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.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-01 Real Assets versus Financial Assets.
Topic: 01-01 Real Assets versus Financial Assets

2. _______ are real assets.
A. Land
B. Machines
C. Stocks and bonds
D. Knowledge
E. Land, machines, and knowledge

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

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-01 Real Assets versus Financial Assets.
Topic: 01-01 Real Assets versus Financial 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.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-01 Real Assets versus Financial Assets.
Topic: 01-01 Real Assets versus Financial Assets

4. _______ are financial assets.
A. Bonds
B. Machines
C. Stocks
D. Bonds and stocks
E. Bonds, machines, and stocks

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

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-01 Real Assets versus Financial Assets.
Topic: 01-01 Real Assets versus Financial Assets

5. _________ financial asset(s).
A. Buildings are
B. Land is a
C. Derivatives are
D. Canadian T-Bills are
E. Derivatives and Canadian bonds are

Buildings and land are real assets.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-01 Real Assets versus Financial Assets.
Topic: 01-01 Real Assets versus Financial 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.

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Easy
Learning Objective: 01-01 Real Assets versus Financial Assets.
Topic: 01-01 Real Assets versus Financial Assets

7. A security that pays a specified cash flow over a specific period is called
A. fixed income.
B. stock option.
C. mutual fund.
D. real estate.
E. index.

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Easy
Learning Objective: 01-02 Financial Assets.
Topic: 01-02 Financial Assets

8. _________ is a commodity.
A. Swap
B. Money
C. Gold
D. Future contract
E. Treasury-bill

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Easy
Learning Objective: 01-02 Financial Assets.
Topic: 01-02 Financial Assets

9. Compared to investments in debt securities, equity investments tend to be
A. equally risky.
B. riskier.
C. less risky.
D. more important.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-02 Financial Assets.
Topic: 01-02 Financial Assets

10. Which one of the following is a not role of the financial markets?
A. Consumption timing
B. Information
C. Separation of ownership and control
D. Increasing wealth of the economy
E. Risk allocation

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Easy
Learning Objective: 01-03 Financial Markets and the Economy.
Topic: 01-03 Financial Markets and the Economy

11. Holding highly diversified portfolios without spending effort or other resources attempting to improve investment performance through security analysis is a characteristic of
A. Active management.
B. Passive management.
C. Both active and passive management.
D. Risk-return trade-off.
E. Efficient markets.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-05 Markets Are Competitive.
Topic: 01-05 Consumption Timing

12. The attempt to improve performance either by identifying mispriced securities or by timing the performance of broad asset classes is a characteristic of:
A. Active management
B. Passive management
C. Both active and passive management
D. Risk-return trade-off
E. Efficient markets

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-05 Markets Are Competitive.
Topic: 01-10 Markets Are Competitive

13. A common measure of credit risk in the banking sector is
A. systemic Risk.
B. treasury-bill.
C. TED spread.
D. LIBOR.
E. yield curve.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-07 The Financial Crisis of 2008.
Topic: 01-17 The Financial Crisis of 2008

14. _______ is in an insurance contract against the default of one or more borrowers.
A. Collateralized debt obligation
B. credit default swap
C. Freddie Mac
D. Adjustable-rate mortgage
E. Fannie Mae

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-07 The Financial Crisis of 2008.
Topic: 01-17 The Financial Crisis of 2008

15. Systemic risk is
A. credit risk.
B. an insurance contract against the default of one or more borrowers.
C. firm-specific risk.
D. default risk.
E. the potential breakdown of the financial system when problems in one market spill over and disrupt others.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-07 The Financial Crisis of 2008.
Topic: 01-17 The Financial Crisis of 2008

16. 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.

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.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-02 Financial Assets.
Topic: 01-02 Financial Assets

17. 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.

A debt 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.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-02 Financial Assets.
Topic: 01-02 Financial Assets

18. Money market securities
A. are short term.
B. are highly marketable.
C. are generally very low risk.
D. are highly marketable and are generally very low risk.
<u>E.</u> All of the options.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-02 Financial Assets.
Topic: 01-02 Financial Assets

19. An example of a derivative security is
A. a common share of Microsoft.
B. a call option on Intel stock.
C. a commodity futures contract.
<u>D.</u> a call option on Intel stock and a commodity futures contract.
E. a common share of Microsoft and a call option on Intel stock.

The values of a call option on Intel stock and a commodity futures contract are derived from that of an underlying asset; the value of a common share of Microsoft is based on the value of the firm only.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-02 Financial Assets.
Topic: 01-02 Financial Assets

20. 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 the value of the related security affects the value of the derivative and/or is a true statement.

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Easy
Learning Objective: 01-02 Financial Assets.
Topic: 01-02 Financial Assets

21. 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.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-02 Financial Assets.
Topic: 01-02 Financial Assets

22. Financial assets permit all of the following except
A. consumption timing.
B. allocation of risk.
C. separation of ownership and control.
D. elimination of risk.

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

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 01-01 Real Assets versus Financial Assets.
Topic: 01-01 Real Assets versus Financial Assets

23. 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.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-03 Financial Markets and the Economy.
Topic: 01-03 Financial Markets and the Economy

24. 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.

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Easy
Learning Objective: 01-03 Financial Markets and the Economy.
Topic: 01-03 Financial Markets and the Economy

25. Which of the following are mechanisms that have evolved to mitigate potential agency problems?

I) Using the firm's stock options for compensation
II) Hiring bickering family members as corporate spies
III) Boards of directors forcing out underperforming management
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

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Medium
Learning Objective: 01-03 Financial Markets and the Economy.
Topic: 01-03 Financial Markets and the Economy

26. 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.

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Medium
Learning Objective: 01-03 Financial Markets and the Economy.
Topic: 01-03 Financial Markets and the Economy

27. Theoretically, takeovers should result in
A. improved management.
B. increased stock price.
C. increased benefits to existing management of the taken-over firm.
D. improved management and increased stock price.
E. All of the options.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-03 Financial Markets and the Economy.
Topic: 01-03 Financial Markets and the Economy

28. 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.

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Medium
Learning Objective: 01-03 Financial Markets and the Economy.
Topic: 01-03 Financial Markets and the Economy

29. 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. All of the above.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 01-03 Financial Markets and the Economy.
Topic: 01-03 Financial Markets and the Economy

30. 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.

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

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 01-04 The Investment Process.
Topic: 01-09 The Investment Process

31. 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.

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

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 01-04 The Investment Process.
Topic: 01-09 The Investment Process

32. 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.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 01-04 The Investment Process.
Topic: 01-09 The Investment Process

33. 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.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Medium
Learning Objective: 01-04 The Investment Process.
Topic: 01-09 The Investment Process

34. _______ are examples of financial intermediaries.
A. Commercial banks
B. Insurance companies
C. Investment companies
D. Credit unions
E. All of the options

All are institutions that bring borrowers and lenders together.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-06 The Players.
Topic: 01-13 The Players

35. 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 and assess credit risk of borrowers.
E. All of the options.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-06 The Players.
Topic: 01-13 The Players

36. ________ specialize in helping companies raise capital by selling securities.
A. Commercial bankers
B. Investment bankers
C. Investment issuers
D. Credit raters

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

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-06 The Players.
Topic: 01-13 The Players

37. 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.

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Easy
Learning Objective: 01-06 The Players.
Topic: 01-13 The Players

38. In 2016, ____________ was(were) the most significant financial asset(s) of U.S. commercial banks in terms of total value.
A. loans and leases
B. cash
C. real estate
D. deposits
E. investment securities

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-06 The Players.
Topic: 01-13 The Players

39. In 2016, ____________ was(were) the most significant liability(ies) of U.S. commercial banks in terms of total value.
A. loans and leases
B. cash
C. real estate
D. deposits
E. investment securities

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-06 The Players.
Topic: 01-13 The Players

40. In 2016, ____________ was(were) the most significant real asset(s) 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

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-01 Real Assets versus Financial Assets.
Topic: 01-01 Real Assets versus Financial Assets

41. In 2016, ____________ was(were) the least significant real asset(s) 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

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-01 Real Assets versus Financial Assets.
Topic: 01-01 Real Assets versus Financial Assets

42. In 2016, ____________ was(were) the least significant liability(ies) of U.S. nonfinancial businesses in terms of total value.
A. bonds and mortgages
B. bank loans
C. inventories
D. trade debt
E. marketable securities

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-02 Financial Assets.
Topic: 01-02 Financial Assets

43. In terms of total value, the most significant liability(ies) of U.S. nonfinancial businesses in 2016 was(were)
A. bank loans.
B. bonds and mortgages.
C. trade debt.
D. other loans.
E. marketable securities.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-02 Financial Assets.
Topic: 01-02 Financial Assets

44. In 2016, ____________ was(were) the least significant financial asset(s) 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

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-01 Real Assets versus Financial Assets.
Topic: 01-01 Real Assets versus Financial Assets

45. New issues of securities are sold in the ________ market(s).
A. primary
B. secondary
C. over-the-counter
D. primary and secondary

New issues of securities are sold in the primary market.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-06 The Players.
Topic: 01-13 The Players

46. Investors trade previously issued securities in the ________ market(s).
A. primary
B. secondary
C. primary and secondary
D. derivatives

Investors trade previously issued securities in the secondary market.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-06 The Players.
Topic: 01-13 The Players

47. Investment bankers perform which of 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 options
E. None of the options

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

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Easy
Learning Objective: 01-06 The Players.
Topic: 01-13 The Players

48. 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. None of the options

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

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-06 The Players.
Topic: 01-13 The Players

49. 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.

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

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-07 The Financial Crisis of 2008.
Topic: 01-17 The Financial Crisis of 2008

50. 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.

Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: Easy
Learning Objective: 01-07 The Financial Crisis of 2008.
Topic: 01-17 The Financial Crisis of 2008

51. The sale of a mortgage portfolio by setting up mortgage pass-through securities is an example of
A. credit enhancement.
B. credit swap.
C. unbundling.
D. derivatives.

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Easy
Learning Objective: 01-07 The Financial Crisis of 2008.
Topic: 01-17 The Financial Crisis of 2008

52. 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 may 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

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Medium
Learning Objective: 01-07 The Financial Crisis of 2008.
Topic: 01-17 The Financial Crisis of 2008

53. ________ 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. All of the options

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.

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Easy
Learning Objective: 01-07 The Financial Crisis of 2008.
Topic: 01-17 The Financial Crisis of 2008

54. ________ 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. All of the options

Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: Easy
Learning Objective: 01-07 The Financial Crisis of 2008.
Topic: 01-17 The Financial Crisis of 2008