Lancaster University

2019 EXAMINATIONS

PART II (SECOND AND FINAL YEAR) ACCOUNTING AND FINANCE

AcF304 FINANCIAL MARKETS

(2 hours + 15 minutes reading time)

All Sections (A, B, C and D) are compulsory.

Students should answer ALL questions in Sections A, C and D.

Students should answer 8 out of 12 questions in Section B

The use of standard calculators is allowed.

Section A (30 marks)

Instructions:

- Write your NAME, SURNAME and LIBRARY CARD NUMBER on the coloured MCQ form
- Use PENCIL + ERASER
- There are 15 Multiple Choice Questions worth **2 marks** each.
- Choose only **one answer** for each question on the MCQ form. Two or more boxes ticked, or illegible answers, are considered as incorrect answers
- There are no marks deducted for an incorrect answer.

1. NetCorp is in the process of launching an IPO. Last year the company had revenues of $225 million and earnings of $19 million. NetCorp's investment bankers would like to estimate the value of the company using comparable companies. The investment bankers have assembled the following data for 5 representative companies in the same industry sector that have recently gone public. In each case the ratios are based on the IPO price.

Company	**Price / Earnings**
ITE	17.4
Entegris	21.2
TSMC	19.8
AbbVie	24.3
BCW	23.8

After the IPO, NetCorp will have 20 million shares outstanding. What would NetCorp's IPO price be if it was issued in line with the industry mean?

a) $20.23
b) $20.83
c) $21.30
d) $22.83

2. A bank decides to insure its exposure to a Turkish government bond and buys a 10-year Turkish CDS contract on the 30th December 2018 at a CDS spread of 550 bps and for a $15 million notional amount. How much does the bank pay for this protection?

a) A one-off payment of $825,000
b) An annual payment of $550,000
c) An annual payment of $825,000
d) A one-off payment of $550,000

3. A Treasury Inflation Protected Security (TIPS) has a real coupon rate of 3.5% per annum.An investor purchases $100,000 as soon as the bond is issued. Inflation after 6 months is 3% per annum.
What dollar amount of coupon will the investor receive at the 6-month period?

a) $1776.25
b) $1750.00
c) $3500.00
d) $1772.08

4. Investment Banks are quoting the following GBP/USD rates.
Bank A GBP/USD 1.2990 BID - 1.3010 OFFER
Bank B GBP/USD 1.3012 BID - 1.3022 OFFER
Bank C GBP/USD 1.2995 BID - 1.3015 OFFER

You, the Client, wish to sell GBP buy USD.
What is the best price available to you?

a) 1.2995
b) 1.3012
c) 1.3022
d) 1.2990

5. The US stock markets fell heavily in the 1st quarter of 2018 principally due to rising bond yields taking the 10-year yield to circa 3.25% Yield-to-Maturity (YTM). 10-year yields subsequently fell below 2.75% YTM in the following months. What was the key driver of this sharp downward move in yields?

a) The US economy slowed significantly in Q2 2018 and Q3 2018.
b) Brexit fears.
c) Investors buy bonds when stocks fall and the investment sentiment is 'risk off'.
d) Progress on US/China trade talks

6. You pay $996.73 for a 28-day T-bill. It is worth $1,000 at maturity. What is its investment rate?

a) 4.265083%
b) 4.288384%
c) 4.218079%
d) 4.276663%

7. An open market ________ leads to a(n) ________ of reserves and deposits in the banking system and hence to a(n) ________ of the monetary base and the money supply.

a) sale; expansion; contraction
b) purchase; expansion; contraction
c) sale; expansion; expansion
d) purchase; expansion; expansion

8. Which yield curve theory best explains a ‘humped’ shaped yield curve?

    a) Pure Expectations Theory.
    b) Liquidity Preference Theory
    c) Market Segmentation Theory.
    d) None of the above.

9. In a Treasury auction of $2.1 billion par value 91-day T-bills, the following bids were submitted:

Bidder	**Bid Amount**	**Price per $100**
1	$500 million	$99.40
2	$750 million	$99.01
3	$1.5 billion	$99.25
4	$1 billion	$99.36
5	$600 million	$99.39

If only these competitive bids are received, who will receive T-bills, in what quantity, and at what price?

    a) 1, 4 and 5 at $99.40
    b) 1, 2, 3, 4 and 5 at $99.40
    c) 1, 4 and 5 at $99.36
    d) 1, 2, 3, 4 and 5 at $99.36

10. Trading bonds via an ECN (Electronic Trading Network) is most suitable for

    a) Corporate Bonds
    b) Government Bonds
    c) Bonds approaching maturity.
    d) All of the above

11. Four banks are quoting the following prices. From which bank would you borrow from and with which bank would you lend to?

BANK A: 6 9/16 - 6 5/8%
BANK B: 6 5/8 - 6 11/16%
BANK C: 6 9/16 - 6 13/16%
BANK D: 6 1 /2 - 6 9/16%

    a) Lend Bank D & Borrow Bank C
    b) Lend Bank C & Borrow Bank A
    c) Lend Bank B & Borrow Bank C
    d) Lend Bank B & Borrow Bank D

12. Suppose NetCorp Inc. was trading at \$18.50 per share. At that time it pays an annual dividend of \$0.82 per share, and analysts have set a 1-year target price of \$26.00 per share. What is the expected return on the stock?

    a) 44.97%
    b) 40.54%
    c) 43.24%.
    d) 42.24%

13. The advantage of forward contracts over futures contracts is that forward contracts

    a) are standardised.
    b) have lower default risk.
    c) are more liquid.
    d) are none of the above.

14. A US bank customer will be going to London in June to purchase £100,000 in inventory. The current spot and future exchange rates are.

Exchange Rates GBP/USD	
Period	**Rate**
Spot	1.5342
March	1.6212
June	1.6901
September	1.7549
December	1.8416

The customer enters into a position in June futures to fully hedge her position. When June arrives, the actual exchange rate is GBP/USD 1.7250. How much did the customer save or lose by this strategy?

    a) The customer lost USD 3,490.
    b) The customer lost GBP 3,490.
    c) The customer saved USD 3,490.
    d) The customer saved GBP 3,490.

15. Under an Interest Rate Swap agreement Party A agrees to pay Party B periodic interest rate payments of LIBOR + 50 bps in exchange for periodic interest rate payments of 3%. If LIBOR is 1% what is the net payment between the two parties?

    a) A receives 2.0% and pays B nothing.
    b) B receives 2.0% and pays A nothing.
    c) B receives 1.5% and pays A nothing.
    d) A receives 1.5% and pays B nothing.

Total 30 marks

Section B (40 marks)

Answer only **<u>8 out of 12</u>** questions.

5 marks per question

1. How does a flat yield curve represent a different interest outlook under the Expectations Theory versus the Liquidity Preference Theory?

2. Explain what Active investment versus Passive investment is and how Active fund managers are strategically responding to the threat posed from passive Fund Managers.

3. Why would ‘haircuts’ on collateral increase sharply during a financial crisis?

4. What are the arguments for and against the Federal Open Market Committee (FOMC) releasing directives immediately after their 6-weekly meeting?

5. What are the advantages and disadvantages of quantitative easing as an alternative to conventional monetary policy when short-term interest rates are at the zero-lower-bound?

6. What are the reasons for financial institutions to engage in foreign exchange trading activities?

7. Why is there a Corporate Bond Liquidity problem today that didn’t exist before the Financial Crisis?

8. What do corporate bond ratings represent? How do they relate to corporate bond risk premium, yield and overall risk?

9. Explain why Floating Rate Note (FRN) price volatility is typically significantly less than for non-FRNs.

10. Explain why Gold and the US Dollar have an inverse price relationship.

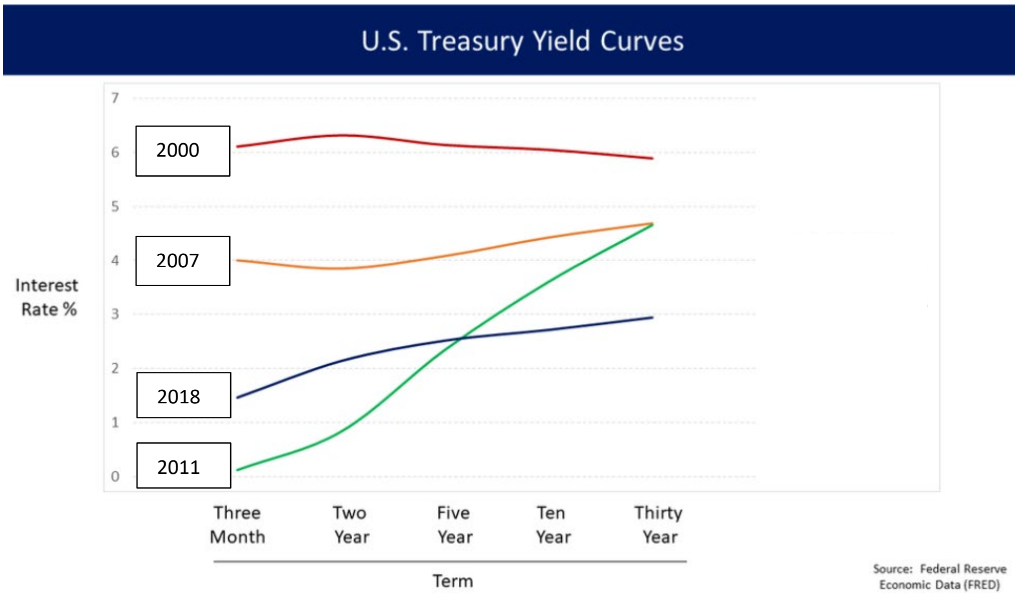
11. What are the core features of a Credit Default Swap? Describe the motive of the Protection Buyer and Protection Seller.

12. Describe the main features of Mortgage Pass-through securities.

Total 40 marks

Section C (15 marks)

QUESTION 13



Based on the above chart, provide answers to **ALL** the following questions:

a) What would have been a profitable trade to put on involving both short-term and long-term bonds to take advantage of the yield curve shift between 2011 and 2018?

(2 marks)

b) Looking at the 2011 yield curve, suppose a highly successful auction of 30-year bonds took place at that time. What impact would this have likely had on the yield curve?

(1 mark)

c) What does an inverted yield curve mean and what does it imply about perceptions of future economic activity?

(2 marks)

d) Suppose in 2000 the Federal Reserve had announced a new significant Quantitative Easing programme focused on 30-year bonds. What trade involving 2-year and 30-year bonds would likely have been profitable?

(2 marks)

e) Describe how AAA rated debt, A rated debt and Corporate Emerging Market debt normally trades in yield premium terms in relation to US Treasury Bonds and to each other:
e.g. XXX rated debt will yield above XXX rated debt and above US Treasury Bonds but below XXX rated debt.

(3 marks)

f) Emerging Market Debt performed weakly in 2018. What was the main reason for this?

(4 marks)

g) What can we say about the shape of the US Treasury yield curve in February 2011 compared to the shape of the US Treasury yield curve today?

(1 mark)

Total 15 marks

Section D (15 marks)

QUESTION 14

In a paragraph or so explain **3 out of the 4** terms below.

5 marks for each question

a) Accrued Interest

b) Recovery Rate

c) A REPO (Repurchase Agreement)

d) OPEC and its role in the oil market

Total 15 marks

END OF PAPER