Chapter 1
Role of Financial Markets and Institutions

Key Terms Matching

In the following exercise, place a letter from the right column with the correct number in the left column.

Key Term	**Definition**
____ **1.** Bonds	a. financial contracts whose values are derived from the values of underlying assets **4**
____ **2.** Broker	b. a person or institution executing securities transactions between two parties **2**
____ **3.** Capital market	c. long-term debt obligations issued by corporations and government agencies to support their operations **1**
____ **4.** Derivative securities	d. a market that facilitates the issuance of new securities **8**
____ **5.** Financial market	e. a market that facilitates the trading of existing securities **9**
____ **6.** Liquidity	f. a market that facilitates the flow of short-term funds with maturities of less than one year **7**
____ **7.** Money market	g. a market that facilitates the flow of long-term funds **3**
____ **8.** Primary market	h. a market in which financial assets (securities) can be bought or sold **5**
____ **9.** Secondary market	i. the degree to which securities can easily be sold without a loss of value **6**
____ **10.** Stocks	r. certificates representing partial ownership in a firm **10**

Definitional Problems

1. Financial market participants that provide funds are called surplus, while participants that need to obtain funds are called deficit.

2. A market in which financial assets (securities) such as stocks and bonds can be purchased or sold is a(n) financial market.

3. Capital market securities are securities with maturities of more than one year;
Money market securities are securities with maturities of one year or less.

4. In general, money market securities have a higher degree of liquidity than capital market securities.

5. Two primary uses of derivative securities are hedging and speculation

6. Bonds are long-term debt obligations issued by corporations and government agencies to support their operations.

7. Long-term debt securities tend to have a higher expected return than money market securities, but they have higher risk as well.

True/False Problems

____ **1.** A financial market is a market in which financial assets can be purchased or sold. **T**

____ **2.** The federal government commonly acts as a surplus unit. **F**

____ **3.** Households are the main providers of funds. **T**

____ **4.** Those financial markets that facilitate the flow of short-term funds (with maturities of less than one year) are known as capital markets, while those that facilitate the flow of long-term funds are known as money markets. **F**

____ **5.** Primary markets facilitate the trading of existing securities**. F**

____ **6.** An organized exchange is a telecommunications network. **F**

____ **7.** Bonds are long-term debt obligations issued by corporations and government agencies to support their operations. **T**

____ **8.** Long-term debt securities tend to have lower risk but a higher return than money market securities. **F**

____ **9.** Derivative securities are financial contracts whose values are derived from the values of underlying assets. **T**

Multiple Choice Problems

1. Which of the following are not main participants in financial market transactions?
   a. households
   b. financial institutions
   c. governments
   d. businesses
   e. all of the above are main participants in financial market transactions.

2. Financial markets
   a. facilitate the flow of funds from deficit to surplus units.
   b. facilitate the flow of funds from surplus to deficit units.
   c. are markets in which financial assets such as stocks and bonds can be purchased and sold.
   d. None of the above are true.
   e. Only answers b and c are correct.

3. Financial markets facilitating the flow of short-term funds with maturities of less than one year are known as
   a. money markets.
   b. capital markets.
   c. primary markets.
   d. secondary markets.
   e. none of the above.

4. Financial markets facilitating the trading of existing securities are known as
   a. money markets.
   b. capital markets.
   c. primary markets.
   d. secondary markets.
   e. none of the above.

5. Which of the following is not an organized exchange?
   a. New York Stock Exchange
   b. FOREX
   c. Nasdaq
   d. All of the above are organized exchanges.

6. Which of the following transactions would not be considered a secondary market transaction?
   a. An individual investor purchases some existing shares of IBM stock through his broker.
   b. An institutional investor sells some Disney stock through his broker.
   c. Microsoft issues new shares of common stock using its investment bank.
   d. All of the above would occur in the secondary market.

7. _________________ are not considered capital market securities.
   a. Repurchase agreements
   b. Municipal bonds
   c. Corporate bonds
   d. Equity securities
   e. Mortgages

8. _____________ are long-term debt obligations issued by corporations and government agencies to support their operations.
   a. Common stock
   b. Derivative securities
   c. Bonds
   d. None of the above

9. Long-term debt securities tend to have a ____________ expected return and __________ risk than money market securities.
   a. lower; lower
   b. lower; higher
   c. higher; lower
   d. higher; higher

Computations

1.

A client has a \$5 million portfolio and invests 5 percent of it in a money market fund projected to earn 3 percent annually. Estimate the value of this portion of his portfolio after seven years.

2.

A client invests \$500,000 in a bond fund projected to earn 7 percent annually. Estimate the value of her investment after 10 years.

3.

For liquidity purposes, a client keeps \$100,000 in a bank account. The bank quotes a stated annual interest rate of 7 percent. The bank's service representative explains that the stated rate is the rate one would earn if one were to cash out rather than invest the interest payments. How much will your client have in his account at the end of one year, assuming no additions or withdrawals, using the following types of compounding?

A. Quarterly
B. Monthly

4.

A couple plans to set aside \$20,000 per year in a conservative portfolio projected to earn 7 percent a year. If they make their first savings contribution one year from now, how much will they have at the end of 20 years?

5.

Two years from now, a client will receive the first of three annual payments of \$20,000 from a small business project. If she can earn 9 percent annually on her investments and plans to retire in six years, how much will the three business project payments be worth at the time of her retirement?

6.

To cover the first year's total college tuition payments for his two children, a father will make a \$75,000 payment five years from now. How much will he need to invest today to meet his first tuition goal if the investment earns 6 percent annually?

7.

A perpetual preferred stock position pays quarterly dividends of \$1,000 indefinitely (forever). If an investor has a required rate of return of 12 percent per year on this type of investment, how much should he be willing to pay for this dividend stream?

8.

At retirement, a client has two payment options: a 20-year annuity at €50,000 per year starting after one year or a lump sum of €500,000 today. If the client's required rate of return on retirement fund investments is 6 percent per year, which plan has the higher present value and by how much?

9.

You are considering investing in two different instruments. The first instrument will pay nothing for three years, but then it will pay $20,000 per year for four years. The second instrument will pay $20,000 for three years and $30,000 in the fourth year. All payments are made at year-end. If your required rate of return on these investments is 8 percent annually, what should you be willing to pay for:

A. The first instrument
B. The second instrument (use the formula for a four-year annuity)