%

Ans: b

Difficulty: Difficult

Ref: Money Market Securities

44. Relative to venture capital funds, buyout funds tend to rely:
- a. more heavily on debt and they are riskier.
 - b. more heavily on debt and they are less risky.
 - c. less heavily on debt and they are riskier.
 - d. less heavily on debt and they are less risky.

Ans: b

Difficulty: Difficult

Ref: Private Equity

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. A bond sells at a premium if its coupon rate is greater than the market yield.

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 bankruptcy, bondholders are paid before 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 $1 - \text{dividend yield}$.

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: True

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

27. Certificates of deposit (CDs) and MMDA's are insured to \$250,000 by the FDIC.

Ans: True

Difficulty: Moderate

Ref: Nonmarketable Financial Assets

28. With repurchase agreements, both the buying price and selling price are set when the agreement is initiated.

Ans: True

Difficulty: Moderate

Ref: Money Market Securities

29. The typical banker's acceptance has a maturity of nine months.

Ans: False

Difficulty: Easy

Ref: Money Market Securities

30. Bond investors typically pay more for a bond than its quoted price.

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 = $1 - \text{dividend payout rate}$

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.

Difficulty: Moderate

Ref: Derivative Securities

11. 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

12. 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: $10.606 \times (1.0-0.34) = 7.00$ 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 and P/E ratio.

Answer: Dividend yield = $\$1/\$60 = 0.0167 = 1.67\%$
P/E ratio = $\$60/\$4 = 15$
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 dividend payout ratio and the firm's retention ratio (plowback ratio).

Answer: Payout rate = $\$1/\$4 = 0.25 = 25\%$
Retention ratio = $1 - \text{payout ratio} = 1 - 0.25 = 75\%$
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 $\text{EPS} \times \text{P/E} = \$6 \times 15 = \$90$
Difficulty: Moderate
Ref: Equity Securities

6. Carl purchased a \$10,000 T-bill that had 260 days to maturity and was quoted with a bank discount of 1.6%. After holding the T-bill for 200 days, Carl sold the T-bill when it had a quoted bank discount of 2.0%. Find Carl's bond equivalent yield (BEY) and his equivalent annual yield.

Answer: Buying Price: $10,000 \times [1 - 0.016 \times (260/360)] = 9,884.444$
 Selling Price: $10,000 \times [1 - 0.020 \times (60/360)] = 9,966.666$

$$\text{Return}_{\text{BEY}} = [(9,966.67 - 9,884.44)/9,884.44 \times (365/200)] = 1.518\%$$

$$\text{Return}_{\text{EAY}} = [(1 + (9,966.67 - 9,884.44)/9,884.44)]^{365/200} = 1.523\%$$

Difficulty: Difficult
 Ref: Money Market Securities

7. TR Bank is planning to purchase a T-bill with a face value of \$100,000. The T-bill is quoted at a bank discount of 2.1% and has 320 days to maturity. Find the T-bill's price, bond equivalent yield (BEY) and equivalent annual yield (EAY).

Answer: Price: $100,000 \times [1 - 0.021 \times (320/360)] = \$98,133.33$

$$\text{Return}_{\text{BEY}} = [(100,000 - 98,133.33)/98,133.33 \times (365/320)] = 2.140\%$$

$$\text{Return}_{\text{EAY}} = [1 + (100,000 - 98,133.33)/98,133.33]^{365/320} = 2.173\%$$

Difficulty: Moderate
 Ref: Money Market Securities

8. Bond's issued by McDonalds are yielding 6.75%, whereas comparable risk bonds issued by the city of Omaha are yield 4.45%. What Nebraska residents should purchase the Omaha bonds?

Answer: Find the tax rate that makes the after-tax bond returns equal.

$$4.45 = 6.75 \times (1 - t); \text{ solve for } t$$

$$t = 0.3407 \text{ or } 34.07\%$$

Therefore, Nebraska residents with tax rates above 34.07% should purchase the city of Omaha bonds.

Difficulty: Moderate
 Ref: Fixed-Income Securities