

Name _____

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Section Number _____

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.**Helpful Equations for the Sara and Tom Questions:**Assume F = future value, P = present value, and i = yield to maturity

$$F = P \times (1+i)^N$$

$$F = P \times i$$

$$F = \frac{P \times i}{1 - [1/(1+i)^N]}$$

- 1) In the bond market, the bond demanders are the _____ and the bond suppliers are the _____ 1) _____
 A) lenders; borrowers B) lenders; advancers
 C) borrowers; lenders D) borrowers; advancers
- 2) Assume today's one-year interest rate is 0.10%, the three-year interest rate is 0.60%, and the three-year liquidity premium is 0.20%. According to the Liquidity Premium Theory, which of the following is a possible combination of future one-year interest rates? 2) _____
 A) 0.10%, 1.0% B) 0.10%, 0.10% C) 0.20%, 0.30% D) 0.60%, 0.60%
- 3) Tom would like to borrow \$250 from Sara today. In return, Tom has agreed to pay Sara \$35 forever, but will never pay back the \$250. (Assume they both live forever). What is Sara's yield to maturity? 3) _____
 A) 17.45% B) 14.25% C) 15% D) 14%
- 4) When talking about a coupon bond, face value and _____ mean the same thing. 4) _____
 A) discount value B) amortized value
 C) coupon value D) par value
- 5) When the interest rate on a bond is _____ the equilibrium interest rate, in the bond market there is excess _____ and the interest rate will _____. 5) _____
 A) below; supply; fall B) above; demand; fall
 C) above; supply; rise D) above; demand; rise
- 6) A particularly attractive feature of the _____ is that it tells you what the market is predicting about future short-term interest rates by just looking at the slope of the yield curve. 6) _____
 A) liquidity premium theory B) expectations theory
 C) separable markets theory D) segmented markets theory
- 7) Everything else held constant, if the tax-exempt status of municipal bonds were eliminated, then 7) _____
 A) the interest rates on municipal, Treasury, and corporate bonds would all increase.
 B) the interest rates on municipal bonds would still be less than the interest rate on Treasury bonds.
 C) the interest rate on municipal bonds would exceed the rate on Treasury bonds.
 D) the interest rate on municipal bonds would equal the rate on Treasury bonds.

- 8) Sara decides to lend Tom \$3,000 for 3 years at 1% interest rate with all interest and principal due at the end of the 3 years. What is the total amount Tom must pay Sara 3 years into the future? 8) _____
 A) \$3,325.17 B) \$2,008.80 C) \$3090.90 D) \$2,697.45
- 9) A _____ is bought at a price below its face value, and the _____ value is repaid at the maturity date. 9) _____
 A) coupon bond; face B) discount bond; face
 C) discount bond; discount D) coupon bond; discount
- 10) If an individual moves money from a money market deposit account to currency, 10) _____
 A) M1 stays the same and M2 stays the same.
 B) M1 increases and M2 stays the same.
 C) M1 stays the same and M2 increases.
 D) M1 increases and M2 decreases.
- 11) If you have a very low tolerance for risk, which of the following bonds would you be least likely to hold in your portfolio? 11) _____
 A) a corporate bond with a rating of Aaa B) a municipal bond
 C) a corporate bond with a rating of Baa D) a U.S. Treasury bond
- 12) Adverse selection is a problem associated with equity and debt contracts arising from 12) _____
 A) the borrower's lack of good options for obtaining funds.
 B) the lender's relative lack of information about the borrower's potential returns and risks of his investment activities.
 C) the lender's inability to legally require sufficient collateral to cover a 100% loss if the borrower defaults.
 D) the borrower's lack of incentive to seek a loan for highly risky investments.
- 13) In the Gordon growth model, a decrease in the required rate of return on equity 13) _____
 A) increases the future stock price. B) increases the current stock price.
 C) reduces the future stock price. D) reduces the current stock price.
- 14) A _____ yield curve predicts a future increase in inflation. 14) _____
 A) flat B) downward sloping
 C) slight upward sloping D) steeply upward sloping
- 15) The _____ interest rate is adjusted for expected changes in the price level. 15) _____
 A) ex post real B) ex post nominal
 C) ex ante nominal D) ex ante real
- 16) If a security pays \$55 in one year and \$133 in three years, its present value is \$150 if the interest rate is 16) _____
 A) 5 percent. B) 10 percent. C) 12.5 percent. D) 15 percent.
- 17) If the interest rates on all bonds rise from 5 to 6 percent over the course of the year, which bond would you prefer to have been holding? 17) _____
 A) A bond with one year to maturity B) A bond with ten years to maturity
 C) A bond with five years to maturity D) A bond with twenty years to maturity
- 18) Using the one-period valuation model, assuming a year-end dividend of \$1.00, an expected sales price of \$100, and a required rate of return of 5%, the current price of the stock would be 18) _____
 A) \$110.00. B) \$101.00. C) \$100.00. D) \$96.19.

- 19) Reducing risk through the purchase of assets whose returns do not always move together is _____ 19) _____
 A) discounting. B) intermediation. C) intervention. D) diversification.
- 20) For simple loans, the simple interest rate is _____ the yield to maturity. 20) _____
 A) equal to B) greater than
 C) less than D) not comparable to
- 21) Which of the following bonds would you prefer to be buying? 21) _____
 A) A \$10,000 face-value security with a 7 percent coupon selling for \$10,000
 B) A \$10,000 face-value security with a 10 percent coupon selling for \$9,000
 C) A \$10,000 face-value security with a 9 percent coupon selling for \$10,000
 D) A \$10,000 face-value security with a 10 percent coupon selling for \$10,000
- 22) An increase in the expected inflation rate causes the supply of bonds to _____ and the supply 22) _____
 curve to shift to the _____, everything else held constant.
 A) increase; left B) decrease; left C) decrease; right D) increase; right
- 23) In the Gordon Growth Model, the growth rate is assumed to be _____ the required return on 23) _____
 equity.
 A) less than B) greater than C) equal to D) proportional to
- 24) Which of the following was a contributing factor to the 2003-2005 housing bubble? 24) _____
 A) Real median income rising 7% per year B) A rising inflation rate
 C) Affordable home prices D) Negative real mortgage interest rates
- 25) If gold becomes acceptable as a medium of exchange, the demand for gold will _____ and the 25) _____
 demand for bonds will _____, everything else held constant.
 A) increase; decrease B) increase; increase
 C) decrease; decrease D) decrease; increase
- 26) Assume Tom would like to borrow money from Sara for 3 years but can only afford \$50 annual 26) _____
 loan payments. If Sara agrees to lend money to Tom at an interest rate of 9%, how much money
 can Tom afford to borrow today?
 A) \$130.25 B) \$140.58 C) \$160.25 D) \$126.56
- 27) An equal decrease in all bond interest rates 27) _____
 A) increases the price of a ten-year bond more than the price of a five-year bond.
 B) decreases the price of a five-year bond more than the price of a ten-year bond.
 C) decreases the price of a ten-year bond more than the price of a five-year bond.
 D) increases the price of a five-year bond more than the price of a ten-year bond.
- 28) QE-2 was a program of the Federal Reserve to create _____ of _____ by buying 28) _____

 A) \$800 billion, money, T-bonds B) \$400 billion, excess reserves, MBS
 C) \$600 billion, excess reserves, T-bonds D) \$400 billion, money, MBS
- 29) Recently the Federal Reserve announced that they would keep short-term interest rates low until 29) _____
 2013. According to the Expectations Theory of interest rates, which of the following could we
 expect to happen?
 A) a rising 3-year interest rate B) a parallel shift in the yield curve
 C) a steeper yield curve D) a falling 10-year interest rate

- 30) The British Banker's Association average of interbank rates for dollar deposits in the London market is called the _____
 A) Libor rate. B) federal funds rate.
 C) Treasury Bill rate. D) prime rate.
- 31) A discount bond selling for \$15,000 with a face value of \$20,000 in one year has a yield to maturity of _____
 A) 3 percent. B) 20 percent. C) 25 percent. D) 33.3 percent.
- 32) If prices in the bond market become more volatile, everything else held constant, the demand curve for bonds shifts _____ and interest rates _____.
 A) right; rise B) right; fall C) left; rise D) left; fall
- 33) All else equal, the _____ the coupon rate on a bond, the _____ the bond's duration.
 A) higher; longer B) greater; longer C) lower; shorter D) higher; shorter
- 34) Sara decides to loan Tom \$750 at an 8% interest rate for 3 years. She wants Tom to pay her back in 3 equal annual payments. What will be Tom's annual payments?
 A) \$201.56 B) \$210.22 C) \$245.25 D) \$291.02
- 35) According to the expectations theory of the term structure _____
 A) yield curves should be equally likely to slope downward as slope upward.
 B) when the yield curve is steeply upward sloping, short-term interest rates are expected to remain relatively stable in the future.
 C) investors have strong preferences for short-term relative to long-term bonds, explaining why yield curves typically slope upward.
 D) when the yield curve is downward sloping, short-term interest rates are expected to remain relatively stable in the future.
- 36) U.S. Treasury bills pay no interest but are sold at a _____. That is, you will pay a lower purchase price than the amount you receive at maturity.
 A) premium B) default C) discount D) collateral
- 37) The Bush tax cut reduced the top income tax bracket from 39% to 35% over a ten-year period. Supply and demand analysis predicts the impact of this change was a _____ interest rate on municipal bonds and a _____ interest rate on Treasury bonds.
 A) lower; lower B) lower; higher C) higher; lower D) higher; higher
- 38) Assume UW Credit Union has a current capital-to-asset ratio of 7% and would like to maintain that ratio over the next year. Also assume the credit union's assets are expected to grow 15% over the next year. What is the credit union's required return on assets?
 A) 22.2% B) 0.55% C) 1.05% D) 15.0%
- 39) Which of the following are short-term financial instruments?
 A) A residential mortgage.
 B) A share of Walt Disney Corporation stock.
 C) A repurchase agreement.
 D) A Treasury note with a maturity of four years.
- 40) A \$10,000 8 percent coupon bond that sells for \$10,000 has a yield to maturity of _____
 A) 8 percent. B) 10 percent. C) 12 percent. D) 14 percent.

- 41) If Greece defaults on their sovereign debt sometime in the near future, we should expect the interest rate on Irish government bonds to _____, and the interest rate on U.S. government bonds to _____. 41) _____
 A) rise, fall B) fall, rise C) rise, rise D) fall, fall
- 42) Which of the following are generally true of all bonds? 42) _____
 A) A fall in interest rates results in capital losses for bonds whose terms to maturity are longer than the holding period.
 B) Even though a bond has a substantial initial interest rate, its return can turn out to be negative if interest rates rise.
 C) The longer a bond's maturity, the greater is the rate of return that occurs as a result of the increase in the interest rate.
 D) Prices and returns for short-term bonds are more volatile than those for longer term bonds.
- 43) Holding everything else constant, 43) _____
 A) the more liquid is asset A, relative to alternative assets, the greater will be the demand for asset A.
 B) the lower the expected return to asset A relative to alternative assets, the greater will be the demand for asset A.
 C) if wealth increases, demand for asset A increases and demand for alternative assets decreases.
 D) if asset A's risk rises relative to that of alternative assets, the demand will increase for asset A.
- 44) Which of the following is not a factor pushing down the 10-year interest rate in 2011? 44) _____
 A) A slowing economy B) Euro-Zone debt crisis
 C) A \$1.3 trillion federal deficit D) QE-2
- 45) The _____ states that the nominal interest rate equals the real interest rate plus the expected rate of inflation. 45) _____
 A) Fisher equation B) Keynesian equation
 C) Marshall equation D) Monetarist equation
- 46) What is the return on a 5 percent coupon bond that initially sells for \$1,000 and sells for \$1,200 next year? 46) _____
 A) 5 percent B) -5 percent C) 25 percent D) 10 percent
- 47) If you expect the inflation rate to be 4 percent next year and a one year bond has a yield to maturity of 7 percent, then the real interest rate on this bond is 47) _____
 A) -3 percent. B) -2 percent. C) 3 percent. D) 7 percent.
- 48) In September 2011, the Federal Reserve announced they would undertake "operation twist" whereby they would buy long-term bonds and sell short-term bonds. According to the Bond Market model, we should expect 48) _____
 A) an upward shift of the yield curve.
 B) a steepening yield curve.
 C) falling short-term and rising long-term interest rates.
 D) rising short-term and falling long-term interest rates.
- 49) The currency component includes paper money and coins held in _____. 49) _____
 A) the hands of the nonbank public B) ATMs
 C) bank vaults D) the central bank

50) Fannie Mae and Freddie Mac buy _____ from intermediaries and sell _____ to investors. 50) _____

- A) MBS, Certificate of Deposits
- C) CMOs, mortgages

- B) mortgages, MBS
- D) Commercial Paper, mutual funds

- 1) A
- 2) A
- 3) D
- 4) D
- 5) B
- 6) A
- 7) C
- 8) C
- 9) B
- 10) B
- 11) C
- 12) B
- 13) B
- 14) D
- 15) D
- 16) B
- 17) A
- 18) D
- 19) D
- 20) A
- 21) B
- 22) D
- 23) A
- 24) D
- 25) A
- 26) D
- 27) A
- 28) C
- 29) D
- 30) A
- 31) D
- 32) C
- 33) D
- 34) D
- 35) A
- 36) C
- 37) C
- 38) C
- 39) C
- 40) A
- 41) A
- 42) B
- 43) A
- 44) C
- 45) A
- 46) C
- 47) C
- 48) D
- 49) A
- 50) B

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V-1

E-1