

Chapter 01 The Investment Environment

Multiple Choice Questions

1. The material wealth of a society is a function of _____.
 - A. all financial assets
 - B. all real assets
 - C. all financial and real assets
 - D. all physical assets
 - E. all commodities

2. _____ is/are a real asset(s).
 - A. Only land
 - B. Only machines
 - C. Only stocks and bonds
 - D. Only knowledge
 - E. Land, machines, and knowledge are real assets

3. 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.

4. _____ is/are financial assets.
 - A. Only bonds
 - B. Only machines
 - C. Only stocks
 - D. Stocks and bonds
 - E. Knowledge

5. _____ financial asset(s).

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

6. 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

7. In 2009, _____ was the most significant real asset of Taiwanese households in terms of total value.

- A. consumer durables and semi-durables
- B. foreign assets
- C. real estate
- D. mutual funds
- E. bank loans

8. In 2009, Currency and _____ were the least significant financial assets of Taiwanese households in terms of total value.

- A. real estate
- B. mutual funds
- C. life insurance reserves
- D. debt securities and other
- E. pension fund reserves

9. In 2009, _____ was the most significant financial asset of Taiwanese households in terms of total value.

- A. real estate
- B. mutual funds
- C. debt securities and other
- D. life insurance reserves
- E. deposits

10. In 2009, _____ was the most significant asset of Taiwanese households in terms of total value.

- A. real estate
- B. mutual funds
- C. debt securities and other
- D. life insurance reserves
- E. pension fund reserves

11. In 2009, _____ was the most significant liability of Taiwanese households in terms of total value.

- A. foreign liabilities
- B. loans
- C. accounts payable
- D. real estate
- E. other debt

12. Which of the following financial assets made up the greatest proportion of the financial assets held by Taiwanese households?

- A. Deposits
- B. Life insurance reserves
- C. Mutual funds
- D. Debt securities and other
- E. Personal trusts

13. In 2009, _____ of the total assets of Taiwanese households were domestic financial assets.

- A. 20.4%
- B. 34.2%
- C. 56.5%
- D. 71.7%
- E. 82.5%

14. The largest component of domestic net worth of Taiwan in 2009 was _____.

- A. equipment
- B. real estate
- C. other assets
- D. consumer durables and semi-durables
- E. inventories

15. The smallest component of domestic net worth of Taiwan in 2009 was _____.

- A. equipment
- B. real estate
- C. other assets
- D. consumer durables and semi-durables
- E. inventories

16. The national net worth of Taiwan in 2009 (in NT\$ 100 million) was _____.

- A. NT\$154,111
- B. NT\$264,387
- C. NT\$426,698
- D. NT\$1,302,656
- E. NT\$1,709,836

17. A fixed-income security pays _____.

- A. a fixed level of income for the life of the owner
- B. a fixed stream of income or a stream of income that is determined according to a specified formula for the life of the security
- C. a variable level of income for owners on a fixed income
- D. a fixed or variable income stream at the option of the owner
- E. a riskless return that is fixed for life

18. A debt security pays _____.

- A. a fixed level of income for the life of the owner
- B. a variable level of income for owners on a fixed income
- C. a fixed or variable income stream at the option of the owner
- D. a fixed stream of income or a stream of income that is determined according to a specified formula for the life of the security
- E. a riskless return that is fixed for life

19. Money market securities _____.

- A. are short term
- B. are highly marketable
- C. are generally very low risk
- D. are short term, highly marketable, and generally very low risk
- E. highly marketable and generally very low risk

20. An example of a derivative security is/are _____.

- A. a common share of Microsoft
- B. an Intel bond
- C. a commodity futures contract and a call option on Intel stock
- D. a call option on Intel stock and an Intel bond
- E. a common share of Intel stock

21. The value of a derivative security _____.
A. depends on the value of the related security
B. is unable to be calculated
C. is unrelated to the value of the related security
D. has been enhanced due to the recent misuse and negative publicity regarding these instruments
E. is worthless today
22. 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 risks
E. enhance their balance sheets
23. Financial assets can permit all of the following except _____.
A. consumption timing
B. allocation of risk
C. separation of ownership and control
D. elimination of risk
E. easy transfer of ownership
24. The _____ refers to the potential conflict between management and shareholders.
A. agency problem
B. diversification problem
C. liquidity problem
D. solvency problem
E. regulatory problem

25. 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. it causes managers to take undue risks.
- E. it causes managers to be too conservative.

26. 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

27. 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.

28. Theoretically, takeovers should result in _____.

- A. improved management
- B. increased stock price
- C. increased benefits to existing management of taken over firm
- D. improved management and increased stock price
- E. worse management and decreased stock price

29. 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

30. The Sarbanes-Oxley Act _____.

- A. requires corporations to have more independent directors
- B. requires the firm's CFO to personally vouch for the firm's accounting statements
- C. prohibits auditing firms from providing other services to clients
- D. requires corporations to have more independent directors and requires the firm's CFO to personally vouch for the firm's accounting statements
- E. requires corporations to have more independent directors and requires the firm's CFO to personally vouch for the firm's accounting statements, prohibits auditing firms from providing other services to clients, and requires corporations to have more independent directors and requires the firm's CFO to personally vouch for the firm's accounting statements

31. Asset allocation refers to _____.

- A. choosing which securities to hold based on their valuation
- B. investing only in "safe" securities
- C. the allocation of assets into broad asset classes
- D. bottom-up analysis
- E. top-down analysis

32. Security selection refers to _____.

- A. choosing which securities to hold based on their valuation
- B. investing only in "safe" securities
- C. the allocation of assets into broad asset classes
- D. top-down analysis
- E. moving assets between stocks and bonds

33. Which of the following portfolio construction methods starts with security analysis?

- A. Top-down
- B. Bottom-up
- C. Middle-out
- D. Buy and hold
- E. Asset allocation

34. Which of the following portfolio construction methods starts with asset allocation?

- A. Top-down
- B. Bottom-up
- C. Middle-out
- D. Buy and hold
- E. Asset allocation

35. _____ are examples of financial intermediaries.

- A. Commercial banks
- B. Insurance companies
- C. Investment companies
- D. Credit unions
- E. Commercial banks, insurance companies, investment companies, and credit unions

36. Financial intermediaries exist because small investors cannot efficiently _____.

- A. diversify their portfolios
- B. assess credit risk of borrowers
- C. advertise for needed investments
- D. diversify their portfolios, assess credit risk of borrowers, or advertise for needed investments
- E. diversify their portfolios or assess credit risk of borrowers

37. _____ specialize in helping companies raise capital by selling securities.
- A. commercial bankers
 - B. investment bankers
 - C. investment issuers
 - D. credit raters
 - E. commercial bankers, investment bankers, investment issuers, and credit raters
38. Commercial banks 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
39. In 2009, _____ was the most significant financial asset of U.S. commercial banks in terms of total value.
- A. loans and leases
 - B. cash
 - C. real estate
 - D. deposits
 - E. investment securities
40. In 2009, _____ was the most significant liability of U.S. commercial banks in terms of total value.
- A. loans and leases
 - B. cash
 - C. real estate
 - D. deposits
 - E. investment securities

41. In 2009, _____ was the most significant real asset of U.S. nonfinancial businesses in terms of total value.

- A. equipment and software
- B. inventory
- C. real estate
- D. trade credit
- E. marketable securities

42. In 2009, _____ was the least significant real asset of U.S. nonfinancial businesses in terms of total value.

- A. equipment and software
- B. inventory
- C. real estate
- D. trade credit
- E. marketable securities

43. In 2009, _____ was the least significant liability of U.S. nonfinancial businesses in terms of total value.

- A. bonds and mortgages
- B. loans
- C. inventories
- D. trade debt
- E. marketable securities

44. In terms of total value, the most significant liability of U.S. nonfinancial businesses in 2009 was _____.

- A. loans
- B. bonds and mortgages
- C. trade debt
- D. other loans
- E. marketable securities

45. In 2009, _____ was the least significant financial asset of U.S. nonfinancial businesses in terms of total value.

- A. cash and deposits
- B. trade credit
- C. trade debt
- D. inventory
- E. marketable securities

46. New issues of securities are sold in the _____ market(s).

- A. primary
- B. secondary
- C. over the counter
- D. primary and secondary
- E. primary and over the counter

47. Investors trade previously issued securities in the _____ market(s).

- A. primary
- B. secondary
- C. primary and secondary
- D. derivatives
- E. primary and derivatives

48. 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. make trades for small investors
- E. market new stock and bond issues for firms, provide advice to the firms as to market conditions, price, etc, and design securities with desirable properties

49. Until 1999, the _____ Act(s) prohibited banks in the United States from both accepting deposits and underwriting securities.
- A. Sarbanes-Oxley
 - B. Glass-Steagall
 - C. SEC
 - D. Sarbanes-Oxley and SEC
 - E. Fair Credit
50. The spread between the LIBOR and the Treasury-bill rate is called the _____.
- A. term spread
 - B. T-bill spread
 - C. LIBOR spread
 - D. TED spread
 - E. FRED spread
51. Mortgage-backed securities were created when _____ began buying mortgage loans from originators and bundling them into large pools that could be traded like any other financial asset.
- A. GNMA
 - B. FNMA
 - C. FHLMC
 - D. FNMA and FHLMC
 - E. GNMA and FNMA
52. 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. a Ponzi scheme

53. Which of the following is true about mortgage-backed securities?

- I) They aggregate individual home mortgages into homogeneous pools.
 - II) The purchaser 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

54. _____ were designed to concentrate the credit risk of a bundle of loans on one class of investor, leaving the other investors in the pool relatively protected from that risk.

- A. Stocks
- B. Bonds
- C. Derivatives
- D. Collateralized debt obligations
- E. TIPS

55. _____ are in essence an insurance contract against the default of one or more borrowers.

- A. Credit default swaps
- B. CMOs
- C. ETFs
- D. Collateralized debt obligations
- E. Collars

Chapter 01 - The Investment Environment

Short Answer Questions

56. Discuss the agency problem in detail.

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

58. Discuss securitization as it relates to the field of investments.

Chapter 01 The Investment Environment **Answer Key**

Multiple Choice Questions

1. The material wealth of a society is a function of _____.
A. all financial assets
B. all real assets
C. all financial and real assets
D. all physical assets
E. all commodities

The material wealth of a society is a function of all real assets.

*AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Assets*

2. _____ is/are a real asset(s).
A. Only land
B. Only machines
C. Only stocks and bonds
D. Only knowledge
E. Land, machines and knowledge are real assets

Land, machines and knowledge are real assets; stocks and bonds are financial assets.

*AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Assets*

3. 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.

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

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Assets

4. _____ is/are financial assets.

- A. Only bonds
- B. Only machines
- C. Only stocks
- D.** Stocks and bonds
- E. Knowledge

Machines and knowledge are real assets; stocks and bonds are financial assets.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Assets

5. _____ financial asset(s).
- A. Buildings are
 - B. Land is a
 - C. Derivatives are
 - D. U.S. Agency bonds are
 - E. Derivatives and U.S. Agency bonds are**

Land and Buildings are real assets.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Assets

6. 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

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.

AACSB: Analytic
Bloom's: Understand
Difficulty: Basic
Topic: Assets

7. In 2009, _____ was the most significant real asset of Taiwanese households in terms of total value.

- A. consumer durables and semi-durables
- B. foreign assets
- C. real estate**
- D. mutual funds
- E. loans

See Table 1.1.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Assets

8. In 2009, Currency and _____ were the least significant financial assets of Taiwanese households in terms of total value.

- A. real estate
- B. mutual funds
- C. life insurance reserves
- D. debt securities and other**
- E. pension fund reserves

See Table 1.1.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Assets

9. In 2009, _____ was the most significant financial asset of Taiwanese households in terms of total value.

- A. real estate
- B. mutual funds
- C. debt securities and other
- D. life insurance reserves
- E.** deposits

See Table 1.1.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Assets

10. In 2009, _____ was the most significant asset of Taiwanese households in terms of total value.

- A.** real estate
- B. mutual funds
- C. debt securities and other
- D. life insurance reserves
- E. pension fund reserves

See Table 1.1.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Assets

11. In 2009, _____ was the most significant liability of Taiwanese households in terms of total value.

- A. foreign liabilities
- B.** loans
- C. accounts payable
- D. real estate
- E. other debt

See Table 1.1.

AACSB: Analytic
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Difficulty: Basic
Topic: Assets

12. Which of the following financial assets made up the greatest proportion of the financial assets held by Taiwanese households?

- A.** Deposits
- B. Life insurance reserves
- C. Mutual funds
- D. Debt securities and other
- E. Personal trusts

See Table 1.1.

AACSB: Analytic
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Difficulty: Intermediate
Topic: Assets

13. In 2009, _____ of the total assets of Taiwanese households were domestic financial assets.

- A. 20.4%
- B. 34.2%
- C. 56.5%**
- D. 71.7%
- E. 82.5%

See Table 1.1.

AACSB: Analytic
Bloom's: Remember
Difficulty: Intermediate
Topic: Assets

14. The largest component of domestic net worth of Taiwan in 2009 was _____.

- A. equipment
- B. real estate**
- C. other assets
- D. consumer durables and semi-durables
- E. inventories

See Table 1.2.

AACSB: Analytic
Bloom's: Remember
Difficulty: Intermediate
Topic: Assets

15. The smallest component of domestic net worth of Taiwan in 2009 was _____.

- A. equipment
- B. real estate
- C. other assets**
- D. consumer durables and semi-durables
- E. inventories

See Table 1.2.

AACSB: Analytic
Bloom's: Remember
Difficulty: Intermediate
Topic: Assets

16. The national net worth of Taiwan in 2009 (in NT\$ 100 million) was _____.

- A. NT\$154,111
- B. NT\$264,387
- C. NT\$426,698
- D. NT\$1,302,656**
- E. NT\$1,709,836

See Table 1.2.

AACSB: Analytic
Bloom's: Remember
Difficulty: Intermediate
Topic: Assets

17. A fixed-income security pays _____.

- A. a fixed level of income for the life of the owner
- B. a fixed stream of income or a stream of income that is determined according to a specified formula for the life of the security**
- C. a variable level of income for owners on a fixed income
- D. a fixed or variable income stream at the option of the owner
- E. a riskless return that is fixed for life

A fixed-income security pays a fixed stream of income or a stream of income that is determined according to a specified formula for the life of the security.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Asset Types

18. A debt security pays _____.

- A. a fixed level of income for the life of the owner
- B. a variable level of income for owners on a fixed income
- C. a fixed or variable income stream at the option of the owner
- D. a fixed stream of income or a stream of income that is determined according to a specified formula for the life of the security**
- E. a riskless return that is fixed for life

Only answer D is correct.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Asset Types

19. Money market securities _____.
- A. are short term
 - B. are highly marketable
 - C. are generally very low risk
 - D.** are short term, highly marketable, and generally very low risk
 - E. highly marketable and generally very low risk

Are short term, highly marketable, and generally very low risk.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Asset Types

20. An example of a derivative security is/are _____.
- A. a common share of Microsoft
 - B. an Intel bond
 - C.** a commodity futures contract and a call option on Intel stock
 - D. a call option on Intel stock and an Intel bond
 - E. a common share of Intel stock

A call option on Intel stock and an Intel bond. Common stocks and bonds are not derivative assets.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Asset Types

21. The value of a derivative security _____.

- A. depends on the value of the related security
- B. is unable to be calculated
- C. is unrelated to the value of the related security
- D. has been enhanced due to the recent misuse and negative publicity regarding these instruments
- E. is worthless today

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

AACSB: Analytic
Bloom's: Understand
Difficulty: Basic
Topic: Asset Types

22. 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 risks.
- E. enhance their balance sheets.

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.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Asset Types

23. Financial assets can permit all of the following except _____.

- A. consumption timing
- B. allocation of risk
- C. separation of ownership and control
- D. elimination of risk**
- E. easy transfer of ownership

Financial assets do not allow risk to be eliminated. However, they do permit allocation of risk, consumption timing, and separation of ownership and control.

AACSB: Analytic
Bloom's: Remember
Difficulty: Intermediate
Topic: Assets

24. The _____ refers to the potential conflict between management and shareholders.

- A. agency problem**
- B. diversification problem
- C. liquidity problem
- D. solvency problem
- E. regulatory problem

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

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Management

25. 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. it causes managers to take undue risks.
- E. it causes managers to be too conservative.

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.

AACSB: Analytic
Bloom's: Understand
Difficulty: Basic
Topic: Financial Management

26. 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

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

AACSB: Analytic
Bloom's: Understand
Difficulty: Intermediate
Topic: Financial Management

27. 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.

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.

AACSB: Analytic
Bloom's: Understand
Difficulty: Intermediate
Topic: Financial Management

28. Theoretically, takeovers should result in _____.
- A. improved management
 - B. increased stock price
 - C. increased benefits to existing management of taken over firm
 - D.** improved management and increased stock price
 - E. worse management and decreased stock price

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.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Management

29. 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

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

AACSB: Analytic
Bloom's: Understand
Difficulty: Intermediate
Topic: Financial Management

30. The Sarbanes-Oxley Act _____.

- A. requires corporations to have more independent directors
- B. requires the firm's CFO to personally vouch for the firm's accounting statements
- C. prohibits auditing firms from providing other services to clients
- D. requires corporations to have more independent directors and requires the firm's CFO to personally vouch for the firm's accounting statements
- E. requires corporations to have more independent directors and requires the firm's CFO to personally vouch for the firm's accounting statements, prohibits auditing firms from providing other services to clients, and requires corporations to have more independent directors and requires the firm's CFO to personally vouch for the firm's accounting statements

The Sarbanes-Oxley Act requires corporations to have more independent directors and requires the firm's CFO to personally vouch for the firm's accounting statements, prohibits auditing firms from providing other services to clients, and requires corporations to have more independent directors and requires the firm's CFO to personally vouch for the firm's accounting statements.

AACSB: Analytic
Bloom's: Remember
Difficulty: Intermediate
Topic: Regulation

31. Asset allocation refers to _____.
- A. choosing which securities to hold based on their valuation
 - B. investing only in "safe" securities
 - C. the allocation of assets into broad asset classes
 - D. bottom-up analysis
 - E. top-down analysis

Asset allocation refers to the allocation of assets into broad asset classes.

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Difficulty: Intermediate
Topic: Financial Management

32. Security selection refers to _____.
- A. choosing which securities to hold based on their valuation
 - B. investing only in "safe" securities
 - C. the allocation of assets into broad asset classes
 - D. top-down analysis
 - E. moving assets between stocks and bonds

Security selection refers to choosing which securities to hold based on their valuation.

AACSB: Analytic
Bloom's: Remember
Difficulty: Intermediate
Topic: Financial Management

33. Which of the following portfolio construction methods starts with security analysis?

- A. Top-down
- B. Bottom-up**
- C. Middle-out
- D. Buy and hold
- E. Asset allocation

Bottom-up refers to using security analysis to find securities that are attractively priced. Top-down refers to using asset allocation as a starting point.

AACSB: Analytic
Bloom's: Remember
Difficulty: Intermediate
Topic: Portfolio

34. Which of the following portfolio construction methods starts with asset allocation?

- A. Top-down**
- B. Bottom-up
- C. Middle-out
- D. Buy and hold
- E. Asset allocation

Bottom-up refers to using security analysis to find securities that are attractively priced.

AACSB: Analytic
Bloom's: Remember
Difficulty: Intermediate
Topic: Portfolio

35. _____ are examples of financial intermediaries.

- A. Commercial banks
- B. Insurance companies
- C. Investment companies
- D. Credit unions
- E. Commercial banks, insurance companies, investment companies, and credit unions**

Banks, insurance companies, investment companies, and credit unions are institutions that bring borrowers and lenders together.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Institutions

36. Financial intermediaries exist because small investors cannot efficiently _____.

- A. diversify their portfolios
- B. assess credit risk of borrowers
- C. advertise for needed investments
- D. diversify their portfolios, assess credit risk of borrowers, or advertise for needed investments**
- E. diversify their portfolios or assess credit risk of borrowers.

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.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Institutions

37. _____ specialize in helping companies raise capital by selling securities.
- A. commercial bankers
 - B. investment bankers**
 - C. investment issuers
 - D. credit raters
 - E. commercial bankers, investment bankers, investment issuers, and credit raters

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

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Institutions

38. Commercial banks 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.

See Table 1.3.

AACSB: Analytic
Bloom's: Understand
Difficulty: Basic
Topic: Financial Institutions

39. In 2009, _____ was the most significant financial asset of U.S. commercial banks in terms of total value.

- A. loans and leases
- B. cash
- C. real estate
- D. deposits
- E. investment securities

See Table 1.3.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Institutions

40. In 2009, _____ was the most significant liability of U.S. commercial banks in terms of total value.

- A. loans and leases
- B. cash
- C. real estate
- D. deposits
- E. investment securities

See Table 1.3.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Institutions

41. In 2009, _____ was the most significant real asset of U.S. nonfinancial businesses in terms of total value.

- A. equipment and software
- B. inventory
- C. real estate**
- D. trade credit
- E. marketable securities

See Table 1.4.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Institutions

42. In 2009, _____ was the least significant real asset of U.S. nonfinancial businesses in terms of total value.

- A. equipment and software
- B. inventory**
- C. real estate
- D. trade credit
- E. marketable securities

See Table 1.4.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Institutions

43. In 2009, _____ was the least significant liability of U.S. nonfinancial businesses in terms of total value.

- A. bonds and mortgages
- B. loans**
- C. inventories
- D. trade debt
- E. marketable securities

See Table 1.4.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Institutions

44. In terms of total value, the most significant liability of U.S. nonfinancial businesses in 2009 was _____.

- A. loans
- B. bonds and mortgages**
- C. trade debt
- D. other loans
- E. marketable securities

See Table 1.4.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Institutions

45. In 2009, _____ was the least significant financial asset of U.S. nonfinancial businesses in terms of total value.

- A. cash and deposits
- B. trade credit
- C. trade debt
- D. inventory
- E. marketable securities

See Table 1.4.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Institutions

46. New issues of securities are sold in the _____ market(s).

- A. primary
- B. secondary
- C. over the counter
- D. primary and secondary
- E. primary and over the counter

New issues of securities are sold in the primary market.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Markets

47. Investors trade previously issued securities in the _____ market(s).

- A. primary
- B. secondary**
- C. primary and secondary
- D. derivatives
- E. primary and derivatives

Investors trade previously issued securities in the secondary market.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Markets

48. 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. make trades for small investors
- E. market new stock and bond issues for firms, provide advice to the firms as to market conditions, price, etc, and design securities with desirable properties**

Investment bankers market new stock and bond issues for firms, provide advice to the firms as to market conditions, price, etc, and design securities with desirable properties.

AACSB: Analytic
Bloom's: Understand
Difficulty: Basic
Topic: Financial Markets

49. Until 1999, the _____ Act(s) prohibited banks in the United States from both accepting deposits and underwriting securities.

- A. Sarbanes-Oxley
- B. Glass-Steagall**
- C. SEC
- D. Sarbanes-Oxley and SEC
- E. Fair Credit

Until 1999, the Glass-Steagall Act prohibited banks in the United States from both accepting deposits and underwriting securities.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Regulation

50. The spread between the LIBOR and the Treasury-bill rate is called the _____.

- A. term spread
- B. T-bill spread
- C. LIBOR spread
- D. TED spread**
- E. FRED spread

The spread between the LIBOR and the Treasury-bill rate is called the TED spread.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Financial Markets

51. Mortgage-backed securities were created when _____ began buying mortgage loans from originators and bundling them into large pools that could be traded like any other financial asset.

- A. GNMA
- B. FNMA
- C. FHLMC
- D.** FNMA and FHLMC
- E. GNMA and FNMA

Mortgage-backed securities were created when FNMA and FHLMC began buying mortgage loans from originators and bundling them into large pools that could be traded like any other financial asset.

AACSB: Analytic
Bloom's: Remember
Difficulty: Basic
Topic: Securities

52. 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. a Ponzi scheme

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

AACSB: Analytic
Bloom's: Understand
Difficulty: Basic
Topic: Securities

53. Which of the following is true about mortgage-backed securities?

- I) They aggregate individual home mortgages into homogeneous pools.
 - II) The purchaser 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

III is not correct because the bank no longer owns the mortgage investments.

AACSB: Analytic
Bloom's: Understand
Difficulty: Intermediate
Topic: Securities

54. _____ were designed to concentrate the credit risk of a bundle of loans on one class of investor, leaving the other investors in the pool relatively protected from that risk.

- A. Stocks
B. Bonds
C. Derivatives
D. Collateralized debt obligations
E. TIPS.

Collateralized debt obligations were designed to concentrate the credit risk of a bundle of loans on one class of investor, leaving the other investors in the pool relatively protected from that risk.

AACSB: Analytic
Bloom's: Understand
Difficulty: Basic
Topic: Securities

55. _____ are in essence an insurance contract against the default of one or more borrowers.

- A. Credit default swaps
- B. CMOs
- C. ETFs
- D. Collateralized debt obligations
- E. Collars

Credit default swaps are in essence an insurance contract against the default of one or more borrowers.

*AACSB: Analytic
Bloom's: Understand
Difficulty: Basic
Topic: Securities*

Short Answer Questions

56. Discuss the agency problem in detail.

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.

Feedback: 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.

*AACSB: Reflective Thinking
Bloom's: Analyze
Difficulty: Intermediate
Topic: Financial Management*

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

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.

Feedback: 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.

AACSB: Reflective Thinking

Bloom's: Analyze

Difficulty: Intermediate

Topic: Assets

58. Discuss securitization as it relates to the field of investments.

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. Example: mortgage-backed securities. Securitization allows investors to hold partial ownership in financial assets that would otherwise be beyond their reach (e.g., mortgages). Financial engineering involves bundling or unbundling. Bundling involves combining separate securities.

Feedback: The purpose of this question is to ascertain if the student understands the importance of securitization and the impact it has on the field of investments.

AACSB: Reflective Thinking

Bloom's: Analyze

Difficulty: Intermediate

Topic: Securities