Question #1 of 26

Question ID: 1210820

Market values of assets are *most likely* to be affected when:

A) New information reveals that market's expectations about earnings were accurate.

B) New information confirms markets expectations of future earnings.

C) New information reveals that market's expectations about earnings were inaccurate.

Explanation

Market values change when new information differs from expectations that are currently priced in.

(Study Session 17, Module 46.1, LOS 46.b)

Related Material

SchweserNotes - Book 5

Question #2 of 26

Question ID: 1210839

ABC Inc. stock's price is inversely related to the business cycle; it is higher during economic downturns. Which of the following appropriately characterizes the consumption hedging property of an investment in ABC stock and the equity risk premium demanded by investors for an investment in it?

A) Due to its poor consumption hedging ability, an investment in ABC stock would command a higher equity risk premium.

B) Due to its desirable consumption hedging ability, an investment in ABC stock would command a lower equity risk premium.

C) Due to its desirable consumption hedging ability, an investment in ABC stock would command a higher equity risk premium.

Explanation

Assets that pay off during times of scarcity provide desirable consumption hedging property. Investors will demand a lower equity risk premium on such assets.

(Study Session 17, Module 46.2, LOS 46.i)

Related Material

[SchweserNotes - Book 5]

Question #3 of 26

Question ID: 1210821

Investors are *least likely* to increase their savings rate when:

A) Expected rates of returns increase.

B) Uncertainty about their future income increases.

C) Uncertainty about their future income decreases.

Explanation

Investors would increase their savings rate when uncertainty about future income increases and/or expected rates of return increase.

(Study Session 17, Module 46.1, LOS 46.c)

Related Material

[SchweserNotes - Book 5]

Question #4 of 26

Question ID: 1210840

Price multiples are *least likely* to increase when:

A) Inflation expectations decline.

B) Earnings growth increases.

C) Equity risk premium increases.

Explanation

Price multiples are positively related to earnings growth and negatively related to each of the components of the discount rate (i.e., real rate, inflation premium, equity risk premium).

(Study Session 17, Module 46.2, LOS 46.j)

Related Material

[SchweserNotes - Book 5]

Question #5 of 26

Question ID: 1210829

Which of the following is *most likely* to be the shape of the yield curve during recessions?

A) Flat

B) Upward sloping

C) Downward sloping

Explanation

During recessions, policy rates tend to be low. Over a longer period, investor's expect inflation to be higher as the economy comes out of recession and hence longer-term rates tend to be higher resulting in an upward sloping yield curve.

(Study Session 17, Module 46.1, LOS 46.d)

Related Material

SchweserNotes - Book 5

Question #6 of 26

Question ID: 1210841

Value stocks are *most likely* to be characterized by:

A) Immature markets.

B) High earnings growth.

C) Low price multiples.

Explanation

Value stocks tend to have low price multiples, high dividend yield and tend to be in mature industries with low earnings growth.

(Study Session 17, Module 46.2, LOS 46.k)

Related Material

SchweserNotes - Book 5

Question #7 of 26

Question ID: 1210827

Janet Grange's current one-period inter-temporal rate of substitution is 0.95. Janet is *most likely* to invest in a default-free inflation indexed one-period bond if:

A) The bond's return is 4.89% or more.

B) The bond's return is 5% or more.

C) The bond's return is 5.26% or more.

Explanation

Real risk-free rate = (1/E(inter-temporal rate of substitution)-1 = (1/0.95))-1 = 0.0526 or 5.26%

(Study Session 17, Module 46.1, LOS 46.c)

Related Material

SchweserNotes - Book 5

Question #8 of 26

Question ID: 1210838

Which of the following assets provides a most effective hedge against bad consumption outcomes?

A) Real estate

B) Risk-free bonds.

C) Equity

Explanation

Risk-free bonds (especially long maturity bonds) provide an effective hedge against bad consumption outcomes. Equity prices and real estate values tend to be positively related to the state of the economy and hence do not provide good hedges against bad consumption outcomes.

(Study Session 17, Module 46.2, LOS 46.i)

Related Material

SchweserNotes - Book 5

Question #9 of 26

Question ID: 1210824

A hight default-free interest rate is *most likely* to be associated with:

A) expectations of goods and services being less available in the future relative to today.

B) investors attaching high utility to future consumption relative to current consumption.

C) expectations of higher income in the futer.

Explanation

An increase in real GDP growth means that more goods and services will be available in the future relative to today. Investors will be less willing to substitute across time, leading to more borrowing and less saving. This leads to an increase in the real default-free interest rate.

(Study Session 17, Module 46.1, LOS 46.c)

Related Material

SchweserNotes - Book 5

Question #10 of 26

Question ID: 1210836

Spreads for issuers in the consumer cyclical sector are *most likely* to:

A) Be unrelated to business cycle.

B) Decrease during economic downturns.

C) Increase during economic downturns.

Explanation

Spreads on issues from the consumer cyclical sectors tend to rise during economic downturns and fall during expansions reflecting cyclicality in earnings of the companies in the sector.

(Study Session 17, Module 46.2, LOS 46.g)

Related Material

SchweserNotes - Book 5

Question #11 of 26

Question ID: 1210823

Rapidly developing economies like India and China have high GDP growth rates and therefore are *most likely* to have a:

A) High real rate, low inter-temporal rate of substitution and a low rate of current consumption.

B) High real rate, low inter-temporal rate of substitution and a high rate of current borrowing by investors.

C) Low real rate, high inter-temporal rate of substitution and a low rate of current borrowing by investors.

Explanation

High GDP growth leads to higher future expected incomes and therefore high rate of current consumption (low savings, high borrowings, and an increase in the real default-free rate of interest) and a low inter-temporal rate of substitution.

(Study Session 17, Module 46.1, LOS 46.c)

Related Material

SchweserNotes - Book 5

Question #12 of 26

Question ID: 1210831

Break-even inflation rate is *most appropriately* described as the:

A) The difference between market's expectation of the inflation rate and the risk premium for inflation uncertainty.

B) The difference in yields of non-inflation indexed and inflation indexed risk-free bonds.

C) The difference in yields between long-dated and short-dated government bonds.

Explanation

Break-even inflation is the difference in nominal and real risk-free rates. It comprises premium for inflation and the risk premium for uncertainty in inflation.

(Study Session 17, Module 46.1, LOS 46.e)

Related Material

SchweserNotes - Book 5

Question #13 of 26

Question ID: 1210825

The real rate of return is *most likely* higher:

A) Higher the utility investors attach to future consumption relative to current consumption.

B) Higher the expectations of lower income in the future.

C) Lower the utility investors attach to future consumption relative to current consumption.

Explanation

Real rate of return is higher, higher the utility of current consumption relative to future consumption. If investors expect lower incomes in the future, the utility of future consumption relative to current consumption will be higher and real rate will be lower.

(Study Session 17, Module 46.1, LOS 46.c)

Related Material

SchweserNotes - Book 5

Question #14 of 26

Question ID: 1210833

The break-even inflation rate is expected to be 2% over the next year. What is the credit spread for a 2% annual pay corporate bond maturing in one year with a market price of \$96.91 (\$100 par) if the real risk-free rate of return over the next year is 1%?

A) 0.19%

B) 2.25%

C) 2.00%

Explanation

The YTM on the corporate bond is (102/96.91) – 1 = 5.25%.

Credit spread = Yield - BEI - R = 5.25% - 2% - 1% = 2.25%

(Study Session 17, Module 46.1, LOS 46.f)

Related Material

SchweserNotes - Book 5

Question #15 of 26

Question ID: 1210822

The marginal utility of current consumption is *most likely* higher:

A) During economic expansions.

B) During economic contractions.

C) Higher the wealth.

Explanation

Diminishing marginal utility of wealth means that an investor's marginal utility of consumption declines as wealth increases. This suggests that marginal utility of consumption is higher during periods of scarcity, such as during economic contractions.

(Study Session 17, Module 46.1, LOS 46.c)

Related Material

SchweserNotes - Book 5

Question #16 of 26

Question ID: 1210842

Sector rotation strategies are *least likely* to seek to:

A) relate business cycle to sector performance.

B) Invest in better performing sector as soon as the shift starts materializing.

C) earn higher risk premium than any of the individual sectors.

Explanation

Sector rotation strategies seek to understand the relationship between performance of different sectors and business cycle and forecast the shifts in business cycle so as to rotate money out before the shift in performance occurs. Such strategies want to earn higher risk premiums (returns over risk-free rate).

(Study Session 17, Module 46.2, LOS 46.l)

Related Material

SchweserNotes - Book 5

Question #17 of 26

Question ID: 1210834

Jeff Dentmat is expecting overall credit spreads to narrow over the next few years. Which of the following conclusions can Dentmat most appropriately make?

A) High rated corporate bonds will outperform low-rated corporate bonds.

B) Government bonds will outperform low-rated corporate bonds.

C) Risky bonds will outperform risk-free bonds.

Explanation

When credit spreads narrow, lower rated bonds outperform higher rated bonds.

(Study Session 17, Module 46.1, LOS 46.f)

Related Material

SchweserNotes - Book 5

Question #18 of 26

Question ID: 1210843

As compared to an investment in equities, the difference in discount rate for valuation of commercial real estate is *most likely* due to:

A) inflation uncertainty.

B) the break-even inflation rate.

C) lack of liquidity.

Explanation

The additional risk-premium for real estate is due to lack of liquidity.

(Study Session 17, Module 46.2, LOS 46.m)

Related Material

SchweserNotes - Book 5

Question #19 of 26

Question ID: 1210826

The price of a zero-coupon, inflation indexed, risk-free bond that pays $1 in one period is:

A) $1.00

B) The expected value of the investors' inter-temporal rate of substitution between current period and one period from now.

C) Uncertain.

Explanation

The price of a The price of a zero-coupon, inflation indexed, risk-free bond that pays $1 in one period is the expected value of the investors' inter-temporal rate of substitution between current period and one period from now. This value is less than $1 as the utility of current consumption is greater than consumption in one period in the future.

(Study Session 17, Module 46.1, LOS 46.c)

Related Material

SchweserNotes - Book 5

Question #20 of 26

Question ID: 1210835

Differences in credit spreads across sectors are *least likely* due to:

A) Differences in services and products that an industry produces.

B) Differences in ratings.

C) Differences in leverage typical of the sector.

Explanation

Differences in credit spreads across sectors is related to differences in products/services the sector produces and leverage typically used in the sector.

(Study Session 17, Module 46.2, LOS 46.g)

Related Material

SchweserNotes - Book 5

Question #21 of 26

Question ID: 1210818

Which of the following is *least likely* to explain a decline in the S&P 500 index:

A) A decline in expected inflation.

B) An increase in Treasury yields.

C) A decrease in expectations about corporate earnings.

Explanation

Equity market prices are positively related to expected earnings/cash flows and negatively related to discount rate. Discount rate is positively related to inflation expectations and treasury yields (risk-free rate).

(Study Session 17, Module 46.1, LOS 46.a)

Related Material

SchweserNotes - Book 5

Question #22 of 26

Question ID: 1210832

Credit spreads are *most likely* to:

A) Rise during recessions.

B) Rise during expansions.

C) Rise with policy rates.

Explanation

Credit losses (probability of default and loss given default) tend to be higher during recessions and hence credit spreads are higher during recessions.

(Study Session 17, Module 46.1, LOS 46.f)

Related Material

SchweserNotes - Book 5

Question #23 of 26

Question ID: 1210828

The risk-premium for uncertainty in inflation is *most likely* to be:

A) positively related to the term spread.

B) unrelated to the term spread.

C) negatively related to the term spread.

Explanation

Term spread (i.e., difference in yield between long dated government bonds and short-dated government bonds) is normally positive. Given that longer-term government bonds have a higher risk premium for uncertainty in inflation; term spread would be higher resulting in a positive relationship.

(Study Session 17, Module 46.1, LOS 46.d)

Related Material

SchweserNotes - Book 5

Question #24 of 26

Question ID: 1210837

Corporate earnings from which of the following sectors would be most sensitive to business cycle?

A) Consumer non-discretionary

B) non-cyclical

C) Consumer durable

Explanation

Earnings of companies in cyclical industries such as consumer durable or consumer discretionary would be more sensitive to business cycle as opposed to companies in non-cyclical industries such as consumer non-discretionary.

(Study Session 17, Module 46.2, LOS 46.h)

Related Material

SchweserNotes - Book 5

Question #25 of 26

Question ID: 1210819

Market values of assets are *most likely* to be affected when either:

A) Real risk-free rates, inflation premium, timing/magnitude of expected cash flows change.

B) Real risk-free rates, risk premiums, timing/magnitude of expected cash flows change.

C) Risk free interest rates, risk premiums, timing and/or magnitude of expected cash flows change.

Explanation

Market values of assets are affected when the expected cash flows or discount rate changes. The discount rate can change either due to changes in risk-free rate or due to changes in risk premiums.

(Study Session 17, Module 46.1, LOS 46.a)

Related Material

SchweserNotes - Book 5

Question #26 of 26

Question ID: 1210830

If the market expects inflation to decrease over the next few years but the uncertainty about inflation was increasing, the break-even inflation rate is *most likely* to:

A) Increase.

B) Be uncertain.

C) Decrease.

Explanation

BEI = expected inflation + risk premium for uncertainty about inflation. While inflation is expected to decrease, the higher inflation uncertainty increases the risk premium. Hence the overall impact is uncertain.

(Study Session 17, Module 46.1, LOS 46.e)

Related Material

SchweserNotes - Book 5