Sample Exam 2
Morning Session

Calculating Your Score

Topic	*Maximum Score*	*Your Score*
Ethics	18	
Quantitative Methods	14	
Economics	12	
Accounting and Corporate Finance	34	
Asset Valuation	36	
Portfolio Management	6	
Total	120	

The morning and afternoon exams are identically weighted over the topics and readings. You can therefore treat the morning and afternoon exams as independent events.

If you took more than three hours (180 minutes) to complete this portion of the exam, you should adjust your score downward by one point for each minute you ran over.

Remember: the real exam *will be more difficult* than these sample exams. The main reason for this is the general anxiety and stress that you will be feeling on exam day, coupled with the time pressure you will be under. Many of the questions on this practice exam and the real exam are not individually difficult, so if you take extra time to answer the questions on this practice exam, your score will go up significantly. However, if you want an accurate measure of your potential performance on the exam, adhere to the 3-hour time limit.

After you have finished grading your sample exam, you may find it useful to use the exam questions and recommended solutions for review purposes (as flash review points). Many of these questions were specifically written for your use as study tools. Once again, I feel I should remind you not to memorize these questions; you will not see them on the actual exam. What you will see on the exam, though, are the concepts, terms, and procedures presented in these questions.

Your actual exam will most likely "look different" than what you see in this book. Please remember, no study provider knows the content of the actual exam. These sample exams are our "best guess" as to the structure and content of your actual exam.

Test Answers

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120. A B C D

SAMPLE EXAM 2
MORNING SESSION

The following 18 questions relate to Ethics.

1. Trent Howell, CFA, is the chief compliance officer of an investment advisory firm with branches in major cities across the U.S. Howell has read in a *Wall Street Journal* article that a competing firm has been accused of permitting some high level executives' personal transactions to have priority over clients' transactions. Howell decides to establish and enforce stricter policies at his own firm according to the procedures recommended by the CFA Institute. According to Standard VI(B) – Priority of Transactions, it is recommended that firm policy include all of the following procedures EXCEPT:
   A. limited front-running by employees.
   B. blackout periods.
   C. disclosure to clients of the firm's policies in regard to personal investing.
   D. limited employee participation in equity IPOs.

2. Juan Perez, CFA, is a research analyst for a large Wall Street brokerage firm where he follows the pharmaceuticals industry. While a large pharmaceuticals convention is in town, Perez happens to be in a restaurant where several analysts he has never met before are discussing their investment recommendations. Perez overhears the analysts agree that PharmCo Inc. is a strong "Buy," but cannot hear the details of why they are recommending purchasing stock in the company. The next day, Perez changes his "Sell" recommendation on PharmCo to "Buy," based solely on the conversation he overheard between the analysts the night before. Which standard did Perez violate?
   A. Standard I(C) – Misrepresentation.
   B. Standard V(A) – Diligence and Reasonable Basis.
   C. Standard III(E) – Preservation of Confidentiality.
   D. Standard II(A) – Material Nonpublic Information.

3. Allen Winkler, CFA, an equity analyst, recently had lunch with his former professor, Kim Thompson. Thompson told him about a new theoretical stock valuation model she designed. Upon returning to his office, Winkler recreated Thompson's model and revised it slightly. He then tested the revised model using Standard & Poor's (S&P) equity databases. The results were so impressive that his supervisors decided to create a small new fund called the Technical Fund directed toward their technically oriented clients. In the fund's prospectus, Winkler included a discussion of the model and the results of his tests. According to Standard I(C) – Misrepresentation, is Winkler required to credit Thompson for having developed the original model and S&P as the source of the data?

	Credit Thompson	Credit S&P
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

4. Donald Smith, CFA, has been assigned by his employer to analyze Braden Corporation. Prior to joining his current firm, Smith worked as an investment banker and received options on 1,000 shares of Braden stock as part of his compensation for assisting the company with a large secondary offering. The options are currently at-the-money and will expire in two years. In addition, Smith has been speaking with Braden about a consulting arrangement in which Smith would be paid to work with Braden's investor relations department to improve the flow of information to the firm's current and prospective shareholders. According to Standard VI(A) – Disclosure of Conflicts, which of the following is **CORRECT**? In his next report on Braden Corporation:
   A. Smith must disclose the consulting agreement to clients, prospects, and his employer, but needs not disclose the options since they are currently not in-the-money.
   B. Smith must disclose the options to clients, prospects, and his employer, but needs not disclose the consulting agreement since it has not yet been finalized.
   C. Smith only needs to disclose the options to clients and prospects and disclose the consulting agreement to his employer.
   D. Smith must disclose both the options and the consulting agreement to clients, prospects, and his employer.

5. Jason Socco, a Level 1 candidate for the CFA exam, has severe test anxiety. He is very smart and has a good college grade point average, but he is afraid to take the graduate entrance exam required to get his M.B.A. He has diligently prepared for the exam, but he begins to panic on the night before the exam. He decides to program as much as possible into his palm pilot "just in case" he needs help on the exam even though he knows taking this information into the exam room is prohibited and considered cheating. The exam is not as difficult as he expected, however, and he does not actually use any information he stored in his calculator. Socco has:
   A. violated both Standard VII(A) – conduct as Members and Candidates in the CFA Program and Standard I(D) – Misconduct.
   B. violated only Standard VII(A) – Conduct as Members and Candidates in the CFA Program because the test was not part of his professional activities for his employer.
   C. violated only Standard I(D) – Misconduct because it was not the CFA exam.
   D. not violated CFA Institute's Standards of Professional Conduct because it wasn't the CFA exam and was not part of his professional activities for his employer.

6. Diane Harris, a CFA Institute member, is a portfolio manager for Worldwide Investments. Robert Cline, one of her clients, offered her the use of his condominium in Aspen for one week in February if she improves the performance of his portfolio to return at least two percentage points above that of the S&P 500 during the next 12 months. Immediately after learning about the offer, Harris informed her manager of all terms of this agreement in writing and received verbal consent to the arrangement. At the end of the year, Harris met the performance criteria set by Cline and accepted the vacation. Did Harris violate Standard IV(B) – Additional Compensation Arrangements?
   A. Yes.
   B. No, because the arrangement did not involve any cash.
   C. No, because Harris notified and received consent from her employer to enter the arrangement.
   D. No, because bonuses from clients for doing her job well do not create any conflict of interest.

7. Stan White, CFA, heads the marketing department of a large brokerage firm, American Securities. He reports directly to the president of the firm, who has mandated that beginning this year, the firm must present all past performance results in accordance with the Global Investment Performance Standards. According to the standards, which of the following statements is an acceptable indication of American Securities' compliance with the Global Investment Performance Standards?
   A. American Securities has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).
   B. American Securities has prepared and presented this report utilizing calculation methodologies in accordance with the Global Investment Performance Standards (GIPS®).
   C. American Securities has presented this report in compliance with the Global Investment Performance Standards (GIPS®). Please reference "Disclosures" for exceptions.
   D. American Securities has been verified for compliance with the Global Investment Performance Standards (GIPS®) by ABC verifier. A copy of the verification report is available upon request.

8. Betty Cantor, a CFA Institute member, was about to issue a neutral report on HLC Corporation, a high-tech firm, when she talked to Donald Watson, her former manager and mentor, who is now with another investment firm. Watson is very bullish on HLC and tells Cantor that "everyone knows HLC is going to experience a major stock price increase over the next year." Cantor knows Watson has been an exceptionally insightful analyst in the high-tech sector. According to the CFA Institute Standards of Practice Handbook, is it acceptable for Cantor to change her recommendation to a "Buy" based on the comments of Watson?
   A. Yes, because this information is nonmaterial, nonpublic information.
   B. Yes, because based on experience, Watson's views are generally correct.
   C. No, because Watson's comments could be considered inside information.
   D. No, because she does not have a reasonable basis for recommending this stock.

9. Six months ago, Tom Hayes, CFA, left his position as a portfolio manager and accepted a position as senior portfolio manager at a smaller boutique firm. One of Hayes's first recommendations at his new job is Selldex. He had researched and recommended the stock six months ago while employed at his old firm, and he still believes it has great investment potential. He recreates his old Selldex research, updates it, and makes the recommendation. According to the CFA Institute Standards of Practice, Hayes's actions:
   A. are not in violation of any standard.
   B. are in violation of Standard IV (A) – (Duties to Employers) Loyalty because his previous employer paid for the original research.
   C. are in violation of Standard I(D) – Misconduct because the research he did at his old employer is the employer's property.
   D. are in violation of Standard I(C) – Misrepresentation since he did not properly cite the original report.

10. Jack Wilson is a financial planner and registered representative for Altona Financial Services. Wilson recently passed Level 3 of the CFA examination and is awaiting approval of his work experience. Wilson provides financial advice to individuals and is also able to recommend securities transactions to such clients. On several occasions, Wilson has entertained clients. Wilson generally uses his expense account to charter a limousine service for six hours even though the meetings only last for two or three hours. With the remaining time, Wilson takes his wife to dinner, which he pays for himself. Wilson often receives thank-you gifts of nominal value from his clients which he does not disclose to his employer. Which of the following *best* describes Wilson's actions under the CFA Institute Code and Standards? Wilson has:
    A. violated the Code and Standards with respect to his use of the limousine service and with respect to his acceptance of gifts from clients.
    B. not violated the Code and Standards with respect to his use of the limousine service or with respect to his acceptance of gifts from clients.
    C. not violated the Code and Standards with respect to his use of the limousine service but has violated the Code and Standards with respect to his acceptance of gifts from clients.
    D. violated the Code and Standards with respect to his use of the limousine service but has not violated the Code and Standards with respect to his acceptance of gifts from clients.

11. Craig Boone, a Level 1 CFA candidate, is a trader on the fixed income desk at a large Wall Street financial institution. He has observed that one of the salesmen on the desk has been reallocating some trades at the end of the day, giving better execution to a large client at the expense of several smaller clients, a practice he strongly suspects is illegal. A bond trader has also been involved by modifying his books to support the reallocation. Boone was told by the salesman that it is a common practice on Wall Street, that the firm's senior management is aware of it, and that Boone should "just do his job" as he, himself, is not being asked to do anything illegal or unethical. If Boone makes a personal record of the suspect activity, takes it home for his personal files, and subsequently reveals it to regulatory authorities, he would:
    A. be in violation of the Standards for beaching his duty of loyalty to his employer.
    B. be in violation of the Standards by acting deceitfully and unethically.
    C. be in violation of the Standards for disclosing confidential information.
    D. not be in violation of any Standards.

12. WEB, an investment-banking firm, is the principal underwriter for MTEX's upcoming debenture issue. Lynn Black, CFA, is an analyst with WEB, and she learned from an employee in MTEX's programming department that a serious problem was recently discovered in the software program of its major new product line. In fact, the problem is so bad that many customers have canceled their orders with MTEX. Black checked the debenture's prospectus and found no mention of this development. The red herring prospectus has already been distributed. According to the CFA Institute Standards of Professional Conduct, Black's *best* course of action is to:
    A. inform her immediate supervisor at WEB of her discovery.
    B. keep quiet because this is material nonpublic inside information.
    C. notify potential investors of the omission on a fair and equitable basis.
    D. report her discovery to the Division of Corporation Finance of the Securities Exchange Commission.

13. Fred Gersey is the compliance officer for Regiment Advisors, a registered investment adviser to retail and institutional mutual funds. Regiment has publicly acknowledged in writing the CFA Institute Code and Standards as part of its internal policies. Regiment is contemplating the use of research and investment decision-making services provided by a third party in return for commission business on client trading. Gersey has been charged with establishing the review committee for the approval of such services. All of the following information requests by Regiment personnel would most likely be allowable under the CFA Institute Code and Standards, as long as they are disclosed to clients, **EXCEPT**:
   A. a trader's request for weekly insider trading activities by corporate executives in the technology and telecommunications industries.
   B. a research analyst's request for weekly data involving prescriptions, new drug approvals, and patient user rates from a pharmaceutical company.
   C. a marketer's request for daily third party portfolio analytics for use in client mailings and for print advertising of the firm's investment products.
   D. a portfolio manager's request for proxy information regarding how corporate boards of directors were establishing employee compensation and the vehicles for such compensation.

14. Mary Walters, CFA, is a trust officer at a regional branch of Money Center bank. She has entered into a referral agreement whereby she will refer clients to Bob Sear, a tax attorney who she believes is the best in the business. He has told Walters that he will do the tax work on her children's trust, created by their grandparents, in return for such referrals. According to the CFA Institute Code and Standards, Walters:
   A. should disclose the arrangement to her employer only.
   B. should disclose the arrangement to prospective clients she refers only.
   C. should disclose the arrangement to both her employer and prospective clients she refers.
   D. does not need to disclose the arrangement.

15. Ronaldo Jenkins, CFA, is chief investment officer of Windwatch Advisors, a discretionary investment advisory firm. With over 15 years experience in various asset classes, Jenkins is head of Windwatch's proxy voting committee. He serves on the boards of several non-profit organizations and public companies and advises local municipal governments. During a recent search for an investment bank for a fixed income offering on behalf of a municipality, Jenkins learns in confidence that an investment bank, which is a large subsidiary of a publicly-traded commercial bank owned by Windwatch clients, is experiencing financial difficulties and will be shut down. Jenkins may take any of the following actions without violating CFA Institute Standards of Professional Conduct **EXCEPT**:
   A. cease all personal trades in the stock of the parent commercial bank.
   B. share the information received about the investment bank with his compliance officer.
   C. approach the investment bank about making public disclosure of the financial difficulties and pending closure.
   D. share the information received about the investment bank with Windwatch's head of equity investments for informational purposes as a shareholder of the parent commercial bank.

16. Mary Woods is a client services and marketing manager for LAM Asset Management, which has managed domestic equity and fixed income assets for over 20 years for institutional and high net worth clients. Woods recently completed Level 2 of the CFA examination and is registered for the Level 3 examination. In an effort to diversify its business, LAM hired two international equity portfolio managers and required Woods and other employees to take a 2-week course on international equity portfolios, client servicing, and marketing. Subsequently, Woods prepared a marketing presentation regarding LAM's international equity capabilities citing experienced portfolio managers and a proven track record, and she assured returns above the long-term risk-free rate of return, based on 20 years' investment experience in managing client portfolios. Regarding her marketing activities for LAM's international equity product, Woods has:
   A. violated CFA Institute Standards of Professional Conduct by compromising her fiduciary duty to LAM's domestic equity clients.
   B. violated CFA Institute Standards of Professional Conduct by misrepresenting the services that LAM could provide and the firm's qualifications in international equity.
   C. not violated CFA Institute Standards of Professional Conduct since Woods marketed the product to sophisticated investors with extensive knowledge of international equity markets and investment manager capabilities.
   D. not violated CFA Institute Standards of Professional Conduct since Woods's marketing of the product fulfilled LAM's fiduciary duty to create diversified portfolios for clients, balancing portfolio returns with an appropriate level of risk.

17. While visiting Cassori Company, Mark Ramsey, CFA, overheard management make comments that were not public information but were not really meaningful by themselves. Combining this information with his own analysis and other outside sources, Ramsey decides to change his recommendation on Cassori from "Buy" to "Sell." According to the CFA Institute Standards of Professional Conduct, Ramsey:
   A. must not issue his report until Cassori's management makes their comments public.
   B. must contact Cassori's managers and have them publicly announce their statements.
   C. may issue his "Sell" report because the facts are nonmaterial, but should maintain a file of the facts and documents leading to this conclusion.
   D. must report these events to his immediate supervisor and legal counsel, since they have become material in combination with his analysis.

18. Compliance with the Global Investment Performance Standards does NOT require firms to:
   A. include all fee-paying and non-fee-paying accounts in at least one composite.
   B. apply GIPS on a firm-wide basis.
   C. document in writing the policies and procedures used to comply with GIPS.
   D. specifically define what constitutes the firm that is claiming compliance.

The following 14 questions relate to Quantitative Methods.

19. Jim Franklin recently purchased a home for \$300,000 on which he made a down payment of \$100,000. He obtained a 30-year mortgage to finance the balance on which he pays a fixed annual rate of 6%. If he makes regular, fixed monthly payments, what loan balance will remain just after the 48th payment?
   A. \$94,615.
   B. \$186,109.
   C. \$189,229.
   D. \$192,444.

20. An investor purchased a $10,000, 5-year corporate note one year ago for $10,440. The note pays an annual coupon of $600. Over the past year, the note's annual yield-to-maturity has dropped by 1%. What total return did the investor earn over the year?
   A. 8.0%.
   B. 8.5%.
   C. 9.0%.
   D. 9.5%.

21. An investor holds a portfolio consisting of one share of each of the following stocks:

Stock	*Price at the beginning of the year*	*Price at the end of the year*	*Cash dividend during the year*
A	$10	$20	$0
B	$50	$60	$1
C	$100	$110	$4

   For the 1-year holding period, the portfolio total return is *closest* to:
   A. 15.79%.
   B. 18.42%.
   C. 18.75%.
   D. 21.88%.

22. Which of the following are the *weakest* and *strongest* measurement scales?

	Weakest	Strongest
A.	Ordinal	Ratio
B.	Ordinal	Interval
C.	Nominal	Ratio
D.	Nominal	Interval

23. An analyst observes the following four annual returns: $R_1 = +10\%$, $R_2 = -15\%$, $R_3 = 0\%$, and $R_4 = +5\%$. The equivalent compound annual rate is:
   A. –5.0%.
   B. –0.5%.
   C. 0.0%.
   D. 7.4%.

24. Given 45, 20, 30, and 25, what is the range and mean absolute deviation of these numbers?

	Range	Mean absolute deviation
A.	25	7.5
B.	25	9.4
C.	30	7.5
D.	30	9.4

25. An investor wants to buy a condominium in Florida. The value of her portfolio is currently \$1,000,000 and she needs \$100,000 in one year for the down payment. She doesn't mind decreasing her capital as long she has \$950,000 remaining in her portfolio after the down payment is made. She is considering two new portfolios for her holdings. The details on the two portfolios are:

	Expected Annual Return	*Standard Deviation of Returns*
Portfolio 1	17%	15%
Portfolio 2	12%	10%

According to Roy's Safety-First criterion, the portfolio she would prefer and the probability that this safety-first-optimal portfolio will produce a return of less than 2% are:

	Optimal portfolio	Probability <1%
A.	Portfolio 1	32%
B.	Portfolio 1	16%
C.	Portfolio 2	32%
D.	Portfolio 2	16%

26. Using a sample of 28 quarterly observations, an analyst determines that the correlation coefficient between Stock A and Stock B is 0.35. What is the computed t-statistic and is this correlation coefficient significantly different from zero at the 5% level?

Student's t-Distribution		
Level of Significance for One-Tailed Test		
df	0.050	0.025
Level of Significance for Two-Tailed Test		
df	0.100	0.050
25	1.708	2.060
26	1.706	2.056
27	1.703	2.052
28	1.701	2.048
29	1.699	2.045

	Computed t-statistic	Different from 0 at the 5% level
A.	1.91	No
B.	2.03	Yes
C.	1.91	Yes
D.	2.11	Yes

27. In an attempt to estimate the average monthly return for aggressive equity funds, an analyst gathers the following sample of monthly returns:

Month 1 = +2%, Month 2 = –4%, Month 3 = +1%, Month 4 = +5%

The sample standard deviation of the monthly returns and the 99% confidence interval (approximate) for the mean return is *closest* to:

	<u>Sample std. dev.</u>	<u>99% confidence interval</u>
A.	2.94%	–10.22% to 12.22%
B.	2.94%	–5.48% to 7.48%
C.	3.74%	–5.48% to 7.48%
D.	3.74%	–10.22% to 12.22%

28. According to Chebyshev's inequality, the minimum proportion of observations falling within 3 standard deviations of the mean for a negatively skewed distribution is *closest* to:
A. 56%.
B. 68%.
C. 75%.
D. 89%.

Use the following data to answer Questions 29 and 30.

The following table summarizes the results of a poll taken of CEOs and analysts about the economic impact of a pending piece of legislation:

Group	*Predict Positive Impact*	*Predict Negative Impact*
CEOs	40	30
Analysts	70	60

29. What is the probability that a randomly selected individual from this group will be an analyst who thinks the legislation will have a positive impact on the economy?
A. 0.30.
B. 0.35.
C. 0.40.
D. 0.45.

30. What is the probability that a randomly selected individual from this group will be either an analyst or someone who thinks this legislation will have a positive impact on the economy?
A. 0.75.
B. 0.80.
C. 0.85.
D. 0.90.

31. An analyst decides to select 10 stocks for her portfolio by placing the ticker symbols for all the stocks traded on the New York Stock Exchange in a large bowl. She randomly selects 20 stocks and will put every other one chosen into her 10-stock portfolio. The analyst used:
A. cluster sampling.
B. simple random sampling.
C. stratified random sampling.
D. systematic random sampling.

32. Which of the following pairs of tests would both generally be conducted *nonparametrically*?

	First type of test	Second type of test
A.	Value of a variance for a normal population	Difference between two medians
B.	Whether a sample is random or not	Difference between two medians
C.	Large sample test of the value of a population mean	Whether a sample is random or not
D.	Whether a sample is random or not	Value of a variance for a normal population

The following 12 questions relate to Economics.

33. The Zaxon Company produces one product and labor is the only variable resource in the production process. In the short run, Zaxon faces a horizontal demand curve at $20 per unit. The average product of labor in the short run is given in the following table:

Resource Units	*Average Product of Labor*
1	25
2	22.5
3	20
4	17.5

If the price of each unit of labor (worker-days) is $350, and only whole units can be employed, how many units of labor will Zaxon employ?

A. 1.
B. 2.
C. 3.
D. 4.

34. Which of the following would be *most likely* to have gains from an unexpected increase in the inflation rate?

A. Holders of floating rate debt securities.
B. The owner of a shopping mall.
C. A home owner with a fixed-rate mortgage.
D. Workers in the auto industry.

35. An analyst gathers the following information about Monument State Bank:

- Demand deposits $400 million
- Loans and securities $260 million
- Reserve requirement 10%
- The bank has a total of $50 million in cash and deposits with the Federal Reserve.

Monument State Bank is in a position to make additional loans of:
A. $5 million.
B. $10 million.
C. $26 million.
D. $40 million.

36. The demand for labor will be less elastic:
A. at lower wage rates than at higher wage rates.
B. in the long run than in the short run.
C. the less labor intensive the production process.
D. the less the opportunities to substitute labor for capital in the production process.

37. In a full employment economy, the quantity theory of money states that any increase in the supply of money in excess of the rate of growth of real GDP will lead to:
A. increased prices.
B. increased velocity.
C. increased production.
D. decreased quantity of money.

38. When the economy is operating at potential GDP, an unannounced decrease in the rate of growth of the money supply intended to reduce inflation will *most likely* lead to lower inflation and:
A. a decrease in output in both the short run and the long run.
B. no change in output in both the short run and the long run.
C. a decrease in output in the short run, and lower inflation but no change in output in the long run.
D. a decrease in output in the short run, but no change in output or inflation in the long run.

39. If the price of product X increases from $2.00 per unit to $2.25 per unit, the demand will decrease from 7.5 million units to 6.7 million units. What is the price elasticity of demand for the product, and is the demand for the product elastic or inelastic?
A. –1.04; elastic.
B. –0.96; elastic.
C. –1.04; inelastic.
D. –0.96; inelastic.

40. Which of the following statements about a monopolist is TRUE? A monopolist will:
A. earn economic profits in all situations.
B. maximize the average profit per unit sold.
C. charge the highest price for which it can sell its product.
D. sell at the output level where marginal revenue equals marginal cost.

41. Euros are currently quoted at \$1.31, and British pounds are quoted at \$1.85. Forward contracts on British pounds are trading at \$1.88. The cross rate for the Euro/pound rate and the forward premium or discount on the British pound forward contract relative to the dollar are *closest* to:

	Cross rate	Premium or discount
A.	0.708	1.62% discount
B.	1.412	1.62% premium
C.	0.708	1.62% premium
D.	1.412	1.62% discount

42. Which statement about the following production possibilities chart is TRUE?

Units of output per worker day		
	Mexico	Brazil
Food	1	3
Clothing	3	6

A. Brazilian workers are the high-cost producers of both food and clothing.
B. Mutual gains could be realized from trade if Mexico specialized in food production and Brazil in clothing production.
C. Joint output would be maximized if Mexico specialized in the production of clothing and Brazil in the production of food.
D. No gains from trade are possible because Brazilian workers produce more of both food and clothing than Mexican workers do.

43. One year ago, 1 New Zealand dollar (NZD) purchased 1.2 Australian dollars (AUD). Now, 1 NZD purchases 1.1 AUD. Assume that New Zealand and Australia are trading partners. Which of the following statements is the *least likely*? Over the past year, the New Zealand:
A. current account had a deficit balance with Australia.
B. government removed a high tariff on a major imported good.
C. economy had a higher inflation rate than did Australia's economy.
D. government recently undertook an unanticipated expansionary fiscal policy action.

44. From an initial situation of long-run equilibrium at full-employment real GDP, an increase in aggregate demand that is permanent will:
A. Increase real GDP, but not prices in the short run, while in the long run, prices will increase, nominal GDP will increase as a result and real GDP will remain at the new (short-run) higher level.
B. Increase nominal GDP, real GDP, and prices in the short run, while in the long run, prices will increase further but real GDP will decrease to its original level.
C. Increase nominal GDP, real GDP, and prices in the short run and in the long run.
D. Increase prices and nominal GDP in the short run, further increase prices and nominal GDP in the long run, but not increase real GDP in the short run or the long run.

The following 34 questions relate to Financial Statement Analysis and Corporate Finance.

45. In accrual accounting, the matching principle states that:
A. an entity should match the duration of its assets to the duration of its liabilities and equity.
B. an entity should recognize revenues only when received and expenses only when they are paid out.
C. transactions and events producing cash flows are allocated only to time periods in which the cash flows occur.
D. operating performance can be measured only if related revenues and expenses are accounted for during the same time period.

46. Which of the following statements about revenue recognition methods is TRUE?
   A. The completed contract method recognizes revenue at the time of the sale.
   B. The cost recovery method recognizes revenue and associated costs of goods sold (COGS) only when cash is received.
   C. The percentage of completion method recognizes profit corresponding to the costs incurred as a proportion of estimated total costs.
   D. The installment sales method recognizes sales when cash is received, but no gross profit is recognized until all of the COGS are collected.

47. A company changes from an incorrect method of accounting to an acceptable one. Which of the following statements about this change is TRUE?
   A. It is a prior period adjustment and can be accounted for by a direct adjustment to retained earnings.
   B. It is an extraordinary item and is reported net of taxes below the operating income line.
   C. If the change is voluntary, it is a change in accounting principle and is reported below the line net of taxes.
   D. If the change is mandated by a new accounting standard, it is an unusual or infrequent item and is reported as a separate line in net income from continuing operations.

48. When preparing a statement of cash flows under the indirect method, the adjustment to net income for an increase in wages payable (WP) and a decrease in the deferred tax liability (DTL) on the balance sheet compared to the prior reporting period is:

	Increase in WP	Decrease in DTL
A.	Negative	No adjustment
B.	Positive	Negative
C.	Positive	No adjustment
D.	Negative	Positive

49. An analyst gathers the following information:

• Net income	$100
• Decrease in accounts receivable	30
• Depreciation	25
• Increase in inventory	17
• Increase in accounts payable	10
• Decrease in wages payable	5
• Increase in deferred taxes	17
• Sale of fixed assets	150
• Purchase of fixed assets	340
• Profit from the sale of fixed assets	5
• Dividends paid out	35
• Sale of new common stock	120

Based on the above information, the company's cash flow from operations is:
   A. $155.
   B. $165.
   C. $175.
   D. $182.

50. Which of the following statements about cash flow is *least likely correct*? Cash flow from:
   A. operations includes changes in working capital accounts and cash operating expenses.
   B. financing includes debt issued to purchase equipment and the sale of the company's common stock.
   C. investing includes the purchase of plant and equipment and the sale of common shares of another company.
   D. investing includes interest income from bonds owned.

51. An analyst gathered the following data about a company:
    - The company had 500,000 shares of common stock outstanding for the entire year.
    - The company's beginning stock price was $40, its ending price was $60, and its average price is $50.
    - The company has 120,000 warrants outstanding for the entire year.
    - Each warrant allowed the holder to buy one share of common stock at $45 per share.

    How many shares of common stock should the company use in computing its diluted earnings per share?
    A. 488,000.
    B. 500,000.
    C. 508,000.
    D. 512,000.

52. Books Forever, Inc. uses notes payable to buy inventory. Assuming an initial current ratio that is greater than 1 and an initial quick (or acid test) ratio that is less than 1, what is the effect of this transaction on the current ratio, the quick ratio, and net income?

	Current ratio	Quick ratio	Net income
A.	Decrease	Decrease	No impact
B.	Increase	Increase	No impact
C.	Decrease	Increase	Increase
D.	Increase	Decrease	No impact

53. Normal Corp. has a current ratio above 1 and a quick ratio is less than 1. Which of the following actions will increase the current ratio and decrease the quick ratio? Normal Corp.:
    A. buys fixed assets on credit.
    B. uses cash to purchase inventory.
    C. pays off accounts payable from cash.
    D. uses long-term debt to finance equipment.

54. Which of the following statements about intangible assets is *least likely correct*?
    A. Advertising fees are generally expensed.
    B. In most countries, R&D costs cannot be expensed.
    C. Intangible assets are reflected at their purchase prices when acquired from an outside entity.
    D. Generally, intangible assets cannot be reported on the balance sheet when produced internally.

55. Which of the following accounting practices is *most likely* to decrease reported earnings in the current period?
    A. Using the straight-line method of depreciating instead of an accelerated method.
    B. Capitalizing advertising expenses rather than expensing them in the current period.
    C. Using LIFO inventory cost methods during a period of rising prices.
    D. Amortizing capitalized expenses over longer periods.

56. Which of the following statements about dilutive securities is *least likely correct*?
    A. A simple capital structure is one that contains only common stock and antidilutive securities.
    B. A complex capital structure is one that contains potentially dilutive securities.
    C. A dilutive security is one that will cause earnings per share (EPS) to decrease if it is converted into common stock.
    D. Warrants with exercise prices less than the year-end stock price can be antidilutive.

57. As of January 1, a company had 22,500 $10 par value common shares outstanding. On July 1, the company repurchased 5,000 shares. The company also has 11,000, 10%, $100 par value preferred shares. If the company's net income is $210,000, its diluted earnings per share is *closest* to:
   A. $5.00.
   B. $7.50.
   C. $10.00.
   D. $10.50.

58. In periods of *rising prices* and stable or increasing inventory quantities, which of the following statements about companies that use LIFO inventory accounting compared with FIFO is FALSE? Compared with FIFO companies, LIFO companies will have:
   A. higher COGS, lower taxes.
   B. higher net income, higher taxes.
   C. higher cash flows, lower working capital.
   D. lower inventory balances, lower working capital.

59. An analyst notes the following about a company:
   - Beginning inventory was reported as $5,000.
   - Costs of goods sold was reported as $8,000.
   - Ending inventory was $7,000 (the analyst has physically verified this amount).

   Which of the following statements about this situation is *most likely correct*?
   A. Purchases must have been $8,000.
   B. The company must be using LIFO.
   C. If the analyst discovered that beginning inventory was overstated by $1,000 then COGS must have been understated by $1,000.
   D. If the analyst discovered that beginning inventory was understated by $2,000 then earnings before taxes must have been overstated by $2,000.

60. Which of the following statements about a company that capitalizes significant costs this year is *least likely correct*? Compared with expensing, a company that capitalized these costs would:
   A. show smoother reported income and lower return on assets in future years.
   B. have higher cash flow from operations and lower cash flow from investing.
   C. have better debt-to-asset and debt-to-equity ratios and the same total cash flows.
   D. have lower profitability ratios this year and higher cash flows from operations.

61. In the early years of an asset's life, a firm that chooses an accelerated depreciation method instead of using straight-line depreciation will tend to have:
   A. lower net income and lower equity.
   B. higher assets and higher net income.
   C. higher return on equity and higher return on assets.
   D. lower depreciation expense and lower turnover ratios.

62. Which of the following definitions used in accounting for income taxes is *least correct*?
   A. An income tax expense is an expense resulting from current period pretax income and change in deferred taxes.
   B. A valuation allowance is a reserve against deferred tax assets based on the likelihood that those assets will not be realized.
   C. A timing difference is the result of tax return treatment of a transaction that differs from its financial reporting treatment.
   D. A deferred tax liability is a balance sheet amount related to the difference between tax expense and taxes payable that is expected to be recovered from future operations.

63. Which of the following statements about temporary and permanent differences in the analysis of income taxes is **FALSE**?
A. An example of a permanent difference is tax-exempt interest revenue.
B. Permanent differences are differences in taxable and pretax income that are never reversed.
C. An example of a temporary difference is the proceeds from life insurance on key employees.
D. In the liability method, deferred tax assets and liabilities are measured and an assumption is made that temporary differences will reverse.

64. Which of the following statements about the financial statement effects of issuing bonds is *least correct*?
A. Issuance of debt has no effect on cash flow from operations.
B. Periodic interest payments have no effect on cash flow from financing.
C. Periodic interest payments decrease cash flow from operations by the amount of interest paid.
D. Payment of debt at maturity decreases cash flow from operations by the face value of the debt.

65. Javox, Inc. is considering leasing an asset that has an estimated economic life of 10 years and a lease term of 8 years. The lease will not transfer ownership to Javox at expiration, and if Javox chooses to buy the asset at the termination date, they must pay the fair market value. If Javox leases the asset, it must be considered a(n):
A. capital lease.
B. cash flow lease.
C. operating lease.
D. There is not enough information to classify the lease.

66. In general, as compared to companies with capital leases, companies with operating leases report:
A. higher working capital and higher asset turnover.
B. higher cash flow from operations and lower cash flow from financing.
C. lower debt to equity and return on equity ratios (in the early years).
D. lower expense in the early years and higher expenses over the life of the lease.

67. An asset is considered impaired if:
A. fixed assets are lower than current assets.
B. assets are carried below their market values.
C. the book value of the asset is greater than the market value of the asset.
D. assets are carried at more than the sum of their undiscounted expected cash flows.

68. Eatan Inc. has a take-or-pay contract with SeaTac Inc. for \$1,000,000 per year for five years. Eatan also recently sold receivables of \$500,000. The present value (PV) of Eatan's take-or-pay contract is \$4,000,000 and the buyer of the receivables has recourse to Eatan. Once an analyst has adjusted Eatan's debt to equity ratio, earnings before interest and taxes (EBIT), and assets for these two off-balance-sheet financing arrangements, the changes are *best* described by:

	Debt-to-equity	EBIT	Assets
A.	Increase	Decrease	Increase by \$4,000,000
B.	Increase	Increase	Increase by \$5,000,000
C.	Decrease	Decrease	Increase by \$5,000,000
D.	Increase	Increase	Increase by \$4,500,000

69. Which of the following statements about the cost of capital components is *least likely correct*? The:
A. cost of new equity is (D_1/Stock price) plus growth.
B. cost of retained earnings is the required rate of return on common stock.
C. cost of new preferred stock is the preferred dividend by the preferred's par value less foliation costs.
D. after-tax cost of debt is based on the expected yield to maturity on newly issued debt.

70. Project X has an internal rate of return (IRR) of 14%. Project Y has an IRR of 17%. Both projects have simple cash flows (all positive after the initial one). Which of the following statements is *most likely correct*? If the required rate of return is:
A. 14%, the net present value (NPV) of Project Y will exceed the NPV of project X.
B. less than 17%, Project Y will always have a shorter payback than Project X.
C. greater than 17%, Project Y will always have a shorter payback than Project X.
D. 10%, both projects will have a positive NPV, and the NPV of Project Y will exceed the NPV of Project X.

71. AlcoBanc owns a piece of property that is under consideration for a new bank branch. Which of the following is NOT a relevant incremental cash flow in analyzing a capital budgeting project? The:
A. interest costs of a loan for the property purchase.
B. business gained at other branches due to new customers at the proposed site.
C. loss of customers at alternative branches due to conducting business at the proposed site.
D. $150,000 AlcoBanc could get if they sold the property instead of building a new branch.

72. The increase in inventory required due to a new capital budgeting project implementation would be classified as a:
A. cost (negative cash flow) at time zero.
B. benefit (positive cash flow) at time zero.
C. cost (negative cash flow) in each year the firm needs the increased inventory.
D. benefit (positive cash flow) in each year the firm needs the increased inventory.

73. Xanos Corporation faced a 50% marginal tax rate last year and showed the following financial and tax reporting information:
- Deferred tax asset of $1,000.
- Deferred tax liability of $5,000.

Based only on this information and the news that the tax rate will decline to 40%, which of the following statements is TRUE?
A. Deferred tax asset is reduced by $400 and deferred tax liability is reduced by $2,000.
B. Deferred tax liability is reduced by $1,000 and income tax expense is reduced by $800.
C. Deferred tax asset is reduced by $200 and the income tax expense is reduced by $1,000.
D. Income tax expense is reduced by $800 and the deferred tax liability is reduced by $2,000.

74. Hanson Aluminum, Inc. is considering whether to build a mill based around a new rolling technology the company has been developing. Management views this project as being riskier than the average project the company undertakes. Based on their analysis of the projected cash flows, management determines that the project's internal rate of return is equal to the company's marginal cost of capital. If the project goes forward, the company will finance it with newly issued debt. Should management accept or reject this project?
A. Accept, because the project returns the company's cost of capital.
B. Accept, because the marginal cost of the new debt is less than the project's internal rate of return.
C. Reject, because the project reduces the value of the company when its risk is taken into account.
D. Management should be indifferent between accepting and rejecting the project.

75. In evaluating an investment in a company, a critical factor to consider is the company's corporate governance policies. Good corporate governance leads to better results for the company and ultimately, its investors. The structure of a corporate board and the qualities of its members are of utmost importance. Which of the following is NOT an important requirement of good corporate governance?
A. Members of the board should serve staggered, multiple-year terms.
B. A board should be composed of at least a majority of independent board members.
C. There need to be internal mechanisms to support the independent work of the board.
D. Board members should have appropriate experience and expertise relevant to the company's business.

76. Printers Inc. produces hand-held printers and has the following production information:

- 150,000 units produced.
- Retail price is $10.
- Variable cost per unit is $6.
- Fixed costs are $100,000.

Printers' breakeven quantity and the degree of operating leverage (DOL) at 150,000 units are *closest* to:

	Breakeven	DOL
A.	10,000	1.0
B.	10,000	1.2
C.	25,000	1.0
D.	25,000	1.2

77. Which of the following statements *best* describes the effect of an increase in the tax rate on a firm's component costs of capital for debt, preferred stock, and common equity?

	Debt	Preferred stock	Common equity
A.	Decreases	No effect	No effect
B.	Decreases	Increases	Increases
C.	Increases	Decreases	Decreases
D.	Increases	No effect	No effect

78. A company has 35 million shares outstanding with a current market price of $49.75 per share. The company has maintained a $1.00 per share quarterly dividend for several years, but for the next quarter management is considering whether to implement a $35,000,000 share repurchase in place of the regular quarterly dividend. Assuming the shares are held in a tax-deferred account, so that the tax treatments of either alternative are the same, what is the net impact on the wealth of shareholders if the next cash dividend is replaced by the share repurchase?
A. –$100.00.
B. –$14.52.
C. $0.
D. +$85.48.

The following six questions relate to Portfolio Management.

79. Which of the following is *most likely* to result in a capital market line (CML) that is not a straight line?
A. Investors' risk tolerance decreasing.
B. Borrowing rate exceeds the lending rate.
C. An increase in the Sharpe ratio.
D. Increase in the proportion of the portfolio invested in the risk-free asset.

80. An analyst gathers the following data about the returns for three stocks.

	Stock A	*Stock B*	*Stock C*
E(R)	0.04	0.09	0.11
σ^2	0.0025	0.0064	0.0081

$Cov_{A,B} = 0.001$
$\rho_{B,C} = 0.60$

The correlation coefficient between the returns of Stock A and Stock B ($\rho_{A,B}$) and the covariance between the returns of Stock B and Stock C ($Cov_{B,C}$) are *closest* to:

	$\rho_{A,B}$	$Cov_{B,C}$
A.	0.01	0.002
B.	0.01	0.004
C.	0.25	0.002
D.	0.25	0.004

81. A portfolio manager should **NOT**:
A. recommend higher-risk investments for a 24-year old college graduate.
B. focus on timing and security selection when constructing a client investment strategy.
C. manage the portfolio of a couple in the midpoint of their careers with a strategy with a long time horizon and moderate risk.
D. implement the four-step portfolio management process as follows: write a policy statement, develop the investment strategy, implement the plan, and monitor and update (rebalance) as needed.

82. Which of the following possible portfolios **CANNOT** lie on the efficient frontier?

Portfolio	*Expected Return*	*Standard Deviation*
1	8	6
2	10	6
3	14	12
4	14	16

A. Portfolio 1 only.
B. Portfolio 3 only.
C. Portfolios 1 and 4.
D. Portfolios 2 and 3.

83. Which of the following types of risk are essentially the same?
A. Market risk and unsystematic risk.
B. Total risk and the variance of returns.
C. Systematic risk and firm-specific risk.
D. Undiversifiable risk and unsystematic risk.

84. An investor plans to divide her funds evenly between two assets. Assets 1 and 2 have standard deviations of 10% and 30%, respectively. If the two assets are perfectly positively correlated, the standard deviation of returns of the two-asset portfolio is *closest* to:
   A. 10%.
   B. 15%.
   C. 20%.
   D. 30%.

The following 36 questions relate to Asset Valuation.

85. Which of the following statements about security markets is *least likely correct?*
   A. The NYSE and the AMEX are price-driven markets and NASDAQ is a dealer market.
   B. Primary capital markets relate to the sale of new issues and secondary capital markets are where securities trade after their initial offerings.
   C. Call markets are markets in which the security is only traded at specific times and continuous markets are markets where trades occur at any time the market is open.
   D. The third market describes direct trading of securities between two parties with no broker intermediary and the fourth market describes over-the-counter (OTC) trading of shares listed on an exchange.

86. The predictability of a central bank's reactions to economic shocks can *best* be measured by:
   A. the standard deviation of the price of gold in the central bank's home currency.
   B. the volatility of spread between straight and inflation-indexed bond yields.
   C. the difference between actual price inflation and economists' mean inflation forecast.
   D. how well forward interest rates anticipate policy changes.

87. With regard to the weighting schemes used in the construction of market indices, which of the following statements is ***most likely correct?***
   A. Equal weighting places an upward bias on the index.
   B. Price-weighting produces a downward bias.
   C. Market-weighting places a downward bias on the index relative to price weighting.
   D. Unweighted indices are biased toward stocks with relatively large market values.

88. If a price index has been increasing over the past two months, where would the 30-day moving-average lie relative to the current index level?
   A. It would lie on it.
   B. It would lie above it.
   C. It would lie below it.
   D. Cannot be determined without additional information.

89. An analyst is valuing a company's preferred stock of a company that pays a $6 annual dividend. The company's bonds currently yield 7.5% and preferred shares are selling to yield 75 basis points below the company's bond yield. Assuming a perpetual dividend, the value of the preferred stock is *closest* to:
   A. $72.73.
   B. $80.00.
   C. $88.89.
   D. $90.00.

90. An investor buys a stock at $32 a share and deposits 50% margin. Assume that the maintenance margin is 25%, the stock pays no dividends, and transaction and borrowing costs are zero. Given this information, calculate the return on this margin transaction if the stock is sold for $37.50, *and* the price at which the investor would receive a margin call on the margined position.

	Expected <u>rate of return</u>	Margin call will occur <u>when stock hits a price of:</u>
A.	17.2%	$24.00
B.	17.2%	$21.33
C.	34.4%	$21.33
D.	34.4%	$24.00

91. The risk-free rate is 5% and the expected return on the market index is 15%. A stock has a:
- Beta of 1.0.
- Dividend payout ratio of 40%.
- Return on equity (ROE) of 15%.

If the stock is expected to pay a $2.50 dividend, its intrinsic value using dividend discount model is *closest* to:
A. $27.77.
B. $41.67.
C. $50.00.
D. $53.33.

92. All else equal, a stock's price, according to the dividend discount model, will increase when the:
A. expected dividend decreases.
B. expected return on equity (ROE) increases.
C. estimated required rate of return on the stock increases.
D. difference between the required rate of return and the growth rate increases.

93. According to Michael Porter, which of the following is *least likely* to be a factor determining the intensity of competition within an industry?
A. Level of technology.
B. The threat of new entrants.
C. The threat of substitute products.
D. Bargaining power of buyers and suppliers.

94. An analyst gathered the following data about a company for the coming year:
- Sales are estimated to be $3,000,000.
- The company's tax rate will be 30%.
- Interest expense will be $150,000.
- The company has 180,000 common shares outstanding.
- The estimated depreciation expense will be $200,000.
- Earnings before interest, taxes, depreciation, and amortization (EBITDA) profit margin is estimated to be 20%.

The analyst's estimate of the company's earnings per share (EPS) would be:
A. $0.42.
B. $0.97.
C. $1.98.
D. $4.63.

95. Which of the following statements regarding the industry life cycle is *least likely correct*? If the industry is in the:
    A. mature growth phase, growth is above normal.
    B. deceleration phase, growth of substitute products causes declining profit margins.
    C. pioneering phase, the industry experiences high sales growth but small or negative margins.
    D. stabilization and market maturity phase, industry growth rates approach those of the aggregate economy.

96. A stock that currently does not pay a dividend is expected to pay its first dividend of \$1.00 five years from today. Thereafter, the dividend is expected to grow at an annual rate of 25% for the next three years and then grow at a constant rate of 5% per year thereafter. The required rate of return is 10.3%. What is the value of the stock today?
    A. \$20.65.
    B. \$20.95.
    C. \$22.72.
    D. \$23.87.

97. Which of the following statements about bond call features is *least likely correct*? Embedded call options in callable bonds:
    A. expose investors to additional reinvestment rate risk.
    B. expose investors to reduced capital appreciation potential.
    C. create risk because they add uncertainty to the bond's cash flow pattern.
    D. can be valued using the difference between the zero-volatility spread and the nominal spread.

98. All else equal, which of the following will **NOT** increase the interest rate risk of a bond?
    A. A longer maturity.
    B. Inclusion of a call feature.
    C. A lower coupon.
    D. A decrease in the YTM.

99. Which of the following statements about the risks associated with investing in bonds is **FALSE**?
    A. Credit risk is the likelihood that an investor will be unable to sell the security quickly and at a fair price.
    B. Reinvestment risk is the uncertainty about the rate at which cash flows from the security can be reinvested.
    C. Volatility risk is the risk that the price of a bond with an embedded option will decline when expected yield volatility changes.
    D. Interest rate risk is the risk that a bondholder faces if the price of a bond held in a portfolio will decline due to rising market interest rates.

100. One year ago, an investor purchased a 10-year, \$1,000 par value, 8% semiannual coupon bond with an 8% yield to maturity. Now, one year later, interest rates remain unchanged at 8%. If the investor sells the bond today (immediately after receiving the second coupon payment, and with no transaction costs) he will have a capital:
    A. gain of \$80.
    B. loss of \$80.
    C. gain of \$0.
    D. gain of \$160.

101. A company has two \$1,000 face value bonds outstanding both selling for \$701.22. The first issue has an annual coupon of 8% and 20 years to maturity. The second bond has the same yield as the first bond but

has only five years remaining until maturity. The second issue pays interest annually as well. What is the annual interest payment on the second issue?

A. \$13.59.
B. \$18.56.
C. \$27.18.
D. \$37.12.

102. If a bond has a convexity of 60 and a modified duration of 10, the convexity adjustment associated with a 25 basis point interest rate decline would be:

A. –2.875%.
B. –2.125%.
C. –0.0375%.
D. +0.0375%.

103. A semiannual-pay bond is callable in five years at \$1,080. The bond has an 8% coupon and 15 years to maturity. If an investor pays \$895 for the bond today, what are the yield to call (YTC) and the yield to maturity (YTM), respectively?

	YTC	YTM
A.	10.77%	9.31%
B.	12.07%	9.31%
C.	10.77%	10.21%
D.	12.07%	10.21%

104. Concerning the ability to trade banker's acceptances and commercial paper in a secondary market, which of the following choices is **CORRECT**?

	Banker's acceptance	Commercial paper
A.	Liquid	Liquid
B.	Liquid	Illiquid
C.	Illiquid	Liquid
D.	Illiquid	Illiquid

105. Which of the following statements regarding provisions for paying off bonds is *least likely correct*?

A. Nonrefundable bonds can be callable.
B. Serial bonds are an issue with several staggered maturity dates.
C. Amortizing securities make periodic principal and interest payments.
D. A sinking fund provision gives the company the option to retire portions of the bond issue prior to maturity.

106. Which of the following statements regarding the risks inherent in bonds is *most likely correct*?

A. Call options increase the risk of the issuer.
B. Interest rate risk involves the risk that the coupon rate will adjust downward if market rates decline.
C. The reinvestment rate assumption in calculating bond yields is generally not significant to the bond's yield.
D. Default risk deals with the likelihood that the issuer will fail to meet its obligations as specified in the indenture.

107. If an investor wants only investment grade bonds in her portfolio, she should NOT purchase a(n):

A. A-rated municipal bond.
B. 3-year municipal bond rated BB.
C. 10-year zero-coupon corporate bond rated AAA.
D. 15-year, semiannual coupon corporate bond rated BBB.

108. An investor is choosing between a 10% corporate bond and a 6% municipal bond with similar risk and similar maturity. What is the marginal tax rate that will make the investor indifferent between the two bonds?
    A. 0%.
    B. 30%.
    C. 40%.
    D. 60%.

109. Which of the following statements about futures margins is *least likely correct*?
    A. Variation margin must always be paid in cash or cash equivalents.
    B. The initial margin is set by the clearinghouse based on the historical volatility of the price of the underlying asset.
    C. If the balance of the margin account exceeds the initial level, the trader can remove the excess funds from the account.
    D. If the margin account balance falls below the maintenance margin level, the account balance must be brought back up to the maintenance level.

110. Which of the following is **NOT** a way to close a futures position?
    A. Delivery: delivering the underlying asset.
    B. Cancellation: canceling the position on the floor of the exchange.
    C. Offset: taking on an opposite position to bring the net position to zero.
    D. Exchange-for-physicals: privately negotiating the terms of the transaction with a trader with an opposite position and delivering the asset and closing the contract off the floor of the exchange.

111. Three months ago, Jen Baker purchased one American put option contract on Mechor Corporation for $4 per option share. Baker also owns 100 shares of Mechor. The following data applies to Baker's position:

• Option strike price	$60
• Stock price on date of option purchase	$60
• Stock price today	$52
• Time to option expiry from today	1 month

Given only the above data, if Baker exercises her option today, the *profit/loss* (from the date of the option purchase) on Baker's combined stock/put position is:
    A. –$800.
    B. –$400.
    C. $400.
    D. $800.

112. Two Level 1 CFA candidates are discussing futures and make the following statements:

Candidate 1: Futures are traded using standardized contracts. They require margin and incur interest charges on the margin loan.

Candidate 2: If the margin balance falls below the maintenance margin amount due to a change in the contract price for the underlying assets, the investor must add funds to bring the margin back up to the initial margin requirement.

Are the candidates' statements *correct* or *incorrect*?

	Candidate 1	Candidate 2
A.	Correct	Correct
B.	Correct	Incorrect
C.	Incorrect	Correct
D.	Incorrect	Incorrect

113. Which of the following statements for puts at expiration is FALSE? The:
   A. put buyer's maximum loss is the put option's premium.
   B. maximum loss to the writer of a put is the strike price less the premium.
   C. maximum gain to the buyer of a put is limited to the strike price less the premium.
   D. put holder will exercise the option whenever the stock's price is greater than the exercise price.

114. Which of the following statements is *most likely correct*? When compared to closed-end funds, exchange-traded funds (ETFs):
   A. have lower expense ratios and smaller deviations from net asset value.
   B. offer in-kind redemptions but less diversification.
   C. have lower bid-ask spreads and are easier to sell short.
   D. have greater diversification and less currency risk.

115. Which one of the following is NOT a type of fee charged by a mutual fund?
   A. Redemption fees.
   B. 12b-1 fees.
   C. Management fees.
   D. Encumbrance fees.

116. Which of the following statements regarding mutual funds is *least likely correct*?
   A. Closed-end investment companies are started through an initial public offering to raise funds.
   B. A no-load fund charges no fee to buy the fund's shares so it sells shares below their net asset value (NAV).
   C. A load fund's offering price is the sum of the NAV of a share and a sales charge.
   D. Open-end investment companies are funds that continue to sell and repurchase shares after the fund's inception.

117. Which choice below correctly specifies both an advantage and a disadvantage of exchange-traded funds (ETFs) relative to other equity investments?

	Advantage of ETFs	Disadvantage of ETFs
A.	Diversification	Large bid-ask spreads for low-volume funds
B.	Trade like traditional equity	Increased capital gains tax
C.	May have better risk management	Composition of fund is not made public
D.	No trading at a discount or premium to NAV	Dividends are never reinvested immediately

118. All of the following are types of hedge fund strategies EXCEPT:
   A. long/short.
   B. event-driven.
   C. market-neutral.
   D. exchange-traded.

119. Which of the following statements regarding hedge fund performance is TRUE?
   A. There is a high correlation between the performance of hedge funds and more conventional investments.
   B. Hedge funds have demonstrated a higher risk profile than traditional equity investments as measured by the standard deviation of returns.
   C. More recently, the reward-to-risk ratio as measured by the Sharpe ratio has been lower for hedge funds than for most of the other types of equity investments.
   D. As a class, hedge funds have historically outperformed major equity and fixed income benchmarks such as the S&P 500 and the Lehman Brothers government/corporate bond index.

120. A manager establishes a collateralized commodity futures position with a contract value of $20 million. He purchases 60-day Treasury bills (T-bills) with a bank discount yield of 8.867% to collateralize the futures position. After 60 days, the loss on the futures position is $100,000. The holding period return on the position, is *closest* to:
   A. −0.5000%.
   B. 0.9978%.
   C. 1.0000%.
   D. 1.2254%.

Sample Exam 2
Afternoon Session

Calculating Your Score

Topic	*Maximum Score*	*Your Score*
Ethics	18	
Quantitative Methods	14	
Economics	12	
Accounting & Corporate Finance	34	
Asset Valuation	36	
Portfolio Management	6	
Total	120	

The morning and afternoon exams are identically weighted over the topics and readings. You can therefore treat the morning and afternoon exams as independent events.

If you took more than three hours (180 minutes) to complete this portion of the exam, you should adjust your score downward by one point for each minute you ran over.

Remember: the real exam *will be more difficult* than these sample exams. The main reason for this is the general anxiety and stress that you will be feeling on exam day, coupled with the time pressure you will be under. Many of the questions on this practice exam and the real exam are not individually difficult, so if you take extra time to answer the questions on this practice exam, your score will go up significantly. However, if you want an accurate measure of your potential performance on the exam, adhere to the 3-hour time limit.

After you have finished grading your sample exam, you may find it useful to use the exam questions and recommended solutions for review purposes (as flash review points). Many of these questions were specifically written for your use as study tools. Once again, I feel I should remind you not to memorize these questions; you will not see them on the actual exam. What you will see on the exam, though, are the concepts, terms, and procedures presented in these questions.

Your actual exam will most likely "look different" than what you see in this book. Please remember, no study provider knows the content of the actual exam. These sample exams are our "best guess" as to the structure and content of your actual exam.

Test Answers

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SAMPLE EXAM 2
AFTERNOON SESSION

The following 18 questions relate to Ethics.

1. An analyst for a foreign branch of HB Investments, which is based in Lagos, has just issued a recommendation on an IPO. Unknown to the analyst, who is a CFA charterholder, members of her team manipulated the valuation model to increase the newly public company's stock price. She and all of the analysts on the team purchased shares of the oversubscribed IPO for their personal accounts and then purchased the remainder of the firm's allocation of shares for appropriate client accounts, a practice which is permitted by local securities laws. Which of the following is **TRUE**? The analyst:
   A. did not violate the Standard I(A) Knowledge of the Law.
   B. violated Standard I(A) Knowledge of the Law by purchasing the shares of the IPO but not by allowing the report to be published.
   C. violated Standard I(A) Knowledge of the Law by allowing the report to be published and being associated with that activity but not by purchasing IPO shares.
   D. violated Standard I(A) Knowledge of the Law both by allowing the report to be published and by purchasing the shares of the IPO, and she should have reported and dissociated herself from both activities.

2. Eric Burke, CFA, is managing director at Washington Brothers, an investment advisory firm. He has been asked to accompany a research analyst and a portfolio manager from Washington Brothers to a meeting with an important client whose account has been managed according to a proprietary model. For the meeting, the research analyst has constructed a presentation that details the historical account performance as well as future expectations. Burke reviews the written presentation prepared by the research analyst for the client and sees that it states that the 20% the portfolio returned last year will be repeated over the coming year, but neglects to mention that market volatility is no longer stable, a key assumption of the model. Burke decides the report is acceptable and makes a presentation to the client in which he does not mention the role of stable volatility in the returns to portfolios based on the model. According to CFA Institute Standards of Professional Conduct, which of the following Standards have been violated by Burke or the research analyst?
   A. Standard III(B) Fair Dealing, and Standard IV(C) Responsibilities of Supervisors.
   B. Standard V(A) Diligence and Reasonable Basis, and Standard I(C) Misrepresentation.
   C. Standard III(C) Suitability, and Standard V(A) Diligence and Reasonable Basis.
   D. Standard I(C) Misrepresentation, and Standard III(C) Suitability.

3. John Anderson's company is participating in an acquisition. To speed up the process, his manager gave him a report from another company's analyst, also working on the project, and told Anderson to put it on company letterhead and distribute the report by the end of the day. If Anderson, who is a CFA Institute member, complies, which of the following CFA Institute Standards of Professional Conduct will he have violated?
   A. No violation.
   B. Standard II(A) Material Nonpublic Information.
   C. Standard I(C) Misrepresentation.
   D. Standard V(B) Communication with Clients and Prospective Clients.

4. Emily Wells, CFA, retail broker for Charthouse Securities, has been asked by a retail client to buy a substantial position in Computo Inc., a highly speculative company that is working on developing a solar-powered computer. Wells believes that this would be an inappropriate investment for the client. According to Standard III(C) Suitability, Wells should take which of the following actions?
   A. Execute the trade in accordance with the client's request, but mark the ticket "unsolicited."
   B. Execute the order if her supervisor approves the trade.
   C. Seek an affirmative statement from the client that suitability is not a consideration in this trade and refuse to execute the trade without such a statement.
   D. Execute the trade immediately because if the stock goes up, she is liable for the missed gains.

5. Jim James, CFA, supervises several financial analysts at his firm. James's compensation in the firm is tied to the commissions of the brokers in the firm. James tells Sally Jones, an analyst, to use a report prepared by a rival firm as the basis for her report. He tells her that she will need to make minor changes and that she can then put her name on the report before sending it to clients. The report contains a "Buy" recommendation on a stock in which James' supervisor owns a large stake. Which of the following statements is **TRUE**? If Jones complies with James' request:
   A. she has violated Standard I(C) Misrepresentation, but James has not.
   B. both she and James have violated Standard I(C) Misrepresentation.
   C. neither she nor James has violated Standard I(C) Misrepresentation.
   D. James has violated Standard I(C) Misrepresentation, but Jones has not.

6. Laura Grayson, CFA, is a partner in a small investment advisory firm that caters to high net worth individuals. Grayson also manages an investment account for her mother. Her mother's accountant has advised Grayson that for tax purposes, Grayson should sell her mother's position in Safety Airlines, realizing a large gain, and then immediately repurchase the position. Several of Grayson's clients also hold positions in Safety Airlines. According to the CFA Institute Standards of Professional Conduct, if Grayson follows the advice of the accountant, she:
   A. is not in violation of any Standards.
   B. is in violation of Standard III(B) Fair Dealing for not dealing fairly with all clients.
   C. is in violation of Standard II(B) Market Manipulation for engaging in a practice that will artificially inflate the trading volume of a security.
   D. is in violation of Standard III(C) Suitability for not considering the appropriateness of the trade with respect to her mother's investment objectives.

7. Judy Dudley, CFA, is an analyst and plans to visit a company that she is analyzing in order to prepare a research report. Standard I(B) Independence and Objectivity:
   A. requires Dudley to pay for all her own expenses and to not accept any gifts or compensation for writing a research report.
   B. requires Dudley to pay for her own transportation costs, to not accept any gifts or compensation for writing the report, but allows her to accept accommodations and meals that are not lavish.
   C. requires Dudley not to accept any compensation for writing a research report, but allows her to accept company paid transportation, lodging, and meals.
   D. allows Dudley to accept transportation, lodging, expenses, and compensation for writing a research report, but requires that she disclose such an arrangement in her report.

8. Campbell Hill, CFA, has recently joined a pension fund management company as its Chief Compliance Officer. One of Hill's first priorities in his new position is to formalize the company's investment policies and procedures. Hill distributes a memo stating that effective immediately, material supporting all company research reports will be kept in the company database in electronic form for ten years, while hard copies of the same material will be maintained for one year only. The memo also states that hard copy records of all material supporting investment-related communications with clients must be kept on file for five years (the period mandated by local regulations). With respect to Standard V(C) Record Retention, which of the following statements is TRUE?
   A. Only Hill's policies regarding research reports violate Standard V(C), because record retention refers to hard copy, not electronic records, and one year is not long enough.
   B. Hill's policies regarding both research reports and investment-related communications violate Standard V(C).
   C. Hill's policy regarding investment actions does not violate Standard V(C), but the policy regarding investment-related communications does because Standard V(C) requires records be kept for seven years.
   D. Neither of Hill's policies violates Standard V(C).

9. In calculating total firm assets for a GIPS-compliant performance statement, Allen Bundy, CFA, finds that there is a mix of fee-paying and non-fee-paying accounts, some of which are discretionary and some of which are non-discretionary accounts. Should Bundy include non-discretionary accounts and non-fee-paying accounts in the calculation of total firm assets?

	Non-discretionary accounts	Non-fee-paying accounts
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

10. Dawn Shepard, CFA, is a broker for a regional brokerage firm. Her company's research department has recently changed its recommendation on the common stock of Orlando, Inc. from "Buy" to "Sell." Concurring with the report's analysis, Shepard faxed the change to all her current customers who hold Orlando, Inc. in their accounts. The next day, one of her customers, who had never before expressed an interest in Orlando, calls and places a "buy" order for 500 shares of Orlando. According to Standard III(B) Fair Dealing, Shepard, under these circumstances:
   A. has complied with the Fair Dealing Standard and may accept the order because it is unsolicited.
   B. may accept the order, but must advise the customer of the change in recommendation before accepting the order.
   C. should delay executing the order until existing clients who bought on the original recommendations have an opportunity to act on the new recommendation.
   D. may accept the order only if the customer acknowledges in writing that she was notified of the change in the recommendation.

11. Paul James, CFA, is a retail stock broker for a national financial services corporation. James's client base is mainly comprised of small to medium-sized individual accounts. James notices that one client in particular, Chet Young, Ph.D., is particularly adept at picking undervalued stocks. James decides to watch Young's trades and mimic them in his own account. James:
   A. is in violation of Standard VI(B) Priority of Transactions because he is front running the client's account.
   B. is in violation of Standard V(A) Diligence and Reasonable Basis because he doesn't have a reasonable basis for his trades.
   C. is not in violation of any Standards.
   D. is in violation of Standard I(D) Misconduct because he has misappropriated confidential client information.

12. Nicholas Hart, CFA, is a retail broker for a national financial institution and has a client base composed mainly of high net worth individuals. During the past year, Hart's wife was extremely ill and was hospitalized for several months. Hart was financially responsible for her mounting medical bills and tried to pay them as best as he could. Despite his best efforts to meet his obligations, Hart was forced to declare personal bankruptcy, but did not disclose this to any of his clients. According to the CFA Institute Standards of Professional Conduct, Hart:
    A. is not in violation of any standard.
    B. is in violation of Standard V(B) Communication with Clients and Prospective Clients for not disclosing his bankruptcy to his clients.
    C. is in violation of Standard VII(A) Conduct as Members and Candidates in the CFA Program for compromising the integrity of the CFA designation.
    D. is in violation of Standard I(D) Misconduct for personal misconduct that reflects adversely on his professional reputation.

13. Marie Marshall, CFA, is a registered representative for Everest Broker-Dealer who maintains a client base of high net worth individuals, trusts, endowments, and foundations. Such clients pay Everest a quarterly fee, as well as reduced commission costs on securities transactions. Marshall receives compensation based on the overall success of the firm, along with a recently implemented quarterly bonus based on the trading volume in her clients' accounts. During her annual portfolio reviews with clients, Marshall receives several questions regarding recent increases in portfolio turnover. Marshall truthfully indicates that recent increases in volatility caused the firm to make more tactical investment recommendations in client portfolios which resulted in increased portfolio turnover during the period. By not disclosing the new compensation arrangement, Marshall has:
    A. violated Standard V(B) Communication with Clients and Prospective Clients.
    B. violated Standard IV(B) Additional Compensation Arrangements.
    C. violated Standard VI(A) Disclosure of Conflicts.
    D. not violated the Standards of Professional Conduct.

14. Chris Matlock, a CFA charterholder and an analyst for R&B Securities, is preparing a "Buy" recommendation on King Company. According to CFA Institute Standards of Professional Conduct, which of the following is *least likely* to be a conflict of interest that he would be required to disclose?
    A. Matlock's wife has a trust fund that holds King Company stock.
    B. Matlock's son works at King Company as a sales agent.
    C. Matlock has a consulting contract with King Company.
    D. R&B is a market maker for King Company stock.

15. Fred Reilly, CFA, an investment advisor at a regional office of a national financial institution, has been informed by a long-term client, Rob Harrison, that he would like to terminate the relationship and move his company's pension plan and his personal account to another firm. Reilly obliges and completes the paperwork to close the account. As Reilly gathers the files on Harrison's personal account to put into storage, he notices some discrepancies which lead him to suspect that Harrison has engaged in illegal activity with regard to company funds. Which of the following actions is most appropriate for Reilly to take under the Standards?
    A. Reilly informs Harrison's business partners of the suspected illegal activities because he is no longer a client, and they may have legal liability as well.
    B. Reilly reports his suspicions to governmental or regulatory authorities.
    C. Reilly does nothing since he must always maintain the confidentiality of client information even after they have left the firm.
    D. Reilly reports his suspicions to outside counsel.

16. Fred Dean, CFA, has just taken a job as trader for LPC, a large insurance company. One of his first duties in his new position is to execute the purchase of a block of East Street Industries, a firm that is a major client of his previous employer. During his prior employment, Dean was informed directly by East Street's CEO that the company's sales have experienced a sudden drop and are 20% below current analyst estimates. This information has not yet been announced. In reviewing the research report supporting the purchase decision, Dean realizes that the buy decision is based on sales forecasts that he knows are wrong. Which of the following actions would be the *most appropriate* for Dean to take according to CFA Institute Standards of Professional Conduct?
    A. Anonymously post the information about the drop in sales on an Internet bulletin board to achieve public dissemination of the information and inform his supervisor of the posting.
    B. Contact the CEO and urge him to make the information public and make the trade if he refuses.
    C. Share the information only with his immediate supervisor and the firm's compliance officer.
    D. Request that the firm place East Street's stock on a restricted list and refuse to make any buy or sell trades of the company's stock.

17. Firms that present at least five years of performance that complies with GIPS:
    A. may drop the oldest year's data as each new year of compliant performance is added.
    B. must supply this performance history to new prospects, but not to existing clients.
    C. can include non-compliant performance data for prior years.
    D. must supply a list of firm composites and their descriptions to all clients and all prospects.

18. Bob Sampson is employed by a mid-sized money management firm in Munich. He is the head portfolio manager for a Global Equities fund. The fund has been in existence for eight years, and Sampson has managed it for six years. Beginning this year, the firm has decided to present all of its performance information in compliance with the Global Investment Performance Standards (GIPS). Which of the following actions is required in order to claim GIPS compliance? The firm must present *at least*:
    A. five years of GIPS compliant performance information with no additional disclosure required for prior years.
    B. five years of GIPS compliant performance information and non-compliant performance information since inception in the "Disclosures" section.
    C. at least three years of GIPS compliant performance information and non-compliant performance information since inception in the "Disclosures" section.
    D. eight years of GIPS compliant performance information.

The following 14 questions relate to Quantitative Methods.

19. An investor wants to receive $10,000 a year for ten years with the first payment starting five years from today. If the investor can earn a 14% annual return, the amount that she will have to invest today is *closest* to:
    A. $27,091.
    B. $30,884.
    C. $52,161.
    D. $73,667.

20. Which of the following statements about the following frequency distribution is **FALSE**?

Return Interval	*Frequency*
0% to 5%	10
> 5% to 10%	20
> 10% to 15%	30
> 15% to 20%	20

A. The return intervals are mutually exclusive.
B. The cumulative absolute frequency of the fourth interval is 20.
C. The relative frequency of the second return interval is 25%.
D. The data set includes 80 observations with largest relative and absolute frequencies occurring in the third interval.

21. An analyst gathers quarterly sales data over five years for Tasty Chips, a maker of potato chips, and for the potato chip industry. The analyst plans to use a simple regression model (with industry sales as the independent variable) as an aid in predicting future sales levels for Tasty Chips. Part of the output of his regression analysis is a table containing the following elements:

- Sum of the squares regression (SSR) = 500.
- Sum of the squared errors (SSE) = 1,500.
- Sum of the squared total variation (SST) = 2,000.

Which of the following statements is most likely **CORRECT**? The coefficient of determination between firm sales and industry sales is:
A. 0.25, indicating that the variation in industry sales explains 25% of the variation in company sales.
B. 0.50, indicating that the variation in industry sales explains 25% of the variation in company sales.
C. 0.50, indicating that the variation in company sales explains 50% of the variation in industry sales.
D. 0.87, indicating that the variation in company sales explains 75% of the variation in industry sales.

22. An investor in a mutual fund earns a 25% return the first year, loses 25% in the second year, gains 30% in the third year, and then loses 30% in the fourth year. The average annual compound growth rate of this investment and the value of an initial $10,000 investment at the end of four years are *closest* to:

	<u>Compound growth rate</u>	<u>Ending value</u>
A.	–3.9%	$8,530
B.	0.0%	$8,530
C.	0.0%	$10,000
D.	–3.9%	$10,000

23. An analyst obtains the following annual returns for a group of stocks: 10%, 8%, 7%, 9%, 10%, 12%, 11%, 10%, 30%, and 13%. This:
A. distribution has a median greater than its mode.
B. distribution's arithmetic mean is 12 and the median is 10.5.
C. distribution is skewed to the right and the mean is less than the median.
D. distribution is skewed to the right and the mean is greater than the mode.

24. An analyst gathers the following data about the mean monthly returns of four securities.

Security	*Mean Monthly Return*	*Standard Deviation*
W	0.5	0.4
X	0.9	0.7
Y	1.2	4.7
Z	1.5	5.2

Which security has the lowest and highest level of relative risk as measured by the coefficient of variation?

	Lowest	Highest
A.	W	Y
B.	W	Z
C.	X	Y
D.	X	Z

25. Over a sample period, an investor gathers the following data about four mutual funds.

Mutual Fund	*Risk-Free Rate*	*Portfolio Return*	*Portfolio Standard Deviation*	*Portfolio Beta*
1	5%	12%	15%	1.0
2	5%	13%	18%	1.2
3	5%	15%	20%	1.4
4	5%	18%	24%	1.8

Based solely on the Sharpe measure, an investor would prefer mutual fund:
A. 1.
B. 2.
C. 3.
D. 4.

26. Which of the following statements about probability concepts is CORRECT?
A. A random variable is a quantity whose outcomes are certain.
B. Subjective probability is a probability that is based on personal judgment.
C. A conditional probability is the probability that two or more events happen concurrently.
D. An empirical probability is one based on logical analysis rather than on observation or personal judgment.

Use the following data to answer Questions 27 and 28.

Alex White, the current portfolio manager, is examining his portfolio. The portfolio contains 100 stocks that are either value or growth stocks. 40% of the stocks are value stocks. A previous portfolio manager selected 70% of the value stocks and 80% of the growth stocks.

27. What is the probability of selecting a stock at random that is a value stock and was selected by a previous portfolio manager?
    A. 25%.
    B. 28%.
    C. 40%.
    D. 48%.

28. What is the probability of selecting a stock at random that is either a value stock or was selected by a previous portfolio manager?
    A. 28%.
    B. 76%.
    C. 88%.
    D. 16%.

29. Which of the following statements about the normal distribution is FALSE? The normal distribution:
    A. has a mean of zero and a standard deviation of one.
    B. is completely described by its mean and standard deviation.
    C. is bell-shaped, with tails extending without limit to the left and to the right.
    D. has a mean, median, and mode that are equal.

30. A manager forecasts a bond portfolio return of 10% and estimates a standard deviation of annual returns of 4%. Assuming a normal returns distribution and that the manager is correct:
    A. the 90% confidence interval will be from 3.20% to 17.2%.
    B. there is a 95% probability that the portfolio return will be between 2.16% and 17.84%.
    C. the 1% confidence interval will be from −0.32% to 20.32%.
    D. there is a 32% probability that the portfolio return will be between 6% and 14%.

31. An investment has an expected return of 10% with a standard deviation of 5%. If the returns are normally distributed, the chance of losing money is *closest* to:
    A. 2.5%.
    B. 5.0%.
    C. 16.0%.
    D. 32.0%.

32. Which of the following statements about sampling and estimation is FALSE?
    A. Sampling error is the difference between the observed value of a statistic and the value it is intended to estimate.
    B. A simple random sample is a sample obtained in such a way that each element of the population has an equal probability of being selected.
    C. The central limit theorem states that the sample mean for large sample size will not be distributed normally regardless of the distribution of the underlying population.
    D. The sampling distribution of a statistic is the distribution of all the distinct possible values that the statistic can assume when computed from samples of the same size randomly drawn from the same population.

The following 12 questions relate to Economics.

33. The crowding-out effect suggests that:
A. expansionary fiscal policy leads to inflation.
B. restrictive fiscal policy is an effective weapon against inflation.
C. as government spending increases, so will incomes and taxes. The higher taxes will reduce both aggregate demand and output.
D. greater government deficits will drive up interest rates, thereby reducing private investment.

34. An economist is developing a regression model of real GDP as a function of labor input. She needs to select a time series that represents the total amount of labor performed in a year. Which of the following is the *most appropriate* indicator of total labor performed that she can use for this model?
A. Aggregate hours.
B. Average workweek.
C. Number of employed.
D. Total labor compensation.

35. The 1-year forward rate for the British pound is USD1.5670 and the spot rate is USD1.5530. The real rate of interest is 2% in all world economies. If expected inflation equals 3% in the U.S. and interest rate parity holds, the nominal interest rate in the U.K. is *closest* to:
A. 2.00%.
B. 4.06%.
C. 5.95%.
D. 5.00%.

36. Which of the following does the U.S. central bank most often use to change the money supply?
A. The discount rate.
B. The deposit expansion multiplier.
C. Open market operations.
D. The required reserve ratio.

37. Which of the following will cause an *increase* in the demand for labor?
A. An increase in the labor supply.
B. A decrease in labor productivity.
C. A decrease in the price of production machinery.
D. An increase in the demand for the final good or service.

38. In the short run, the impact of an increase in the money supply on the price level and real output will be:

	Price level	Real output
A.	Increase	Increase
B.	Increase	No change
C.	No change	Increase
D.	No change	No change

39. The law of diminishing marginal returns explains:
A. the shape of the long-run average cost curves.
B. the upward sloping portion of the short-run marginal cost curve.
C. the initial decrease in the short-run average costs.
D. the upward sloping portion of the long-run marginal cost curve.

40. A firm in a perfectly competitive market will tend to expand its output as long as:
A. its marginal revenue is positive.
B. the market price is greater than the marginal cost.
C. its marginal revenue is greater than the market price.
D. the market price is greater than the marginal revenue.

41. Which of the following statements regarding economic costs is TRUE?
A. Sunk costs involve setting aside payments to retire long-term debt.
B. In the long run, expected average marginal cost is the most relevant cost to the firm.
C. Fixed costs are not a consideration in the short run operating decision, but must be considered in the long run.
D. The marginal revenue from selling an additional unit of output must be at least as great as the expected average total cost.

42. The following table illustrates the domestic prices of items of similar quality—shoes, toys, and hats—in the United States and Mexico.

Item	*United States*	*Mexico*
Shoes	50	480
Toys	4	36
Hats	10	96

Assuming that one U.S. dollar exchanges for 12 Mexican pesos and that transportation costs are zero, which goods will tend to be imported into the U.S.?
A. The U.S. will import all three goods from Mexico.
B. Mexico will import toys and hats from the U.S. and export shoes to the U.S.
C. Mexico will import shoes from the U.S. and export toys and hats to the U.S.
D. The U.S. will import hats and shoes from Mexico and export toys to Mexico.

43. Which of the following statements about exchange rates is TRUE?
A. Non-U.S. dollar foreign exchange rate quotes are called cross rates.
B. In regular local direct exchange rates, the dollar is always in the denominator.
C. A quote of 1.67 Australian dollars (AUD) per U.S. dollar (USD) can be converted to a quote of 0.60 USD/AUD.
D. When the exchange rate goes from 0.6 AUD/USD to 0.7 AUD/USD, the AUD has appreciated relative to the USD.

44. A natural monopoly is *most likely* to exist when:
A. ATC increases as output increases.
B. economies of scale are great.
C. all production is divided up between just a few firms.
D. expensive natural resources are used in production.

The following 34 questions relate to Financial Statement Analysis and Corporate Finance.

45. Which of the following statements about types of nonrecurring items is FALSE?
   A. Unusual or infrequent items are reported "above the line" (before net income from continuing operations).
   B. Extraordinary items are unusual and infrequent items that are reported net of taxes "above the line."
   C. Discontinued operations are reported "below the line" (after net income from continuing operations but before net income) net of taxes.
   D. The cumulative effects of a change in accounting principles are reported in the income statement "below the line" net of taxes, before net income.

Use the following data to answer Questions 46 through 48.

• Net sales	$1,200
• Cost of goods sold	650
• Increase in inventory	100
• Decrease in A/R	25
• Increase in A/P	50
• Cash interest paid	45
• Dividends paid	25
• Cash interest received	20
• Sale of common stock	275
• Retirement of long-term debt	125
• Purchase of equipment	120

46. The company's cash flow from operations is:
   A. $425.
   B. $500.
   C. $650.
   D. $700.

47. The company's cash flow from investing is:
   A. –$150.
   B. –$120.
   C. $120.
   D. $150.

48. The company's cash flow from financing is:
   A. –$425.
   B. –$375.
   C. $125.
   D. $275.

49. Which of the following statements about the analysis of cash flows is FALSE?
   A. Interest payments on debt are not a financing cash flow.
   B. Dividends received are an operating cash flow.
   C. Both the direct and indirect methods involve adding back noncash items such as depreciation and amortization.
   D. When using the indirect method, an analyst should add any losses on the sales of fixed assets to net income.

50. Which of the following statements is TRUE, assuming stable inventory quantities? In a period of:
A. falling prices, FIFO results in higher COGS and higher taxes.
B. rising prices, LIFO results in higher cash flows and higher net income.
C. falling prices, LIFO results in lower working capital and FIFO results in lower inventory balances.
D. rising prices, FIFO results in higher taxes, lower cash flows and higher working capital while LIFO results in higher COGS and lower inventory balances.

51. An analyst gathered the following data about a company:

	1991	*2001*
Operating profit margin (EBIT/S)	0.15	0.10
Asset turnover (S/A)	1.5	1.8
Leverage multiplier (A/E)	1.5	1.6
Tax retention rate (1 – t)	0.7	0.7
Interest expense ratio (I/A)	0.05	0.05

The company's return on equity:
A. decreased because the company's profit margin fell.
B. increased because the company's leverage multiplier rose.
C. increased because the company's asset turnover increased.
D. remained constant because the company's fall in profits was offset by an increase in the asset turnover and the leverage multiplier.

52. Edelman Corp. has an operating profit margin of 8% on sales volume of $2 million. When Edelman's sales volume increased to $3 million, its operating profit margin rose to 10%. Edelman's operating leverage is:
A. 1.50.
B. 1.75.
C. 2.00.
D. 4.75.

Use the following data for Questions 53 and 54.

Bentlom Company's common sized financial statements show the following information:
- Earnings after taxes 15%
- Current liabilities 20%
- Equity 45%
- Sales $800
- Cash 10%
- Total assets $2,000
- Accounts receivable 15%
- Inventory 20%

53. Bentlom's total long-term debt-to-equity ratio and current ratio are *closest* to:

	Debt-to-equity ratio	Current ratio
A.	77.8%	2.25
B.	98.2%	2.50
C.	98.2%	2.25
D.	77.8%	2.50

54. Bentlom's after-tax return on equity (ROE) is:
    A. 6.0%.
    B. 12.0%.
    C. 13.3%.
    D. 18.0%.

55. Jerry Clark, CFA, has been hired to review the financial statements of a company by a client who values his knowledge and expertise. The client is considering investing in the company and is concerned that the company is being overly aggressive in its accounting practices. Which of the following company activities would **NOT** tend to increase current period net income?
    A. Due to a recent jump in prices, the company has decided to change its inventory valuation method from FIFO to LIFO.
    B. The company capitalizes its advertising costs and amortizes the costs over three years.
    C. The company routinely books the full value of any new contracts it obtains as revenue when at least 25% of the payment has been received.
    D. The company has decided to amortize operating expenses over an 18-month period instead of 12 months since its production process has been adjusted.

56. The following sequence of events involves a company's stock. The company:
    - Had 100,000 shares of common stock outstanding at the beginning of the year.
    - Issued 20,000 shares of common stock on June 1.
    - Issued a 10% stock dividend on July 1.
    - Issued 1,000, 10% bonds convertible into 21 shares of stock each, on September 1.

    Assuming the convertible bonds are dilutive, what is the weighted average number of shares that the company will use to compute its basic and diluted earnings per share?

	Basic	Diluted
A.	132,000	129,833
B.	122,833	129,833
C.	132,000	146,000
D.	122,833	146,000

57. An analyst gathered the following data about a company:
    - 1,000 common shares are outstanding (no change during the year).
    - Net income is $5,000.
    - The company paid $500 in preferred dividends.
    - The company paid $600 in common dividends.
    - The average market price of their common stock is $60 for the year.
    - The company has 100 warrants (for one share each) outstanding that are exercisable at $50.

    The company's diluted earnings per share is *closest* to:
    A. $3.83.
    B. $4.42.
    C. $4.55.
    D. $5.00.

58. How many of the following statements about the LIFO and FIFO inventory accounting methods are FALSE?
    I. For purposes of inventory analysis, FIFO is preferred over LIFO.
    II. FIFO cost of goods sold = LIFO cost of goods sold – change in LIFO reserve.
    III. In periods of declining prices, LIFO debt-to-equity ratios are higher than FIFO debt-to-equity ratios.
    IV. If LIFO cost of goods sold is overstated by $200,000, ending inventory will be understated by $200,000.
    A. None.
    B. One.
    C. Two.
    D. Three.

Use the following data for Questions 59 and 60.

A company uses LIFO and had a LIFO reserve of $90,000 in 2006 and $85,000 in 2005. The company's marginal tax rate is 28% and cost of goods sold is $100,000 for 2006.

59. 2006 year-end retained earnings, if the firm had used FIFO, would change by:
    A. $58,440.
    B. $27,550.
    C. $61,200.
    D. $64,800.

60. The change in 2006 net income if FIFO inventory costing had been used is:
    A. –$3,600.
    B. –$1,200.
    C. $1,200.
    D. $3,600.

61. A company using LIFO reports the following:
    - Cost of goods sold was $27,000.
    - The beginning inventory was $6,500 and the ending inventory was $6,200.
    - The beginning LIFO reserve was $1,200.
    - The ending LIFO reserve was $1,400.

    The *best* estimate of the company's cost of goods sold on a FIFO basis would be:
    A. $21,300.
    B. $26,800.
    C. $27,500.
    D. $28,400.

62. A company that capitalizes costs instead of expensing costs would have:
    A. higher income variability and higher cash flows from operations.
    B. lower cash flows from investing and lower income variability.
    C. lower cash flows from operations and higher profitability in early years.
    D. lower profitability in the earlier years and lower leverage ratios.

63. A company using straight-line depreciation reports gross investment in fixed assets of $100, accumulated depreciation of $50, and annual depreciation expense of $10. What is the average age and the average depreciable life of the fixed assets?

	Average age	Average depreciable life
A.	5 years	10 years
B.	5 years	5 years
C.	10 years	5 years
D.	10 years	10 years

64. Loose Truck, Inc. has cash of $100,000, accounts receivable of $500,000, and inventory of $400,000. The firm has accounts payable of $200,000, notes payable of $300,000, and long-term debt of $200,000. The firm wishes to increase its current ratio to 2.4. How much would current assets *or* current liabilities need to change in order to increase the current ratio to 2.4?

	Current assets	Current liabilities
A.	+$200,000	–$83,333
B.	+$200,000	+$83,333
C.	+$680,000	–$83,333
D.	+$680,000	+$83,333

65. A company issues $10 million in 8% annual, 5-year bonds, when the market rate is 8.25%. The initial balance sheet liability and liability one year from the date of issue are *closest* to:

	Initial liability	Liability one year later
A.	$9,900,837	$9,884,018
B.	$9,900,837	$9,917,656
C.	$10,000,000	$9,975,000
D.	$10,000,000	$10,025,000

66. Use the following data for a company leasing a machine with a capital lease:

- The lease period is ten years.
- The lease payments are $2,980.59 at the end of each year.
- The firm will own the asset at the end of the lease term but the salvage value will be negligible.
- 8.5% is the firm's incremental borrowing rate.
- 8% is the implicit lease rate.

If the company uses straight-line depreciation, the first year's reported lease expense is:

A. $2,635.
B. $2,980.
C. $3,200.
D. $3,600.

67. Which of the following is *least likely* to be an incentive for structuring a lease as an operating lease instead of a capital lease?

A. The period of use is short relative to the overall life of the asset.
B. The lessee is in a high tax bracket and the lessor is in a low tax bracket.
C. The corporate bond indenture contains specific covenants relating to financial policies that the company must follow.
D. Management compensation contracts contain provisions expressing compensation as a function of returns on invested capital.

68. When adjusting for off-balance-sheet financing, an analyst should NOT:
    A. ignore operating leases.
    B. treat the sale of receivables with recourse as borrowing and reduce cash flow from operations by the sale amount.
    C. increase liabilities for a commitment to buy $500 million in inventory over the next five years.
    D. adjust liabilities upward for direct or indirect debt guarantees for joint ventures and for investments in affiliates.

Use the following data for Questions 69 through 71.

An analyst identifies the following cash flows for an average-risk project:

- Year 0 –$5,000
- Years 1–2 $1,900
- Year 3 $2,500
- Year 4 $2,000 (The company's cost of capital is 12%)

69. The project's payback period and discounted payback period are *closest* to:

	Payback	Discounted payback
A.	2.63 years	3.9 years
B.	2.48 years	3.0 years
C.	2.63 years	3.0 years
D.	2.48 years	3.9 years

70. The project's net present value is *closest* to:
    A. $552.38.
    B. $770.96.
    C. $1,261.59.
    D. $3,300.00.

71. The project's internal rate of return is *closest* to:
    A. 14.32%.
    B. 15.83%.
    C. 18.26%.
    D. 23.19%.

72. For accounting information to be useful for an analyst, it should be reliable. Which of the following is *not* a characteristic of reliability?
    A. Predictive value.
    B. Verifiability.
    C. Representational faithfulness.
    D. Neutrality.

73. Sarah Evens has been studying the effects of takeover defenses on shareholder value. Evens is evaluating various uses of golden parachutes, poison pills and greenmail, all of which can affect share value. Good corporate governance requires a careful review of a firm's takeover defenses. When conducting this review, Evens should *most likely* consider which of the following a negative factor?

A. In a hostile bidder situation, the board would be willing to pay off such a bidder in cash to preserve the company's independence.
B. Shareholders have voted down an amendment to the bylaws that would have provided a poison pill.
C. A change of control issue would not trigger the interest of a local government.
D. The firm refuses to provide golden parachutes.

74. The following information applies to World Turn Co.:

- 10% rate of interest on newly issued bonds.
- 7% growth rate in earnings and dividends.
- The last dividend paid was $0.93.
- Shares sell for $16.
- Stock's beta is 1.5.
- Market risk premium is 6%.
- Risk-free rate of interest is 5%.
- The firm is in a 40% marginal tax bracket.

If the appropriate risk premium relative to the bond yield is 4%, World Turn's equity cost of capital using the dividend discount model (DDM) and the capital asset pricing model (CAPM), is *closest* to:

	DDM	CAPM
A.	13.2%	6.5%
B.	12.8%	14.0%
C.	13.2%	14.0%
D.	12.8%	6.5%

75. Which of the following statements regarding the weighted average cost of capital and the marginal cost of capital is **TRUE**?

A. The marginal cost of capital is always greater than the firm's average cost of funds.
B. The marginal cost of capital is likely to fall as the company raises additional capital due to economies of scale in financing.
C. The breakeven point where a firm runs out of retained earnings and must raise outside equity capital typically results in a decrease in the marginal cost of capital schedule.
D. When considering the marginal cost of capital schedule and the investment opportunity schedule, the maximum total capital budget before the firm must sell new shares of common stock and the dollar amount of retained earnings available are equal if the firm is financed solely with equity.

76. All of the following are problems associated with the internal rate of return (IRR) method of choosing investment projects **EXCEPT**:

A. using IRR to rank mutually exclusive projects assumes reinvestment of cash flows at the IRR.
B. for independent projects, the IRR and NPV can lead to different investment decisions.
C. for mutually exclusive projects, the IRR and NPV methods may result in different investment decisions.
D. if there are negative cash flows after time zero (sign changes from plus to minus and then back to plus), the result is multiple IRRs.

77. Two profitable companies are identical in financial and operating structure except for the following features:
    - Company A uses LIFO inventory accounting, whereas Company B uses FIFO.
    - Company B has certain take-or-pay contracts outstanding, whereas Company A uses notes payable to finance all of its inventory needs.
    - Company A employs the completed contract method to account for a new three-year project, whereas Company B employs the percentage-of-completion method.

    Using only this information, and assuming prices are rising, which of the following statements is *least likely true* concerning the current year's financial statements?
    A. Company A will report a lower change in retained earnings than Company B.
    B. Company A's earnings should be considered to be of lower quality relative to Company B.
    C. Company A will report a higher total debt-to-equity ratio when compared to Company B.
    D. Company A will experience higher levels of earnings variability relative to Company B.

78. Lester Brock is a research analyst preparing a research report on National Brick Company. The financials look solid, and he is contemplating issuing a "Buy" opinion on the stock. However, Brock does have concerns regarding the shareowner rights for equity investors. He is evaluating the shareowner rights of National Brick as outlined in the company's corporate governance statement and its articles of incorporation. Which of the following policies is detrimental to the shareowner rights of the company?
    A. The Company uses a third-party entity to tabulate shareowner votes.
    B. Shareowners can cast the cumulative number of votes allotted to their shares.
    C. Shareowners are permitted to vote either by paper ballot or a proxy voting service.
    D. Shareowners can approve changes to the corporate structure only with a supermajority vote.

The following six questions relate to Portfolio Management.

79. Which of the following statements about portfolio theory is *least accurate?*
    A. As the correlation between two assets increases, the benefits of diversification also increase.
    B. The optimal portfolio for each investor is at the point where her highest indifference curve is tangent to the efficient frontier.
    C. The efficient frontier represents the set of portfolios that has the highest rate of return for every given level of risk, or the lowest risk for every level of return.
    D. The inputs required for Markowitz portfolio optimization are the expected return for each asset available for investment, the standard deviation for each asset, and the correlation between each pair of assets.

80. Which of the following statements about risk is *least likely correct?*
    A. Total risk consists of systematic and unsystematic risk.
    B. The capital market line plots expected return against total risk.
    C. The efficient frontier plots expected return against unsystematic risk.
    D. The security market line plots expected return against systematic risk.

81. A portfolio manager is constructing a new equity portfolio consisting of a large number of randomly chosen domestic stocks. As the number of stocks in the portfolio increases, what happens to the expected levels of systematic and unsystematic risk?

	Systematic risk	Unsystematic risk
A.	Increases	Remains the same
B.	Decreases	Decreases
C.	Remains the same	Increases
D.	Remains the same	Decreases

82. The risk-free rate is 5% and the expected market return is 15%. A portfolio manager is projecting a return of 20% on a portfolio with a beta of 1.5. After adjusting for risk, this portfolio's return will:
A. be equal to the market.
B. outperform the market.
C. underperform the market.
D. be less risky than the market.

83. Refusing to invest in companies that sell tobacco products, alcohol, or products that are harmful to the environment would constitute a set of investment restrictions that would best be classified according to which one of the following investment constraint categories?
A. Liquidity.
B. Style investing.
C. Unique needs and preferences.
D. Factors that are considered to be either legal or regulatory.

84. An analyst is considering the merits of adding a new issue to an existing one-stock portfolio. As such, she needs to know the covariance and correlation coefficient between the two assets to assess the risk-return benefits of adding the new security.

Year	*Stock 1*	*Stock 2*
1999	12%	5%
2000	15%	0%
2001	–3%	10%

Given the above return data, the correlation coefficient between the two securities is *closest* to:
A. –0.93.
B. –0.90.
C. –0.30.
D. 0.30.

The following 36 questions relate to Asset Valuation.

85. Which of the following statements about types of orders is FALSE?
A. Market orders are orders to buy or sell at the best price available.
B. Limit orders are orders to buy or sell at or away from the market price.
C. A short sale is the sale of stock an investor does not own with the intent of buying it back later at a lower price.
D. A stop buy order is typically used to protect a short position in a security and is placed below the current market price.

86. Which of the following statements is NOT a technical point that affects short sales?
A. A short sale can only be placed on an uptick or a zero tick following an uptick.
B. The short seller must pay the lender of the stock any dividends paid by the company.
C. The short seller must initially deposit the same margin as an investor who has acquired the stock.
D. The short seller must subsequently replace the borrowed stock at a price lower than the price at which he or she sold the stock.

Use the following data for Questions 87 and 88.

An analyst gathered the following data for three stocks:

	Dec. 31, 2005		*Dec. 31, 2006*	
	Share Price	Outstanding Shares	Share Price	Outstanding Shares
Stock A	\$10	5,000	\$15	5,000
Stock B	\$40	10,000	\$30	10,000
Stock C	\$50	12,000	\$25	12,000

87. Assuming that December 31, 2005 is the beginning date of the index, the price-weighted index on December 31, 2005 and the holding period return on a price-weighted index for the year are *closest* to:

	Index value	HPR
A.	100	–36%
B.	33.33	–36%
C.	100	–30%
D.	33.33	–30%

88. If the beginning index value is 100, the ending value-weighted index equals:
A. 23.33.
B. 25.00.
C. 64.29.
D. 70.00.

89. Which of the following implications of stock market efficiency for technical analysis and fundamental analysis is *most correct?* If market prices are:
A. weak-form efficient, technical analysis that depends only on past trading data should be of limited or no value.
B. weak-form efficient, technical analysis that depends only on past trading data should be of substantial value.
C. semistrong-form efficient, fundamental analysis using the top-down approach should yield consistently superior returns.
D. semistrong-form efficient, fundamental analysis using only publicly available market information should generate abnormal returns after considering risk and transaction costs.

90. The following data pertains to a firm's common stock:
- The stock will pay no dividends for two years.
- The dividend three years from now is expected to be \$1.
- Dividends are expected to grow at a 7% rate from that point onward.

If an investor requires a 17% return on this investment, how much will the investor be willing to pay for this stock now?
A. \$6.24.
B. \$7.31.
C. \$8.26.
D. \$10.00.

91. An analyst forecasts the following for a stock:
- The normalized trailing price earnings (P/E) ratio will be 12X.
- The stock's price currently is $100.
- The stock is expected to pay a $5 dividend this coming year on projected earnings of $10.

If the analyst were to buy and hold the stock for the year, the projected rate of return based on these forecasts would be:
A. 10%.
B. 15%.
C. 20%.
D. 25%.

92. Brittany Smith, an analyst for Highflyers, Inc., is analyzing an industry. She has collected the following data regarding the industry:
- The demand in the industry is growing rapidly.
- Profit margins are high and growing.
- The number of competitors is expected to increase in the next few years, but competition is currently minimal.
- Return on equity (ROE) in the industry is currently above normal.

The industry is *most likely* in the:
A. pioneering phase.
B. mature growth phase.
C. market maturity phase.
D. rapid accelerating growth phase.

93. Which of the following is *least likely* an underlying assumption of technical analysis?
A. Supply and demand are governed solely by rational behavior.
B. Actual shifts in supply and demand can be observed in market price behavior.
C. The market price of any good or service is determined solely by the interactions of supply and demand.
D. Prices for individual securities and the market tend to move in trends that persist for long periods of time.

94. Which of the following statements about advantages of technical analysis is *least likely correct*? Technical analysis:
A. is not heavily dependent on accounting statements.
B. requires little subjective judgment in interpreting specific trading rules.
C. incorporates psychological as well as economic reasons underlying price changes.
D. permits analysts to recognize a movement to a new equilibrium without knowing the reason for the change.

95. Which of the following statements about the application of the constant growth dividend discount model to the valuation of an equity security is *least likely correct*? Other things being equal, the:
A. price is positively related to the growth rate and negatively related to the dividend.
B. required rate of return is negatively related to the price and positively related to the growth rate.
C. growth rate is positively related to the return on equity and negatively related to the dividend payout ratio.
D. price is positively related to return on equity (ROE) and negatively related to the investor's required rate of return.

96. Stephen Kroller, CFA, an analyst at J.P. Brothers LLC, analyzes international equity funds. Kroller constructs a sample of funds that have 10-year performance histories at a minimum. Based on the returns of the funds in his sample, Kroller concludes that international equity funds outperformed their comparable U.S. stock indexes over the 10-year period. Kroller's sample and test results are *most likely* subject to:
   A. nonsynchronous trading bias.
   B. no specific sources of bias.
   C. sample selection bias.
   D. survivorship bias.

97. Which of the following statements about the valuation of an option-free bond is *most likely correct*? Other things equal:
   A. a bond's value is more sensitive to yield increases than to yield decreases.
   B. the value of a long-term bond is more sensitive to interest rate changes than the value of a short-term bond.
   C. the value of a low-coupon bond is less sensitive to interest rate changes than the value of a high-coupon bond.
   D. whether the bond's value will increase or decrease when rates increase depends on whether the bond is selling at a discount, at par, or at a premium.

98. An investor is considering floating-rate debt and other investments to protect against unexpected increases in inflation. Her friend suggests Treasury Inflation Protected Securities (TIPS) because the coupon rate is adjusted for inflation semiannually. The friend also states on-the-run Treasury issues have narrower bid-ask spreads than other Treasury issues. Should the investor agree or disagree with the friend's statements about TIPS and on-the-run issues?

	TIPS	On-the-run issues
A.	Agree	Agree
B.	Agree	Disagree
C.	Disagree	Agree
D.	Disagree	Disagree

99. An investor in the 28% tax bracket is considering buying one of the following securities:
   - A fully taxable Treasury security offering a 6.0% yield.
   - A municipal bond offered at par offering a 4.0% yield.

   What is the after-tax yield on the Treasury and the taxable-equivalent yield on the municipal bond?

	After-tax yield on the treasury	Taxable-equivalent yield on the municipal
A.	4.32%	2.88%
B.	4.32%	5.56%
C.	6.48%	2.88%
D.	6.48%	5.56%

100. Which of the following statements about debt securities is *most likely correct*?
   A. On-the-run Treasury securities refers to older Treasury issues.
   B. Insured bonds are bonds collateralized by an escrow of securities guaranteed by the U.S. government.
   C. Tax-backed municipal bonds are supported through revenues generated from projects that are funded in whole or in part with the proceeds of the original bond issue.
   D. A collateralized mortgage obligation is a derivative of a passthrough security with a payment structure that redistributes risk among investors in various tranches.

101. An investor has a 1-year, semiannual, 10% coupon bond which is priced at $1,025. If the 6-month spot rate on a bond-equivalent basis is 8%, the 1-year theoretical spot rate as a BEY is:
   A. 6.4%.
   B. 7.3%.
   C. 8.0%.
   D. 8.2%.

102. The 3-year annual spot rate is 7%, the 4-year annual spot rate is 7.5%, and the 5-year annual spot rate is 8%. Based on the pure expectations theory of interest rates, the 1-year implied forward rate in four years is closest to:
   A. 7.00%.
   B. 7.75%.
   C. 9.00%.
   D. 10.00%.

103. A bond priced at par ($1,000) has a modified duration of 8 and a convexity of 50. If interest rates fall 50 basis points, the bond's price goes to approximately:
   A. $1,041.25.
   B. $1,040.00.
   C. $958.75.
   D. $875.00.

104. Which of the following statements regarding mortgage-backed securities (MBS) and collateralized mortgage obligations (CMOs) is *most likely correct*?
   A. MBS are created from CMOs.
   B. Creating CMOs does not reduce the overall prepayment risk of a mortgage passthrough security.
   C. The prepayment option of an MBS benefits the security holder.
   D. The cash flows received on the MBS are quite similar to those of a callable coupon bond.

105. Which of the following statements about embedded options is *least likely correct*?
   A. The call option on a bond cannot trade separately from the bond.
   B. An investor benefits when a floating rate bond has an interest rate floor.
   C. The prepayment right granted with a mortgage favors the issuer/borrower.
   D. If the market value of a putable bond falls below the par value, the issuer will likely exercise the option.

106. A $1,000 par, semiannual-pay bond is trading for 89.14, has a coupon rate of 8.75%, and has accrued interest of $43.72. The clean price of the bond is:
   A. $847.69.
   B. $891.40.
   C. $935.12.
   D. $1,000.00.

107. Which of the following is *least likely* the reason that floating rate bonds may trade at prices different from their par values?
   A. Sometimes the market rate exceeds the cap placed on the coupon rate.
   B. A time lag exists between the rate change in the market and the time when the coupon rate is reset.
   C. The fixed quoted margin on the floating rate security may differ from the margin required by the market.
   D. Resetting interest rates makes floating rate bonds more susceptible to the price risk that results from changing interest rates.

108. A domestic investor is purchasing foreign bonds. Which of the following statements regarding the exchange rate risk and price movement of the asset is *most correct?*
   A. The depreciation of both the asset and the foreign currency benefits the domestic investor.
   B. The depreciation of the asset and the appreciation of the foreign currency benefit the domestic investor.
   C. The appreciation of the asset and the depreciation of the foreign currency benefit the domestic investor.
   D. The appreciation of both the asset and the foreign currency benefits the domestic investor.

109. Which of the following statements about futures and forwards is *most correct?* Futures:
   A are subject to default risk, but forwards are not.
   B. are private contracts, but forwards are exchange traded.
   C. are individualized contracts, but forwards are standardized.
   D. require that traders post margin in order to trade, but forwards typically require no cash transaction until the delivery date.

110. Which of the following statements about futures markets is *most correct?*
   A. Speculators trade to reduce some preexisting risk exposure.
   B. Hedgers accept market risk in exchange for expected profits.
   C. Open interest is the number of futures contracts for which delivery is currently obligated.
   D. The role of the clearinghouse is to take an active position in the market to maintain a fair and orderly market by providing liquidity when the normal flow of orders is not adequate.

111. Which of the following statements about call options is *least likely correct?*
   A. American call options are more flexible and tend to be more valuable than European call options.
   B. The buyer of a call option has an obligation to perform.
   C. A call option is in-the-money when the strike price is below the stock price.
   D. The lower the strike price relative to the stock's underlying price, the more the call option is worth.

112. An investor notices that one Australian dollar is selling for $0.67 in U.S. dollars. A put option on an Australian dollar with an exercise price of $0.75 is selling for $0.14. An investor takes a long position of one Australian dollar and buys a protective put. What is the value of the strategy at expiration and what is the profit if the price of one Australian dollar at expiration is $0.70?

	Value at expiration	Protective put profit
A.	$0.75	–$0.06
B.	$0.75	$0.08
C.	$0.61	$0.08
D.	$0.61	–$0.06

113. A 3-year annual-pay currency swap takes place between a New Zealand company with New Zealand dollars (NZD) and a U.S. company with U.S. dollars (USD). The New Zealand company swaps NZD for USD on which it makes end-of-period payments based on the rate in effect at the beginning of each period. The U.S. company makes fixed-rate payments in NZD.
   - The fixed swap rate at the initiation of the swap was 7%; at the end of the swap it was 8%.
   - The variable rate at the end of year 1 was 6%, at the end of year 2 was 8%, and at the end of year 3 was 7%.
   - At the beginning of the swap, one million USD were exchanged at a NZD/USD rate of 2.
   - At the end of the swap period, the exchange rate was NZD/USD 1.5.

At the end of year 2, the:

A. New Zealand company gives the U.S. company USD60,000.
B. U.S. company gives the New Zealand company USD80,000.
C. New Zealand company gives the U.S. company USD80,000.
D. U.S. company gives the New Zealand company NZD160,000.

114. A dealer arranges an equity swap with a mutual fund. The notional principal on the swap is $50 million and quarterly payments have been scheduled. The mutual fund agrees to pay the dealer the return on the S&P 400 Midcap Index, which is currently at 1,038.4. Three months later it is 1,052.5. The dealer pays a fixed rate of 5.50% to the mutual fund with payments made on the basis of 91 days in the period and 365 days in the year. What is the net payment and who makes it?

A. Dealer pays $6,687.
B. Dealer pays $1,364,546.
C. Mutual fund pays $6,687.
D. Mutual fund pays $1,364,546.

115. Which of the following statements about the income approach to estimating a property's market value is *least likely correct*? The income approach:

A. ignores the effect of income taxes on an investment.
B. typically assumes that inflation probably won't affect the valuation.
C. views a property's value as the present value of its future income.
D. estimates the property's value using gross realized rental income less expenses, which include vacancy and collection losses, insurance, taxes, utilities, and repairs and maintenance.

116. A commercial office building would earn $2,000,000 annually if fully occupied. The building has a 7% vacancy rate and annual operating expenses of $250,000 a year. The interest costs of financing the purchase of the building would be $160,000 a year. The investor's marginal tax rate is 36%. The investor wants to earn 12% pre-tax return on this investment. Using the income approach, the value the investor would place on the office building would be *closest* to:

A. $12,083,000.
B. $12,563,333.
C. $13,416,667.
D. $14,583,333.

117. Allison Fletcher is analyzing a real estate investment with the following characteristics:

- Purchase price is $2.5 million.
- Down payment is $500,000, financing at 10%, with 20 annual end-of-year payments.
- Gross annual rents are $300,000.
- Depreciation is $60,000 per year.
- Maintenance and taxes are $35,000 per year.

If Fletcher is in a 35% marginal income tax bracket, the first year after-tax cash flow is *closest* to:

A. –$19,000.
B. $5,000.
C. $28,000.
D. $40,500.

118. All of the following are benefits of funds of funds (FOF) investing EXCEPT:

A. they may permit access to otherwise closed hedge funds.
B. they allow investors to diversify the risks of holding a single hedge fund.
C. the fee is generally quite reasonable since the investor only pays the manager of the FOF.
D. the manager of the FOF will usually have expertise in finding good-quality funds even though information on the investment strategies of funds is difficult to obtain.

119. Open-end funds differ from closed-end funds in that:
   A. open-end funds stand ready to redeem their shares, while closed-end funds do not.
   B. closed-end funds stand ready to redeem their shares, while open-end funds do not.
   C. closed-end funds require experienced fund managers, while open-end funds do not.
   D. open-end funds issue shares that are then traded in secondary markets, while closed-end funds do not.

120. Which of the following would be *least likely* to provide an effective hedge for an investor with a portfolio primarily in fixed-coupon bonds?
   A. Sell bond futures.
   B. Buy commodity-linked equities.
   C. Buy commodity options.
   D. Buy interest rate puts.