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Finance 268

Module 1 Honors Quiz

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1. Which of the following are new advancements and changes in finance? — **1 / 1 point**

- [ ] Banking
- [x] Information technology

  ✓ **Correct**

- [x] Behavioral finance

  ✓ **Correct**

- [ ] Insurance

2. What did Andrew Carnegie believe some people succeed in business and others don't? — **1 / 1 point**

- (●) The business world selects for people with natural talent
- ( ) The business world selects for people who work hard
- ( ) The business world selects for people with a good education
- ( ) The business world selects for people who get lucky opportunities

  ✓ **Correct**

3. The main difference between Value at Risk and Stress Testing is: — **1 / 1 point**

- ( ) Value at Risk takes a non-statistical approach, as opposed to Stress Testing.
- (●) Stress Testing takes a non-statistical approach with its scenarios analysis.
- ( ) Value at Risk is not a quantitative approach.
- ( ) There are no differences between the two approaches.

  ✓ **Correct**

4. According to the Capital Asset Pricing Model (CAPM), a security with: — **1 / 1 point**

- ( ) An alpha of zero is able to generate a return which greater than the market return.
- ( ) A positive alpha is considered overpriced, since the security outperforms the market.
- ( ) An alpha of zero is able to generate a return which is inferior to the market return.
- (●) A positive alpha is considered underpriced, since the security outperforms the market.

  ✓ **Correct**
  Remember: Alpha is the constant in the linear relationship between the returns of the security and the returns of the market.

5. Which of the following are true about fat tail distributions? — **1 / 1 point**

- (●) They are a good model for some financial data
- ( ) The mean is a good representation of the distribution
- ( ) They are the best choice for most types of data
- ( ) We must rely on the central limit theorem to gather useful information about them.

  ✓ **Correct**

For example, the daily change in stock price is usually small, but some days (e.g. immediately after a market crash) it can be very large.

6. If an insurance company has 10000 policies, and each has 0.1 probability of making a claim, what is the standard deviation of the fraction of policies which result in a claim? **1 / 1 point**

0.003

✓ **Correct**

7. Why was the National Association of Insurance Commissioners created? **1 / 1 point**

- ○ To suggest laws that would prevent insurance corporations from becoming "too big to fail"
- ○ To suggest laws that would decentralize the insurance industry
- ◉ To suggest laws that would decrease the complexity of insurance regulation
- ○ To suggest laws that would strengthen the insurance industry

✓ **Correct**

8. Insurance is managed by employers, so if an employee is sick and loses her job, her insurance will be expensive due to preexisting conditions; by contrast, a healthy person who loses his job may not be incentivized to purchase health insurance. This is an example of **1 / 1 point**

- ○ Moral hazard
- ◉ Selection bias
- ○ Pooled risk
- ○ HMO

✓ **Correct**

9. In addition to earthquake, hurricane and terrorism, which of the following could be categorized as a "disaster" risk? **1 / 1 point**

- ○ Market liquidity risk
- ◉ A World War
- ○ Bankruptcy Risk
- ○ Currency Risk

✓ **Correct**
This risk does not emerge from the market but has an impact on it.

10. One of the mentioned assumptions of portfolio management theory is that investors are rational. A rational investor: **1 / 1 point**

- ○ Invests only in fully diversified portfolios.
- ○ Is always averse to risk.
- ○ Invests in passive funds rather than active funds.
- ◉ Prefers a higher return for a given risk and prefers a lower risk for a given return

✓ **Correct**

11. The market portfolio, which includes all traded assets available in the market, must have a beta which is: **1 / 1 point**

- ○ Negative
- ○ Equal to 0
- ○ Above 1
- ◉ Equal to 1

✓ **Correct**
The expected return (systematic risk) of a market portfolio is identical to the expected return (systematic risk) of the market as a whole.

12. Among the risks associated with short selling a stock are: (check all that apply) **1 / 1 point**

- ☑ *Default risk:* potential unlimited losses when buying back the stock.

✓ **Correct**
There is no upper limit on the price of the stock.

- ☑ *Regulatory risk:* a ban on short sales can create a surge in the stock price.

✓ Correct

A surge in the stock price can force the short seller to cover short positions at huge losses.

- [x] *Dividend risk:* the short seller must provide dividend payments on the shorted stock to the entity from whom the stock has been borrowed.

✓ Correct

- [ ] *Systematic risk:* the uncertainty inherent to the market as a whole and which cannot be diversified.

13. Leveraging your portfolio: (check all that apply)

1 / 1 point

- [x] Allows you increase your return on equity, magnifying positive (or negative) returns by borrowing money.

✓ Correct

- [x] Increases your default risk by magnifying the standard deviation (risk) of your portfolio.

✓ Correct

By investing more in the risky asset in order to increase your portfolio return, you bear the risk of an asset pricing crash which could prevent you from paying back the money you previously borrowed, hence going bankrupt.

- [ ] Does not increase the standard deviation of your portfolio, since the borrowed money is risk free and therefore has a standard deviation of zero.
- [ ] Increases systematic risk within your portfolio, that is the uncertainty inherent to the market as a whole and which cannot be diversified.

14. You are an investor who wants to form a portfolio that lies to the right of the “optimal” minimum standard deviation portfolio on the efficient frontier. You must:

1 / 1 point

- ○ Invest only in risky securities.
- ◉ Borrow money at the risk-free rate, invest in the minimum standard deviation portfolio and, in addition, only in risky securities.
- ○ Borrow money at the risk-free rate and invest everything in the minimum standard deviation portfolio.
- ○ Invest only in risk-free securities.

✓ Correct