

## Chapter 1 The Investment Environment

### Multiple Choice Questions

1. In 2002, \_\_\_\_\_ was the most significant asset of U. S. nonfinancial businesses in terms of total value.  
A) equipment and structures  
B) inventory  
C) real estate  
D) trade credit  
E) marketable securities

Answer: C Difficulty: Easy

Rationale: See Table 1.5, page 13.

2. The net wealth of the aggregate economy is equal to the sum of \_\_\_\_\_.  
A) all financial assets  
B) all real assets  
C) all financial and real assets  
D) all physical assets  
E) none of the above

Answer: B Difficulty: Easy

Rationale: Financial assets do not directly contribute the productive capacity of the economy.

3. \_\_\_\_\_ of an investment bank.  
A) Salomon Smith Barney is an example  
B) Merrill Lynch  
C) Goldman Sachs is an example  
D) B and C are each examples  
E) Each of the above is an example

Answer: E Difficulty: Easy

Rationale: See page 16.

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4. \_\_\_\_\_ are financial assets.

- A) Bonds
- B) Machines
- C) Stocks
- D) A and C
- E) A, B and C

Answer: D Difficulty: Easy

Rationale: Machines are real assets; stocks and bonds are financial assets.

5. An example of a derivative security is \_\_\_\_\_.

- A) a common share of General Motors
- B) a call option on Mobil stock
- C) a commodity futures contract
- D) B and C
- E) A and B

Answer: D Difficulty: Easy

Rationale: The values of B and C are derived from that of an underlying financial asset; the value of A is based on the value of the firm only.

6. \_\_\_\_\_ was the first to introduce mortgage pass-through securities.

- A) Chase Manhattan
- B) Citicorp
- C) FNMA
- D) GNMA
- E) None of the above

Answer: D Difficulty: Easy

Rationale: See page 17.

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7. A bond issue is broken up so that some investors will receive only interest payments while others will receive only principal payments, which is an example of \_\_\_\_\_.  
A) bundling  
B) credit enhancement  
C) unbundling  
D) financial engineering  
E) C and D

Answer: E Difficulty: Easy

Rationale: Unbundling is one of many examples of financial engineering that offer more alternatives to the investor.

8. An example of a primitive security is \_\_\_\_\_.  
A) a common share of General Motors  
B) a call option on Mobil stock  
C) a call option on a stock of a firm based in a Third World country  
D) a U. S. government bond  
E) A and D

Answer: E Difficulty: Easy

Rationale: A primitive security's return is based only upon the earning power of the issuing agency, such as stock in General Motors and the U. S. government.

9. The \_\_\_\_\_ refers to the potential conflict between management and shareholders due to management's control of pecuniary rewards as well as the possibility of incompetent performance by managers.  
A) agency problem  
B) diversification problem  
C) liquidity problem  
D) solvency problem  
E) regulatory problem

Answer: A Difficulty: Easy

Rationale: The agency problem describes potential conflict between management and shareholders. The other problems are those of firm management only.

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10. \_\_\_\_\_ financial asset(s).

- A) Buildings are
- B) Land is a
- C) Derivatives are
- D) U. S. Agency bonds are
- E) C and D

Answer: E Difficulty: Easy

Rationale: A and B are real assets.

11. The value of a derivative security \_\_\_\_\_.

- A) depends on the value of the related primitive security
- B) can only cause increased risk.
- C) is unrelated to the value of the related primitive security
- D) has been enhanced due the recent misuse and negative publicity regarding these instruments
- E) is worthless today

Answer: A Difficulty: Easy

Rationale: Of the factors cited above, only A affects the value of the derivative and/or is a true statement.

12. In terms of total value, the most significant liability of U. S. nonfinancial businesses in 2002 was \_\_\_\_\_.

- A) bank loans
- B) bonds and mortgages
- C) trade credit
- D) consumer credit
- E) marketable securities.

Answer: B Difficulty: Easy

Rationale: See Table 1.5, page 13.

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13. Money market funds were a financial innovation partly inspired to circumvent \_\_\_\_\_.  
A) Regulation B, which is still in existence  
B) Regulation D  
C) DIDMCA  
D) Regulation M  
E) Regulation Q, which is no longer in existence

Answer: E Difficulty: Easy

Rationale: Regulation Q limited the amount of interest that banks could pay to depositors; money market funds were not covered by Regulation Q and thus could pay a higher rate of interest. Although Regulation Q no longer exists, money market funds continue to be popular. See page 18.

14. \_\_\_\_\_ are an indirect way U. S. investor can invest in foreign companies.  
A) ADRs  
B) IRAs  
C) SDRs  
D) GNMA's  
E) Krugerrands

Answer: A Difficulty: Easy

Rationale: Only ADRs represent an indirect investment in a foreign company.

15. \_\_\_\_\_ are examples of financial intermediaries.  
A) Commercial banks  
B) Insurance companies  
C) Investment companies  
D) Credit unions  
E) All of the above

Answer: E Difficulty: Easy

Rationale: All are institutions that bring borrowers and lenders together.

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16. Financial intermediaries exist because small investors cannot efficiently \_\_\_\_\_.  
A) diversify their portfolios  
B) gather information  
C) monitor their portfolios  
D) advertise for needed investments  
E) all of the above.

Answer: E Difficulty: Easy

Rationale: The individual investor cannot efficiently and effectively perform any of the tasks above without more time and knowledge than that available to most individual investors.

17. Firms that specialize in helping companies raise capital by selling securities are called \_\_\_\_\_.  
A) commercial banks  
B) investment banks  
C) savings banks  
D) credit unions  
E) all of the above.

Answer: B Difficulty: Easy

Rationale: An important role of investment banks is to act as middlemen in helping firms place new issues in the market.

18. In 2002, 79.4% of the total liabilities of the U. S. government were in the form of  
A) currency  
B) government securities issued  
C) life insurance reserves  
D) pension fund reserves  
E) gold

Answer: B Difficulty: Easy

Rationale: See Table 1.6, page 14.

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19. Financial assets \_\_\_\_\_.  
A) directly contribute to the country's productive capacity  
B) indirectly contribute to the country's productive capacity  
C) contribute to the country's productive capacity both directly and indirectly  
D) do not contribute to the country's productive capacity either directly or indirectly  
E) are of no value to anyone

Answer: B Difficulty: Easy

Rationale: Financial assets indirectly contribute to the country's productive capacity because these assets permit individuals to invest in firms and governments. This in turn allows firms and governments to increase productive capacity.

20. The sale of a mortgage portfolio by setting up mortgage pass-through securities is an example of \_\_\_\_\_.  
A) credit enhancement  
B) securitization  
C) unbundling  
D) derivatives  
E) none of the above

Answer: B Difficulty: Easy

Rationale: The financial asset is secured by the mortgages backing the instrument.

21. The over-the-counter securities market is an example of \_\_\_\_\_.  
A) an auction market  
B) a brokered market  
C) a dealer market  
D) a direct search market  
E) none of the above

Answer: C Difficulty: Easy

Rationale: The over-the-counter market consists of dealers who own the securities and bring buyer and seller together, profiting from the spread.

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22. A corporation needing financing engages an insurance company to place its credit behind the corporation's credit for a fee, which is an example of \_\_\_\_\_.  
A) bundling  
B) credit enhancement  
C) securitization  
D) unbundling  
E) none of the above

Answer: B Difficulty: Easy

Rationale: The insurance company thus backs the firm and enhances the firm's credit reputation.

23. Corporate shareholders are best protected from incompetent management decisions by  
A) the ability to engage in proxy fights.  
B) management's control of pecuniary rewards.  
C) the ability to call shareholder meetings.  
D) the threat of takeover by other firms.  
E) one-share / one-vote election rules.

Answer: D Difficulty: Moderate

Rationale: Proxy fights are expensive and seldom successful, and management may often control the board or own significant shares. It is the threat of takeover of underperforming firms that has the strongest ability to keep management on their toes.

24. The national net worth of the U. S. in 2002 was \_\_\_\_\_.  
A) \$15.411 trillion  
B) \$26.431 trillion  
C) \$40.269 trillion  
D) \$55.651 trillion  
E) \$70.983 trillion

Answer: B Difficulty: Moderate

Rationale: See Table 1.1, page 5.



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25. The tax deduction for corporations issuing zero-coupon bonds \_\_\_\_\_.  
A) has remained unchanged over the years  
B) is zero  
C) has increased over the years  
D) has decreased over the years  
E) is not relevant as the yields are extremely high

Answer: D Difficulty: Moderate

Rationale: Corporations are allowed to deduct imputed interest on these bonds, but the original technique was too generous and created large tax deductions. When the government revised its procedure for calculating imputed interest the deductions decreased and corporations became much less willing to issue these securities. See page 18.

26. In 2002, \_\_\_\_\_ of the assets of U. S. households were financial assets as opposed to tangible assets.  
A) 20.4%  
B) 34.2%  
C) 64.1%  
D) 71.7%  
E) 82.5%

Answer: C Difficulty: Moderate

Rationale: See Table 1.2, page 5.

27. About \_\_\_\_\_ of the adult U. S. population holds shares of stock directly.  
A) 5%  
B) 25%  
C) 40%  
D) 75%  
E) 90%

Answer: C Difficulty: Moderate

Rationale: See page 5.

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28. The organized exchanges are examples of \_\_\_\_\_.  
A) auction markets  
B) continuous markets  
C) secondary markets  
D) A and B  
E) A, B, and C

Answer: E Difficulty: Easy

Rationale: The organized exchanges have all of the above characteristics. See page 20.

29. Investment bankers perform the following role(s) \_\_\_\_\_.  
A) market new stock and bond issues for firms  
B) provide advice to the firms as to market conditions, price, etc  
C) design securities with desirable properties  
D) all of the above  
E) none of the above

Answer: D Difficulty: Easy

Rationale: Investment bankers perform all of the roles described above for their clients.

30. Eurodollars have the following characteristics:  
A) They are dollar-denominated deposits in foreign banks.  
B) They are not subject to Regulation Q.  
C) They are in banks exempt from U. S. reserve requirements.  
D) They earn tax-free income.  
E) A, B, and C

Answer: E Difficulty: Easy

Rationale: Characteristics A, B, and C apply to Eurodollars. See page 18.

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31. Theoretically, takeovers should result in \_\_\_\_\_.  
A) improved management  
B) increased stock price  
C) increased benefits to existing management of taken over firm  
D) A and B  
E) A, B, and C

Answer: D Difficulty: Easy

Rationale: Theoretically, when firms are taken over, better managers come in and thus increase the price of the stock; existing management often must either leave the firm, be demoted, or suffer a loss of existing benefits.

32. Collateralized mortgage obligations were created to  
A) aggregate individual mortgages into relatively homogeneous pools  
B) meet the demand for mortgage-backed securities with a range of maturities  
C) rebundle separate branches into a single unit  
D) circumvent the requirements of Regulation Q  
E) provide government insurance for mortgages

Answer: B Difficulty: Easy

Rationale: CMOs were created unbundling pools of mortgages to meet investor demand for mortgage-backed securities with a range of maturities. See page 17.

33. Derivative securities are  
A) potentially dangerous because they are highly leveraged.  
B) an effective tool to better manage business returns and risk.  
C) always structured as option contracts.  
D) both A and B are true  
E) all of the above are true

Answer: D Difficulty: Moderate

Rationale: Derivative securities were created to allow the transfer of risk from one party to another. They can be used to effectively reduce risk, or, because of leverage effects, to greatly increase risk.

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34. Individual investors are most likely to trade securities in
- A) a direct search market.
  - B) an auction market.
  - C) the primary market.
  - D) a super market.
  - E) a block transaction.

Answer: B Difficulty: Easy

Rationale: Direct search markets are sporadic markets for specialized goods. Brokered markets, including block transactions and primary market transactions, are less accessible to individual traders. Most individual security trades take place in auction markets or dealer markets.

35. Important trends changing the contemporary investment environment are
- A) globalization.
  - B) securitization.
  - C) bundling and unbundling.
  - D) financial engineering.
  - E) all of the above

Answer: E Difficulty: Easy

Rationale: All of these are examples of important trends in the contemporary investment environment.

36. Human capital
- A) is an important part of national wealth.
  - B) is considered a financial asset
  - C) is the value of the earnings potential of the work force
  - D) is considered a real asset
  - E) is reflected on the balance sheet of U.S. households

Answer: C Difficulty: Easy

Rationale: Human capital is not included in the assets making up national wealth. See page 4.

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37. What are the objectives of businesses issuing securities to the public?
- A) To get the best possible price for their securities.
  - B) To market the issues to the public at the lowest cost.
  - C) To issue fairly simple securities requiring little incremental analysis.
  - D) All of the above are true.
  - E) None of the above is true.

Answer: D Difficulty: Easy

Rationale: Business-sector security issuers prefer simplicity and uniformity. This has created a demand for middlemen who transform simple securities into complex issues to suit particular market niches.

38. Stripped Treasury securities are
- A) examples of tax-induced innovations.
  - B) examples of derivative assets.
  - C) separated into an income component and a principal component.
  - D) targeted to meet the needs of investors in different income brackets
  - E) all of the above are true

Answer: E Difficulty: Easy

Rationale: All of these statements describe stripped Treasuries.

39. The means by which individuals hold their claims on real assets in a well-developed economy are
- A) investment assets.
  - B) depository assets.
  - C) derivative assets
  - D) financial assets.
  - E) exchange-driven assets

Answer: D Difficulty: Easy

Rationale: Financial assets allocate the wealth of the economy. Book example: it is easier for an individual to own shares of an auto company than to own an auto company directly.

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40. The term "human capital" refers to
- A) the total amount of capital owned by humans.
  - B) the value of a firm's management personnel.
  - C) the value of a firm's blue-collar workers.
  - D) the value of equipment that is operated by company personnel.
  - E) the value of the earnings potential of the workforce.

Answer: E Difficulty: Moderate

Rationale: Answer E is the definition of human capital. It is not included in national wealth, which consists of structures, equipment, inventories of goods, and land.

41. Which of the following financial assets makes up the greatest proportion of the financial assets held by U.S. households?
- A) pension reserves
  - B) life insurance reserves
  - C) mutual fund shares
  - D) debt securities
  - E) personal trusts

Answer: A Difficulty: Moderate

Rationale: Pension reserves make up 17.3% of households' financial assets. The next largest category is corporate equity (10.4%). Table 1.2, page 5, shows the balance sheet of U.S. households.

42. Which of the following are mechanisms that have evolved to mitigate potential agency problems?
- I) compensation in the form of the firm's stock options
  - II) hiring bickering family members as corporate spies
  - III) underperforming management teams being forced out by boards of directors
  - IV) security analysts monitoring the firm closely
  - V) takeover threats
- A) II and V
  - B) I, III, and IV
  - C) I, III, IV, and V
  - D) III, IV, and V
  - E) I, III, and V

Answer: C Difficulty: Moderate

Rationale: All but the second option have been used to try to limit agency problems.

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43. Financial intermediaries differ from other businesses in that both their assets and their liabilities are mostly
- A) illiquid.
  - B) financial.
  - C) real.
  - D) owned by the government.
  - E) regulated.

Answer: B Difficulty: Easy

Rationale: Table 1.7, page 15, shows the balance sheet for Financial Institutions. Financial assets make up 96.4% of total assets and most of the liabilities shown are financial in nature.

44. Which of the following is true about GNMA pass-throughs?
- I) They separate individual home mortgages into heterogeneous pools.
  - II) The purchaser of a GNMA receives monthly interest and principal payments received from payments made on the pool.
  - III) The banks that originated the mortgages maintain ownership of them.
  - IV) The banks that originated the mortgages continue to service them.
- A) II, III, and IV
  - B) I, II, and IV
  - C) II and IV
  - D) I, III, and IV
  - E) I, II, III, and IV

Answer: C Difficulty: Moderate

Rationale: I is not correct because the mortgages are aggregated into homogeneous pools. III is not correct because the bank no longer owns the mortgage investments. It is true that the bank continues to service the mortgages (IV) and that the GMNA purchasers receive the payments on interest and principal as they "pass-through".

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45. Although derivatives can be used as speculative instruments, businesses most often use them to
- A) attract customers.
  - B) appease stockholders.
  - C) offset debt.
  - D) hedge.
  - E) enhance their balance sheets.

Answer: D Difficulty: Easy

Rationale: Firms may use forward contracts and futures to protect against currency fluctuations or changes in commodity prices. Interest-rate options help companies control financing costs.

46. The market for new automobiles is best described as
- A) a primary, brokered market.
  - B) a primary, dealer market.
  - C) a primary direct search market.
  - D) a secondary auction market.
  - E) a secondary negotiable market.

Answer: B Difficulty: Moderate

Rationale: New cars sell in a primary market, used ones in a secondary market. New autos typically sell through dealers, who maintain their own inventory of the cars and earn a profit from selling them.

47. A WEBS security
- A) limits the diversification potential of investors who hold it.
  - B) may be traded only in the primary market.
  - C) is linked directly to the value of a composite index of futures contracts.
  - D) must be earned as a performance bonus within a corporation rather than purchased.
  - E) tracks the performance of an index of share returns for a particular country.

Answer: E Difficulty: Moderate

Rationale: WEBS (World Equity Benchmark Shares) allow investors to trade portfolios of foreign stocks in a selected country. They can be traded by investors in secondary markets (Amex) and allow U.S. investors to diversify their portfolios of foreign stocks.



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48. During the period between 2000 and 2002, a large number of scandals were uncovered. Most of these scandals were related to

- I) Manipulation of financial data to misrepresent the actual condition of the firm.
- II) Misleading and overly optimistic research reports produced by analysts.
- III) Allocating IPOs to executives as a quid pro quo for personal favors.
- IV) Greenmail.

- A) II, III, and IV
- B) I, II, and IV
- C) II and IV
- D) I, III, and IV
- E) I, II, and III

Answer: E Difficulty: Moderate

Rationale: I, II, and III are all mentioned as causes of recent scandals.

49. Some of the recent regulatory responses to scandals has been to

- A) make corporate executive and board members personally responsible for the accuracy of financial reports.
- B) mandate a greater role for disinterested outsiders on the board of directors.
- C) create a new oversight board to oversee the auditing of public companies.
- D) prohibit auditors from providing other services to clients.
- E) all of the above.

Answer: E Difficulty: Moderate

Rationale: A, B, and C are all mentioned as responses to recent scandals.

50. A disadvantage of using stock options to compensate managers is that

- A) it encourages managers to undertake projects that will increase stock price.
- B) it encourages managers to engage in empire building.
- C) it can create an incentive for managers to manipulate information to prop up a stock price temporarily, giving them a chance to cash out before the price returns to a level reflective of the firm's true prospects.
- D) all of the above.
- E) none of the above.

Answer: C

Rationale: A is a desired characteristic. B is not necessarily a good or bad thing in and of itself. C creates an agency problem.

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### Short Answer Questions

51. Discuss the agency problem in detail.

Answer: Managers are the agents of the shareholders, and should act on their behalf to maximize shareholder wealth (the value of the stock). A conflict (the agency conflict) arises when managers take self-interested actions to the detriment of shareholders. The roles of the board of directors selected by the shareholders are to oversee management and to minimize agency problems. However, often these boards are figureheads, and individual shareholders do not own large enough blocks of the shares to override management actions. One potential resolution of an agency problem occurs when inefficient management actions cause the price of the stock to be depressed. The firm may then become a takeover target. If the acquisition is successful, managers may be replaced and potentially, stockholders benefit.

Difficulty: Moderate

Rationale: The question is designed to ascertain that the student understands the corporate relationship between shareholders, management, and the board of directors. In addition, this problem has been addressed extensively in recent years, both in the popular financial press during the mergers and acquisitions mania of the 1980s, and in the academic literature as agency theory.

52. Discuss the similarities and differences between real and financial assets.

Answer: Real assets represent the productive capacity of the firm, and appear as assets on the firm's balance sheet. Financial assets are claims against the firm, and thus appear as liabilities on the firm's balance sheet. On the other hand, financial assets are listed on the asset side of the balance sheet of the individuals who own them. Thus, when financial statements are aggregated across the economy, the financial assets cancel out, leaving only the real assets, which directly contribute to the productive capacity of the economy. Financial assets contribute indirectly only.

Difficulty: Moderate

Rationale: The purpose of this question is to ascertain if the student understands the difference between real and financial assets, both in the aggregate balance sheet context and the relative contribution of the two types of assets to the productive capacity of the economy.

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53. Discuss the euro in relation to its impact on globalization. How is it currently used and what are the plans for its future use?

Answer: The euro was introduced in 1999 as a new currency and has replaced the currencies of twelve participating countries so there will be one common European currency in the participating countries. A common currency is expected to facilitate global trade and encourage the integration of markets across national boundaries.

Difficulty: Moderate

54. Discuss the following ongoing trends as they relate to the field of investments: globalization, bundling and unbundling, securitization,

Answer: Globalization offers a wider array of investment choices than what would be available to investors who could only choose domestic securities. As efficient communication technology has become available, globalization of markets has been significantly enhanced. There are many mechanisms by which one country's investors can hold foreign companies' securities. Some examples are ADRs, WEBS, and direct purchase.

Securitization refers to aggregating underlying financial assets, such as mortgages, into pools and then offering a security that represents a claim on these underlying assets. Examples are GNMA's, CARs, SLMA's, and others. Securitization allows investors to hold partial ownership in financial assets that would otherwise be beyond their reach (mortgages, auto loans, student loans, etc.).

Bundling involves combining separate securities together into one composite security. Examples are combining primitive and derivative securities, and combining three primitive securities such as common stock, preferred stock, and bonds (see Figure 1.3, page 24, for an example with the Boise Cascade Corporation). Unbundling is the opposite - two or more security classes are created by separating a composite security into parts. (see Figure 1.4, page. 24, for an example with FNMA).

All of the terms described fall under the general name "financial engineering". When niche market opportunities exist in a capitalist economy, people or organizations will arise to meet the demand if profit making is possible.

Difficulty: Moderate

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55. Discuss the four types of securities markets. Also distinguish between the middlemen in the different markets.

Answer: We can differentiate four types of markets: direct search markets, brokered markets, dealer markets, and auction markets.

A direct search market is one where buyers and sellers must seek each other out directly. One example of a transaction taking place in such a market would be the sale of a used refrigerator in which the seller advertises for buyers in a local newspaper. Sporadic participation and low-priced and nonstandard goods characterize such markets. It does not pay most people or firms to seek profits by specializing in such an environment.

A brokered market is sufficiently active that brokers can find it profitable to offer search services to buyers and sellers. A good example is the real estate market, where economies of scale in searches for available homes and for prospective buyers make it worthwhile for participants to pay brokers to conduct the searches for them.

In a dealer market, the dealer specializes in various assets, purchasing them for their own inventory and selling them for a profit from their inventory. Dealers, unlike brokers, trade assets for their own accounts. The dealer's profit margin is the "bid-asked" spread-the difference between the price at which the dealer buys for and sells from inventory. Dealer markets save traders on search costs because market participants can easily look up prices at which they can buy from or sell to dealers.

In an auction market all transactors converge at one place to bid on or offer a good. The New York Stock Exchange (NYSE) is an example of an auction market. An advantage of auction markets over dealer markets is that one need not search to find the best price for a good. If all participants converge, they can arrive at mutually agreeable prices and thus save the bid-asked spread.

Difficulty: Moderate