Chapter 1/2
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.** Dealer ____ **2.** Money market mutual fund ____ **3.** Perfect market ____ **4.** Privatization	a. a person making a market in specific securities by adjusting his inventory of securities b. a mutual fund concentrating in money market securities c. a market in which all information about any securities for sale in primary and secondary markets is continuously and freely available to investors d. the sale of government-owned firms to individuals

Definitional Problems

1. Derivative securities are ____________ whose values are derived from the values of underlying assets.

2. When particular securities are perceived to be overvalued by the market, their prices _____________ as these securities are sold.

3. The valuation of a security is measured as the _________ of its expected cash flows.

4. When security prices fully reflect all available information, the market for these securities is said to be ________________.

5. A visible marketplace for secondary market transactions is known as a(n) ________________.

6. The __________________ is an example of an organized exchange.

7. The __________________ is an example of the over-the-counter (OTC) market.

8. In addition to brokerage services, securities firms often act as ______________, making a market in specific securities by adjusting their inventory of securities.

9. In general, money market securities have a higher degree of _____________ than capital market securities.

10. A market in which existing securities are traded is called a _____________ market, while a market that facilitates the issuance of new securities is called a ______________ market.

True/False Problems

____ **1.** Speculating with derivative contracts on an underlying assets typically results in both higher risk and higher returns than speculating in the underlying asset itself.

____ **2.** Securities that are not as safe and liquid as other securities are never considered for investment by anyone.

____ **3.** When a depository institutions offers a loan, it is acting as a creditor.

____ **4.** A broker executes securities transactions between two parties and charges a fee.

____ **5.** Among others, deficit units receive funding from insurance companies and pension funds.

Multiple Choice Problems

1. If investors speculate in derivative contracts rather than the underlying asset, they will probably achieve ____________ returns, and they are exposed to relatively ___________ risk.

a. lower; lower
b. lower; higher
c. higher; lower
d. higher; higher

2. When particular securities are perceived to be ______________ by the market, their prices decrease when they are sold by investors.

a. undervalued
b. overvalued
c. fairly priced
d. efficient
e. none of the above

3. Which of the following is not a reason why depository institutions are popular financial institutions, according to your text?

a. They offer deposit accounts that can accommodate the amount and liquidity characteristics desired by most surplus units.
b. They repackage funds received from deposits to provide loans of the size and maturity desired by deficit units.

c. They accept the risk on loans provided.
d. They have more expertise than individual deficit units in evaluating the creditworthiness of surplus units.
e. All of the above are reasons why depository institutions are popular financial institutions.

4. Securities firms
a. sometimes act as a broker.
b. provide investment banking services.
c. often act as a dealer.
d. sometimes provide advisory services.
e. all of the above

5. The main source of funds for ________________ is proceeds from selling securities to households and businesses, while their main use of funds is providing loans to households and businesses.
a. savings institutions
b. commercial banks
c. mutual funds
d. finance companies
e. pension funds

6. Which of the following are not considered depository financial institutions?
A) finance companies
B) commercial banks
C) savings institutions
D) credit unions
E) All of the above are depository financial institutions.

7. In general, securities with ____________ characteristics will offer _________ yields.
A) favorable; higher
B) favorable; lower
C) unfavorable; lower
D) none of the above

8. Default risk is likely to be highest for
A) short term Treasury securities.
B) AAA corporate securities.
C) long term Treasury securities.
D) BBB corporate securities.

9. Which of the following is not a typical money market security?
A) Treasury bills
B) Treasury bonds
C) Commercial paper
D) Negotiable certificates of deposit

10. Some financial institutions such as commercial banks are required by law to invest only in
A) junk bonds.
B) corporate stock.
C) Treasury securities.
D) investment-grade bonds.

11. There is a ___________ relationship between the risk of a security and the expected return from investing in the security.
A) positive
B) negative
C) indeterminable
D) none of the above

12. An aggregate purchase by investors of low-yield instruments in favor of high-yield instruments places _____________ pressure on the yields of low-yield securities and _____________ on the yields of high-yield securities.
A) upward; upward
B) downward; downward

C) upward; downward
D) downward; upward

13. Which of the following statements is incorrect?
A) Financial markets attract funds from investors and channel the funds to corporations.
B) Money markets enable corporations to borrow funds on a short-term basis so that they can support their existing operations.
C) Financial institutions serve solely as intermediaries with the financial markets and never serve as investors.
D) Investors seek to invest their funds in the stock of firms that are presently undervalued and have much potential to improve.

14. Commercial paper is subject to:
A) interest rate risk.
B) default risk.
C) A and B.
D) none of the above.

15. If economic conditions cause investors to sell stocks because they want to invest in safer securities with much liquidity, this should cause a ________ demand for money market securities, which placed __________ pressure on the yields of money market securities.
A) weak; downward
B) weak; upward
C) strong; upward
D) none of the above

16. When a firm sells its commercial paper at a ____________ price than projected, their cost of raising funds will be ___________ than what they initially anticipated.
A) higher; higher
B) lower; lower
C) higher; lower
D) lower; higher
E) Answers c and d are correct.

Computation part

1. If an investor buys a T-bill with a 90-day maturity and $50,000 par value for $48,500 and holds it to maturity, what is the annualized yield? (use standard 365 days per a year)

2. An investor buys a T-bill with 180 days to maturity and $250,000 par value for $242,000. He plans to sell it after 60 days, and forecasts a selling price of $247,000 at that time. What is the annualized yield based on this expectation? (use standard 365 days per a year)

3. A firm plans to issue 30-day commercial paper for $9,900,000. Par value is $10,000,000. What is the firm's cost of borrowing? (use standard 365 days per a year)

4. An investor purchased an NCD a year ago in the secondary market for $980,000. He redeems it today and receives $1,000,000. He also receives interest of $30,000. The investor's annualized yield on this investment is ____ percent. (use standard 365 days per a year)

5. An investor initially purchased securities at a price of $9,923,418 with an agreement to sell them back at a price of $10,000,000 at the end of a 90-day period. The repo rate is ____ percent. (use standard 365 days per a year)

6. Current Treasury-bill yields are approximately 2 percent. Assume an investor considering the purchase of a newly-issued three-month Treasury bill expects interest rates to increase within the next three months and has a required rate of return of 2.5 percent. Based on this information, how much is this investor willing to pay for a three-month Treasury bill with face value 10.000? (use standard 365 days per a year)

7. A repurchase agreement calls for an investor to buy securities for $4,925,000 and sell them back in 60 days for $5,000,000. What is the yield? (use standard 365 days per a year)

8. An investor, purchases a six-month (182-day) T-bill with a $10,000 par value for $9,700. If the Treasury bill is held to maturity, the annualized yield is ____ percent. (use standard 365 days per a year)

9. When an investor purchases a six-month (182-day) T-bill with a $10,000 par value for $9,700, the Treasury bill discount is ____ percent. (use standard 360 days per a year)

10. Robbins Corp. frequently invests excess funds in the Mexican money market. One year ago, Robbins invested in a one-year Mexican money market security that provided a yield of 25 percent. At the end of the year, when Robbins converted the Mexican pesos to dollars, the peso had depreciated from $.12 to $.11. What is the effective yield earned by Robbins?