

## **Learning Module 4: Overview of Equity Securities**

**Q.110 LagRos Ltd. has total assets of \$3.2 million and liabilities of \$1.2 million. If its shares trade for \$25, and 70,000 shares are outstanding in the open market, then LagRos' book value is most likely:**

- A. \$1,750,000.**
- B. \$2,000,000.**
- C. \$3,200,000.**

**The correct answer is B.**

**Book value refers to the net difference between a company's assets and liabilities. It is the amount of money that shareholders of a company would receive if the company were to be liquidated. Book value is different from market value. Market value is the value of a company on the financial market, according to market participants. It is a company's worth determined by the total value of the company's outstanding shares in the market.**

$$\begin{aligned}\text{Book value} &= \text{Total assets} - \text{Total liabilities} \\ &= \$3.2 \text{ million} - \$1.2 \text{ million} \\ &= \$2,000,000\end{aligned}$$

**Book value doesn't take into account market prices. Market value does.**

**A is incorrect. It represents market value, i.e., the total value of the company's outstanding shares in the market.**

**C is incorrect. It represents the value of the company's assets.**

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (a) Describe characteristics of types of equity securities.**

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Q.111 Which of the following is *most likely* correct regarding callable common shares? Given callable common shares:

- A. shareholders have the right to buy more shares at a pre-established price.
- B. the company has the right to buy back the shares at a pre-established price.
- C. shareholders have the right to sell back the shares at a pre-established price.

The correct answer is **B**.

Callable common shares are a specific type of equity security that grants the issuing company the right, but not the obligation, to repurchase the shares from shareholders at a predetermined price within a certain period.

This feature is often included in the share structure to provide the company with flexibility in managing its capital structure and to potentially retire shares when it is financially advantageous to do so. The predetermined price is usually set at the time of the share issuance and is intended to offer a level of protection to investors against the company calling the shares at an inopportune time.

This can be strategically beneficial for the company, for example, if the shares are trading below the call price and the company wishes to reduce the number of shares outstanding to increase earnings per share or if the company wants to adjust its capital structure.

**A is incorrect.** This option confuses callable common shares with rights offerings or warrants. In a rights offering, existing shareholders are given the right to purchase additional shares at a pre-established price, usually at a discount to the current market price.

This is done to raise additional capital while giving existing shareholders the opportunity to maintain their proportional ownership in the company. Warrants are similar in that they give the holder the right to buy the company's stock at a specified price before the expiry date. Neither of these instruments involves the company having the right to buy back shares.

**C is incorrect.** This option describes putable shares, not callable shares. Putable shares grant the shareholder the right, but not the obligation, to sell the shares back to the company at a predetermined price.

This feature is designed to protect the investor, allowing them to exit their investment at a known price if certain conditions are met or if the investor chooses to do so. While putable shares offer a form of downside protection to the shareholder, callable shares provide the company with strategic flexibility in managing its shares outstanding.

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (a) Describe characteristics of types of equity securities.**

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Q.112 Which of these is/are *least likely* common characteristics of private equity securities?

- I. Illiquid
- II. Giving the company's management time to focus on long-term value creation
- III. Liquid

A. III.

B. I & II.

C. II & III.

The correct answer is A.

The illiquid nature of private equity is a defining feature, contrasting sharply with the liquidity found in public equity markets where securities can be bought and sold with relative ease. The lack of liquidity in private equity is a critical consideration for investors, as it impacts their ability to exit investments and realize gains within a short timeframe. Therefore, identifying liquidity as the least likely characteristic of private equity securities is accurate.

**B is incorrect.** Private equity investments are not traded on public exchanges, making them difficult to sell quickly. This illiquidity is a fundamental aspect of private equity, as it allows investors and company management to focus on long-term growth and value creation without the pressures of short-term market fluctuations. The illiquid nature of these investments requires investors to commit their capital for extended periods, typically several years, which aligns with the strategic goals of private equity.

**C is incorrect.** One of the primary advantages of private equity investment is that it provides company management with the opportunity to concentrate on long-term value creation. Without the constant scrutiny and performance pressures from public market investors, private equity-backed companies can pursue strategic initiatives, invest in research and development, and undertake restructuring or expansion efforts that may take time to yield financial results. This focus on long-term growth is a key feature of private equity investing.

***CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (c) Compare and contrast public and private equity securities.***

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Q.115 Which of the following statements is *least likely* accurate?

- A. Management actions can directly influence book value.
- B. Management actions have an indirect impact on market value.
- C. Management actions do not influence book value or market value.

The correct answer is **C**.

Management decisions and actions have a significant impact on both the book value and the market value of a company. Book value, which represents the net asset value of a company, can be directly affected by management through decisions that alter the company's assets and liabilities. For instance, decisions related to capital expenditure, acquisitions, or debt management can lead to changes in the company's assets and liabilities, thereby affecting its book value.

Similarly, management actions can indirectly influence the market value of a company, which reflects the collective perceptions of investors about the company's future prospects. Strategic decisions, financial performance, and future outlook communicated by the management can influence investor sentiment and, consequently, the market price of the company's shares.

**A is incorrect.** Management decisions regarding investments, asset disposals, or changes in financial structure directly impact the assets and liabilities on the balance sheet, thereby affecting the book value. For example, if a company's management decides to sell a significant asset, this would directly reduce the company's total assets and, assuming liabilities remain constant, decrease the book value.

**B is incorrect.** The market value of a company is determined by investor perceptions and expectations about the company's future earnings and growth potential. Management decisions related to strategic direction, financial management, and operational efficiency can influence these perceptions. Conversely, poor management decisions can lead to a loss of investor confidence and a decrease in market value.

***CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (g) Contrast the market value and book value of equity securities.***

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Q.977 Putable common shares will *most likely* benefit the:

- A. firm.
- B. brokers.
- C. shareholders.

The correct answer is **C**.

Putable common shares provide a significant benefit to shareholders by offering them the right to sell their shares back to the issuing company at a predetermined price. This feature is particularly advantageous in scenarios where the market price of the shares falls below this predetermined price, allowing shareholders to limit their potential losses.

Essentially, putable shares act as a form of protection for investors, offering them a way to exit their investment without incurring significant losses in a declining market. This safety net can make putable common shares an attractive investment option, as it provides a measure of security against market volatility and downturns.

**A is incorrect.** While issuing putable common shares might seem beneficial to a firm by potentially making its shares more attractive to investors, it primarily benefits the shareholders. For the firm, this feature can represent a financial obligation, as it requires the company to buy back shares at the predetermined price, which could be higher than the market price.

This obligation can lead to cash outflows that the firm might not have anticipated, especially if a large number of shareholders decide to exercise their put options during a market downturn. Therefore, while putable shares can be a strategic tool for companies to attract investors, the direct financial benefit is skewed towards the shareholders rather than the firm itself.

**B is incorrect.** Brokers may indirectly benefit from the trading of putable common shares due to the potential for increased transactions and, consequently, commissions. However, the primary and direct benefit of putable common shares is to the shareholders, not the brokers.

The put option embedded in these shares is a protective feature for the shareholders, allowing them to sell their shares back to the company under specific conditions. While brokers facilitate these transactions, the intrinsic value and protection offered by putable common shares are designed with the shareholders' interests in mind, not the brokers'.

Therefore, stating that brokers are the primary beneficiaries of putable common shares overlooks the direct financial safeguard these shares provide to the shareholders.

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (a) Describe characteristics of types of equity securities.**

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Q.978 YULU Company floated 1000 callable common shares in 2014. In 2015, the company exercised its call options on 200 shares at \$15. The current market price of the shares is \$18. Which of the following is *least accurate* about the firm's decision to exercise its call rights on the 200 shares?

- A. The firm will incur losses of \$600.
- B. The firm will be able to reissue shares at a higher price.
- C. The decision will reduce the dividends the company has to pay in subsequent years.

The correct answer is **A**.

The decision by YULU Company to exercise its call options on 200 shares at \$15, when the current market price is \$18, is a strategic financial move. This action allows the company to repurchase shares at a predetermined price, which is lower than the market value, thus potentially leading to financial benefits for the company.

**B is incorrect.** The statement that the firm will be able to reissue shares at a higher price is accurate and reflects one of the potential benefits of exercising call options. By repurchasing shares at the call price of \$15, the company has the opportunity to reissue or resell these shares at the current market price of \$18 or higher, depending on market conditions. This ability to capitalize on the difference between the call price and the market price can lead to increased capital for the company.

**C is incorrect.** The decision to exercise call options and repurchase shares will indeed reduce the dividends the company has to pay in subsequent years. By reducing the total number of shares outstanding, the company decreases the dividend obligations, assuming the dividend per share remains constant. This reduction in dividend payments can lead to cost savings and improved financial flexibility for the company. However, upon closer examination, this option accurately describes a financial benefit of exercising call options on shares.

***CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (f) Explain the role of equity securities in the financing of a company's assets.***

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Q.979 The type of private investment that is a hybrid of debt and equity is *most likely*:

- A. mezzanine financing.
- B. initial public offering
- C. private investment in public equity.

The correct answer is **A**.

Mezzanine financing represents a unique form of capital that serves as a bridge between debt and equity, making it an essential tool for companies in transition or seeking growth without diluting ownership. This type of financing is particularly beneficial for companies that are in a phase of rapid expansion, such as launching new products or acquiring other businesses.

Mezzanine financing provides flexibility to the borrower, as it typically involves less stringent repayment terms compared to traditional loans and offers lenders the option to convert their debt into equity in the event of default. This conversion option is a critical feature that distinguishes mezzanine financing from other forms of capital, providing a safety net for lenders while offering potential upside from equity participation.

The structure of mezzanine financing often includes subordinated debt, preferred equity, and warrants, which collectively create a hybrid financial instrument that addresses the specific needs of growing companies.

**B is incorrect.** An initial public offering (IPO) represents a significant milestone for private companies, marking their transition to publicly traded entities. This process involves offering shares of the company to the public for the first time, thereby raising capital from a broad base of investors. While an IPO can provide substantial funds for growth and expansion, it fundamentally differs from mezzanine financing in its structure and implications for the company.

**C is incorrect.** Private Investment in Public Equity (PIPE) is a financing mechanism where investors purchase shares of a publicly traded company directly from the company at a discount to the current market price. This approach allows public companies to raise capital quickly and with fewer regulatory hurdles compared to traditional public offerings.

PIPE deals involve investing in public companies, whereas mezzanine financing is typically associated with private companies seeking growth capital without going public. Additionally, PIPE transactions are purely equity-based, providing investors with immediate ownership stakes in the company, unlike mezzanine financing, which offers a hybrid of debt and equity with conversion options.

***CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (f) Explain the role of equity securities in the financing of a company's assets.***

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Q.982 The market value of a firm's equity *most likely* reflects:

- A. its operating results.
- B. its financial decisions.
- C. expectations of its future performance.

The correct answer is **C**.

The market value of a firm's equity is a reflection of the collective expectations of its future performance by investors. This valuation is dynamic and incorporates all publicly available information, including past performance, current conditions, and future prospects.

The market value is determined through the trading of the firm's shares in the stock market, where each share's price is a direct reflection of investor sentiment regarding the company's future earnings and growth potential. Investors analyze a wide range of factors, including industry trends, economic indicators, and company-specific news, to form their expectations.

**A is incorrect.** While operating results, such as revenue, profit margins, and cash flow, are important indicators of a company's current financial health, they do not directly determine the market value of a firm's equity. Operating results are historical data that investors use as part of their analysis to form expectations about the company's future performance. However, the market value is more influenced by these future expectations rather than past performance alone.

**B is incorrect.** Financial decisions, such as capital structure, dividend policy, and investment choices, can influence a firm's risk profile and potential for growth, which in turn can affect investor perceptions and expectations. However, the market value of a firm's equity is not a direct reflection of these decisions.

Instead, it encapsulates investors' reactions to these decisions in the context of future performance expectations. While this decision impacts the firm's financial structure, the market value of its equity will ultimately reflect how investors assess the potential success of the expansion and its impact on future earnings.

***CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (g) Contrast the market value and book value of equity securities.***

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Q.984 Which of the following is *least likely* a reason why companies opt for private equity?

- A. To make acquisitions.
- B. To take a private company public.
- C. To fund the development of new technology.

The correct answer is **B**.

Private equity refers to capital investment made into companies that are not publicly traded. The primary goal of private equity is to generate returns through various strategies, including restructuring, improving operational efficiency, and driving growth, often with a longer-term investment horizon.

One of the key characteristics of private equity is its focus on private companies or taking public companies private, rather than taking private companies public. This process, known as a public-to-private transaction, involves buying out all of a public company's shares, thereby delisting it from public stock exchanges.

The rationale behind such transactions often includes removing the pressures of quarterly earnings reports and providing the company with more flexibility to implement long-term strategies without the scrutiny of public investors. Therefore, using private equity to take a private company public contradicts the typical use cases for private equity funds, which are more aligned with direct investments in private companies or buyouts of public companies.

**A is incorrect.** Private equity firms can provide the necessary capital and strategic support for such transactions. Acquisitions can be a critical component of a company's growth strategy, allowing it to expand its market presence, diversify its product offerings, or acquire new technologies.

Private equity firms bring not only capital but also expertise in structuring and financing deals, operational improvements, and strategic planning, making them valuable partners in the acquisition process. This collaboration can enable companies to pursue larger or more strategic acquisitions than they might be able to finance through traditional means such as bank loans or public equity markets.

**C is incorrect.** Funding the development of new technology is another key reason companies seek private equity investment. In sectors such as technology, biotechnology, and renewable energy, the development and commercialization of new products or services can require significant upfront investment, often before generating any revenue.

Private equity can provide the patient capital needed to support research and development activities, scale operations, and bring innovations to market. Unlike venture capital, which typically focuses on early-stage companies with high growth potential, private equity can support companies at various stages of development, including more mature companies looking to innovate or pivot their business models.

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (c) Compare and contrast public and private equity securities.**

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Q.985 In the case of a share denominated in foreign currency, the appreciation of the foreign currency *most likely*:

- A. increases the returns.
- B. not affect the returns.
- C. decreases the returns.

The correct answer is **A**.

When a share is denominated in a foreign currency, the appreciation of that currency relative to the investor's local currency will most likely increase the returns on that investment. This is because the value of the foreign currency increases, making the returns when converted back into the local currency higher than they would have been without the appreciation.

For instance, if an investor from the United States invests in a company listed in Europe and the Euro appreciates against the US Dollar, when the investor converts the dividends or sale proceeds back into US Dollars, they will receive more dollars for each Euro than they would have before the appreciation. This increase in the exchange rate effectively boosts the investment's return in the investor's local currency.

**B is incorrect.** The appreciation or depreciation of a foreign currency directly affects the returns of shares denominated in that currency for investors holding a different local currency. The change in exchange rates alters the value of dividends and capital gains when they are converted back into the investor's local currency, making it incorrect to suggest that the returns would not be affected.

**C is incorrect.** The appreciation of the foreign currency relative to the investor's local currency increases the value of returns when they are converted back into the local currency, thereby increasing the overall returns on the investment.

***CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (d) Describe methods for investing in non-domestic equity securities.***

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Q.987 Global Depository Receipts (GDR) are *most likely* denominated in:

- A. USD.
- B. the local currency of the firm.
- C. the local currency of the buyer.

The correct answer is **A**.

Global Depository Receipts (GDRs) are financial instruments used by companies to facilitate the trading of their shares in foreign markets. They are typically denominated in US dollars (USD), which is a widely accepted currency in international financial transactions. This denomination in USD allows investors from different countries to invest in foreign companies without the need to deal with the complexities of currency conversion.

GDRs are issued by an international depository bank, representing the ownership of a certain number of shares in a foreign company. The use of USD as the denomination currency makes GDRs an attractive option for investors looking to diversify their portfolios internationally without the added risk of currency fluctuations.

**B is incorrect.** Suggesting that GDRs are denominated in the local currency of the firm is a misunderstanding of how these instruments are structured. While the underlying shares represented by the GDRs are indeed of companies based in various countries, the GDRs themselves are designed to be traded on international markets.

Denominating them in the local currency of the issuing company would complicate transactions for international investors, who would then have to navigate currency exchange rates and conversions. The use of USD as the denomination currency avoids these complications, making GDRs more accessible and attractive to a global audience.

**C is incorrect.** While this approach might seem to offer convenience to investors, it would introduce significant complexity and inefficiency into the trading and settlement of GDRs. Investors come from various countries with different currencies, and denominating GDRs in each investor's local currency would be impractical. The standard practice of using USD as the denomination currency for GDRs addresses this issue by providing a common and stable currency that facilitates international investment and trading.

***CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (d) Describe methods for investing in non-domestic equity securities.***

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Q.1770 Which of the following is *most likely* an appropriate statement regarding the ownership interest of common shareholders?

- A. They have a residual claim after debt holders and preferred shareholders.
- B. They have a residual claim before debt holders and preferred shareholders.
- C. They have a residual claim after debt holders and before preferred shareholders.

The correct answer is **A**.

Common shareholders have a residual claim on the assets of a company, which means they are entitled to the company's assets only after all other claims have been satisfied. This includes the claims of debt holders and preferred shareholders.

In the event of a company's liquidation, debt holders are paid first, as their claims are secured by the company's assets. Following the satisfaction of all debt-related claims, preferred shareholders receive their share, given their preference over common shareholders in the distribution of assets.

Only after these obligations are met do common shareholders receive any remaining assets. This hierarchical structure ensures that the riskier investments, represented by common shares, are rewarded last, reflecting their higher risk compared to debt instruments and preferred shares.

**B is incorrect.** Suggesting that common shareholders have a residual claim before debt holders and preferred shareholders contradicts the established hierarchy of claims in a company's capital structure. Debt holders, being creditors, have a priority claim on the company's assets, especially in cases of liquidation.

This is followed by preferred shareholders, who have a preferential claim over common shareholders but do not typically enjoy the same voting rights. This option misrepresents the fundamental principles of corporate finance and the legal framework governing corporate liquidation processes.

**C is incorrect.** This option inaccurately places common shareholders' claims after debt holders but before preferred shareholders. In reality, preferred shareholders have a higher claim on assets than common shareholders, primarily due to the preferential nature of their shares. Preferred shares often come with fixed dividends and have priority over common shares in asset distribution upon liquidation.

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (e) Compare the risk and return characteristics of different types of equity securities.**

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Q.1771 Which of the following parties *most likely* benefits from callable shares when the market price is greater than the call price?

- A. Callable equity holders.
- B. Callable equity issuing firms.
- C. Debtholders of callable equity issuing firms.

The correct answer is **B**.

When the market price is greater than the call price, callable equity issuing firms are the parties that most likely benefit. Callable shares provide the issuing firm with the option, but not the obligation, to repurchase shares at a predetermined call price.

This feature is particularly advantageous when the market price exceeds the call price, as it allows the firm to repurchase shares at a lower cost than the current market value. This action can lead to several benefits for the firm, including reducing the number of shares outstanding, which may increase earnings per share and potentially boost the stock price.

Additionally, by repurchasing shares at the call price, the firm can avoid paying higher dividends on those shares in the future, thus saving on dividend payments. Furthermore, if the firm believes its stock is undervalued, repurchasing shares can signal confidence to the market, potentially leading to a positive reevaluation of the stock.

**A is incorrect.** While callable equity holders have the potential to benefit from an increase in the stock price, they are at a disadvantage when the shares are called at a price lower than the current market value. This scenario results in a loss of potential gains for the equity holders, as they are forced to sell their shares back to the company at the predetermined call price, which is lower than the market price. Therefore, the benefit primarily accrues to the issuing firm rather than the callable equity holders.

**C is incorrect.** Debtholders of callable equity issuing firms are generally not directly affected by the call feature of equity shares. The call feature pertains to the equity side of the firm's capital structure and does not impact the terms or conditions of the firm's debt. Debtholders' primary concern would be the firm's ability to meet its debt obligations, which is influenced by factors such as the firm's overall financial health, cash flow, and profitability, rather than the specifics of its equity structure. While the firm's actions to repurchase shares could indirectly affect its financial flexibility, this does not directly benefit or harm debtholders in the context of callable shares.

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (a) Describe characteristics of types of equity securities.**

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Q.1772 Which of the following is *most likely* a similarity between common shares and preferred shares?

- A. Both have voting rights.
- B. Both can have put and call features.
- C. Both make fixed periodic payments.

The correct answer is **B**.

These features add flexibility and potential financial benefits for the shareholders. A put feature allows shareholders to sell their shares back to the issuing company at a predetermined price, which can be particularly advantageous in a declining market.

Conversely, a call feature enables the company to buy back shares from investors at a predetermined price, which can be beneficial for the company if it wants to reduce the number of shares in circulation and potentially increase the value of remaining shares. These features are mechanisms that can be embedded in the terms of both common and preferred shares, providing strategic options for both the shareholders and the issuing companies.

**A is incorrect.** This option suggests that both common and preferred shares have voting rights, which is not accurate. Typically, common shares grant voting rights to shareholders, allowing them to vote on corporate matters, including the election of the board of directors.

In contrast, preferred shares usually do not come with voting rights, which is one of the key distinctions between the two types of equity. This difference reflects the trade-off between the potential for higher dividends associated with preferred shares and the influence over corporate governance afforded by common shares.

**C is incorrect.** This option implies that both common and preferred shares make fixed periodic payments, which is misleading. Preferred shares are known for providing fixed dividend payments, which are typically paid out before any dividends are distributed to common shareholders.

However, common shares do not guarantee fixed periodic payments. Dividends on common shares are variable and depend on the company's profitability and the decisions made by its board of directors.

***CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (b) Describe differences in voting rights and other ownership characteristics among different equity classes.***

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Q.1773 What is *most likely* the appropriate advantage of participating preferred shares?

- A. Participating preferred shares can be exchanged for common stocks at the conversion ratio.

B. Any dividends that are not paid for participating preferred shares accumulate for the next period.

C. Investors in participating preferred shares receive an extra dividend if the firm's profits exceed a specified limit.

The correct answer is **C**.

A preferred share is a share that guarantees its owner fixed dividend payments. The dividends of preferred shares are paid before the dividends of ordinary shares can be paid.

There are four major types of preference shares: Participating, Cumulative, Convertible, and Callable shares.

- Participating - Holders of participating preference shares receive an additional amount of money (extra dividend) if the firm exceeds its financial goals for that financial year.
- Cumulative - Cumulative shares protect investors against downturns in the company profits. The shareholders of cumulative preference shares receive unpaid dividends before any other shareholders' dividends can be paid. Assume that a company that pays its preference shareholders a dividend of \$20 per year per share suffers losses for five years and is, thus, unable to make dividend payments. Assuming that it makes profits on the 5<sup>th</sup> year, the company will have to pay the accumulated \$80 dividends per share to cumulative preference shareholders before paying dividends to other shareholders.
- Convertible - Convertible shares give the shareholder the choice of converting their preferred shares to common shares. Preference shareholders will convert their shares to common shares when the market value of common shares increases. By converting their shares to common shares, they give up the benefit of receiving a fixed dividend. Once converted to common shares, the shares cannot be converted back to preference shares.
- Callable shares - Callable shares give the issuing company the right to buy back ("call") their shares at a pre-determined price. Companies will exercise this right when the market price of their shares is higher than the pre-determined price.

**A is incorrect.** While conversion is a feature of convertible preferred shares, it is not characteristic of participating preferred shares. Convertible preferred shares allow shareholders to convert their preferred shares into a predetermined number of common shares, usually at the

discretion of the shareholder. However, it does not relate to the distribution of extra dividends based on company profits, which is the defining advantage of participating preferred shares.

**B is incorrect.** This option describes cumulative preferred shares, not participating preferred shares. Cumulative preferred shares have the feature where unpaid dividends accumulate and must be paid out before dividends can be distributed to common shareholders. This ensures that shareholders of cumulative preferred shares are protected against periods when the company might not be able to distribute dividends.

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (a) Describe characteristics of types of equity securities.**

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Q.1775 Stratton VCs is a venture capital firm that invests in different stages of a firm. In which of the following stages will Stratton *least likely* invest its funds?

- A. Late-stage.
- B. Seed investing stage.
- C. Mezzanine financing stage.

The correct answer is **A**.

Venture capital firms like Stratton VCs play a crucial role in the growth and development of companies by providing necessary funding at various stages of a company's lifecycle. These stages range from the very early seed stage, where the company might only have an idea or a prototype, to later stages where the company is expanding its market presence or scaling operations.

The least likely stage for a venture capital firm to invest in is the late-stage. This is primarily because, by the late stage, companies are often looking towards public markets for funding or are already generating sufficient revenue and profits that do not necessitate venture capital investment.

Venture capital is inherently risk-tolerant and seeks higher returns through equity or ownership stakes in companies that are in their nascent or growth phases. Late-stage companies typically do not offer the high-risk, high-reward profile that venture capitalists seek.

**B is incorrect.** It suggests that venture capital firms like Stratton VCs would least likely invest in the seed investing stage. This is not accurate. The seed stage is actually one of the primary stages where venture capitalists invest.

At this stage, companies are in their infancy, often pre-revenue, and require capital to develop their product or service. Venture capitalists provide this early-stage funding in exchange for equity, betting on the company's future growth and success.

The seed stage represents a significant opportunity for venture capitalists to enter at the ground level and potentially reap substantial rewards as the company grows.

**C is incorrect.** It implies that venture capital firms would least likely invest in the mezzanine financing stage. This is also inaccurate. Mezzanine financing is a late-stage funding option that helps prepare a company for an initial public offering (IPO) or a significant private equity investment. It is a hybrid of debt and equity financing, often used by companies to bridge the gap between venture capital funding and public offering or sale.

Venture capitalists may participate in mezzanine financing to help a company in its final growth phase before an exit, such as an IPO, where the venture capitalist can realize returns on their investment. While not as common as early-stage investments, mezzanine financing is still within the realm of venture capital activity.

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (f) Explain the role of equity securities in the financing of a company's assets.**

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Q.1776 Arabco, an oil exploring public limited company, is under financial distress due to declining oil prices. To receive quick financing, Arabco has decided to sell part of its equity to private investors. Which of the following types of investment procedures *most likely* describes this situation?

- A. Mezzanine financing.
- B. Leveraged buyout (LBO).
- C. Private investment in public equity (PIPE).

The correct answer is **C**.

Arabco's decision to sell part of its equity to private investors due to financial distress caused by declining oil prices is most accurately described by Private Investment in Public Equity (PIPE). PIPE is a financing option where private investors purchase shares of a publicly traded company directly from the company at a discount to the current market price.

This method is particularly appealing to companies in need of quick financing without the extensive regulatory requirements and time-consuming processes associated with public offerings. In situations where a company is facing financial challenges or is in need of immediate capital infusion, PIPE transactions offer a viable solution by providing quick access to funds while allowing the company to remain publicly traded.

This approach is beneficial for both the company, which receives the necessary capital, and the private investors, who acquire shares at a discounted rate with the potential for significant returns if the company recovers.

**A is incorrect.** Mezzanine financing is a hybrid form of financing that combines elements of debt and equity financing. It typically involves the issuance of debt that can be converted into equity in the event of a default, or it may include warrants or options to purchase equity at a later date.

Mezzanine financing is often used by companies looking to finance growth or acquisitions without diluting current shareholders' equity significantly. It is not the most suitable description for Arabco's situation, as the company is specifically looking to sell equity directly to private investors to address its immediate financial distress.

**B is incorrect.** A Leveraged Buyout (LBO) involves the acquisition of a company using a significant amount of borrowed money (leverage) to meet the cost of acquisition. The assets of the company being acquired and those of the acquiring company are often used as collateral for the loans.

LBOs are typically executed by private equity firms aiming to take a public company private, improve its financial performance, and eventually sell it for a profit. This strategy is not applicable to Arabco's scenario, as the company is seeking to raise funds by selling equity to private investors rather than being acquired through a leveraged buyout.

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (f) Explain the role of equity securities in the financing of a company's assets.**

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Q.1777 Farah Jan is an investment analyst. She is evaluating methods of investing in non-domestic equity securities, and she has identified some of the obstacles of direct financing. Which of the following is *least likely* a disadvantage of direct financing?

- A. The foreign stock exchange may be illiquid.
- B. Investors must be familiar with the regulations of foreign markets.
- C. Investments and returns are denominated in the local currency of the investor.

The correct answer is **C**.

In the context of direct financing, especially when investing in non-domestic equity securities, the primary concern is the currency risk associated with investments and returns being denominated in a foreign currency, not the local currency.

When investments are made directly in foreign markets, the returns are typically subject to exchange rate fluctuations, which can either positively or negatively affect the investment outcome when converted back to the investor's local currency. Therefore, having investments and returns denominated in the local currency would actually mitigate this currency risk, making it an advantage rather than a disadvantage.

**A is incorrect.** The illiquidity of foreign stock exchanges is a genuine concern for investors engaging in direct financing. Illiquid markets can make it difficult to execute trades without affecting the price of the security, leading to potentially higher transaction costs and making it challenging to enter or exit positions.

This illiquidity can significantly impact investment strategies, especially for those requiring the flexibility to quickly adjust positions in response to market changes.

**B is incorrect.** Familiarity with the regulations of foreign markets is indeed a critical factor and a potential obstacle for investors considering direct financing in non-domestic equity securities. Different countries have varying regulatory environments, including rules regarding foreign ownership, taxation, and reporting requirements.

These regulations can significantly affect the feasibility and attractiveness of investment opportunities. Investors must navigate these complexities to ensure compliance and optimize their investment strategies, making this a notable disadvantage of direct financing.

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (d) Describe methods for investing in non-domestic equity securities.**

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Q.1778 Which of the following depository receipts is *most likely* issued outside of the United States and denominated in US dollars?

- A. Global Depository Receipt.
- B. American Depository Receipt.
- C. Basket of listed depository receipts.

The correct answer is **A**.

Global Depository Receipts (GDRs) are financial instruments used by companies to facilitate the trading of their shares in foreign markets. GDRs are particularly significant for companies looking to attract investment from regions outside their home country. They are issued outside of the United States but are denominated in US dollars, making them an attractive option for investors looking to invest in foreign companies without the complications of currency conversion and the associated risks.

GDRs allow investors to gain exposure to foreign markets while providing companies with access to a broader investor base. The fact that GDRs are denominated in US dollars is a critical feature, as the US dollar is widely regarded as a global currency, thus providing a level of stability and familiarity to investors. This characteristic of GDRs facilitates international trade in securities by simplifying transactions for investors who prefer or are required to deal in US dollars.

**B is incorrect.** ADRs are issued by US depository banks and represent a certain number of shares in a foreign company. They allow US investors to invest in non-US companies without dealing with the complexities of foreign markets and currencies, as ADRs are traded on US exchanges and are denominated in US dollars. However, unlike GDRs, ADRs are issued within the United States, making them distinct from GDRs, which are issued outside the US.

**C is incorrect.** The option refers to a collection or portfolio of depository receipts, which can include both ADRs and GDRs, among others, and is typically traded as a single entity on stock exchanges. This option does not specifically address the question of being issued outside of the United States and denominated in US dollars.

While a basket of listed depository receipts can provide investors with diversified exposure to foreign companies, it does not directly answer the question regarding the issuance location and currency denomination. Therefore, it is not the most accurate answer to the question posed.

***CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (d) Describe methods for investing in non-domestic equity securities.***

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Q.1779 Which of the following is the *least risky* type of equity for an investor?

- A. Non-cumulative common stock.
- B. Preferred stock with a put feature.
- C. Preferred stock with a call feature.

The correct answer is **B**.

Preferred stocks with a put feature are considered the least risky type of equity for an investor because they provide an additional layer of security. The put feature allows the investor to sell the stock back to the issuing company at a predetermined price, which can protect the investor from significant losses if the stock's market price falls below this level.

This feature essentially sets a floor on the potential loss an investor can face, as they have the option to exit their investment at the put price regardless of how low the market price may drop. This safety net is particularly valuable in volatile or declining markets, where the risk of loss is higher. The ability to sell the stock back to the issuer at a known price provides a measure of liquidity and price stability that is not available with other types of equity.

**A is incorrect.** It lacks the protective mechanisms that preferred stocks offer. Non-cumulative common stockholders are last in line to receive dividends, and in the event of the company's liquidation, they are the last to be paid after all debts and preferred shareholders have been settled.

Additionally, non-cumulative common stock does not guarantee dividend payments, and if the company decides not to pay dividends in a given period, those dividends are not owed to the shareholders in the future. This lack of dividend protection and prioritization in the capital structure increases the risk for investors holding non-cumulative common stock.

**C is incorrect.** Preferred stock with a call feature is riskier than preferred stock with a put feature from the investor's perspective. The call feature allows the issuing company to repurchase the stock from the shareholders at a predetermined price before the stock's maturity date.

This feature can limit the upside potential for investors, as the company may choose to call the stock during favorable market conditions, forcing investors to sell back their shares potentially at a price lower than the market value or the value they could have realized if they held onto the stock longer.

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (a) Describe characteristics of types of equity securities.**

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Q.1780 Prion Corp is a public limited company that manufactures lifeboats. Sadin Nigar is an equity analyst who is evaluating the equity of Piron Corp. She has summarized the most important financial information of the company in the following table:

Total Assets	\$575 million
Total liabilities	\$225 million
Revenue during the year	\$101 million
Number of shares outstanding	8.75 million
Market capitalization	\$393.75 million

Using the given data, the per-share book value of equity of the company is *closest to*:

- A. \$40.
- B. \$45.
- C. \$66.

The correct answer is A.

Book value is the net value of a firm's assets, obtained by subtracting total liabilities from total assets. It represents the amount of money that shareholders will receive if the company were to be liquidated.

$$\text{Book value} = \text{Total Assets} - \text{Total liabilities}$$

$$\text{Book value per share} = \frac{(\$575,000,000 - \$225,000,000)}{8,750,000 \text{ shares}} = \$40/\text{share}.$$

\$40/share implies that shareholders will receive \$40 for every share they hold if the company gets liquidated.

**B is incorrect.** It represents the market value per share, obtained by dividing the market capitalization by the total number of shares outstanding.

**C is incorrect.** It has been obtained by dividing total assets by the total number of outstanding shares. Book value is obtained by subtracting total liabilities from total assets, then dividing the result by the total number of outstanding shares.

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (g) Contrast the market value and book value of equity securities.**

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Q.1781 Prion Corp is a public limited company that manufactures lifeboats. Sadin Nigar is an equity analyst who is evaluating the equity of Piron Corp. She has summarized the most important financial information of the company in the following table:

Total Assets	\$575 million
Total liabilities	\$225 million
Revenue during the year	\$101 million
Number of shares outstanding	8.75 million
Market capitalization	\$393.75 million

Using the given data, the per-share market value of equity of the company is *closest to*:

- A. \$40.
- B. \$45.
- C. \$65.70.

The correct answer is **B**.

Market value is the value of a company on the financial market, according to market participants. It is a company's worth determined by the total value of the company's outstanding shares in the market. It is obtained by multiplying the total number of outstanding shares by the current market price of the shares.

$$\begin{aligned} \text{Market value per share} &= \frac{\text{Total market capitalization}}{\text{Number of shares outstanding}} \\ &= \frac{\$393,750,000}{8,750,000 \text{ shares}} \\ &= \$45/\text{share} \end{aligned}$$

**A is incorrect.** It represents book value, obtained by dividing the net asset value (total assets - total liabilities) by the total number of outstanding shares.

**C is incorrect.** It has been obtained by dividing total assets by the total number of outstanding shares.

**CFA Level I, Topic 6 - Equity, Learning Module 4: Overview of Equity Securities. LOS (g): Distinguish between the market value and book value of equity securities.**

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Q.1782 Using the data given below, calculate Piron Corp's price-to-book value of the equity.

Total Assets	\$575 million
Total liabilities	\$225 million
Revenue during the year	\$101 million
Number of shares outstanding	\$8.75 million
Market capitalization	\$393.75 million

- A. 1.125
- B. 1.6
- C. 1.75

The correct answer is **A**.

The price-to-book value of equity is calculated as the Market value (or Price of equity) divided by the Book value of equity.

$$\text{Book value} = \text{Total Assets} - \text{Total liabilities}$$
$$(\$575,000,000 - \$225,000,000)$$
$$\text{Book value per share} = \frac{\$393,750,000}{8,750,000 \text{ shares}} = \$40/\text{share}.$$

$$\text{Market value per share} = \frac{\text{Total market capitalization}}{\text{Number of shares outstanding}}$$
$$= \frac{\$393,750,000}{8,750,000 \text{ shares}}$$
$$= \$45/\text{share}$$

$$\text{Price-to-book value} = \frac{\text{Market value}}{\text{Book value of equity}}$$
$$= \frac{\$45}{\$40}$$
$$= 1.125$$

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (g) Contrast the market value and book value of equity securities.**

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Q.1783 Parco Inc. is a public limited company from Turkey. Parco is the market leader in plastic hanger manufacturing. Using the data provided in Parco Inc.'s balance sheet, calculate the return on Parco's equity at the end of 2016.

Net Income for 2016	\$5 million
Total Shareholders' Equity for 2016	\$65 million
Net Income for 2015	\$8 million
Total Shareholders' Equity for 2015	\$75 million
Number of shares outstanding	7 million

- A. 6.67%
- B. 7.14%
- C. 7.7%

The correct answer is **B**.

The return on equity (ROE) is a significant financial metric that measures a company's ability to generate profits from its shareholders' equity. The formula for calculating ROE is given by:

$$\text{ROE} = \frac{\text{NetIncome}}{\text{AverageShareholders'Equity})}$$

Therefore:

$$\text{ROE of Parco} = \frac{\$5,000,000}{\left(\frac{(\$65,000,000+\$75,000,000)}{2}\right)} = 7.14\%$$

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (h) Compare a company's cost of equity, its (accounting) return on equity, and investors' required rates of return.**

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Q.1784 Given the following table, what will *most likely* happen to the intrinsic value of Parco's equity if the required rate of return increases?

Net Income for 2016	\$5 million
Total Shareholders' Equity for 2016	\$65 million
Net Income for 2015	\$8 million
Total Shareholders' Equity for 2015	\$75 million
Number of shares outstanding	7 million

- A. The intrinsic value will increase.
- B. The intrinsic value will decrease.
- C. The intrinsic value will remain unchanged.

The correct answer is **B**.

The intrinsic value of a company's equity is fundamentally linked to the present value of its expected future cash flows. When calculating this present value, the required rate of return acts as the discount rate. An increase in the required rate of return means that future cash flows are discounted more heavily, which, in turn, reduces the present value of these cash flows.

Given the direct relationship between the present value of future cash flows and the intrinsic value of equity, an increase in the required rate of return will lead to a decrease in the intrinsic value of Parco's equity.

This relationship can be illustrated through the basic present value formula:

$$PV = \frac{CF}{(1 + r)^n}$$

where PV is the present value, CF is the future cash flow, r is the discount rate (or required rate of return in this context), and n is the number of periods. As r increases, the denominator of the fraction becomes larger, resulting in a smaller PV.

This principle applies to the valuation of equity, where future net incomes (or other relevant cash flows) are discounted back to their present value using the required rate of return. An increase in this rate diminishes the present value of future net incomes, thereby reducing the intrinsic value of equity.

**A is incorrect.** The suggestion that the intrinsic value will increase with an increase in the required rate of return contradicts the fundamental principles of time value of money and discounting. Higher discount rates reduce the present value of future cash flows, not increase them.

**C is incorrect.** The assertion that the intrinsic value will remain unchanged despite an increase in the required rate of return fails to account for the basic mechanics of discounting future cash flows. The intrinsic value of equity is sensitive to changes in the discount rate; it is not a static figure that remains unaffected by variations in the required rate of return. This option ignores the dynamic nature of equity valuation, which is influenced by changes in market conditions, including shifts in the required rate of return.

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (h) Compare a company's cost of equity, its (accounting) return on equity, and investors' required rates of return.**

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Q.3540 AVEX Ltd. is a construction company that primarily deals in the residential construction segment. The company is planning to venture into the commercial real estate sector and has identified an upcoming project. A financial analyst working in the company's corporate finance department uses the company's weighted average cost of capital (WACC) as the discount rate to calculate the commercial real estate project's net present value (NPV). While doing so, the financial analyst is *most likely* to assume that:

- A. residential and commercial real estate projects have different levels of risk.
- B. residential and commercial real estate projects have identical levels of risk.
- C. commercial real estate projects have a higher level of risk than residential real estate projects.

The correct answer is **B**.

When AVEX Ltd., a construction company primarily involved in residential construction, plans to venture into the commercial real estate sector, using the company's weighted average cost of capital (WACC) as the discount rate for calculating the net present value (NPV) of a commercial real estate project inherently assumes that the new project will have a risk profile similar to the company's existing projects.

This assumption is crucial because WACC is calculated based on the company's current capital structure, which reflects the risk associated with its existing operations. If the company's operations are primarily in residential construction, the WACC is tailored to the risk level of residential projects. Therefore, applying the same WACC to a commercial real estate project implies that the financial analyst views the risk levels of residential and commercial real estate projects as identical.

**A is incorrect.** Suggesting that residential and commercial real estate projects have different levels of risk contradicts the premise of using the company's WACC as the discount rate. The WACC is a reflection of the company's overall risk, derived from its existing business model and operations.

If the company's operations are changing significantly, such as venturing into a new sector with potentially different risk characteristics, the WACC might not accurately reflect the new project's risk. However, the question's context implies that the analyst is applying the company's existing WACC, which assumes similar risk levels across projects.

**C is incorrect.** It suggests that commercial real estate projects inherently have a higher level of risk than residential real estate projects. While it's possible for different types of projects to have varying risk profiles, the use of the company's WACC as the discount rate for the NPV calculation does not make such a distinction.

The WACC is a composite rate that reflects the cost of capital based on the company's current risk profile and capital structure. By using the WACC, the analyst is assuming that the commercial project will align with the company's existing risk level, which is based on its history in residential construction. This approach does not account for any potential differences in risk between residential and commercial projects.

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (h) Compare a company's cost of equity, its (accounting) return on equity, and investors' required rates of return.**

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Q.3641 Harry Olsen holds 200 shares of Enric Corporation. If there are two vacancies on Enric Corporation's board, and Enric Corporation allows cumulative voting, then the maximum number of votes that Olsen can cast for a single nominee for the board of directors is *closest to*:

- A. 100.
- B. 200.
- C. 400.

The correct answer is C.

In the context of cumulative voting, Harry Olsen can allocate his votes in a flexible manner across the candidates for the board of directors. Cumulative voting is a system that allows shareholders to concentrate their voting power. If a shareholder owns 200 shares and there are two vacancies on the board, the total number of votes that the shareholder can cast is calculated by multiplying the number of shares by the number of vacancies. Therefore, the formula for calculating the total votes in a cumulative voting scenario is:

$$\text{TotalVotes} = \text{NumberofShares} \times \text{NumberofVacancies}$$

Given that Harry Olsen holds 200 shares and there are two vacancies, the calculation is as follows:

$$\text{TotalVotes} = 200 \times 2 = 400$$

This means Harry Olsen has a total of 400 votes that he can distribute in any way he sees fit, including casting all 400 votes for a single nominee if he chooses. This flexibility is a key feature of cumulative voting, designed to enhance the voting power of minority shareholders and allow them to have a greater impact on the election of directors.

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (c) Compare and contrast public and private equity securities.**

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Q.3642 A firm acquired through a leveraged buy-out will *most likely* be converted into a:

- A. public company.
- B. private company.
- C. debt-free company.

The correct answer is **B**.

A leveraged buy-out (LBO) is a financial transaction where a company is acquired primarily using borrowed funds, with the assets of the company being acquired often serving as collateral for the loans. The structure of an LBO is designed to allow companies or investors to make large acquisitions without having to commit a significant amount of capital.

Following an LBO, the acquired company typically becomes a private entity if it was public prior to the transaction. This transition allows the new owners to restructure the company outside of the public eye, streamline operations, and potentially improve its financial performance without the pressure of public market expectations.

**A is incorrect.** Converting an acquired firm into a public company contradicts the typical outcome of an LBO. One of the primary objectives of an LBO is to take a public company private, not the other way around.

This allows the acquiring entity to work on improving the company's value away from the scrutiny and regulatory requirements of public markets. Making a company public immediately after an LBO would not only be counterproductive but also unlikely due to the significant debt load typically assumed in the process, which would be unattractive to public market investors.

**C is incorrect.** A firm acquired through an LBO will most likely not become a debt-free company. In fact, the opposite is true; the essence of an LBO involves leveraging the acquired company with significant amounts of debt. The strategy behind an LBO is to use the company's future cash flows to pay down this debt over time, ideally leaving the company with a solid financial structure.

However, immediately following the LBO, the company will have a higher debt load than prior to the acquisition. The goal is to manage and reduce this debt over time, not to eliminate it instantly through the acquisition process.

***CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (c) Compare and contrast public and private equity securities.***

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Q.3643 Which of the following American depository receipts (ADRs) *least likely* requires SEC registration?

- A. RULE 144A.
- B. LEVEL II sponsored.
- C. LEVEL III sponsored.

The correct answer is **A**.

An American depository receipt (ADR) represents a negotiable security that signifies an ownership interest in the shares of a non-U.S. company trading in U.S. financial markets. Among the options provided, Rule 144A ADRs are the least likely to require registration with the Securities and Exchange Commission (SEC).

Rule 144A allows for the private placement of securities with qualified institutional buyers, thereby exempting these ADRs from the public registration requirements that typically apply under U.S. securities laws.

This exemption facilitates a more streamlined process for foreign companies to access U.S. capital markets without undergoing the comprehensive registration process mandated by the SEC for public offerings.

**B is incorrect.** In reality, Level II ADRs must adhere to SEC registration and reporting requirements. These ADRs are listed on U.S. stock exchanges, and as such, they are subject to a higher level of regulatory scrutiny compared to Rule 144A ADRs.

The companies issuing Level II ADRs must file a Form 20-F annually, which is the equivalent of the Form 10-K filed by U.S. domestic companies. This requirement ensures that investors have access to detailed information about the financial health and operations of the foreign company, thereby promoting transparency and investor protection.

**C is incorrect.** Level III sponsored ADRs involve the highest level of engagement with U.S. capital markets among the ADR categories. These ADRs not only require SEC registration but also allow the issuing foreign company to raise capital through a public offering of the ADRs in the United States.

The registration process for Level III ADRs includes the submission of a Form F-1, which is the registration statement for foreign issuers intending to make a public offering of securities in the U.S. This comprehensive registration process is designed to provide U.S. investors with extensive disclosure about the foreign issuer, including financial statements, risk factors, and information about the business and its management.

***CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (d) Describe methods for investing in non-domestic equity securities.***

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Q.3644 An exchange-traded fund (ETF) is *most likely* classified as a/an:

- A. American depository receipt.
- B. active investment instrument.
- C. passive investment instrument.

The correct answer is **C**.

An exchange-traded fund (ETF) is most accurately classified as a passive investment instrument. ETFs are designed to track the performance of a specific index, such as the S&P 500 or the NASDAQ, providing investors with a diversified portfolio in a single transaction.

Unlike actively managed funds, where fund managers make decisions on buying and selling individual stocks in an attempt to outperform the market, ETFs aim to replicate the performance of their respective indices. This passive management strategy minimizes the costs associated with frequent trading and active management fees, making ETFs a cost-effective investment option for those looking to achieve market returns.

**A is incorrect.** American Depository Receipts (ADRs) are not related to the structure or purpose of ETFs. ADRs are a way for U.S. investors to invest in foreign companies by purchasing shares that represent a claim to a specific number of foreign stock shares held in a depository.

ADRs trade on U.S. exchanges and are subject to U.S. trading regulations, but they represent ownership in companies outside the U.S. This mechanism is fundamentally different from ETFs, which are investment funds traded on stock exchanges and typically track the performance of a specific index.

**B is incorrect.** While there are actively managed ETFs, the vast majority of ETFs are passive investment instruments. Active investment instruments, such as actively managed mutual funds, involve a fund manager making decisions on the fund's holdings in an attempt to outperform a benchmark index.

This active management approach contrasts with the passive strategy of most ETFs, which seek to replicate the performance of an index without attempting to outperform it. The primary goal of a passive ETF is to provide investors with a return that closely mirrors the return of the tracked index, before fees and expenses, rather than trying to beat the market through active management.

***CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (d) Describe methods for investing in non-domestic equity securities.***

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Q.3868 Which party *most likely* benefits from callable shares when the market price is greater than the call price?

- A. Callable equity holders.
- B. Callable equity issuing firms.
- C. Debt holders of callable equity issuing firms.

The correct answer is **B**.

When the market price of shares is greater than the call price, the issuing firms of callable equity are the ones who benefit the most. Callable shares provide the issuing firm with the option, but not the obligation, to repurchase or "call" these shares at a predetermined price within a certain period. This feature is particularly advantageous for the firm when the market price of its shares exceeds the call price.

In such scenarios, the firm can repurchase shares at the lower call price, effectively reducing the amount of outstanding equity and potentially increasing the value of remaining shares due to the reduced supply. This action can also lead to a positive signal in the market about the firm's financial health and future prospects, as it implies the firm is willing and able to spend capital to buy back shares.

Moreover, by calling the shares, the firm can reduce the dilution of ownership and control, which can be particularly valuable for existing management and shareholders who wish to maintain their stake and influence in the company.

**A is incorrect.** The holders of callable shares are at risk of having their shares repurchased by the issuing firm at the call price, which is lower than the current market price. This means that equity holders lose the opportunity to sell their shares at the higher market price, potentially missing out on additional gains.

Furthermore, the callable feature introduces uncertainty for the shareholders, as they cannot predict when or if their shares will be called, making it a less attractive option for investors looking for stability or planning to hold shares as a long-term investment.

**C is incorrect.** Debt holders of callable equity issuing firms are generally not directly affected by the firm's decision to call shares. The calling of shares primarily impacts the equity side of the firm's balance sheet by reducing the number of shares outstanding.

While there can be indirect effects on the firm's financial structure and potentially its creditworthiness, the direct benefits or disadvantages of calling shares at a price above the call price are not typically borne by debt holders.

Debt holders are more concerned with the firm's ability to meet its debt obligations, which is influenced by its overall financial health and cash flows rather than the specific actions it takes regarding callable equity.

***CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (a) Describe characteristics of types of equity securities.***

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Q.3874 Greenex Inc.'s option-free perpetual preferred stock is currently selling in the market for \$945.63. The annual dividend rate is quoted at 5.5%, and the par value of the stock is \$1,000. If the stock is fairly valued, the required rate of return should be *closest to*:

- A. 0.052
- B. 0.055
- C. 0.0582

The correct answer is **C**.

If the stock is fairly valued, the intrinsic value should be equal to the current market price of \$945.63.

$$\begin{aligned}\text{Intrinsic value} &= \frac{\text{Annual dividend}}{r} \\ &= \frac{\$55}{\$945.63} \\ &= 5.82\%\end{aligned}$$

**CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (h) Compare a company's cost of equity, its (accounting) return on equity, and investors' required rates of return.**

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Q.3950 Which of the following is *least likely* a characteristic of preferred shares?

- A. Fixed preferred dividend payment with no maturity date.
- B. Priority of dividend payment before common shareholders.
- C. Failure to pay a preferred dividend is considered a default.

The correct answer is **C**.

Preferred shares are a type of equity, not debt, and while they often offer dividends that are expected to be paid before any dividends are distributed to common shareholders, the failure to pay these dividends does not constitute a legal default.

Unlike bond interest payments, which if missed can lead to default and potential bankruptcy proceedings, preferred dividends can be suspended in times of financial difficulty without triggering a default. This characteristic allows companies greater flexibility in managing their cash flow under challenging financial conditions.

**A is incorrect.** Preferred shares typically offer fixed dividend payments, which are determined at the time of issuance and remain constant. Additionally, preferred shares generally do not have a maturity date, meaning they remain outstanding indefinitely unless the issuing company decides to redeem them.

This lack of maturity date distinguishes preferred shares from bonds, which have specified repayment dates. The fixed dividend payments and indefinite life make preferred shares an attractive option for investors seeking stable income and long-term investment opportunities.

**B is incorrect.** Preferred shareholders have a priority over common shareholders when it comes to the payment of dividends. In the event of liquidation, preferred shareholders also rank above common shareholders in the claim on assets, although they stand behind debt holders.

This priority in dividend payments ensures that preferred shareholders receive their dividends before any dividends can be distributed to common shareholders, providing a level of income security. However, it's important to note that while preferred shareholders have priority over common shareholders, this does not guarantee the payment of dividends, as the company may decide to suspend dividend payments under certain circumstances without being considered in default.

***CFA Level 1, Topic 6 - Equity Investments, Learning Module 4: Overview of Equity Securities, LOS (a) Describe characteristics of types of equity securities.***

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