David Axelrod

Fin 320 Homework 4

Chapter 12:

5. The maturity of treasury bills are less than 1 year, notes are 1-10 years and bonds are 10 to 30 years

8. Paying off debt is important to most firms. It gives them more financial flexibility when making capital budgeting decisions. Also if interest rates decrease, a callable provision would allow the firms to refinance for a lower interest rate, ultimately saving interest expense.

9. A sinking fund is a bond that requires principal to be paid back during the life of the bond. The final face value of the bond at the end of the period is a fraction of the initial principle of the bond. A good example of a sinking fund is a mortgage where consumers pay a portion of the principle with each payment. Because there is less risk with sinking funds, the interest rate is typically lower

Chapter 13

3. Organized exchanges often have a physical building where trades place where non organized exchanges make trades over the internet. Larger initial capital barriers tend to leave larger firms listing on organized exchanges

4. NASDAQ is an organization that runs an automated computer trading network. Traders can trade at a much larger time interval during the day than traditional exchanges. Furthermore, all trades and quotes are delivered electronically.

RQ1

An exchange traded fund is basket of securities that have been indexed together and trade on the open market. They are much more liquid than mutual funds and, because they are often indexed rather than actively managed, offer lower expense ratios

RQ2

An American depository receipt is a way that American investors can invest in foreign based corporations. The three types are level 1, 2 and 3. Level 1 adrs are traded over the counter and are used to see if American investors are interested in investing in a particular foreign entity. Level 2 adrs are listed on an exchange and have a fair amount of requirements designated by the SEC. They also trade at a higher volume. Level 3 adrs often start trading with a public offering on an exchange. They often trade with substantial volume.

RQ3

A death put option has a provision that concerns death of a holder. If the bondholder dies, the heir has the right to sell the bond back to the corporation at par. This makes the bond marginally less risky to hold for the bondholder and therefor they have to take a lower yield on the bond. If an individual is close to death, purchasing a death put bond would be of value to their heirs so they might execute that trade.

RQ4

The LIBOR-OIS spread measures the difference in interest rates between banks and the rate from bank to central bank. Both are relatively low risk but lending from bank to bank is riskier than lending to the central bank in most countries. If the spread is large, that means that lending to banks is significantly riskier than lending to the government signaling that the financial sector is under stress.

RQ5

There are three types of efficient markets, Weak, semi strong and strong. Weak markets state that prices follow a random walk pattern and no information can be used to predict future prices. The semi strong form incorporates all the information the weak form does plus pertinent public current information that can effect price. The strong form includes all information about a security, public and private. Insider trading cannot exist in a strong form efficient market. Weak markets are conducive to randomness and are supported by the idea that most fund managers do not beat the market because the market is random and alpha cannot be generated. The argument against weak markets is that there are managers out there (especially quant funds) that consistently outperform the market. Semi strong markets are validated by the idea that insider information can lead to abnormally large returns. Arguments against semi strong is that the theory cannot explain trader momentum and exuberance which can move stock prices but doesn’t reflect available information. Strong form market efficiency is supported by the notion that all information is available to investors and that trading on private information is illegal. OF course, an argument against strong form is that there are criminals in financial markets who trade on inside information and make abnormally large returns. It is said that most markets are semi strong in nature.