Question #1 of 45

Question ID: 1462892

According to typical commercial industry classification systems, which of the following industries is classified in the consumer discretionary sector?

A) Apparel.

B) Tobacco.

C) Internet services.

Explanation

Apparel is classified as consumer discretionary, tobacco as consumer staples, and internet services as technology.

(Module 40.1, LOS 40.d)

Question #2 of 45

Question ID: 1458253

The competitive forces identified by Michael Porter include:

A) power of existing competitors and threat of entry.

B) rivalry among existing competitors and power of buyers.

C) threat of substitutes and rivalry among suppliers.

Explanation

Porter's five competitive forces are: (1) rivalry among existing competitors; (2) threat of entry; (3) threat of substitutes; (4) power of buyers; (5) power of suppliers.

(Module 40.1, LOS 40.g)

Question #3 of 45

Question ID: 1458258

Market share stability within an industry is *least likely* to result from a high level of:

A) product innovation.

B) switching costs.

C) barriers to entry.

Explanation

Frequent introductions of new products and innovations tend to make firms' market shares within an industry less stable. High barriers to entry into the industry and high switching costs for customers to change to a competing product both contribute to market share stability.

(Module 40.2, LOS 40.h)

Question #4 of 45

Question ID: 1458252

Economic profits are *most likely* to be earned by firms in an industry that is characterized by:

A) high barriers to entry and low power of buyers.

B) low threat of substitutes and high rivalry among existing competitors.

C) high power of suppliers and low threat of entry.

Explanation

High barriers to entry (low threat of entry) and low power of buyers both increase the potential for economic profits within an industry. The five forces that shape industry competition are rivalry among existing competitors, threat of entry, threat of substitutes, power of buyers, and power of suppliers. The stronger any of these forces are within an industry, the less potential that industry has to generate (or continue to earn) economic profits.

(Module 40.1, LOS 40.g)

Question #5 of 45

Question ID: 1458233

Commercial industry classification systems such as the Global Industry Classification Standard (GICS) typically classify firms according to their:

A) correlations of historical returns.

B) principal business activities.

C) sensitivity to business cycles.

Explanation

Commercial providers of industry classification systems such as the GICS classify firms according to principal business activity, such as Consumer Staples, Financial Services, or Health Care.

(Module 40.1, LOS 40.b)

Question #6 of 45

Question ID: 1458238

Starr Company is an asset management firm. Thomas Company is a manufacturer of apparel. Assuming these firms are representative of their industry groups, how are they *best* classified with regard to their sensitivity to the business cycle?

	Starr	Thomas	
A)	Cyclical	Cyclical	✓
B)	Non-cyclical	Non-cyclical	✗
C)	Cyclical	Non-cyclical	✗

Explanation

Asset management firms are classified in the financial services industry group. Apparel manufacturers are classified in the consumer discretionary industry group. Financial services and consumer discretionary are cyclical industry groups.

(Module 40.1, LOS 40.c)

Question #7 of 45

Question ID: 1458246

A manager tells a research analyst, "A thorough industry analysis should use more than one approach to estimate industry variables," and "An analyst should not compare his valuations to those of other analysts." Which of these two statements is (are) CORRECT?

A) Both of these statements are accurate. ✗

B) Neither of these statements is accurate. ✗

C) Only one of these statements is accurate. ✓

Explanation

The first statement is accurate. When analyzing an industry, an analyst should use different approaches and scenarios when estimating industry variables. The second statement is inaccurate. Comparing one's own forecasts with those of other analysts can be useful for confirming the soundness of the analysis and for identifying industries that are potentially overvalued or undervalued by the consensus view.

(Module 40.1, LOS 40.f)

Question #8 of 45

Question ID: 1458251

The threat of substitutes is *most likely* to be low for a firm that:

A) produces a commodity product in an industry with significant unused capacity. ✗

B) produces a differentiated product with high switching costs. ✓

C) operates in a fragmented market with little unused capacity. ✗

Explanation

The threat of competition from substitute products is likely to be low for a firm that produces a differentiated product with high switching costs. Unused capacity and low industry concentration (a fragmented market) tend to intensify rivalry among industry competitors but are not directly related to the threat of substitutes.

(Module 40.1, LOS 40.g)

Question #9 of 45

Question ID: 1458255

A firm is *most likely* to have pricing power if it operates in an industry characterized by:

A) high concentration, undercapacity, and high market share stability. ✓

B) high concentration, undercapacity, and low market share stability. ✗

C) low concentration, overcapacity, and high market share stability. ✗

Explanation

Firms in highly concentrated industries are more likely to have pricing power than firms in fragmented industries. Firms in industries with tight capacity constraints are more likely to have pricing power than firms in industries with excess capacity. High market share stability is indicative of pricing power because competition is likely less intensive.

(Module 40.2, LOS 40.h)

Question #10 of 45

Question ID: 1458272

A firm that pursues a differentiation strategy is *most likely* to emphasize:

A) gains in market share.

B) market research.

C) operating efficiency.

Explanation

A firm that follows a product or service differentiation strategy needs to emphasize market research to identify needs for which customers are willing to pay a premium. Market share and operating efficiency are more of a focus for firms that pursue a low-cost strategy.

(Module 40.2, LOS 40.l)

Question #11 of 45

Question ID: 1462890

Which of the following classifications of firms is *least likely* to comprise cyclical firms?

A) Telecommunications.

B) Technology.

C) Housing.

Explanation

Both technology and housing firms tend to be quite cyclical, that is, their profits are very sensitive to changes in overall growth. The profits of telecommunications firms, on the other hand, are less economically sensitive.

(Module 40.1, LOS 40.c)

Question #12 of 45

Question ID: 1458248

In the industry life cycle, the growth stage is typically followed by a:

A) mature stage.

B) shakeout stage.

C) decline stage.

Explanation

The typical industry life cycle stages in chronological order are embryonic, growth, shakeout, mature, and decline.

(Module 40.1, LOS 40.f)

Question #13 of 45

Question ID: 1458263

Declining prices that result from the development of substitute products are *most likely* to characterize an industry in the:

A) decline stage.

B) mature stage.

C) shakeout stage.

Explanation

The decline stage of the industry life cycle is often characterized by declining prices as substitute products or global competition emerge, or as a result of decreasing demand due to societal changes.

(Module 40.2, LOS 40.i)

Question #14 of 45

Question ID: 1458244

For relative valuation, a peer group is *best* described as companies:

A) at a similar stage of the industry life cycle.

B) in a similar sector or industry classification.

C) with similar business activities and competitive factors.

Explanation

An analyst should form peer groups of companies that have similar business activities, drivers of demand and costs, and access to capital. Companies in the same industry or sector and companies at the same stage of the industry life cycle are not necessarily comparable for equity valuation purposes.

(Module 40.1, LOS 40.e)

Question #15 of 45

Question ID: 1462894

Over the past few years, the companies in an industry have experienced positive but decreasing profitability and growth rates. The companies have begun to compete intensely with each other and customers switch frequently among brands. This industry's life-cycle stage is *most accurately* described as:

A) shakeout.

B) growth.

C) maturity.

Explanation

The shakeout industry life-cycle stage is characterized by slowing (but still positive) growth, intense competition, and declining profitability, as demand begins to approach market saturation. In contrast, the decline industry stage is characterized by negative growth. The lack of brand loyalty among customers suggests the industry has not yet reached the mature stage.

(Module 40.2, LOS 40.i)

Question #16 of 45

Question ID: 1458234

Auto manufacturers and home builders would *most likely* be grouped together in an industry classification system based on:

A) products and services.

B) sensitivity to business cycles.

C) returns correlations.

Explanation

Auto manufacturing and home building are both cyclical industries. An industry classification system based on business cycle sensitivity would be the most likely to group firms from these industries together. While these industries are both affected by some macro forces, they are also each affected by forces specific to their products and would not necessarily be grouped together in a classification system based on returns correlations.

(Module 40.1, LOS 40.b)

Question #17 of 45

Question ID: 1462891

A conglomerate is in the following lines of business, with segment revenue as a percentage of total revenue: 30% banking, 30% automobiles, 25% apparel, and 15% heavy machinery. Based on the Global Industry Classification Standard, the sector classification for this company is *most likely*:

A) consumer discretionary.

B) financial services.

C) industrials.

Explanation

Automobiles and apparel are classified as consumer discretionary; banking is classified as financial services; and heavy machinery is classified as industrials. Based on revenues, a majority of the firm's sales (55%) are derived from the consumer discretionary sector.

(Module 40.1, LOS 40.d)

Question #18 of 45

Question ID: 1458269

In which of the following industries are technological factors *least likely* a significant influence?

A) Pharmaceuticals.

B) Oil services.

C) Confections.

Explanation

Technological influences are relatively important in the pharmaceuticals and oil services industries, but they are generally not a significant influence in the confections industry.

(Module 40.2, LOS 40.k)

Question #19 of 45

Question ID: 1458271

An aggressive price reduction to gain market share is *most likely* to be associated with a:

A) service differentiation strategy.

B) product differentiation strategy.

C) cost leadership strategy.

Explanation

Michael Porter identified two competitive strategies: cost leadership and product or service differentiation. A firm that uses a cost leadership or low-cost strategy seeks to have low production costs that will enable it to offer lower prices than its competitors to protect or gain market share. A product or service differentiation strategy seeks to gain a price premium for its products by making them distinctive to the consumer.

(Module 40.2, LOS 40.l)

Question #20 of 45

Question ID: 1458264

Which of the following statements about the industry life cycle is *most* accurate?

A) Industry growth rates are highest in the embryonic stage.

B) The growth stage is typically characterized by decreasing prices.

C) The mature stage is followed by a shakeout stage and a decline stage.

Explanation

Prices tend to decrease in the growth stage as firms begin to realize economies of scale in production. The stages of the industry life cycle, in order, are embryonic, growth, shakeout, mature, and decline. Industry growth is slow during the embryonic stage as firms develop products and attempt to gain customer acceptance.

(Module 40.2, LOS 40.i)

Question #21 of 45

Question ID: 1458236

Which of the following industries is *most likely* to be classified as non-cyclical?

A) Autos.

B) Utilities.

C) Housing.

Explanation

Non-cyclical industries are those for which demand is not highly sensitive to business cycles, such as utilities, health care, and food and beverages. Housing and autos are examples of cyclical industries.

(Module 40.1, LOS 40.c)

Question #22 of 45

Question ID: 1458231

Industry analysis is *most likely* to provide an analyst with insight about a company's:

A) competitive strategy.

B) financial performance.

C) pricing power.

Explanation

Industry analysis provides a framework for an analyst to understand a firm in relation to its competitive environment, which determines how much pricing power a firm has. Competitive strategy and financial performance are aspects of company analysis.

(Module 40.1, LOS 40.a)

Question #23 of 45

Question ID: 1458262

Wallace Kidwell is classifying an industry as to its life-cycle stage. Kidwell notes that the industry's growth is stable and largely limited to replacement demand and overall population increases. The companies that comprise the industry have achieved efficient cost structures and strong brand loyalty. This level of brand loyalty has resulted in very few price wars. Kidwell will *most likely* classify the industry life cycle stage as being:

A) Mature.

B) Shakeout.

C) Decline.

Explanation

The mature stage exhibits little or no growth, industry consolidation, and high barriers to entry. Kidwell has noted that the industry is growing, but slowly (replacement demand and population gains). Furthermore, the firms have efficient cost structures and strong brand loyalty; both of which are high barriers to entry.

The decline stage exhibits negative growth, excess capacity, and high competition. Kidwell has observed positive, slow growth and a lack of price wars. Both of these observations are contrary to what would be expected in the decline stage.

The shakeout stage exhibits slowing growth, intense competition, and declining profitability. Kidwell has observed that growth is stable, the firms have achieved efficient cost structures, and price wars are uncommon. Hence, growth is not slowing, competition must not be intense because there are price wars (these occur when competition is intense), and profitability is likely stable given the efficient cost structures.

(Module 40.2, LOS 40.i)

Question #24 of 45

Question ID: 1458266

Technological changes are *most likely* to result in which of the following effects? Evolving technology is likely to result in changes in:

A) the relative demand for various products only.

B) educational curriculum only.

C) educational curriculum and the relative demand for various products.

Explanation

If technological changes result in changes in the set of skills required of workers, this is likely to lead to changes in educational curriculum (and possibly delivery). Such changes often result in the production and demand for new or different products.

(Module 40.2, LOS 40.j)

Question #25 of 45

Question ID: 1458242

Food, beverage, and utility companies are examples of:

A) cyclical industries.

B) declining industries.

C) defensive industries.

Explanation

Food, beverage, and utility companies provide basic necessities of life and are considered to be defensive industries. In a recession, the demand for their products will not fall as much as for some of the other industry groups.

(Module 40.1, LOS 40.d)

Question #26 of 45

Question ID: 1458235

Commercial index providers typically classify companies by:

A) sensitivity to business cycles.

B) principal business activity.

C) statistical grouping.

Explanation

Commercial providers such as Standard and Poor's and MSCI Barra classify companies according to their principal business activity and the products and services they provide.

(Module 40.1, LOS 40.b)

Question #27 of 45

Question ID: 1458237

A firm's earnings are *most likely* to be cyclical if:

A) the firm operates in a growth industry.

B) the firm produces luxury items.

C) most of the firm’s costs depend on its level of output.

Explanation

Producers of luxury items tend to have cyclical earnings because consumers typically decrease their purchases of these items during economic recessions. The earnings of firms with high percentages of variable costs are not as likely to be cyclical as those of firms with high percentages of fixed costs (i.e., high operating leverage). A growth industry has demand that is strong enough that earnings remain relatively unaffected by the business cycle.

(Module 40.1, LOS 40.c)

Question #28 of 45

Question ID: 1458267

Changes in population size and average age that affect industry growth and profitability are *best* described as:

A) demographic influences.

B) macroeconomic influences.

C) social influences.

Explanation

Among the external influences that affect industries, "demographic factors" refers to those that are related to the size and composition of the population.

(Module 40.2, LOS 40.j)

Question #29 of 45

Question ID: 1458249

The experience curve, which illustrates the cost per unit relative to output:

A) slopes upward in the early years and downward in the later years.

B) slopes upward.

C) slopes downward.

Explanation

The experience curve, which shows the cost per unit relative to output, slopes downward because of increases in productivity and economies of scale, especially in industries with high fixed costs.

(Module 40.1, LOS 40.f)

Question #30 of 45

Question ID: 1458273

After completing a thorough industry analysis, which of the following is *most likely* an additional element an analyst should examine when analyzing a specific company within the industry?

A) Competitive strategy.

B) Power of buyers.

C) Threat of entry.

Explanation

Company analysis involves examining a specific firm's financial condition, products and services, and competitive strategy (cost leadership or differentiation). Industry analysis should include examining competitive forces such as the threat of entry and the power of buyers.

(Module 40.2, LOS 40.l)

Question #31 of 45

Question ID: 1458250

Factors that increase competition in an industry *most likely* include:

A) low barriers to entry, low concentration, and high unused capacity.

B) low barriers to entry, high concentration, and high unused capacity.

C) high barriers to entry, low concentration, and low unused capacity.

Explanation

Low barriers to entry increase competition as more firms can enter the business. Industries that are fragmented and have unused capacity tend to be highly competitive as they fight for market share and attempt to utilize excess manufacturing resources.

(Module 40.1, LOS 40.f)

Question #32 of 45

Question ID: 1462895

Which of the following industries is *best* described as non-cyclical and defensive?

A) Consumer staples.

B) Energy.

C) Technology.

Explanation

The consumer staples industry is best classified as non-cyclical and defensive. Energy and technology are best classified as cyclical industries.

(Module 40.2, LOS 40.k)

Question #33 of 45

Question ID: 1458261

Pricing power and return on invested capital are likely to be greatest for firms in an industry characterized by:

A) high concentration and high variability in firms' market shares.

B) overcapacity and high barriers to entry.

C) undercapacity and high switching costs.

Explanation

Pricing power and return on invested capital are likely to be greatest for firms in an industry with high barriers to entry, undercapacity relative to demand, and high switching costs that contribute to stable market shares. High concentration does not ensure pricing power. Even in highly concentrated industries, firms with market shares close to those of their competitors and firms that produce commodity-like products might have relatively little pricing power.

(Module 40.2, LOS 40.h)

Question #34 of 45

Question ID: 1458257

Which of the following conditions is *most likely* to indicate that barriers to entry into an industry are low?

A) Market shares have been stable over the last two business cycles.

B) The industry has significant economies of scale.

C) Investment capital is available at low cost.

Explanation

Readily available capital tends to make entry into an industry easier. If an industry is composed of the same firms over a long period of time, barriers to entry are likely high. Economies of scale are a barrier to entry because existing firms are likely to be producing at a lower cost per unit than a new competitor can achieve.

(Module 40.2, LOS 40.h)

Question #35 of 45

Question ID: 1458243

When classifying companies into peer groups for analysis, an analyst should:

A) disregard industry classifications from commercial providers.

B) examine firms' annual reports to see if they identify competitors.

C) include each company in only one peer group.

Explanation

Annual reports are a good source of information when identifying peer groups because companies may identify their key competitors. It is often appropriate to include a company in more than one peer group. An analyst forming peer groups can use commercially available industry classification systems to identify which companies are in the same industry.

(Module 40.1, LOS 40.e)

Question #36 of 45

Question ID: 1458247

The industry experience curve illustrates the relationship between:

A) company age and profitability.

B) cumulative output and cost per unit.

C) productivity and average years of employment.

Explanation

The industry experience curve shows cost per unit relative to cumulative output. Cost per unit typically decreases over time due to higher utilization rates for fixed capital, improvements in the efficiency of labor, and better product design and manufacturing methods.

(Module 40.1, LOS 40.f)

Question #37 of 45

Question ID: 1458245

When constructing a peer group of firms, an analyst should *least* appropriately consider the firms':

A) cost structures.

B) business cycle sensitivity.

C) industry classification.

Explanation

A peer group should consist of firms that are alike in their principal lines of business, along with other similarities such as cost structures and access to capital. Firms can be similar in business cycle sensitivity but dissimilar in terms of their business activities (e.g., a firm in the home building industry and a firm in the heavy equipment manufacturing industry).

(Module 40.1, LOS 40.e)

Question #38 of 45

Question ID: 1458254

Which of the following statements about switching costs is *most accurate*?

A) Switching costs include the time needed to learn to use a competitor's product. ✓

B) Low switching costs contribute to market share stability. ✗

C) Switching costs tend to be lower for specialized products. ✗

Explanation

Switching costs include the time and expense of learning to use a competitor's product and tend to be higher for specialized or differentiated products. High switching costs contribute to market share stability and pricing power.

(Module 40.2, LOS 40.h)

Question #39 of 45

Question ID: 1458240

Which of the following types of industries is typically characterized by above-normal expansion in sales and profits independent of the business cycle?

A) Defensive. ✗

B) Growth. ✓

C) Counter-cyclical. ✗

Explanation

A growth industry is typically characterized by above-normal expansion in sales and profits independent of the business cycle.

(Module 40.1, LOS 40.c)

Question #40 of 45

Question ID: 1458239

Which of the following types of industries is typically characterized by stable performance during both expansions and contractions of the business cycle?

A) Growth.

B) Defensive.

C) Cyclical.

Explanation

A defensive industry is typically characterized by stable performance during both expansions and contractions of the business cycle.

(Module 40.1, LOS 40.c)

Question #41 of 45

Question ID: 1458270

Which of the following industries is likely to be *most* sensitive to the business cycle?

A) Pharmaceutical.

B) Confectionery.

C) Automobile.

Explanation

The automobile industry is cyclical because demand for new autos fluctuates with the business cycle. The confectionery industry tends to be non-cyclical and defensive because demand for candy tends to be stable through the business cycle. The pharmaceutical industry is non-cyclical because demand for medicines is independent of the business cycle.

(Module 40.2, LOS 40.k)

Question #42 of 45

Question ID: 1458232

During the contraction phase of the business cycle, how will an active portfolio manager using an industry rotation strategy *most likely* treat stocks of companies in a cyclical industry?

A) Underweight the industry.

B) Maintain the target weight of the industry.

C) Rotate out of the industry.

Explanation

A cyclical industry is one that is expected to outperform during an expansion and underperform in a contraction. The industry rotation strategy for a cyclical industry is to overweight during an expansion and underweight during a contraction. This does not imply that a manager will rotate entirely out of a cyclical industry.

(Module 40.1, LOS 40.a)

Question #43 of 45

Question ID: 1458259

A firm is *most likely* to have pricing power if:

A) costs to exit the industry are high.

B) its market share is high.

C) its product is differentiated.

Explanation

Firms offering products that are differentiated in terms of quality and features are more likely to have pricing power than firms that produce undifferentiated (commodity-like) products. High market share does not necessarily imply pricing power; for example, if four firms each have 25% market share, none of them are likely to have significant pricing power. High exit costs can create overcapacity in an industry and result in a high degree of price competition as firms try to maintain production volume during a period of reduced demand.

(Module 40.2, LOS 40.h)

Question #44 of 45

Question ID: 1458256

Pricing power for the firms in an industry is *most likely* to result from low:

A) barriers to entry.

B) industry concentration.

C) levels of capacity.

Explanation

Low capacity is associated with pricing power because it increases the likelihood that supply in the short run will be less than demand at current prices. Low barriers to entry and low industry concentration (a fragmented market) typically suggest firms have little pricing power.

(Module 40.2, LOS 40.h)

Question #45 of 45

Question ID: 1462893

High return on invested capital and high pricing power are *most likely* to be associated with an industry that has:

A) low barriers to entry.

B) high capacity.

C) high concentration.

Explanation

High return on invested capital and high pricing power are associated with high industry concentration (i.e., small number of firms), high barriers to entry, and low industry capacity.

(Module 40.2, LOS 40.h)