SAMPLE EXAM 1
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

1.	A	B	C	D
2.	A	B	C	D
3.	A	B	C	D
4.	A	B	C	D
5.	A	B	C	D
6.	A	B	C	D
7.	A	B	C	D
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94.	A	B	C	D
95.	A	B	C	D
96.	A	B	C	D
97.	A	B	C	D
98.	A	B	C	D
99.	A	B	C	D
100.	A	B	C	D
101.	A	B	C	D
102.	A	B	C	D
103.	A	B	C	D
104.	A	B	C	D
105.	A	B	C	D
106.	A	B	C	D
107.	A	B	C	D
108.	A	B	C	D
109.	A	B	C	D
110.	A	B	C	D
111.	A	B	C	D
112.	A	B	C	D
113.	A	B	C	D
114.	A	B	C	D
115.	A	B	C	D
116.	A	B	C	D
117.	A	B	C	D
118.	A	B	C	D
119.	A	B	C	D
120.	A	B	C	D

Sample Exam 1
Morning Session

The following 18 questions relate to Ethics.

1. Courtney Johnson, CFA, is an investment advisor in independent practice and provides investment services for equity securities. Johnson refers clients seeking fixed-income investments to the fixed-income department at Reliable Securities. Reliable Securities, in turn, provides Johnson with equity research. Johnson has not informed her clients of the arrangement with Reliable. Johnson's clients often praise her for obtaining such quality research and for referring them to Reliable for fixed-income investments that have consistently performed well. Has Johnson violated any CFA Institute Standards of Professional Conduct?
   A. Yes, because the soft dollars generated by the arrangement don't benefit all of the clients.
   B. No, because Johnson recommended high quality fixed-income managers.
   C. Yes, because her clients are unable to evaluate any partiality inherent in Johnson's recommendation of Reliable's services.
   D. No, because Johnson's clients have asked for a recommendation.

2. Russell Finley, CFA, is a managing director at Wilson Brothers, a regional brokerage firm. Finley manages the institutional fixed-income desk and is responsible for 20 employees in both the trading and sales departments. Finley recently called a meeting with the head of trading and the head of sales to review the firm's policies regarding trading by employees in their personal accounts. He instructed the two to review the information with the employees they supervise. A week after the meeting, Finley discovered that a sales assistant made personal trades during a firm "blackout" period on a restricted security. According to the Standards of Professional Conduct, Standard IV(C) Responsibilities of Supervisors, the *least appropriate* action for Finley to take is:
   A. to speak directly to the employee and attain assurance that the violation will not be repeated.
   B. begin an investigation to determine the extent of the wrongdoing.
   C. limit the employee's activities.
   D. increase the monitoring of the employee's activities at the firm.

3. Charlotte Stein, a CFA candidate, obtained a copy of a computerized stock selection model designed by a former MBA classmate who is a Wall Street analyst. After spending some time reviewing the program and making some adjustments, Stein showed the new model to her supervisor. Her supervisor said she did a great job and told Stein to incorporate the new model in her next industry review. She called her old classmate for permission, and he told her to go ahead and use the model, which she did without reference to her former classmate. Stein has:
   A. violated Standard I(C) Misrepresentation.
   B. violated Standard III (E) Preservation of Confidentiality.
   C. violated Standard V(B) Communication with Clients and Prospective Clients.
   D. not violated CFA Institute Standards of Professional Conduct.

4. Justin Matthews, CFA, is the CFO of a regional bank and serves on the bank's investment committee. The investment committee is considering the appropriate actions to take with regard to the bank's temporary surplus of cash. The committee, composed of analysts and investment personnel, recommends to the bank's CEO that the cash be invested in intermediate-term Treasury notes. Matthews feels that the recommendation is too conservative. However, Matthews is the only member of the independent committee that disagrees with the recommendation. In accordance with CFA Institute Standard of Professional Conduct, Matthews:
   A. must accept and support the decision of the committee.
   B. should decline to be associated with the recommendation.
   C. must privately express his concerns to his supervisor.
   D. should document his difference of opinion with the committee.

5. Howard Klein, CFA, supervises a group of research analysts, none of whom is a CFA charterholder or CFA candidate. He has attempted on several occasions to get his firm to adopt a compliance system to ensure that applicable laws and regulations are followed. The firm's principals, however, have never adopted his recommendations. According to CFA Institute Standards of Professional Conduct, Klein at this point:
   A. should decline in writing to accept supervisory responsibility until his firm adopts reasonable compliance procedures.
   B. needs to take no action because the employees are not CFA charterholders or CFA candidates.
   C. needs to take no action because he has fulfilled his obligations under CFA Institute standards.
   D. must resign from the company and document in writing his reasons for doing so.

6. Lisa Crocker, CFA, manages several pension accounts and directs most of her trades through the Zeta Brokerage House. Crocker does this because she believes she gets expedient and low-cost trade execution, and Zeta provides her with excellent research reports used in the management of these accounts. Regional, a small discount brokerage house, has just approached Crocker and said it will execute her trades at half the cost of Zeta. However, Regional does not have a research department. If Crocker does **NOT** switch her business to Regional, has she violated any CFA Institute Standards of Professional Conduct?
   A. Yes, because she has not obtained explicit permission from her clients to use Zeta.
   B. No, because she already had an established relationship with Zeta before Regional's offer.
   C. Yes, because Standard III(A) Loyalty, Prudence and Care states that she must minimize trade expenses.
   D. No, if the higher commissions are commensurate with the value of the research services she receives.

7. Katrina Anderson, CFA, is an investment advisor for Ringfellow Investments, an institutional investment manager with $5 billion in assets under management. Prior to joining Ringfellow, Anderson was in a similar position with a boutique firm that had $500 million in assets under management. Anderson left her previous employer on good terms, did not sign a non-compete agreement, and took no firm materials with her. According to CFA Institute Standards of Professional Conduct, which of the following statements is **TRUE**? Anderson:
   A. must wait 90 days before contacting clients of her previous firm.
   B. must seek permission from her previous employer before contacting clients of their firm.
   C. may contact clients of her previous firm immediately after ending her employment there.
   D. should not contact clients from her previous employment at all since it would harm her previous employer.

8. Richard Chambers, CFA, is a registered representative for Global Brokers. Chambers, who was a leading revenue producer in the firm's New York office, moved last week to the firm's new Botwari office to establish a revenue source in Asia. To develop a strong client base, Chambers follows firm practices and takes advantage of a local law allowing brokers to pay prospective clients as an inducement to gain their business. Chambers sometimes pays local accountants significant sums for referring wealthy clients to him as well, and he discloses this to the clients. Has Chambers violated CFA Institute Standards of Professional Conduct?
   A. No, Chambers has not violated the Code and Standards.
   B. Yes, Chambers has violated Standard III(B) Fair Dealing.
   C. Yes, Chambers is violating U.S. law, which puts him in violation of Standard I(D) Misconduct.
   D. Yes, Chambers has violated Standard VI(C) Referral Fees.

9. Isabelle Burns, CFA, is an investment advisor for a firm whose client base is composed of high net worth individuals. In her personal portfolio, Burns has an investment in Torex, a company that has developed software to speed up internet browsing. Burns has thoroughly researched Torex and believes the company is financially strong yet currently significantly undervalued. According to the CFA Institute Standards of Professional Conduct, Burns may:
   A. not recommend Torex as long as she has a personal investment in the stock.
   B. not recommend Torex to a client unless her employer gives written consent to do so.
   C. recommend Torex to a client, but she must disclose her investment in Torex to the client.
   D. recommend Torex to a client without disclosure as long as it is a suitable investment for the client.

10. Christopher Kim, CFA, is a research analyst for Batts Brothers, an investment banking firm in New York. Kim follows the energy industry and has frequent contact with industry executives. A CEO of a large oil and gas corporation that has previously employed Batts Brothers to underwrite a stock issue has invited Kim to his office to discuss a secondary offering of the company's stock. The CEO wants Batts Brothers to underwrite the stock issue. As an incentive to place the issue quickly with institutional investors, the CEO offers Kim the opportunity to fly on his private jet to his ranch in Texas for an exotic game hunting expedition if Kim's firm can place 90% of the issue within one month. According to CFA Institute Standards of Conduct, Kim:
   A. must not accept such lavish benefits in order to maintain his objectivity.
   B. must obtain written consent from Batts Brothers before accepting the invitation.
   C. may accept the invitation without consent if he submits a statement disclosing the value of the trip to Batts Brothers when he returns.
   D. may accept the invitation without consent only if he discloses the trip to Batts Brothers before accepting.

11. When GIPS and local laws conflict, in order to be in compliance with GIPS, the investment firm must:
   A. follow GIPS and need not reference the local law.
   B. follow local law, and no additional disclosure is required.
   C. follow GIPS but disclose that this is in conflict with local laws.
   D. follow local law but disclose the conflict with GIPS.

12. Kim Vance, a CFA candidate, tells a prospective client, "I may not have a long-term track record, but I am sure you will be satisfied with my performance. Over the three years I have been in the business, my equity-oriented clients have averaged a total return of more than 20% a year." The statement is accurate, but Vance only has a few equity clients, and one of these took a large position in a penny stock (against Vance's advice) and realized a huge gain. This large return caused the average of all of Vance's clients to exceed 20% per year. Without this one investment, the average gain would have been 10% per year. Has Vance violated CFA Institute Standards of Professional Conduct?

A. Yes, because the statement misrepresents Vance's track record.
B. No, because it is true and Vance has not assured such returns in the future.
C. Yes, because the equities composite she mentions does not qualify as a composite.
D. No, because it is true and Vance has not assured such returns in the future, but she must reveal the details behind the statement if asked.

13. Joseph Drake, CFA, is a portfolio manager for Best Investments. The fixed-income desk at Best has developed a new structured product that produces positive returns in a very wide range of interest rate scenarios. Drake thoroughly reads and evaluates an analytical report about the product and is impressed by its return profile. He faxes the cover page of the analysis, which includes the name of the author, to a client with objectives similar to that of the structured product, and handwrites a note to the client saying, "I think you should act quickly on this!" When the client calls requesting the entire report, Drake informs him that the research is proprietary and cannot be released. With respect to the CFA Institute Standards of Professional Conduct, is Drake in violation of Standard V(B) Communication with Clients or Prospective Clients or Standard III(C) Suitability?

	Standard V(B)	Standard III(C)
A.	No	No
B.	Yes	Yes
C.	No	Yes
D.	Yes	No

14. Brian Farley, CFA, is an independent portfolio manager. Currently, Farley's only client is a $75 million university endowment fund. A representative of the endowment fund calls Farley and places a "Sell" order on a portfolio holding whose management has just issued a negative earnings forecast. Farley also owns the security in his retirement account and immediately decides to sell his position. He places simultaneous "Sell" orders for both the client and for his personal account. According to the CFA Institute Standards of Professional Conduct, is Farley in violation of Standard III(B) Fair Dealing or Standard VI(B) Priority of Transactions?

	Standard III(B)	Standard VI(B)
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

15. Franklin Murphy is a trader and CFA Level 3 candidate who works for Wellington & Worrel Advisers. When selecting brokers for client trades, Murphy usually selects between Casanova Broker-Dealer (where he receives discounts on personal securities transactions) and Cedrock Brokers (where he receives investment research used in managing client portfolios). Both Casanova and Cedrock charge higher commission rates than other brokers used by Wellington & Worrel, and Cedrock provides more efficient trade execution than other brokers. According to Standard III(A) Loyalty, Prudence, and Care, Murphy:
   A. violates the Standard by directing trades to Casanova and directing trades to Cedrock.
   B. does not violate the Standard by directing trades to either Casanova or Cedrock.
   C. violates the Standard by directing trades to Cedrock but does not violate the Standard by directing trades to Casanova.
   D. violates the Standard by directing trades to Casanova but does not violate the Standard by directing trades to Cedrock.

16. Art Dodd, CFA, is a registered representative with Owens Securities. He is currently in a dispute with one client, Madge Phillips, CFP, about a limit order for her IRA account that she feels was entered incorrectly, resulting in a loss (in her opinion) of $500. Dodd has been allocated 1,000 shares of a new issue that is oversubscribed. He suggests to Phillips that he will give her 250 shares of his allocation if she forgets about the supposed trade error. Further, he offers to buy her dinner at a very nice restaurant that serves an excellent salmon Kulebyaka, which he suggests they pair with a nice 1997 white Cheval-Blanc Signé. According to the Standards of Practice, Dodd has *most likely* violated:
   A. Standard IV(B) Additional Compensation Arrangements only.
   B. Standard I(D) Misconduct *and* Standard IV(A) Loyalty.
   C. Standard III(B) Fair Dealing only.
   D. Standard I(D) Misconduct only.

17. Which of the following is **NOT** one of the eight major topics of the CFA Institute Global Investment Performance Standards (GIPS)?
   A. Fundamentals of Compliance.
   B. Real Estate.
   C. Private Equity.
   D. Venture Capital.

18. Graham Carson has served as investment advisor to Ron Grayson, a wealthy philanthropist, for one year. Grayson has called a meeting with Carson to discuss his disappointment with two of the portfolio stocks Carson had chosen last year. Grayson feels that in both cases, the individual securities possessed greater risk than he had agreed to in the investment policy statement. Carson reviews his notes and files pertaining to the account and sees that, according to his analysis at the time of the recommendations, the portfolio he recommended to Grayson was consistent with the risk and return objectives as well as the constraints of Grayson's portfolio as detailed in Grayson's most recent investment policy statement (IPS). The individual securities, however, were each quite risky and appeared even more so now, since they had performed so poorly. According to the CFA Institute Standards of Professional Conduct, Carson:
   A. is in violation of Standard III(C) Suitability and Standard V(A) Diligence and Reasonable Basis.
   B. is not in violation of Standard III(C) Suitability or Standard V(A) Diligence and Reasonable Basis.
   C. is in violation of Standard III(C) Suitability, but he is not in violation of Standard V(A) Diligence and Reasonable Basis.
   D. is not in violation of Standard III(C) Suitability, but he is in violation of Standard V(A) Diligence and Reasonable Basis.

The following 14 questions relate to Quantitative Methods.

19. Five years ago, an investor borrowed $5,000 from a financial institution that charged a 6% annual interest rate and immediately took his family to live in Nepal. He made no payments during the time he was away. When he returned, he agreed to repay the original loan plus the accrued interest by making five end-of-year payments starting one year after he returned. If the interest rate on the loan is held constant at 6% per year, what annual payment must the investor make in order to retire the loan?
    A. $1,338.23.
    B. $1,588.45.
    C. $1,638.23.
    D. $1,788.45.

20. If an investment of $4,000 will grow to $6,520 in four years with monthly compounding, the effective annual interest rate will be *closest* to:
    A. 11.21%.
    B. 12.28%.
    C. 12.99%.
    D. 15.75%.

21. An analyst constructs a histogram and frequency polygon of monthly returns for aggressive equity funds over a 20-year period. Which of the following statements about a histogram or a frequency polygon is **TRUE**?
    A. The height of each bar in a frequency polygon represents the absolute frequency for each return interval.
    B. A frequency polygon is a bar chart of continuous data that have been grouped into a frequency distribution.
    C. Both a histogram and a frequency polygon provide a graphical display of data found in a frequency distribution.
    D. To construct a histogram, the analyst would plot the midpoint of the return intervals on the x-axis and the absolute frequency for that interval on the y-axis, connecting neighboring points with a straight line.

22. 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*
X	$20	$10	$0
Y	$40	$50	$2
Z	$100	$105	$4

For the 1-year holding period, the portfolio return is *closest* to:
A. 6.88%.
B. 9.13%.
C. 13.13%.
D. 19.38%.

23. An analyst takes a sample of yearly returns of aggressive growth funds resulting in the following data set: 25, 15, 35, 45, and 55. What are the range, mean absolute deviation (MAD), and sample variance of the data set?

	Range	MAD	Variance
A.	20	12	250
B.	25	60	1,000
C.	40	12	250
D.	40	12	200

24. A security has annual returns of 5%, 10%, and 15%. The coefficient of variation of the security (using the population standard deviation) is *closest* to:
A. 0.3.
B. 0.4.
C. 0.5.
D. 0.6.

25. If an analyst concludes that the distribution of a large sample of returns is positively skewed, which of the following relationships involving the mean, median, and mode is *most likely*?
A. Mean = median = mode.
B. Mean > median > mode.
C. Mean < median < mode.
D. Mean > median < mode.

26. An analyst estimated the following regression between the change in real industrial production and industry sales: industry sales$_t$ = 8,950 + 395 × percentage change in real industrial production$_t$. Inflation is expected to be 3%. If industrial production was $1.2 trillion last year and is expected to be $1.25 trillion next year, the forecast for industry sales is *closest* to:
A. $9,397.
B. $9,610.
C. $10,396.
D. $10,596.

27. An investor opened an account by purchasing 1,000 shares of stock at $42 per share. One year later these shares were trading at $55/share, and the investor purchased 1,000 more shares. At the end of the second year the shares were trading at $54. The time-weighted and money-weighted rates of return on the account were:

	Time-weighted	Money-weighted
A.	13.4%	7.73%
B.	16.4%	5.26%
C.	16.4%	7.73%
D.	13.4%	5.26%

28. Which of the following distributions is *most likely* a discrete distribution?
A. A normal distribution.
B. A univariate distribution.
C. A multivariate distribution.
D. A binomial distribution.

29. An investment has a mean return of 15% and a standard deviation of returns equal to 10%. If the distribution of returns is approximately normal, which of the following statements is INCORRECT? The probability of obtaining a return:
    A. less than 5% is about 16%.
    B. greater than 5% is about 84%.
    C. greater than 35% is about 2.5%.
    D. between 5% and 25% is about 95%.

30. Which of the following statements about the central limit theorem is INCORRECT?
    A. The variance of the distribution of sample means is σ^2 / n.
    B. The central limit theorem has limited usefulness for skewed distributions.
    C. The mean of the population and the mean of all possible sample means are equal.
    D. When the sample size n is large, the sampling distribution of the sample means is approximately normal.

31. An analyst takes a random sample of the returns on 225 stocks from a population with a known variance of returns of 100. The standard error of the sample mean return would be *closest* to:
    A. 0.44.
    B. 0.67.
    C. 2.26.
    D. 6.67.

32. Which of the following statements about hypothesis testing involving a *z*-statistic is FALSE?
    A. The calculated *z*-statistic for testing a sample mean is $z = (\bar{x} - \mu) / (\sigma / \sqrt{n})$.
    B. The *p*-value is the probability of getting a test statistic (z) at least as far from the hypothesized value as the one calculated.
    C. A *z*-test is sometimes used in place of a *t*-test for tests concerning a mean when sample size is small.
    D. If the confidence level is set at 95%, the chance of rejecting the null hypothesis when in fact it is true is 5%.

The following 12 questions relate to Economics.

33. According to the crowding-out effect, which of the following statements is *least likely correct*? The sale of government bonds used to finance excess government spending will:
    A. raise the real interest rate.
    B. raise the nominal interest rate.
    C. reduce private investment spending.
    D. increase the profitability of corporate investment projects.

34. A reserve requirement of 20% implies a potential money deposit expansion multiplier of:
    A. 5.
    B. 8.
    C. 10.
    D. 20.

35. If the economy is just beginning to come out of a recession, which of the following would represent a typical sequence of phases in the business cycle?
    A. Expansion, business peak, contraction, recessionary trough.
    B. Expansion, business peak, recessionary trough, contraction.
    C. Depression, expansion, business peak, contraction.
    D. Depression, contraction, expansion, business peak.

36. Technically, an individual is unemployed when he or she is actively seeking employment or is:
   A. a retiree.
   B. in prison.
   C. a discouraged worker.
   D. waiting to return to a job from which he or she was just laid off.

37. The long-run production decision differs from the short-run production decision in that:
   A. variable costs can be changed in the short run but not the long run.
   B. variable costs can be changed in the long run but not the short run.
   C. fixed costs can be changed in the short run but not the long run.
   D. fixed costs can be changed in the long run but not the short run.

38. Which of the following statements about demand and consumer choice is *least likely correct*?
   A. The elasticity of demand for a good increases over time.
   B. In the short run, if the price of gasoline increases, consumption of gasoline will decrease by a smaller percentage.
   C. In the short run, if the price of a brand of flour increases, consumption of that brand of flour will decrease by a smaller percentage.
   D. If the cross elasticity of demand is negative, the goods are complements.

39. Which of the following statements about a monopolist is FALSE?
   A. The monopolist faces a downward sloping demand curve.
   B. Unlike an oligopolist, a monopolist will always be able to earn economic profit.
   C. A profit-maximizing monopolist will expand output until marginal revenue equals marginal cost.
   D. A profit-maximizing monopolist will supply less of its product than the amount that will maximize the benefits for the overall economy.

40. A market has the following characteristics: a large number of independent sellers each producing a differentiated product, low barriers to entry, producers face downward sloping demand curves, and demand is highly elastic. This description *most closely* describes:
   A. a monopoly.
   B. an oligopoly.
   C. pure competition.
   D. monopolistic competition.

41. The Mexican direct forward exchange rate with the U.S. dollar is higher than that indicated by interest rate parity. Which of the following choices would NOT be part of a currency trader's risk-free profit trading strategy?
   A. Sell USD at spot rate (USD/MXP).
   B. Sell USD forward.
   C. Lend USD at the U.S. interest rate.
   D. Borrow the Mexican Peso at the Mexican interest rate.

42. Accounting profit is often an unsatisfactory performance measure from an economic point of view because it:
   A. does not consider depreciation.
   B. does not consider the opportunity costs of equity capital.
   C. considers marginal costs rather than average costs.
   D. does not consider the impact of taxes.

43. In balance-of-payments accounts, the current account:
A. equals imports minus exports.
B. measures the flow of all investment funds and loans in the United States.
C. is the record of transactions with foreigners that involve either the exchange of ownership rights to real or financial assets, or the extension of loans.
D. is the record of all transactions with foreign nations that involve the exchange of merchandise goods and services, current income derived from investments, and unilateral gifts.

44. The *most likely* effects of the imposition of an effective increase in the minimum wage include:
A. an increase in the real wage, gains in efficiency, and a decrease in inflation.
B. increased unemployment, and excess supply of labor at the new wage rate, and a decrease in economic efficiency.
C. a reduction in non-monetary labor benefits, excess demand for labor, and a shortage of highly skilled workers.
D. a substitution of capital for labor, an increase in non-monetary labor benefits, and a decrease in economic efficiency.

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

45. A project has estimated revenues of $10.0 million and estimated costs of $7.5 million. The following table provides information on amount billed, cash received, and cost incurred for each year of the 3-year project (data are in $ millions).

	Year 1	*Year 2*	*Year 3*
Amount billed	3.0	4.0	3.0
Cash received	3.0	5.0	2.0
Cost incurred	2.0	3.0	2.5

Which of the following statements relating to the cumulative balance sheets and income statement at year-end is INCORRECT?
A. Using the revenue recognition method that tends to smooth income, the company will recognize profit of $0.83 million in year three.
B. If ultimate payment is assured and the cost estimates are unreliable, the company will recognize profit of $1.5 million in year 2.
C. Considering this project only and using the percentage of completion method, total assets at the end of year 3 will be $2.5 million.
D. In comparison to using the percentage of completion method, using the completed contract method will result in lower income, total assets, and shareholder equity during the construction period.

46. A company has a cash conversion cycle of 70 days. If the company's payables turnover decreases from 11 to 10 and receivable days increases by 5, which of the following statements is CORRECT? The company's cash conversion cycle will:
A. decrease by approximately 8 days.
B. decrease by approximately 3 days.
C. increase by approximately 3 days.
D. increase by approximately 2 days.

Use the following data to answer Questions 47 to 49.

A company had the following changes in its balance sheet accounts:

• Net sales	$500
• An increase in accounts receivable	20
• A decrease in accounts payable	40
• An increase in inventory	30
• Sale of common stock	100
• Repayment of debt	10
• Depreciation	2
• Net income	100
• Interest expense on debt	5

47. The company's cash flow from operations is:
    A. $10.
    B. $12.
    C. $92.
    D. $192.

48. The company's cash flow from investing is:
    A. $0.
    B. $2.
    C. $100.
    D. $110.

49. If the ending cash balance is $200, the beginning cash balance was:
    A. $90.
    B. $98.
    C. $110.
    D. $198.

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

• Net sales	$4,000
• Dividends declared	170
• Cost of goods sold	2,000
• Other cash expenses for inputs	500
• Long-term debt principal repayment	250
• Cash tax payments	200
• Purchase of new equipment	300
• Inventory increased by	100
• Accounts payable increased	300
• Depreciation expense	75

The company's cash flow from operations is:
    A. $1,200.
    B. $1,500.
    C. $1,405.
    D. $1,575.

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

• Cash flow from operations	$800
• Purchase of plant and equipment	40
• Sale of land	30
• Issuance of debt	200
• Payment of dividends	50

The company's free cash flow is:
A. $540.
B. $590.
C. $760.
D. $790.

52. A company uses cash to pay off a short-term notes payable. If the company's current ratio before the transaction is 2.0 times and the quick ratio was 1.0 times, how would this transaction affect the company's current, quick and debt ratios?

	Current ratio	Quick ratio	Debt-to-equity ratio
A.	Increase	Increase	Decrease
B.	Decrease	Decrease	Increase
C.	Increase	Remain unchanged	Decrease
D.	Decrease	Remain unchanged	Increase

53. The following data pertains to a company's common-sized financial statements.

• Current assets	40%
• Total debt	40%
• Net income	16%
• Total assets	$2,000
• Sales	$1,500
• Total asset turnover ratio	0.75

• The firm has no preferred stock in its capital structure.

The company's after-tax return on common equity is:
A. 15%.
B. 16%.
C. 20%.
D. 25%.

54. Which of the following statements about the calculation of earnings per share (EPS) is INCORRECT?
A. Other than for stock dividends and stock splits, shares issued enter into the computation from the date of issuance.
B. Shares issued after a stock split must be adjusted for the split.
C. Stock sold or issued in a purchase of assets is included from the date of issuance.
D. Reacquired shares are excluded from the computation from the date of reacquisition.

55. A company has 1,000,000 warrants outstanding at the beginning of the year, each convertible into one share of stock with an exercise price of $50. No new warrants were issued during the year. The average stock price during the period was $60, and the year-end stock price was $45. What adjustment for these warrants should be made, under the treasury stock method, to the number of shares used to calculate basic and diluted earnings per share (EPS)?

	Basic EPS	Diluted EPS
A.	0	166,667
B.	0	0
C.	166,667	166,667
D.	166,667	200,000

56. Which of the following statements about financial ratios is *most likely* accurate?
A. A firm that has a low receivables turnover will have a low current ratio.
B. A company with a high debt-to-equity ratio will have an ROA that's greater than its ROE.
C. Any firm with a high net profit margin will have a high gross profit margin and vice versa.
D. A company that has an inventory turnover of 6 times, a receivables turnover of 9 times, and a payables turnover of 12 times will have a cash conversion cycle of around 70 to 71 days.

57. Which of the following statements about last in, first out (LIFO) versus first in, first out (FIFO) is *least likely correct*? In periods of rising prices and stable or increasing inventory quantities, FIFO, compared to LIFO, results in:
A. lower cash flows and more taxes paid out.
B. higher net income and higher taxes paid out.
C. lower working capital and lower cost of goods sold.
D. lower cost of goods sold and higher inventory balances.

Use the following data to answer Questions 58 and 59.

During an accounting period a company has the following sequence of transactions with a beginning inventory of zero:

Purchases	*Sales*
100 units at $210	80 units at $240
90 units at $225	90 units at $250

58. If the company uses FIFO for inventory accounting, cost of goods sold (COGS) for the period is:
A. $36,750.
B. $36,908.
C. $37,050.
D. $41,250.

59. If the company uses LIFO for inventory accounting, ending inventory will be:
A. $4,200.
B. $4,300.
C. $4,400.
D. $4,500.

60. Patch Grove Nursery uses the LIFO inventory accounting method. Maria Huff, president, wants to determine the financial statement impact of changing to the FIFO accounting method. Select company information follows:

- Year-end inventory $22,000
- Year-end LIFO reserve $4,000
- Beginning of year LIFO reserve $3,000
- LIFO cost of goods sold $18,000
- After-tax income $2,000
- Tax rate 40%

Under FIFO, the nursery's ending inventory and after-tax profit would be:

	FIFO ending inventory	FIFO after-tax profit
A.	$18,000	$1,400
B.	$18,000	$2,600
C.	$26,000	$1,400
D.	$26,000	$2,600

61. Which of the following statements about capitalizing and expensing costs is **INCORRECT**?
A. Companies that capitalize costs will have lower debt-to-asset and debt-to-equity ratios than expensing companies.
B. Companies that expense costs will show the same total cash flows as the capitalizing firm but show higher early year profitability.
C. Companies that capitalize costs and depreciate them over time will show smoother reported income than expensing companies.
D. In the early years, companies that expense costs will have lower profitability ratios, such as return on assets and return on equity, than capitalizing companies.

62. Which of the following is **NOT** an indicator of impairment?
A. Large cost overruns.
B. Negative changes in the business climate.
C. The market value of an asset appreciates unexpectedly.
D. Current operating income, combined with a history of operating income losses, and a forecast of a large decline in the long-term profitability of the asset.

63. A company using straight-line depreciation has an ending gross investment in fixed assets of $750, an accumulated depreciation of $300, and an annual depreciation expense of $150. The average depreciable life of the fixed assets and the average age of the plant and equipment are:

	Depreciable life	Avg. age of P&E
A.	2 years	5 years
B.	5 years	2 years
C.	7 years	5 years
D.	8 years	2 years

64. An analyst gathered the following data about a depreciating asset:
- The company acquired the asset for $8,000.
- The asset has a 4-year useful life and no salvage value.
- The asset will generate $5,000 a year.
- The company's tax rate is 40%.
- For tax purposes, the asset can be depreciated (straight line) over two years.
- For financial accounting purposes the asset is depreciated (straight line) over four years.

Assuming a constant tax rate, what is the deferred tax liability at the end of the second year?

A. $0.
B. $400.
C. $800.
D. $1,600.

65. In accounting for taxes, which of the following statements about temporary and permanent differences is **FALSE**?

A. A permanent difference is reflected in the financial statements by adjusting the effective tax rate.
B. Gains or losses from carrying marketable securities at market value are permanent differences.
C. If a company has permanent but no temporary differences, tax expense equals taxes payable.
D. Tax-exempt interest revenue results in a permanent difference between taxable and pretax income.

66. In a recent meeting of the Board of Directors of Singh Semiconductors, the Board was discussing deferred taxes and the effective tax rate reconciliation disclosures. The Board wanted to learn more about this topic because low effective tax rates relative to the effective tax rates of comparable companies are a potential red flag. At the meeting the following two statements were made by Board members:

Statement 1: When analyzing a firm's effective income tax disclosures, analysts watch out for companies that generate high pretax income on their financial statements while reporting low taxes payable. The reason for this is that such companies are likely to be using aggressive accounting methods and have low-quality earnings.

Statement 2: When analyzing a firm's effective income tax disclosures, analysts watch out for companies that report large restructuring charges. Restructuring charges do not generally have tax cash flow effects in the year they are recorded but could have significant effects in future years.

Are Statements 1 and 2 as made by Singh Semiconductor's Board members *correct*?

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

67. A company has a long-term "take or pay" commitment with its major supplier. When calculating the company's financial ratios, a financial analyst should:

A. ignore the arrangement.
B. add the present value of the minimum future commitment to the company's debt only.
C. add the present value of the minimum future commitment to both the company's debt and assets.
D. subtract the present value of the minimum future commitment from the company's debt and assets.

68. Which of the following statements about leases is FALSE?
    A. If a lease is a capital lease and the lessor is not a dealer in the leased asset, the lease is a direct financing lease.
    B. If the lease is a capital lease and the lessor is a dealer or seller of the leased equipment, the lease is a sales-type lease on the books of the lessor.
    C. In a direct financing lease, the gross profit is recognized at the lease inception, while in a sales-type lease it is not.
    D. To be a capital lease for the lessor, the lease must qualify as a capital lease, be collectable, and contain no significant uncertainties concerning unreimbursable costs.

Use the following to answer Questions 69 through 71.

An analyst gathers the following data about a company:

- A target capital structure of 10% preferred stock, 50% common equity, and 40% debt.
- Outstanding 20-year, annual-pay, 6% coupon bonds selling for $894.
- Common stock selling for $50 per share that is expected to grow at 8% and expected to pay a $2 dividend.
- There is a 10% flotation fee on the sale of new common stock.
- The company's 5%, $100 par preferred stock currently sells for $90.
- The company's tax rate is 40%.

69. The after-tax cost of debt is:
    A. 3.9%.
    B. 4.2%.
    C. 4.5%.
    D. 5.1%.

70. The cost of common equity is:
    A. 9.0%.
    B. 12.0%.
    C. 9.0%.
    D. 15.1%.

71. The after-tax cost of preferred stock capital is:
    A. 5.0%.
    B. 5.6%.
    C. 5.9%.
    D. 6.3%.

72. Business risk is *best* described as resulting from the combined effects of a firm's:
    A. operating risk and leverage risk.
    B. sales risk and operating risk.
    C. financial risk and sales risk.
    D. operating risk and EPS volatility.

73. An investor has obtained the following information about Worldwide Industries, Inc.
    - Net profit margin 8.7%
    - Total asset turnover 2.4 times
    - Dividend payout ratio 35%
    - Tax rate 35%
    - Total sales $120 million
    - Total equity 40% of total assets

Based on this information, Worldwide's ROE is *closest* to:
A. 8.4%.
B. 14.5%.
C. 20.0%.
D. 52.2%.

74. An analyst determines that a company has a return on equity of 16% and pays 40% of its earnings in dividends. If the firm last paid a $1.50 dividend and the stock is selling for $40, what is the required rate of return on the stock?
A. 6.4%.
B. 9.6%.
C. 10.2%.
D. 13.7%.

75. On January 2, a company acquires some state-of-the-art production equipment at a net cost of $14 million. For financial reporting purposes, the firm will depreciate the equipment over a 7-year life using straight-line depreciation and a zero salvage value; for tax reporting purposes, however, the firm will use 3-year accelerated depreciation. Given a tax rate of 35% and a first year accelerated depreciation factor of 0.333, by how much will the company's deferred tax account increase in the first year of the equipment's life?
A. $931,700.
B. $1,064,800.
C. $1,730,300.
D. $2,662,000.

76. Which of the following is *irrelevant* in determining project cash flow for a capital investment?
A. Sunk costs.
B. Tax impacts.
C. Changes in net working capital.
D. Opportunity costs.

77. Winthur Publishing Company invests $800,000 in a printing press that will be depreciated on a straight-line basis over four years and will have a zero salvage value at the end of its life. Sales revenues, operating expenses, and net income for each year are shown in the table below.

	Year 1	*Year 2*	*Year 3*	*Year 4*
Sales	$480,000	$520,000	$640,000	$420,000
Cash expenses	220,000	180,000	360,000	140,000
Depreciation	200,000	200,000	200,000	200,000
Earnings before taxes	60,000	140,000	80,000	80,000
Taxes (at 30%)	18,000	42,000	24,000	24,000
Net income	42,000	98,000	56,000	56,000

What is the average accounting rate of return (AAR) of the printing press project?
A. 12.28%.
B. 15.75%.
C. 18.95%.
D. 24.55%.

78. Which of the following characteristics of a company's Board of Directors Audit Committee is *least likely* required to ensure that they are adequately representing shareowner interests?
A. Any conflicts between the external auditor and the firm are resolved in a manner that favors shareholders.
B. The shareholders vote on whether to approve of the board's selection of the external auditor.
C. The committee regularly reviews the performance, independence, skills, and experience of existing board members.
D. The external auditor is free from management influence.

The following six questions relate to Portfolio Management.

79. From a theoretical perspective, even though the assumption that investors can borrow and lend at the same (risk-free) rate is violated, a straight-line capital market line can still be constructed if:
A. investors are risk neutral.
B. there are no transaction costs.
C. a zero-beta portfolio exists and yields more than the risk-free rate.
D. margin accounts are allowed.

80. Which of the following is NOT among the usual investment constraints that should be considered?
A. Tax concerns.
B. Legal and regulatory factors.
C. Unique needs and preferences.
D. Adherence to the Standards of Practice.

81. Given the following correlation matrix, a risk-averse investor would *least* prefer which of the following two-stock portfolios (all else the same)?

Stock	*A*	*B*	*C*	*D*
A	+1			
B	−0.2	+1		
C	+0.6	−0.1	+1	
D	+0.8	−0.3	+0.5	+1

A. A and C.
B. C and D.
C. B and C.
D. B and D.

82. Which type of risk is positively related to expected excess returns according to the CAPM?
A. Unique.
B. Systematic.
C. Diversifiable.
D. Firm-specific.

83. Which of the following statements about the security market line (SML) and capital market line (CML) is TRUE?
A. The SML is a straight line, but the CML is a curve.
B. The SML involves the concept of a risk-free asset, but the CML does not.
C. The SML uses beta, but the CML uses standard deviation as the risk measure.
D. Both the SML and CML can be used to explain a stock's expected return.

84. The percentage of the variation in returns among institutional portfolios that can be explained by differences in target asset allocations is approximately:
A. 30%.
B. 50%.
C. 70%.
D. 90%.

The following 36 questions relate to Asset Valuation.

85. Jim Craig, CFA, has just started working on a small exchange and has been asked to set up the index. He is interested in examining the difference between a price-weighted and a market-weighted index. The following information is provided by the exchange:

	Stock A		*Stock B*		*Stock C*	
Day	Price	Shares	Price	Shares	Price	Shares
1	$6	200	$95	500	$10	1,000
2	$2	200	$100	500	$12	1,000
3	$7	50	$51	1,000	$16	1,000

- Prices shown are for the last transaction of each day.
- Prior to the start of trading on day 3, a 1-for-4 reverse stock split will be reflected for Stock A, and a 2-for-1 stock split will be reflected for Stock B.
- The market-weighted index is to be standardized to 500 on day 1.
- The initial divisor for the price-weighted index will be equal to 3.

The percentage change in the market-value-weighted index on day 2 is:
A. 6.30%.
B. 8.30%.
C. 12.74%.
D. 14.74%.

86. M. Gomez has purchased 100 shares of each of the stocks in the Dow Jones Industrial Average, a price-weighted index, and intends to reinvest cash dividends in additional shares. Assuming there are no stock splits, stock dividends, or changes in the make-up of the index, how will Gomez's portfolio return based on its initial value compare to that of the DJIA? His portfolio:
A. will have higher returns than the DJIA.
B. will return less than the DJIA because of commissions on reinvested dividends.
C. performance relative to the DJIA will depend on how low-price stocks perform relative to high-price stocks.
D. may do better or worse than the DJIA depending on whether the overall market goes up or down.

87. In the top-down valuation process, the analyst performs the following four actions:
1. Analyze the prospects for various industries.
2. Analyze the individual firms in the industries.
3. Pick the best stocks in the best industries under the economic forecast.
4. Examine the influence of the general economy on the securities markets.

In what order should the analyst perform these actions?
A. 1, 2, 3, 4.
B. 3, 2, 4, 1.
C. 4, 1, 2, 3.
D. 4, 2, 3, 1.

88. Rajiv Gupta completed an industry analysis and presented it to his supervisor for review. In the analysis he presented the degree of concentration and competition within the industry by calculating the four-firm concentration ratio and the Herfindahl index. Gupta noted that the largest five companies in the industry had market shares of 35%, 10%, 20%, 5% and 30%. Gupta used the Herfindahl index for the industry in order to make inferences about industry concentration in terms of its equivalence to that of an industry with a particular number of equal-size firms.

The four-firm concentration ratio and the industry equal-size firm equivalent are:

	Four-firm concentration ratio	Equivalent number of firms
A.	95%	4.8
B.	95%	3.8
C.	1.05	4.8
D.	1.05	3.8

89. For an option-free bond, what are the effects of the convexity adjustment on the magnitude (absolute value) of the approximate bond price change in response to an increase in yield and in response to a decrease in yield, respectively?

	Decrease in yield	Increase in yield
A.	Increase in magnitude	Decrease in magnitude
B.	Increase in magnitude	Increase in magnitude
C.	Decrease in magnitude	Decrease in magnitude
D.	Decrease in magnitude	Increase in magnitude

90. Which of the following alternatives *correctly* assigns the attractive investment opportunities that typically occur within the indicated stage of the business cycle?

	Business cycle stage	Investment opportunities
A.	Recovery	Commodities and cyclicals
B.	Early expansion	Bonds and real estate
C.	Entering recession	Real estate and interest-sensitive stocks
D.	Recession	Bonds and interest-sensitive stocks

91. If all other factors remain unchanged, which of the following would *most likely* reduce a company's price/earnings ratio? The:
A. dividend payout ratio increases, and the dividend growth rate increases.
B. return on equity is expected to increase, and the risk-free rate decreases.
C. dividend growth rate increases, and the required rate of return decreases.
D. required rate of return increases, and the dividend payout ratio decreases.

92. An analyst is asked to calculate the trailing P/E for AdMicro Systems (AMS) on November 15, 2003 when the share price is $27.50. The company's fiscal year ended December 31, 2002. Financial statements indicate that the earnings per share (EPS) for 2002 were $1.27, which included a nonrecurring item amounting to $0.12 per share. As of October 31, 2003, the trailing 12 months' EPS was $1.45 based on three quarters in 2003 and one quarter in 2002. When various nonrecurring and extraordinary items are taken into account, the adjusted EPS for the most recent 12 months is $1.10. Based on this information, the most appropriate P/E estimate the analyst should use for AMS is:
A. 18.97.
B. 21.44.
C. 23.91.
D. 25.00.

93. An analyst wants to determine a country risk premium for use in estimating the required return for foreign equities. Which of the following risks would the analyst be *least likely* to include in the country risk premium?
A. Default risk.
B. Political risk.
C. Business risk.
D. Liquidity risk.

94. Three years ago, at the advice of her financial planner, an investor purchased a $1,000 face, 4.50%, semiannual coupon bond with seven years to maturity priced to yield 6.50% for $888.94. The reinvestment income that must be generated over the life of the bond for the investor to realize a yield of 6.5% is *closest* to:
A. $72.
B. $76.
C. $80.
D. $83.

Use the following data to answer Questions 95 and 96.

Beachballs, Inc. expects abnormally high earnings for the next three years due to the forecast of unusually hot summers. After the 3-year period, their growth will level off to its normal rate of 6%. Dividends and earnings are expected to grow at 20% for years 1 and 2 and 15% in year 3. The last dividend paid was $1.00.

95. If an investor requires a 10% return on Beachballs, Inc., the price she is willing to pay for the stock is *closest* to:
A. $26.45.
B. $36.50.
C. $37.75.
D. $50.00.

96. If she is planning on selling Beachballs, Inc. after one year, the price will be *closest* to:
A. $28.45.
B. $36.50.
C. $38.94.
D. $41.88.

97. Which of the following statements about how various embedded options benefit the issuers or the bondholders is **FALSE**? The:
A. accelerated sinking fund provision favors the issuers.
B. floor placed under the floating coupon rate favors the bondholders.
C. conversion provision favors the bondholders if the stock price rises.
D. option-adjusted spread directly measures the value of the spread inclusive of the embedded option.

98. Which of the following statements about reinvestment risk of a security is FALSE? Reinvestment risk:
A. is minimized with zero-coupon bond issues.
B. becomes more problematic for those investors with longer time horizons.
C. becomes more problematic when the current coupons being reinvested are relatively small.
D. is present to a greater extent for those investors who depend on a bond's coupon for most of their return.

99. Which of the following statements about different types of bonds is *least likely correct*?
A. Municipal bonds are traded primarily on the New York Stock Exchange.
B. Tax-backed bonds are backed by the full faith and credit of the issuer's entire taxing power.
C. Government-sponsored enterprises issue securities directly in the marketplace, but federally related institutions generally do not.
D. Government agency issues of federally related institutions are typically backed by the full faith and credit of the U.S. government.

100. A 10%, 10-year bond is sold to yield 8%. One year passes, and interest rates remained unchanged (8%). Holding all other factors constant, the bond's price during this period:
A. will have increased.
B. will have decreased.
C. will have remained constant.
D. cannot be determined with the data given.

101. Which of the following statements regarding yield spreads is **INCORRECT**? The:
A. option value in percentage terms can be computed by subtracting the OAS from the zero-volatility spread.
B. static spread measures the yield spread over Treasuries after adjustments are made for the shape of the yield curve.
C. nominal yield spread measures the difference between the YTM on a risky bond, the YTM on a Treasury bond of similar maturity, and the yield on a risky bond.
D. static spread is the constant spread that is added to each Treasury spot rate to equate the present value of future bond cash flows to the price of a similar option-free bond.

102. Exactly one year ago, an investor purchased a $1,000 face value, zero-coupon bond with 11 years remaining to maturity. The YTM was 8.0%. Now, one year later, with market rates unchanged, an investor purchases an annuity that pays $40 every six months for 10 years. The combined value of the two investments based on the 8% BEY is *approximately*:
A. $966.
B. $1,000.
C. $1,007.
D. $1,456.

103. An analyst gathered the following information about a 15-year bond:
- 10% semiannual coupon.
- Effective duration of 7.6 years.

If the market yield rises 75 basis points, the bond's price will:
A. fall 5.4%.
B. rise 5.4%.
C. rise 5.7%.
D. fall 5.7%.

104. Which of the following relationships is INCORRECT?
A. Premium bond: coupon rate > yield to maturity; nominal yield > current yield.
B. Premium bond: nominal yield > current yield; current yield > yield to maturity.
C. Discount bond: coupon rate < yield to maturity; nominal yield < yield to maturity.
D. Discount bond: current yield < yield to maturity; nominal yield > yield to maturity.

105. An investor most concerned with reinvestment risk would NOT:
A. prefer a noncallable bond to a callable bond.
B. prefer a lower coupon bond to a higher coupon bond.
C. be more concerned in a decreasing interest rate environment.
D. eliminate reinvestment risk by holding a coupon bond until maturity.

106. For an asset-backed security (ABS), a special purpose vehicle:
A. sells an asset to the issuing corporation, which then proceeds to issue the ABS.
B. takes title to at least some of the firm's fixed assets.
C. is a legal entity responsible for separating assets used as collateral from those of the company seeking financing through an ABS.
D. acts as an intermediary that purchases an asset from the company issuing an ABS and then resells it to obtain sufficient liquid funds to provide collateral for the ABS.

107. The following interest rate information is observed:

	Spot Rates
1 year	10%
2 years	11%
3 years	12%

Based on this data, the 2-year forward rate one year from now is *closest* to:
A. 11%.
B. 12%.
C. 13%.
D. 14%.

108. Which of the following statements about theories of the yield curve is *most likely correct*?
   A. A liquidity preference cannot be consistent with a flat term structure of interest rates.
   B. The pure expectations theory cannot explain a humped term structure of interest rates.
   C. The pure expectations theory suggests that an upward-sloping term structure of interest rates is a consequence of investors expecting short-term rates to remain unchanged for a period of time, followed by investors expecting short-term rates to rise for a period of time.
   D. The liquidity preference theory suggests that a downward-sloping term structure of interest rates is due to investors expecting short-term rates to decline, and although there is a maturity premium to consider, it is not large enough to offset the expectation of declining short-term rates.

109. Which of the following statements about equity forward contracts is *least likely correct*?
   A. The primary risk managed by equity forwards is the uncertainty about dividend payments and their reinvestment.
   B. An asset manager can effectively lock in the price of a specific stock at a particular point in time if he can arrange for the sale of a forward contract on the stock through a reputable dealer.
   C. Selling a forward contract on the FTSE 100 would be an appropriate strategy for a U.K. asset manager who is concerned that equity prices might decline and wants to protect a portfolio with a level of risk that is similar to that of the index.
   D. A pension fund manager who wants to sell a specific group of stocks in the future can accomplish this by either selling a forward contract on each of the stocks or by selling a single forward contract on the portfolio of stocks she wants to sell.

110. Fletcher Miller 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 of $234,919 each.
   - Gross annual rents are $300,000.
   - Depreciation is $60,000 per year.
   - Maintenance and taxes are $35,000 per year.

   The building will be sold at the end of 2 years, producing net after-tax proceeds of $610,000 after the loan balance is repaid. Miller's client, the prospective purchaser, is in the 35% marginal income tax bracket.

   The NPV of this project at a 10% discount rate, based on these estimates is *closest* to:
   A. –$19,000.
   B. $28,000.
   C. $52,000.
   D. $64,000.

111. An industry has five firms with market shares of 45%, 25%, 15%, 10%, and 5%. Calculate the four-firm concentration ratio and the Herfindahl index for this industry.

	Concentration ratio	Herfindahl index
A.	55.00%	9.75%
B.	95.00%	9.75%
C.	55.00%	30.00%
D.	95.00%	30.00%

112. Consider a callable bond issued by Stahl Productions and a putable bond issued by Hearth Creations. Both bonds have option-adjusted spreads (OAS) of 125 basis points (bp). Which of the following statements about the bonds (from the issuer perspective) *could* be TRUE?
A. The *z*-spread for Hearth's bond is based on the differences in YTMs.
B. The cost of the put option on the Hearth bond is –10 bp.
C. The spread over the spot rates for a Treasury security similar to Stahl's bond is 110 bp.
D. Given a nominal spread for the Stahl bond of 130 bp, the option cost is 5 bp.

113. An investor buys a stock for $40 per share and simultaneously sells a call option on the stock with an exercise price of $42 for a premium of $3 per share. Ignoring dividends and transaction costs, what is the maximum profit the writer of this covered call can earn if the position is held to expiration?
A. $2.
B. $3.
C. $5.
D. $8.

114. Consider the following two statements about putable bonds:

Statement #1: As yields rise, the price of putable bonds will fall more quickly than similar option-free bonds (beyond a critical point) due to the decline in value of the embedded put option.

Statement #2: As yields fall, the price of putable bonds will rise more quickly than similar option-free bonds (beyond a critical point) due to the increase in value of the embedded put option.

Should an analyst agree or disagree with these statements?

	Statement 1	Statement 2
A.	Agree	Agree
B.	Disagree	Disagree
C.	Agree	Disagree
D.	Disagree	Agree

115. Which of the following statements about valuation techniques for real estate is *least likely correct*? The:
A. cost approach to valuation is based on what it would cost to rebuild the property at today's prices.
B. sales comparison method and hedonic price estimation to valuing real estate consider similar properties in the analysis.
C. sales comparison approach to valuation is based on the sales price of properties similar to the subject property.
D. income approach to valuation calculates the property's value as the present value of its future annual after-tax cash flows, ignoring financing costs.

116. Biggs, Inc. is considering a real estate investment that provides gross revenues (if fully occupied) of $250,000, a vacancy rate of 4%, and operating expenses of $15,000. The property costs $1,000,000, and the depreciation expense on the property is 2.6% of the cost in the first year and 1.3% of the cost over the next several years. The marginal tax rate is 35%. The after-tax cash flow in year one from the potential investment is:
A. $69,650.
B. $129,350.
C. $146,250.
D. $155,350.

117. All of the following are common features of alternative investments EXCEPT:
  A. illiquidity.
  B. readily available risk and return data.
  C. it is difficult to determine their current market value.
  D. as an asset class, they raise unique legal and tax considerations.

118. The term "mezzanine financing" is used to describe the financing that:
  A. provides for major company expansion.
  B. represents capital provided to initiate commercial manufacturing.
  C. provides capital that supports product development and market research.
  D. provides capital immediately preceding an initial public offering.

119. An analyst has been hired to evaluate a venture capital opportunity by a syndicate of interested potential investors. The analyst estimates the probability that the project will fail in the first year as well as the conditional probability of failure in each of the remaining four years of the project, as follows:

Year	*1*	*2*	*3*	*4*	*5*
Failure probability	0.25	0.20	0.20	0.15	0.10

The syndicate has told the analyst that he will have to put up $2 million initially and believe that he will reap a windfall payoff of $20 million at the end of the fifth year when he plans on taking the new venture public through an initial public offering. Because of its high risk, the required rate of return on the invested equity is 25%. Based on this information, the expected NPV of the project is *closest* to:
  A. $406,480.
  B. $1,265,600.
  C. $1,672,080.
  D. $2,553,600.

120. Keisha Lewis, CFA, is reviewing a study done by Gregory Haynes, a junior analyst who works at her firm. Haynes is examining the elements of risk that relate to global industry analysis. In his report, Haynes makes the following statements:

Statement #1: A source of risk that results from competition in markets can be assessed by considering the relation between the standard deviation of prices and the standard deviation of costs.

Statement #2: Government involvement may provide some companies with an advantage by giving these firms a type of subsidy, while other regulations that are imposed may be a disadvantage to firms competing in a given industry.

Should Lewis agree or disagree with these statements?

	<u>Statement 1</u>	<u>Statement 2</u>
A.	Agree	Agree
B.	Agree	Disagree
C.	Disagree	Agree
D.	Disagree	Disagree

Sample Exam 1
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

1.	A	B	C	D
2.	A	B	C	D
3.	A	B	C	D
4.	A	B	C	D
5.	A	B	C	D
6.	A	B	C	D
7.	A	B	C	D
8.	A	B	C	D
9.	A	B	C	D
10.	A	B	C	D
11.	A	B	C	D
12.	A	B	C	D
13.	A	B	C	D
14.	A	B	C	D
15.	A	B	C	D
16.	A	B	C	D
17.	A	B	C	D
18.	A	B	C	D
19.	A	B	C	D
20.	A	B	C	D
21.	A	B	C	D
22.	A	B	C	D
23.	A	B	C	D
24.	A	B	C	D
25.	A	B	C	D
26.	A	B	C	D
27.	A	B	C	D
28.	A	B	C	D
29.	A	B	C	D
30.	A	B	C	D
31.	A	B	C	D
32.	A	B	C	D
33.	A	B	C	D
34.	A	B	C	D
35.	A	B	C	D
36.	A	B	C	D
37.	A	B	C	D
38.	A	B	C	D
39.	A	B	C	D
40.	A	B	C	D
41.	A	B	C	D
42.	A	B	C	D
43.	A	B	C	D
44.	A	B	C	D
45.	A	B	C	D
46.	A	B	C	D
47.	A	B	C	D
48.	A	B	C	D
49.	A	B	C	D
50.	A	B	C	D
51.	A	B	C	D
52.	A	B	C	D
53.	A	B	C	D
54.	A	B	C	D
55.	A	B	C	D
56.	A	B	C	D
57.	A	B	C	D
58.	A	B	C	D
59.	A	B	C	D
60.	A	B	C	D
61.	A	B	C	D
62.	A	B	C	D
63.	A	B	C	D
64.	A	B	C	D
65.	A	B	C	D
66.	A	B	C	D
67.	A	B	C	D
68.	A	B	C	D
69.	A	B	C	D
70.	A	B	C	D
71.	A	B	C	D
72.	A	B	C	D
73.	A	B	C	D
74.	A	B	C	D
75.	A	B	C	D
76.	A	B	C	D
77.	A	B	C	D
78.	A	B	C	D
79.	A	B	C	D
80.	A	B	C	D
81.	A	B	C	D
82.	A	B	C	D
83.	A	B	C	D
84.	A	B	C	D
85.	A	B	C	D
86.	A	B	C	D
87.	A	B	C	D
88.	A	B	C	D
89.	A	B	C	D
90.	A	B	C	D
91.	A	B	C	D
92.	A	B	C	D
93.	A	B	C	D
94.	A	B	C	D
95.	A	B	C	D
96.	A	B	C	D
97.	A	B	C	D
98.	A	B	C	D
99.	A	B	C	D
100.	A	B	C	D
101.	A	B	C	D
102.	A	B	C	D
103.	A	B	C	D
104.	A	B	C	D
105.	A	B	C	D
106.	A	B	C	D
107.	A	B	C	D
108.	A	B	C	D
109.	A	B	C	D
110.	A	B	C	D
111.	A	B	C	D
112.	A	B	C	D
113.	A	B	C	D
114.	A	B	C	D
115.	A	B	C	D
116.	A	B	C	D
117.	A	B	C	D
118.	A	B	C	D
119.	A	B	C	D
120.	A	B	C	D

SAMPLE EXAM 1
AFTERNOON SESSION

The following 18 questions relate to Ethics.

1. Tony Roberts, CFA, is a portfolio manager at Delta Securities. He suspects a colleague, who is not a member or candidate, of ongoing activities that while not illegal, violate CFA Institute® Standards of Professional Conduct. Roberts and the colleague both report to the same managing director at Delta, and are both currently being considered for a promotion to senior portfolio manager. According to the CFA Institute Standards of Professional Conduct, all of the following are true **EXCEPT** that Roberts:
   A. is required to dissociate from the activities that violate the Code and Standards if they continue.
   B. is governed by the Code and Standards and not local law in this situation.
   C. may need to resign his position with Delta Securities in order to fully dissociate from the activities.
   D. must report the suspected violations of the Code and Standards first to his supervisor and then to CFA Institute.

2. Robert Miguel, CFA, is a portfolio manager for a large investment advisory firm. In appreciation for his impressive portfolio returns last quarter, one of his clients, Kevin Goodman, has invited Miguel and his wife to be his guests at his luxury suite for a major league baseball playoff game. Miguel, a baseball fan, accepts the invitation and attends the game. The next day at work, Miguel discusses the outcome of the game with his supervisor but doesn't mention the fact that he attended the game with a client. According to the CFA Institute Standards of Professional Conduct, Miguel's actions:
   A. are in violation of both Standard I(B) Independence and Objectivity and Standard I(A) Knowledge of the Law.
   B. are not in violation of Standard I(B) Independence and Objectivity or Standard I(A) Knowledge of the Law.
   C. are in violation of Standard I(B) Independence and Objectivity but are not in violation of Standard I(A) Knowledge of the Law.
   D. are not in violation of Standard I(B) Independence and Objectivity but are in violation of Standard I(A) Knowledge of the Law.

3. Ann Smith, CFA, calls Bill Jones, CFA, and tells him that her research shows that Biokem Company is underpriced and that earnings will exceed \$3.00 this year. Jones had never heard of Biokem before her call but knows that Smith is widely considered to be the best analyst in her sector. The report has been released publicly, and Smith tells Jones he's "welcome to it." After their conversation, Jones arranges a conference call with his firm's portfolio managers for whom Biokem is suitable and announces that his research indicates that Biokem is underpriced and will likely earn \$3.00 this year. During the call with the portfolio managers, Jones does not reference his conversation with Smith. According to the CFA Institute Standards of Professional Conduct, which of the following statements is *most accurate*? Jones:
   A. did not violate the Standards since Smith's comments were verbal.
   B. violated the Standards because he did not credit Smith as the source of his recommendation.
   C. did not violate the Standards because he did not actually see the research report that Smith produced.
   D. did not violate the Standards since Smith's recommendation had been released.

4. Doug Watson, CFA, serves in a sales position at Sommerset Brokerage, a registered investment advisor. As part of his employment, he is expected to entertain clients from time to time with dinners, professional sporting events, and golf outings. Frequently at these client outings, Watson drinks excessively. On one occasion, after dropping off a client, Watson was cited by local police for public intoxication. According to the CFA Institute Standards of Professional Conduct, is Watson in violation of either Standard I(A) Knowledge of the Law or Standard I(D) Misconduct?

	Standard I(A)	Standard I(D)
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

5. Kevin Richards is a performance analyst for Reliable Advisors, a retail investment advisory and consulting firm. Richards, who is a Level I CFA candidate, was hired as part of the firm's efforts to attract CFA candidates into critical areas of the firm, such as performance measurement and attribution. Richards' supervisor instructs him to reference the firm's compliance with GIPS in marketing materials to attract more clients. Which of the following about Richards' ability to reference GIPS compliance in marketing materials is **FALSE**? Reliable must:
   A. fully comply with GIPS to make a claim of compliance.
   B. apply GIPS compliance firmwide and not to a specific asset class only.
   C. claim compliance with GIPS only if it has a compliant performance history of five or more years.
   D. include all discretionary fee-paying accounts in composites based on their investment objectives and/or strategies.

6. Peter Taylor, a CFA charterholder and an analyst for a large investment firm, has been offered an all-expense-paid trip by Sweet Pineapple Co. to visit the firm's processing plants in Maui, Oahu, and Kauai. Taylor, a food industry analyst, has been following Sweet's stock for several years and recently issued a "Buy" recommendation on the stock. Taylor believes a review of the firm's processing facilities during its busy January harvest period would be an excellent opportunity for him to assess the firm's productive capacity and learn even more about their business. According to Standard I(B) Independence and Objectivity, it is recommended that Taylor:
   A. pay for his air travel and hotel expenses.
   B. obtain written permission from his employer before he accepts this offer.
   C. accept the expense-paid trip if he discloses the value of the trip in his next report.
   D. pay for all his travel expenses, including the cost of meals and incidental items.

7. Ruth Brett, a Level 1 CFA candidate, is a research analyst for a large investment firm. Due to a demanding work schedule with long hours, Brett was unable to attend any sort of exam preparation class, and has only been able to study sporadically. Feeling nervous and unprepared the night before the exam, Brett writes a few key notes on the bottom of her shoe. At the exam, Brett sees the large number of proctors present and decides not to risk getting caught looking at her shoe. According to the CFA Institute Code of Ethics and Standards of Professional Conduct, Brett is:
   A. not in violation of any standard because she did not use the notes.
   B. in violation of Standard VII(A) Conduct as Members and Candidates in the CFA Program for taking the notes into the examination room but is not in violation of the Code of Ethics.
   C. in violation of the Code of Ethics for bringing the notes into the examination room but is not in violation of any standard because she did not use the notes.
   D. in violation of both the Code of Ethics and Standard VII(A) Conduct as Members and Candidates in the CFA Program for taking the notes into the examination room.

8. Which of the following is NOT included in the CFA Code of Ethics? Members of CFA Institute must:
   A. use reasonable care and exercise independent professional judgment.
   B. strive to maintain and improve the competence of others in the profession.
   C. place their clients' interests before their employer's or their own.
   D. promote the integrity of capital markets.

9. In formulating her report on GammaCorp's common stock, Barb Kramer, CFA, did a complex series of statistical tests on the company's past sales and earnings. Based on this statistical study, Kramer stated in her report that GammaCorp's earnings growth for the next five years will average 15% per year. Her conclusion was based in part on a complex regression analysis with a high level of statistical significance. Has Kramer violated Standard V(B) Communication with Clients and Prospective Clients?
   A. No, because she believes her statements are true and didn't attempt to deceive clients.
   B. Yes, because she didn't give complete details of the statistical model used.
   C. Yes, because she failed to indicate that 15% growth is an estimate.
   D. No, because her statistical studies were diligently and carefully done, and her projections are within the generally accepted bounds of statistical accuracy.

10. Alpha Advisors Inc. is an investment management firm that has a client base that ranges from individuals to large foundations. Many of the firm's personnel responsible for managing larger accounts feel that Alpha must give these accounts "special service" in order to retain their business. Some of these employees have been responsible for developing and revising the firm's policies over time. Concerned that the policies might violate the CFA Institute Standards of Professional Conduct, the president of Alpha has been reviewing the firm's policies and procedures. Which of the following policies is *least appropriate* under the Standards? Alpha:
    A. monitors the personal trading activity of firm personnel and requires them to pre-clear personal trades through the compliance office.
    B. attempts to minimize the time that elapses between when an investment decision is made and when it is released.
    C. regularly calls larger accounts first after changes in investment recommendations have been faxed to all clients.
    D. excludes client accounts of family members of employees from participating in IPOs.

11. Dudley Thompson is a bond salesman for a small broker/dealer in London. His firm is the lead underwriter on a new junk bond issue for the Ibex Corporation. In order to stimulate sales of the new issue, Thompson calls all of his accounts over £1,000,000, many of which belong to elderly clients with low risk tolerances, and tells them that the Ibex issue is a fantastic opportunity for high returns that is not to be missed. Thompson also posts overly optimistic projections for Ibex's performance on several Internet "chat rooms" in order to increase the price of the bond issue and enhance his clients' returns on the investment. According to the CFA Institute Standards of Professional Conduct, is Watson in violation of Standard II(B) Market Manipulation or Standard III(C) Suitability?

	Standard II(B)	Standard III(C)
A.	No	No
B.	Yes	Yes
C.	No	Yes
D.	Yes	No

12. Rob Elliott, a CFA candidate, is an analyst with a large asset management firm. His personal portfolio includes a large amount of common stock of TECH Inc., a semiconductor company which his firm does not currently follow. The director of the research department has just asked Elliott to analyze TECH and write a report about its investment potential, which will be distributed to clients and prospective clients. Based on the CFA Institute Standards of Professional Conduct, the *most appropriate* course of action for Elliot to take would be to:
A. sell his shares of TECH before completing the report.
B. place his shares of TECH in a trust over which he has no control.
C. decline to write the report without specific approval of his supervisor.
D. disclose the ownership of the stock to his employer and in the report if he writes it.

13. Antonio Mendoza, CFA, is an investment manager in private practice under the name Mendoza Investments. He manages small- to medium-sized accounts for individual investors. Mendoza solicits new business by making brief presentations at area senior citizen centers, touting his investment performance record and compliance with the Global Investment Performance Standards. At each presentation, he makes available a 1-page information sheet that outlines his performance history for the past five years. His telephone number is on the sheet for prospective clients who wish to contact him for additional information. At the bottom of the sheet the following is stated: "Mendoza Investments has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®)." Has Mendoza's presentation violated Standard III(D) Performance Presentation or the Global Investment Performance Standards?

	Standard III(D)	GIPS
A.	No	No
B.	No	Yes
C.	Yes	Yes
D.	Yes	No

14. Anne Franklin, CFA, is an analyst who covers technology stocks for Medallion Investments. Franklin frequently meets with company management and makes site visits to company facilities. Cynthia Lucas, chief technology officer for Level Tech, tells several analysts, including Franklin, during a conference call that overseas shipments of the company's revolutionary product are going to be delayed due to manufacturing defects, which she expects are correctable. Medallion manages discretionary accounts for Lucas and Franklin. Subsequent to her meeting, Franklin sends a note to Medallion's investment personnel telling them to "sell the stock in all client accounts," as the shipment information is significant and impacts recent earnings guidance in the market. Franklin's use of the information received from Lucas:
A. violates the Code and Standards, as Franklin received material nonpublic information that should not have been acted upon.
B. violates the Code and Standards, since she directed the sale in all client accounts instead of acting in the best interests of her clients, the Lucas family.
C. does not violate the Code and Standards, as Franklin may have had suspicions about the new product already.
D. does not violate the Code and Standards, as Franklin was adhering to her fiduciary duty to Medallion's clients by sharing the information and recommending a "Sell."

15. R. J. Young is meeting with a new client for the first time. At this meeting, he will be gathering information about the client in order to assess the client's objectives and constraints. As he does for all of his clients, Young will then prepare a written investment policy statement (IPS). According to the recommended procedures for complying with Standard III(C) Suitability, which of the following statements regarding an IPS is FALSE?
A. An IPS should include personal as well as financial data.
B. An IPS should describe the roles and responsibilities of the adviser and client.
C. A member or candidate is not responsible for financial information withheld by the client.
D. A client's IPS should be updated at least quarterly to reflect any changes in their investment profile.

16. Marianne Riley, CFA, owns an investment firm that researches small- and mid-cap stocks. Riley's firm creates portfolios out of these stocks by utilizing a proprietary stock selection model that has successfully provided the firm's clients with at least a 10% return on investment in each of the last seven years. As a result of the outstanding performance, Riley's firm has seen their assets under management grow from $30 million to over $400 million. Before any of her clients or potential clients invest with the firm, Riley has a one-on-one meeting with them to explain the firm's investment process and the details of the stock selection model. Recently, after significant additional research and backtesting, Riley has expanded her research and the application of the model to include micro-cap stocks as well. New clients are made aware of this during initial meetings. Riley has violated:
A. Standard I(C) Misrepresentation.
B. Standard I(C) Misrepresentation and Standard V(A) Diligence and Reasonable Basis.
C. Standard V(A) Diligence and Reasonable Basis and Standard V(B) Communication with Clients and Prospective Clients.
D. Standard V(B) Communication with Clients and Prospective Clients.

17. According to Standard III(A) Loyalty, Prudence, and Care, which of the following statements regarding the voting of proxies on client holdings is FALSE?
A. Voting proxies is an important part of an investment management fiduciary duties.
B. Proxies have economic value to a client.
C. An investment management firm should vote all proxies on client holdings unless the client reserves that right.
D. Members and candidates should explicitly disclose the firm's proxy voting policies to clients.

18. Alvin Gold, CFA, resides in Country A and does business as an investment advisor primarily in Country B. Country A prohibits participation by investment advisors in IPOs, allows trading on non-public information, and does not require disclosure of referral fees. Country B allows participation in IPOs by investment advisors, prohibits trading on non-public information gained by illegal means, and requires disclosure of referral fees of over $100 (U.S. equivalent). Regarding accepting a referral fee of $75 and trading on the basis of material non-public information received in the course of a meeting with two other analysts and the firm's CFO, Gold:
A. need not disclose the referral fee but cannot trade on the non-public information.
B. need not disclose the referral fee and may trade on the non-public information.
C. must disclose the referral fee and cannot trade on the non-public information.
D. must disclose the referral fee but may trade on the non-public information.

The following 14 questions relate to Quantitative Methods.

19. In three years an investor deposits the first of eight $1,000 payments into a special fund. The fund will earn interest at the rate of 5% per year until the end of the fifth year. Thereafter, all money accumulated in the fund will earn a reduced interest rate of 4% compounded annually until the end of the tenth year. How much money will the investor have in the fund at the end of ten years assuming no withdrawals are made?
    A. $8,416.32.
    B. $8,872.93.
    C. $9,251.82.
    D. $9,549.11.

Use the following data to answer Questions 20 and 21.

An investor places $5,000 in an account. The stated annual interest rate is 6% compounded monthly.

20. The value of the account at the end of three years will be *closest* to:
    A. $5,955.
    B. $5,970.
    C. $5,978.
    D. $5,983.

21. The effective annual interest rate is *closest* to:
    A. 6.00%.
    B. 6.09%.
    C. 6.17%.
    D. 6.18%.

22. The initial market value of a portfolio was $100,000. One year later the portfolio was valued at $90,000 and two years later at $99,000. The portfolio's arithmetic and geometric mean annual returns excluding any dividend income are:

	Arithmetic mean	Geometric mean
A.	−1.0%	0.0%
B.	−1.0%	+0.5
C.	0.0%	−0.5
D.	0.0%	0.0

23. A college endowment fund has $150 million. The fund manager intends to withdraw $2 million from the fund for operations, and she has a minimum year-end acceptable level of $151 million. The fund has two choices for the portfolio. The endowment manager can choose Portfolio A, which has an expected return of 10% and a standard deviation of 14%, or Portfolio B, which has an expected return of 12% and a standard deviation of 20%. Given this scenario, which of the following statements regarding Roy's safety-first criterion is TRUE?
    A. The threshold (R_L) is equal to 0.03.
    B. Portfolio B should be chosen because it has a safety-first ratio (SFRatio) of 0.50.
    C. Portfolio A should be chosen because it has a SFRatio of 0.57.
    D. Portfolio A and B are both acceptable, because the SFRatios fall in the acceptable range.

24. An investor purchases 500 shares of Nevada Industries common stock for $22.00 per share today. At t = 1 year, this investor receives a $0.42 per share dividend (which is not reinvested) on the 500 shares and purchases an additional 500 shares for $24.75 per share. At t = 2 years, he receives another $0.42 (not reinvested) per share dividend on 1,000 shares and purchases 600 more shares for $31.25 per share. At t = 3 years (just before the dividend payment), he sells 1,000 of the shares for $35.50 per share and the remaining 600 shares at $36.00 per share. Assuming no commissions or taxes, what is the money-weighted rate of return received on this investment?

A. 12.74%.
B. 14.29%.
C. 17.62%.
D. 18.49%.

25. An analyst performs a simple a regression of the price of W. Byrd stock versus the S&P 500 using monthly data points. The regression results give a sum of squares regression (MSR) of 2,700 and sum of squared errors (SSE) of 300. The standard error of estimate, $\text{SEE} = \sqrt{\frac{300}{58}} = 0.719$. Based on this information, the analyst must determine the number of months used to run the regression and must calculate the coefficient of determination. Which of the following choices is *closest* to the correct information?

	Number of months of data	R^2
A.	59	0.90
B.	59	0.95
C.	60	0.90
D.	60	0.95

26. Jane Acompora is calculating equivalent annualized yields based on the 1.3% holding period yield of a 90-day loan. The correct ordering of the equivalent annual money market yield (MMY), effective annual yield (EAY), and bond equivalent yield (BEY) is:

A. MMY < EAY < BEY.
B. MMY < BEY < EAY.
C. BEY < MMY < EAY.
D. BEY < EAY < MMY.

27. An analyst develops the following probability distribution about the state of the economy and the market.

Initial Probability P(A)	*Conditional Probability P(B × A)*	
Good economy 60%	Bull market	50%
	Normal market	30%
	Bear market	20%
Poor economy 40%	Bull market	20%
	Normal market	30%
	Bear market	50%

Which of the following statements is FALSE?

A. The probability of a normal market is 0.30.
B. The probability of having a good economy and a bear market is 0.12.
C. Given that the economy is good, the chance of a poor economy and a bull market is 0.15.
D. Given that the economy is poor, the combined probability of a normal or a bull market is 0.50.

28. An analyst estimates a stock has a 40% chance of earning 10%, a 40% chance of earning 12.5%, and a 20% chance of earning 30%. What is the stock's standard deviation of expected returns?

A. 5.00%.
B. 5.75%.
C. 7.58%.
D. 9.99%.

29. An investment manager has a pool of five security analysts he can choose from to cover three different industries. In how many different ways can the manager make the assignments given that order matters (i.e., analyst 1, industry 1; analyst 2, industry 2; analyst 3, industry 3 is not the same assignment as analyst 3, industry 1; analyst 2, industry 2; analyst 1, industry 3)?

A. 15.
B. 60.
C. 120.
D. 125.

30. Which of the following describes shortfall risk? Shortfall risk is the:

A. risk due to possible losses in the financial markets.
B. risk of failing to make a contractually promised payment.
C. loss over a particular period that will only be exceeded some specified percentage of the time.
D. probability that portfolio value will fall below some minimum acceptable level over some time horizon.

31. Based on a sample of 12 observations, an analyst is performing a test of the significance (at the 1% level) of a correlation coefficient according to the following set of hypotheses:

H_0: r = 0 versus H_a: r ≠ 0

The sample correlation coefficient (*r*) is 0.79. The analyst has available the following excerpt from a *t*-table.

Table of the Student's *t*-Distribution (one-tailed probabilities)

df	*p* = 0.01	*p* = 0.005
10	2.764	3.169
11	2.718	3.106
12	2.681	3.055

Based on this information, the analyst should:
A. reject the null since $t = 4.075 > t_{0.01}$, 12 df = 2.681.
B. reject the null since $t = 4.075 > t_{0.005}$, 10 df = 3.169.
C. fail to reject the null since $t = 2.075 < t_{0.01}$, 10 df = 2.764.
D. fail to reject the null since $t = 2.075 < t_{0.005}$, 11 df = 3.106.

32. Which of the following statements about hypothesis testing is FALSE?
A. Rejecting a true null hypothesis is a Type I error.
B. The power of a test is the probability of correctly rejecting the null hypothesis.
C. The comparison of the test statistic to the critical value is the key to assessing the validity of the hypothesis.
D. For a one-tailed test involving *X*, the null hypothesis would be H_0: X = 0, and the alternative hypothesis would be H_A: X ≠ 0.

The following 12 questions relate to Economics.

33. The problem associated with managers making decisions that benefit themselves at the expense of stockholders is called the:
A. shirking problem.
B. productivity problem.
C. poor manager problem.
D. principal-agent problem.

34. Assume an economy is operating at full employment and that the central bank announces a decrease in the growth rate of the money supply to reduce inflation, which market participants do not believe is credible. In the short run, are the directions of the impacts on employment and inflation the same or different, and in the long run, are the directions of the impacts on employment and inflation the same or different?

	Short run: Employment and inflation effects	Long run: Employment and inflation effects
A.	Same	Same
B.	Same	Different
C.	Different	Same
D.	Different	Different

35. Under the classification system used by the U.S. Bureau of Labor Statistics, which of the following people would **NOT** be considered unemployed? Someone who:
A. was terminated from his last job.
B. quit his previous job and is looking for new work.
C. is disabled and unable to return to work.
D. was laid off and is waiting to return to a previous job.

36. If the admission price for a rock concert is raised from $25 to $30, causing ticket sales to drop from 60,000 to 40,000, the price elasticity of demand for tickets is:
A. 0.25.
B. 0.50.
C. 1.82.
D. 2.20.

37. Which of the following statements about monopolists is *most likely* correct?
A. Without government intervention, monopolists will always earn profits.
B. A monopolist maximizes price where marginal revenue equals marginal cost.
C. If a monopolist increases the product price, total revenue will increase more than total costs.
D. Monopolists have imperfect information about demand.

38. Which of the following statements about the characteristics of a monopoly and those of an oligopoly is **FALSE**?
A. In an oligopoly, there are often substantial economies of scale.
B. In both a monopoly and an oligopoly, there are high entry barriers into the market.
C. In an oligopoly, the decisions of each seller are independent of the policies followed by competitors.
D. In a monopoly, there is a single seller of a well-defined product for which no good substitutes exist.

39. Which of the following arguments for explaining why nations adopt trade restrictions is the *least* valid?
A. New domestic industries should be protected for a time while they develop and reduce costs.
B. In the long run, trade restrictions protect the net number of jobs in the country by creating jobs.
C. Some industries are highly sensitive to national security, and their products should remain in the country.
D. Tariffs are used to prohibit foreign firms from selling products in the country at below cost in an attempt to gain market share.

40. The effects on the aggregate demand curve of an increase in expected future incomes and of an increase in the money supply, respectively are *most likely*:

	Increase in expected incomes	Increase in money supply
A.	Increase	Increase
B.	Increase	Decrease
C.	Decrease	Increase
D.	Decrease	Decrease

41. An investor is a British citizen working in London, England and observes that with GBP1 he can buy USD1.5664. He also observes that with USD1, he can buy CAD1.4034. Based on this information, what is the direct quote in Great Britain for the Canadian dollar?
A. 0.4549.
B. 0.6384.
C. 0.7126.
D. 2.1983.

42. Which of the following statements related to foreign currency spreads is FALSE?
    A. Current spot spreads are generally wider than forward spreads.
    B. The more widely a currency is traded, the narrower the spread.
    C. Quoted spreads are usually inversely related to transaction size.
    D. Local nonbank quotes are less favorable than interbank quotes.

43. Assume that the 90-day rate for a currency was quoted 1.8235 (USD/FC) while its spot rate was 1.8200. The forward discount or premium expressed as an annualized rate is:
    A. 0.7692% discount.
    B. 0.7692% premium.
    C. 0.7678% discount.
    D. 0.7678% premium.

44. Which of the following statements about the elasticity of demand is FALSE?
    A. The most important determinant of price elasticity of demand is the availability of substitutes.
    B. The second law of demand states that prices are more elastic in the long run than in the short run.
    C. When demand is inelastic, an increase in price will cause a decrease in the total expenditure on a good.
    D. When the price of a product increases, consumers will reduce their consumption by a larger amount in the long run than in the short run.

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

45. Which of the following statements about nonrecurring items is TRUE?
    A. The correction of an accounting error is reported net of taxes below extraordinary items on the income statement.
    B. Restructuring costs are classified as unusual or infrequent and are reported below income from continuing operations net of taxes.
    C. Discontinued operations are classified as unusual or infrequent and are reported as a component of net income from continuing operations.
    D. Uninsured losses from earthquakes and expropriations by foreign governments are classified as extraordinary items and are reported net of taxes after income from continuing operations.

46. A project has the following estimated revenues of $10.0 million and estimated costs are $7.5 million. The table below provides information on amounts billed, cash received, and cost incurred for each year of the 3-year project (data is in millions of dollars).

	Year 1	*Year 2*	*Year 3*
Amounts billed	4.0	3.5	2.5
Cash received	2.0	5.0	3.0
Cost incurred	3.0	3.0	1.5

Which of the following statements relating to the cumulative balance sheet and income statement at year-end is FALSE?

A. Using the accounting method that smooths income, the company will recognize profit of $0.5 million in year 3.
B. Considering this project only, and using the percentage of completion method, total assets at the end of year 3 will be $2.5 million.
C. If ultimate payment is assured and the cost estimates are unreliable, the company will recognize profit of $1 million in year 2.
D. In comparison to using the percentage of completion method, using the completed contract method will result in lower income, total assets, and shareholder equity during the construction period.

47. Which of the following statements about classifying cash flows is FALSE?

A. Cash received from issuing long-term debt and stock is considered financing cash flows.
B. Changes in working capital accounts are included in cash flow from operating activities.
C. All income taxes are considered operating activities, even if some arise from financing and investing.
D. Dividend payments come out of financing cash flows, while interest payments come out of investing cash flows.

48. Kimberwick Technologies reports the following information as of December 31, 2004. In addition, the company reported $1,000 in depreciation expense. If the change in the cash balance for the year was $12,000 using the indirect method, the cash collections and cash flow from operations (CFO) using the direct method is *closest* to:

Data	
Net sales	50,000
Cash flow from financing	–4,250
Cash expenses	4,250
Cash inputs	17,000
Cash taxes	7,000
Increase in receivables	500
Cash flow from investing	–5,000

	Cash collections	CFO
A.	$49,500	$21,250
B.	$49,500	$22,250
C.	$50,000	$21,250
D.	$50,000	$22,250

49. A company has a cash conversion cycle of 80 days. If the company's average receivables turnover increases from 11 to 12, the company's cash conversion cycle:
A. shortens.
B. lengthens.
C. remains unchanged.
D. cannot be determined with the information given.

50. An analyst has gathered the following information about a company:

• Tax rate	33%
• Sales	$1,800,000
• Total assets	$1,200,000
• Interest expense ratio (I/A)	0.044
• Debt ratio	9%
• EBIT	216,000

The company's return on equity is *closest* to:
A. 9%.
B. 10%.
C. 11%.
D. 12%.

51. A company had the following changes in its stock:
- The company had 2 million shares outstanding on December 31, 2000.
- On March 31, 2001, the company paid a 10% stock dividend.
- On June 30, 2001, the company sold $10 million of 7% convertible debentures, convertible into common at $5 per share.
- On September 30, 2001, the company issued and sold 100,000 shares of common stock at par.

The company should compute its 2001 basic earnings per share based on:
A. 2,225,000 shares.
B. 2,250,000 shares.
C. 3,225,000 shares.
D. 3,250,000 shares.

52. An analyst gathered the following data about a company:
- The company had 1 million shares of common stock outstanding for the entire year.
- The company's beginning stock price was $50, its ending price was $70, and its average price is $60.
- The company has 100,000 warrants outstanding for the entire year.
- Each warrant allowed the holder to buy one share of common stock at $50 per share.

How many shares of common stock should the company use in computing its diluted earnings per share?
A. 1,100,000.
B. 1,028,571.
C. 1,083,333.
D. 1,016,667.

53. Haltata Turf & Sod currently uses the first in, first out (FIFO) method to account for inventory. Due to significant tax-loss carryforwards, the company has a tax rate of zero. Currently prices are rising and inventory is stable or increasing. If the company were to use last in, first out (LIFO) instead of FIFO:
A. net income would be lower, and cash flows would be higher.
B. cash flow would remain the same, and working capital would decrease.
C. gross margin would increase, and average stockholder's equity would decrease.
D. the debt-to-equity ratio would increase, and inventory turnover would decrease.

54. Which of the following is *least likely* to be a factor attributable to the differences in accounting and reporting practices around the world?
A. Inflation rates.
B. Tax laws.
C. Cultural differences.
D. Sources of financing.

55. Which of the following statements about the capitalization of interest costs is FALSE?
A. The argument for interest capitalization is that the cost of the self-constructed asset should be identical to the cost of the asset purchased after completion.
B. Interest capitalization will distort the classification of cash flows. The capitalized interest will be reported as cash outflow from operations rather than cash outflow from investing.
C. If a firm capitalizes interest, its interest coverage ratio (EBIT/I) will be misrepresented. The analyst should adjust the interest coverage ratio downward to correct for this misrepresentation.
D. According to the statement of financial accounting standards 34 (SFAS), in the U.S. when a firm constructs its own operating facility, the interest costs incurred during the period of construction should be capitalized.

56. Which of the following statements regarding capitalization and expensing intangible assets is FALSE? Based on U.S. generally accepted accounting practices (GAAP):
A. advertising costs are expensed when incurred.
B. purchased patent and copyright costs are expensed.
C. research and development costs are expensed when incurred.
D. computer software development costs to establish the technological or economic feasibility of software are expensed, but subsequent costs can be capitalized.

57. Which of the following statements about the role of depreciable lives and salvage values in the computation of depreciation expenses for financial reporting is FALSE?
A. Companies typically disclose data about salvage values in annual reports.
B. The useful life of the same depreciable asset can vary from company to company.
C. High estimates of salvage values reduce the depreciation base and reduce depreciation expense.
D. Depreciable lives and salvage value are chosen by management and allow for the possibility of income manipulation.

58. A company has an asset with the following characteristics:
- Net book value of \$500,000 (original cost of \$1,300,000 less accumulated depreciation of \$800,000).
- Undiscounted expected future cash flows of \$470,000.
- Present value of expected future cash flows of \$380,000.

Which of the following statements about the accounting treatment of this asset is FALSE?
A. The asset is deemed to be "impaired," because the present value of expected future cash flows is less than the carrying value.
B. The future impact of an impairment recognition is to increase net income, asset turnover ratios, and leverage ratios.
C. If an impairment is recognized, the company will report a \$120,000 write-off in income from continuing operations.
D. The indicators of impairment include negative changes in the business climate, large cost overruns, and a change in the use of the asset.

59. Acme Corp. purchased a new stamping machine for \$100,000, paid \$10,000 for shipping, and paid \$5,000 to have it installed in their plant. Based on an estimated salvage value of \$25,000 and an economic life of 6 years, the difference between straight-line depreciation and double-declining balance depreciation in the second year of the asset's life is *closest* to:
A. \$15,000.
B. \$16,666.
C. \$10,556.
D. \$7,220.

60. Rivendale Enterprises issued a 3-year, \$20 million face, 8% semiannual coupon bond when market interest rates were at 9%. What was the initial balance sheet liability and what percentage of the cumulative interest expense occurred through year 1?

	Initial liability	Year 1 interest expense
A.	\$19,484,213	31.84%
B.	\$19,484,213	33.05%
C.	\$20,000,000	33.05%
D.	\$20,000,000	31.84%

61. Which of the following statements about accounting for long-term debt is FALSE?
A. For a bond issued at par, interest expense = coupon rate × face value.
B. For a discount coupon bond, cash flow from operations will decrease by the amount of the periodic coupon payment.
C. Issuing zero-coupon bonds has no impact on cash flow from operations.
D. A bond issued at a discount has lower cash flow from operations and higher cash flow from financing than a bond issued at a premium.

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

63. Management of LLW Cabinetry, Inc., is considering leasing a new saw that will greatly increase the plant's throughput. Information on the machine and the terms of the lease are as follows:
- The machine has a fair market value of $2.8 million, an estimated useful life of ten years, and no salvage value.
- Company incremental borrowing rate is 11.5%.
- Lease term of seven years with lease payments of $41,567 due at the beginning of each month.
- Implicit lease rate is 10.0%.
- The lease does not contain a bargain purchase option, and there is no title transfer at the end of the lease.

If management leases the machine (*Note: carry calculations to at least three decimal places*):
A. the current ratio is unaffected (all else equal).
B. the lease period is greater than 75% of the asset's useful life.
C. in the first month, cash flow from operations will decrease by approximately $41,567.
D. in the first month, cash flow from operations will decrease by approximately $21,039.

Use the following data to answer Questions 64 and 65.

During 2000, Rory, Inc., reported net income of $15,000 and had 2,000 shares of common stock outstanding for the entire year. Rory also had 2,000 shares of 10%, $50 par value preferred stock outstanding during 2000. During 1998, Rory issued 100, $1,000 par, 6% bonds for $100,000. Each of these is convertible to 50 shares of common stock. The tax rate is 40%.

64. What is the basic earnings per share (EPS) for Rory?
A. $2.00.
B. $2.50.
C. $2.67.
D. $2.88.

65. What is the diluted EPS of Rory?
A. $0.12.
B. $1.57.
C. $1.23.
D. $2.50.

Use the following data to answer Questions 66 through 68.

A firm issues a 4-year bond with a face value of $10 million and a semiannual coupon rate of 10%. The issuer must make eight periodic payments of $500,000 and a final principal payment of $10 million. The market interest rate is 11% when the bond is issued.

66. The amount listed on the balance sheet of the issuer at the time of issue is *closest* to:
A. $8,567,893.
B. $9,683,272.
C. $10,000,000.
D. $10,329,794.

67. The interest expense for the first period is *closest* to:
A. $500,000.
B. $532,580.
C. $550,000.
D. $1,100,000.

68. The balance sheet liability at the end of the first period will be *closest* to:
A. $9,650,692.
B. $9,715,852.
C. $9,967,420.
D. $10,000,000.

69. An analyst gathered the following data about a project:
- Costs are $8,000 plus $2,000 in shipping and installation.
- For the next five years the project will annually generate $5,000 in sales and $2,000 in costs, not including depreciation.
- The project is being depreciated on a straight-line basis over five years with no salvage value.
- The company's tax rate is 40%, and the weighted average cost of capital is 10%.

The project's net present value (NPV) is *closest* to:
A. –$144.
B. $144.
C. $279.
D. $1,244.

70. Corporate governance is a set of internal controls by which a corporation is managed. It is a primary concern of investors because good corporate governance leads to better results for both the corporation and its investors. Other factors being equal, companies that have shareholder-friendly policies should trade at a premium to those that do not. Good corporate governance practices should include all of the following EXCEPT:
A. the board supports management.
B. the board only acts in the best interest of the shareholders.
C. the firm acts lawfully and ethically in dealings with shareholders.
D. the firm's operating and financial activities are reported in a timely manner to the shareholders.

71. An analyst gathered the following data about a project:

• Fixed cost	$15,000
• Operating cash flow	$10,000
• Variable cost per unit	$2
• Selling price per unit	$5

The project's operating breakeven point is:
A. 5,000 units.
B. 8,333 units.
C. 10,000 units.
D. 13,333 units.

72. Dagmar Industries has 41,200,000 shares outstanding with a current market value of $50 per share. Dagmar made $200 million in profits for the recent quarter, and since only 70% of these profits will be reinvested back into the company, Dagmar's Board of Directors is considering repurchasing $60,000,000 worth of common stock. Dagmar assumes that the stock can be repurchased at the market price of $50 per share. However, after much discussion Dagmar decides to borrow $60 million that it will use to repurchase shares. Dagmar's Chief Financial Officer (CFO) has compiled the following information regarding the repurchase of the firm's common stock:

- Share price at the time of buyback = $50.
- Shares outstanding before buyback = 41,200,000.
- EPS before buyback = $10.00.
- Earnings yield = $10.00 / $50 = 20%.
- After-tax cost of borrowing = 8%.
- Planned buyback = 1,200,000 shares.

Based on the information above, Dagmar's earnings per share (EPS) after the repurchase of its common stock will be *closest* to:

A. $5.03.
B. $8.25.
C. $10.18.
D. $12.35.

73. Which of the following statements is NOT an incentive to the lessee for structuring a lease as an operating lease rather than a capital lease?

A. Operating leases are advantageous to the lessee's management when their compensation depends on return on assets or invested capital.
B. An operating lease is advantageous when the lessee wants to keep debt off its balance sheet.
C. Using operating leases can help keep a lessee's financial ratios within the bounds of its debt covenants.
D. If the lessee is in a higher marginal tax bracket than the lessor, the lease should be structured as an operating lease so that the lessee can take advantage of the depreciation of the leased equipment, thereby reducing its taxable income and the taxes it pays.

74. Restless.com has an 8% rate of interest on newly issued bonds. The firm has a return on equity of 13.33% and a dividend payout ratio of 40%; the last dividend paid was $1.50, and the firm's shares sell for $26. The stock's beta is 1.7, the expected return on the market portfolio is 11%, and the risk-free rate of interest is 6%. If the appropriate risk premium relative to the bond yield is 5% for a dot-com, estimate Restless.com's cost of equity capital using the bond yield plus risk premium (BY + RP), the dividend discount model (DDM) and the capital asset pricing model (CAPM), respectively. The firm is in a 35% marginal tax bracket.

	BY + RP	DDM	CAPM
A.	10.2%	14.2%	24.7%
B.	10.2%	11.4%	13.5%
C.	13.0%	14.2%	14.5%
D.	13.0%	13.2%	13.5%

75. Debt covenants are restrictions imposed by bondholders on the issuer in order to protect the bondholders' position. Which of the following is *least likely* to be an area in which restrictions are imposed by debt covenants?

A. Issuance of new debt.
B. Sinking fund agreements.
C. Bond repurchases at a premium to par.
D. Disposal of certain assets.

76. Jason Hurley, an associate with an online brokerage firm, prepared a report that contained the following two statements.

Statement 1: Sometimes, the effect of increasing a company's financial leverage is to reduce its net income but to increase its return on equity (ROE), which can lead to an increase in the value of a firm's common stock.

Statement 2: As long as ROA is greater than the cost of debt financing, additional financial leverage (holding other factors unchanged) will always increase the firm's ROE and the value of its common stock.

Are Statement 1 and Statement 2, as made by Hurley in his research report, *correct*?

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

77. At a presentation to retail investment clients, a financial advisor makes the following statements about dividends:

Statement 1: "With respect to dividends, an investor should be indifferent between purchasing a stock before or after the payment date because on the payment date the value of the shares will fall by (approximately) the amount of the dividend."

Statement 2: "The holder-of-record date occurs two business days before the ex-dividend date."

Are Statements 1 and 2 correct or incorrect?

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

78. Under which of the following conditions would a firm be *least likely* to issue variable-rate debt?

A. The yield curve is sloping sharply upward.
B. The yield curve is sloping sharply downward.
C. Operating cash flows are positively correlated with short-term interest rates.
D. Operating cash flows are negatively correlated with short-term interest rates.

The following six questions relate to Portfolio Management.

79. An analyst obtains statistics on return information for Vay Industries and Ranch Meatpacking as follows:

$$\sum_{i=j=1}^{12}[R_i - E(R_i)][R_j - E(R_j)] = 71.75;\ \sum_{i=1}^{12}[R_i - E(R_i)]^2 = 379.90;\ \sum_{j=1}^{12}[R_j - E(R_j)]^2 = 135.06$$

Based on this information, what is the covariance between the two sets of returns, and what is the correlation coefficient?

	Covariance	Correlation coefficient
A.	5.98	0.32
B.	5.98	0.42
C.	6.52	0.32
D.	6.52	0.42

80. Without the introduction of a risk-free asset or a zero-beta portfolio, the optimal portfolio on the efficient frontier for each investor is represented by:
A. the market portfolio.
B. any point where an indifference curve intersects the efficient frontier.
C. the point where the capital market line touches the frontier.
D. the point where the investor's highest indifference curve is tangent to the efficient frontier.

81. When an investor can borrow and invest at the risk-free rate, which of the following statements is **NOT** valid?
A. The capital market line (CML) is straight.
B. Any asset/portfolio lying below the CML is inefficient.
C. The *x*-axis measurement of risk is the standardized covariance.
D. Investors who borrow the risk-free asset to lever their portfolio will move their portfolios to the right of the market portfolio on the CML.

82. An analyst determines that four stocks have the following characteristics:

Stock	*Beta*	*Estimated return*
A	0.6	5%
B	1.0	10%
C	1.6	16%
D	2.0	16%

If the risk-free rate is 4% and the expected return on the market is 10%, which of the following statements is **FALSE**?
A. Stock A is overvalued.
B. Stock B is properly valued.
C. Stock C is undervalued.
D. Stock D is overvalued.

83. Which one of the following is **NOT** one of the assumptions of capital market theory?
A. Investors have heterogeneous expectations.
B. Markets are in equilibrium.
C. It is possible to buy or sell fractional shares of any asset or portfolio.
D. There are no taxes or transaction costs involved in buying or selling assets.

84. The risk-free rate is 5% and the expected market risk premium is 10%. A portfolio manager is projecting a return of 20% on a portfolio with a beta of 1.5. After adjusting for risk, this portfolio is expected to:
A. equal the market's performance.
B. outperform the market.
C. underperform the market.
D. be less risky than the market.

The following 36 questions relate to Asset Valuation.

85. Which of the statements about technical analysis and fundamental analysis is FALSE?
    A. Technical analysts believe prices adjust quickly to news, while fundamental analysts believe the reaction is slow.
    B. Both technical analysts and fundamental analysts believe the interaction of supply and demand affects the price of a security.
    C. Technical analysts look for evidence of changes in supply and demand through market signals and indicators, while fundamental analysts look for changes in value.
    D. Fundamental analysts make decisions based on their examination of the economy, an industry, and company variables, while technical analysts make decisions based on their examination of past market data.

86. An investor buys a stock for $50. The initial margin requirement is 50%, and the maintenance margin requirement is 25%. The price below which the investor would receive a margin call would be:
    A. $25.00.
    B. $33.33.
    C. $37.50.
    D. $42.00.

87. Which of the following statements about price indexes is TRUE?
    A. The S&P 500 index is an unweighted price index.
    B. The Dow Jones Industrial Average is an example of a price-weighted index.
    C. A price-weighted index assumes an equal dollar investment in each stock in the index.
    D. The main problem with a price-weighted index is that companies with greater market capitalization have a greater impact on the index than do companies with less market capitalization.

88. A stock index consists of two stocks:
    - Company A has 50 shares valued at $2 each.
    - Company B has 10 shares valued at $10 each.
    - When the index started, the price-weighted index was $6, and the value-weighted index was 1.
    - Nothing has changed except now the price of Company A's stock is selling for $4 per share.

    What is the value of the price-weighted index and the value-weighted index?

	Price-weighted	Value-weighted
A.	6	1.50
B.	7	1.50
C.	6	2.00
D.	7	2.00

89. Which one of the following alternatives correctly assigns the attractive investment opportunities that typically occur within the indicated stage of the business cycle?

	Business cycle stage	Investment opportunities
A.	Recovery	Commodities and real estate
B.	Early expansion	Stocks and bonds
C.	Late expansion	Bonds and interest-sensitive stocks
D.	Recession	Commodities and bonds

90. An investor purchased stock in a company for $20 at the end of a year for which the company reported EPS of $4.00. Due to capital investment needs, the company retains 75% of earnings and intends to maintain this retention rate in the future. Return on equity (ROE) is constant at 33.3%. If the expected price of the stock in 1 year is $25, the expected 1-year holding period return on this stock is:
    A. 12.25%.
    B. 24.00%.
    C. 28.50%.
    D. 31.25%.

91. Consider the following company data:
    - Earnings retention rate at 40%.
    - Required rate of return of 13%.
    - ROE of 15%, expected to remain constant.

    Using the information above, which of the following statements is FALSE? All else equal, if the:
    A. risk-free rate increases, the P/E ratio will decrease.
    B. earnings retention ratio increases, the P/E ratio will increase.
    C. expected inflation rate decreases, the P/E ratio will rise above 8.57.
    D. dividend payout increases, the P/E ratio will increase.

92. An analyst gathered the following data about a company:
    - The historical earnings retention rate of 40% is projected to continue into the future.
    - The sustainable ROE is 12%.
    - The stock's beta is 1.2.
    - The nominal risk-free rate is 6%.
    - The expected market return is 11%.

    If the analyst believes next year's earnings will be $4 per share, what value should be placed on this stock?
    A. $22.24.
    B. $26.67.
    C. $33.32.
    D. $45.45.

93. Using time series analysis, an analyst forecasts the following for Telcom Inc.:
    - Sales per share will be $100.
    - Earnings before depreciation, interest and taxes will be 15% of sales.
    - Depreciation per share will be $5.
    - Interest expense per share will be $3.
    - Tax rate will be 30%.

    Assuming a trailing P/E ratio of 10, the year-end value of Telcom is expected to be:
    A. $25.00.
    B. $32.50.
    C. $43.20.
    D. $49.00.

94. Which of the following is NOT considered an investment constraint in the portfolio management process?
    A. An investor's need for liquidity.
    B. The legal aspects of the account to be managed.
    C. Limits on the amount of risk the client is willing to accept.
    D. An investor's preference to own no stocks of newspaper publishers.

95. An investor purchases 1,000 shares of each of the stocks in the Dow Jones Industrial Index at their closing prices (ignore transactions costs). On a total return basis, if the index stocks remain the same, this portfolio will certainly:
A. perform exactly like the index over time.
B. outperform the index over time.
C. underperform the index over time.
D. perform better than the index over some periods, and worse over others.

96. Which of the following statements about measures of relative value is FALSE? The:
A. price-to-book-value ratio can be used for firms with negative earnings or cash flows.
B. price-to-cash-flow ratio should be used in conjunction with the P/E ratio because cash flows are typically more stable than earnings.
C. price-to-book-value, price-to-cash-flow, and price-to-sales ratios are considered to be good supplements to the P/E ratio when conducting fundamental valuation.
D. price-to-book-value ratio is an appropriate measure for comparing firms with different levels of fixed assets, such as a heavy industrial firm compared to a financial or service firm.

97. Concer-tech produces customized T-shirts for regional bands. Variable costs are $3.00 per T-shirt. The company is just breaking even with fixed costs of $600 per period and a sales price of $5.00 per shirt. The company is considering the purchase of a new machine that will add $500 per period to fixed costs and decrease variable costs by $0.75. What is the change in the number of units the company must sell each period to still break even?
A. –118.
B. +100.
C. +182.
D. +400.

98. The return in excess of the return on a benchmark, default-free security demanded by investors to compensate them for the risk of buying a risky security is called:
A. default risk premium.
B. downgrade risk premium.
C. reinvestment risk premium.
D. credit spread risk premium.

99. When yield volatility increases, the values of a putable and a callable bond will:

	Callable bond	Putable bond
A.	Increase	Increase
B.	Decrease	Decrease
C.	Decrease	Increase
D.	Increase	Decrease

100. Which of the following statements about debt securities is FALSE?
A. Commercial paper is a short-term (less than nine months) vehicle for corporate borrowing.
B. An asset-backed security is a security whose cash flows are linked to a pool of underlying loans or financial instruments.
C. A medium-term note (MTN) differs from a corporate bond in that a MTN is sold to investors on a "firm commitment" basis wherein the investment banker guarantees a price to the issuer.
D. A MTN is a shelf-registered debt instrument that is continually offered to investors by an agent of the issuer and varies in maturity from nine months to over 30 years.

101. An analyst obtains the following data for Treasury bonds:

Maturity	*Coupon*	*Price*
6 months	3.0%	100
1 year	4.0%	100
18 months	5.0%	100

Using the method of bootstrapping, what is the theoretical Treasury spot rate curve with rates expressed as bond equivalent yields?

	6-month spot rate	1-year spot rate	18-month spot rate
A.	1.5%	4.25%	5.03%
B.	3.0%	4.25%	5.13%
C.	3.0%	4.01%	5.13%
D.	3.0%	4.01%	5.03%

102. An investor has a 1-year, 10% semiannual coupon bond with a price of $975. If the 6-month Treasury bill (T-bill) has a holding period yield of 6%, what is the 1-year theoretical spot rate on a bond-equivalent basis?
A. 6.4%.
B. 8.7%.
C. 9.9%.
D. 12.8%.

103. Which of the following is NOT a property concerning the price volatility of an option-free bond?
A. For a given large change in basis points in the required yield, the percentage price increase is smaller than the percentage price decrease.
B. Although the price moves in the opposite direction from the change in required yield, the percentage price change is not the same for all bonds.
C. For large changes in required yield, the percentage price change is not the same for an increase in required yield as it is for a decrease in required yield.
D. For small changes in the required yield, the percentage price change for a given bond is roughly the same, whether the required yield increases or decreases.

104. An 8%, semiannual pay, option-free corporate bond that is selling at par has ten years to maturity. What is the effective duration of the bond based on a 75 basis point change (up or down) in rates?
A. 5.6.
B. 6.8.
C. 7.2.
D. 10.0.

105. The current 4-year spot rate is 4% and the current 5-year spot rate is 5.5%. What is the 1-year forward rate in four years?
A. 8.62%.
B. 9.58%.
C. 10.14%.
D. 11.72%.

106. Which of the following statements about Eurobonds is FALSE? Eurobonds:
A. are issued to investors in several countries simultaneously.
B. trade outside the jurisdiction of any one country.
C. can be denominated in any currency.
D. are referred to as global bonds.

107. The face value of a $1,000,000 T-bill with 78 days to maturity is priced at $987,845. What is the bank discount yield (annualized) quote for the T-bill?
A. 5.160%.
B. 5.750%.
C. 5.610%.
D. 5.670%.

108. Assume an investor holds a portfolio of bonds as follows:
- $2,000,000 par value of 10-year bonds with a duration of 6.95 priced at 95.5000.
- $3,000,000 par value of 15-year bonds with a duration of 9.77 priced at 88.6275.
- $5,000,000 par value of 30-year bonds with a duration of 14.81 priced at 114.8750.

The duration of the portfolio is *closest* to:
A. 10.64.
B. 12.06.
C. 13.28.
D. 13.57.

109. A CFO of a major corporation wants to hedge against a possible interest rate increase by entering into a forward rate agreement. The following quotes are obtained from a dealer for 30-day FRAs:

Dealer quotes
60-Day LIBOR = 0.0480
90-Day LIBOR = 0.0500
180-Day LIBOR = 0.0525

The contract covers a notional principal of $50 million. The company hedges its risk of an increase in 60-day LIBOR with an FRA, and 30 days later when the contract expires, the 60-day LIBOR rate is 5%. What does the company collect from, or pay to, the dealer? The company:
A. collects $16,529.
B. collects $29,691.
C. pays $29,691.
D. neither collects nor pays since the rate on 60-day LIBOR at expiration is the same as the rate on 90-day LIBOR initially.

110. An investor holds a short position in four gold futures contracts. Each gold futures contract is for delivery of 100 ounces of gold. When the contract was entered into on day zero, the futures price was \$350 per ounce. The initial margin is \$1,750 per contract and the maintenance margin is \$1,312.50 per contract. The following table gives information on the evolution of the price of gold over a 4-day period:

Day	*Closing futures price (\$)*
1	345.50
2	348.75
3	355.50
4	356.25

What will the variation margin be on the first day a margin call is received?
A. \$500.
B. \$1,800.
C. \$2,200.
D. \$2,500.

111. An investor writes a covered call with a strike price of \$44 on a stock selling at \$40 for a \$3 premium. The range of possible gains to the writer of this covered call on the combined position is:
A. –\$40 to \$47.
B. \$4 to \$7.
C. –\$37 to \$7.
D. \$7 to infinity.

112. The payoff diagram of portfolio insurance (owning a stock and a put) has the same shape as the payoff diagram for:
A. buying a put option.
B. writing a put option.
C. buying a call option.
D. writing a call option.

113. Which of the following statements about interest rate swaps is FALSE?
A. A plain vanilla interest rate swap is a fixed rate for a variable rate swap.
B. The parties agreeing to a swap typically make no margin deposit.
C. The notional principal amount is used to determine the amount of the interest payments.
D. The counterparties exchange the notional principal at initiation and termination while only net interest rate payments are exchanged on the settlement dates.

114. One afternoon an investor is sitting at her computer and is following the real-time changes in the price of options on a particular asset. She notices that both a European call and a European put on the same underlying asset each have an exercise price of $45. The two options have six months to expiration and are both selling for $4. She also observes that the underlying asset is selling for $43 and that the rate of return on a 1-year Treasury bill is 6%. According to put-call parity, what series of transactions would be necessary to take advantage of any mispricing in this case?
A. Sell the call, sell a T-bill equal to the present value of $45, buy the put, and buy the underlying asset.
B. Buy the call, buy a T-bill equal to the present value of $45, sell the put, and sell the underlying asset.
C. Buy the call, sell a T-bill equal to the present value of $45, sell the put, and buy the underlying asset.
D. Sell the call, buy a T-bill equal to the present value of $45, buy the put, and sell the underlying asset.

115. A building has the following characteristics:
- The building generates $100,000 per year in gross rental income.
- Property taxes are $20,000 per year.
- Other expenses are 20% of gross rental income.
- The market capitalization rate is 15%.

Using the direct capitalization approach, the value of the building is:
A. $300,000.
B. $400,000.
C. $500,000.
D. $600,000.

116. Which one of the following is NOT an investment characteristic of venture capital financing?
A. It is relatively easy to cash out.
B. It is relatively difficult to know how many competitors exist.
C. Due to the uncertainty that surrounds the new venture, it is difficult to estimate cash flows.
D. Some entrepreneurs may be more attached to the success of the idea that is being developed than to the prospect of financial gains.

117. Which of the following statements with respect to hedge fund investing is FALSE?
A. The effect of survivorship bias is greater for a hedge fund database than for other asset classes.
B. Hedge funds only publicly disclose performance information on a voluntary basis.
C. Hedge funds are not typically registered with the SEC in the U.S.
D. Survivorship bias in hedge fund data causes risk to be overstated because funds that take on more risk tend to have higher returns.

118. Valuation methods for closely held companies include all of the following EXCEPT the:
A. cost approach.
B. comparables approach.
C. discount/premium approach.
D. income approach.

119. Which of the following is *least likely* to be one of the risks generally associated with exchange traded funds?
A. Sector risk.
B. Market risk.
C. Liquidity risk.
D. Tracking error risk.

120. Long/short funds are:
   A. exchange traded funds that take long and short positions in common stocks.
   B. hedge funds that vary their long and short positions in common stocks and remain market-neutral at all times.
   C. exchange traded funds that vary their long and short positions in common stocks but do not necessarily remain market-neutral.
   D. hedge funds that frequently use forecasts to vary their long and short positions in common stocks and may or may not be market-neutral.