Midterm 1 Practice Questions

ECON 160: W20

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1) You peruse the available records of some bankers in your area and notice that they persistently gain higher returns on their stock portfolios than the market average. As a believer in efficient markets, what explanation for these rates of returns seems most likely to you?

ANSWER: Bankers have access to inside information, and they use the information to guide their investment decisions.

2) Which of the following is not a feature of common stock?
a) Stockholders receive regular fixed payments on their shares.
b) Stockholders have limited liability.
c) Stock holders are residual claimants.
d) Stockholders have voting rights.

Answer: A

3) A stock has a current annual dividend of $6.00 per year and it is expected to grow by 3% (0.03) a year. It is expected that two years from now the stock will sell for $90.00 a share. If the interest rate is 5% (0.05), the dividend-discount model predicts the stock's current price should be:

a) $94.90
b) $78.68
c) $101.30
d) $94.30

Answer: B

3) the event of bankruptcy, stockholders:
a) are paid before bondholders.
b) receive at least their initial investment due to limited liability.
c) could lose more than their initial investment.
d) are the last to be paid and could end up losing what they have invested

Answer: D

4) The impact from rapid dividend growth on a stock's current price will be:
a) negative, since the company is paying out profits to stockholders.
b) positive since rapid dividend growth causes stockholders to expect higher future dividends.
c) zero; only current dividends are used to determine the current price of a stock.
d) positive, but only if the corporation does not have any debt.

Answer: B

5) Explain why being a residual claimant makes stock ownership risky.

Answer: Stockholders do not receive dividends unless all of the firm's creditors have been paid. If the firm does poorly, stockholders may receive nothing. The result is that returns to stockholders have high variance. In the event that the firm goes bankrupt, stockholders lose their entire investment.

6) The fact that common stockholders are residual claimants means the stockholders:
a) have a claim against the revenue that remains after everyone else is paid.
b) receive their dividends before any other residuals are paid.
c) are paid any past due dividends before other claims are paid.
d) are paid before the bondholders but after any taxes are paid.

Answer: A

7) An index number is valuable because:
a) the level of every index number itself provides critical information.
b) it is more stable than the data it reflects.
c) it provides a meaningful measurement scale to calculate percentage changes.
d) it does not require any calculations to compute percentage changes.

Answer: C

8) People differ on the method by which stock should be valued. Some people are chartists, others behavioralists. The basic difference between these groups is:
a) chartists rely on astrological charts to predict stock values, behavioralists rely on psychology.
b) behavioralists are finance based, chartists study charts of investor psychology.
c) chartists study charts of stock prices; behavioralists focus on investor psychology and behavior.
d) chartists and behavioralists are the same in their approach; essentially there aren't any differences.

Answer: C

9) In the generalized dividend model, if the expected sales price is in the distant future
a) it does not affect the current stock price.
b) it is more important than dividends in determining the current stock price.
c) it is equally important with dividends in determining the current stock price.
d) it is less important than dividends but still affects the current stock price.

Answer: A

10) One of the assumptions of the Gordon Growth Model is that dividends will continue growing at ________ rate.
a) an increasing
b) a fast

c) a constant
d) an escalating

Answer: C

11) All of the following EXCEPT one is a property of an illiquid market. Which one does not belong?
a) Agents cannot buy or sell quickly
b) Attempts to buy or sell tend to move prices around a lot.
c) Prices tend to be inefficient, i.e. different from fundamental value
d) Agents cannot buy or sell large quantities easily.
e) Dealers in illiquid markets are well capitalized

Answer: E

Treynor's Dealer Model. Please refer to Table III at

www.newyorkfed.org/markets/statistics/deal.pdf. The questions below refer to the

numbers as of close of trading October 3, 2007.

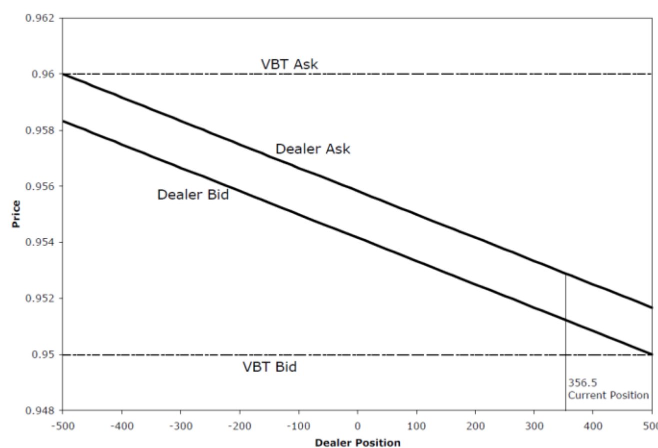
12) Taking all the dealer positions together, observe that primary dealers hold a net

long position in bonds. Using the Treynor model, depict the dealers' actual position in

between their maximum short and maximum long position.

Answer: The current net position of dealer is –106.4+ 114.0 + 43.9 + 262.0 = 356.5 million.

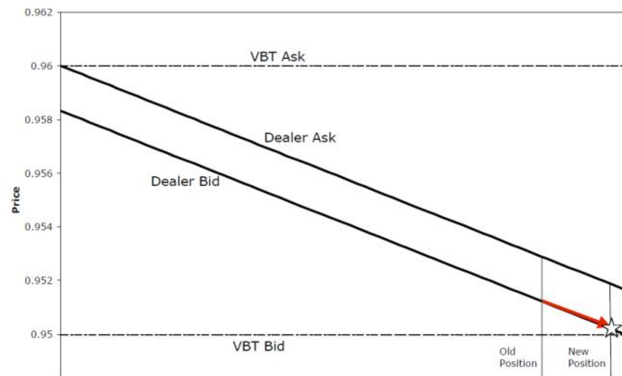
This can be represented on the Treynor figure as:



Max positions are just for illustration.

13) According to the Treynor model, how would dealers change their quoted price if they were to receive an order to sell a large quantity of bonds?

Answer: If the dealers' customers (traders) want to sell bonds, then the dealers must buy bonds; this will increase their long position. Dealers move to the right in our figure, lowering both their bid and ask prices.



Treynor argues that it is rational for dealers to quote the prices given by their final position, *if the sale goes through*. Thus, if a customer seeks to large order, as depicted above, they will receive the dealer bid marked with a star for the entire batch.

14) In the Treynor model, the quoted price at the maximum short and maximum long position depends on the price at which value investors are willing to absorb excess inventories. But the size of the maximum position depends on the dealers' ability and willingness to shoulder the risk involved. What is the relevant risk in holding an inventory of bonds?

Answer: Just as with holding any other asset, dealers are exposed to a price risk. If they are long, and the price of the bond drops (interest rates rise), then they incur a loss. Of course, if the price increases, they will make a gain. The situation is reversed if the dealer is short. The size of the gain or loss will always be proportional to the dealer's position – so a larger position implies increased risk.

In addition, corporate bonds always trade at a spread over riskless Treasuries reflecting credit risk. There is always the danger that the seller of bonds knows some bad news about the issuer of the bonds that is not yet public knowledge but will cause the bond price to fall once it becomes public knowledge.

15) Leaving aside corporate securities, observe that the dealers are engaged in at least two different arbitrage trades, long Agency securities and short Governments, while at the same time long the near end of the yield curve and short the far end. Under what conditions will such arbitrages make money for the dealers?

Answer: Dealers are hoping that the price of governments goes down relative to the price of agencies. That is, they are hoping the interest on governments will go up relative to the interest on agencies. This is a bet not on the overall movement of interest rates (up or down) but rather on the spread.

The dealers are long debt that will mature soon, but short debt that has later maturity. Thus they are hoping that the price of short-term debt will increase relative to the price of long-term debt. That means that interest rates will drop in the near term relative to the long term. This is a bet not on the overall movement of

interest rates (up or down) but rather on the spread, or the slope of the yield curve.

Dealers are betting that the yield curve will get steeper.