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 **1** b. a mutual fund concentrating in money market securities **2** c. a market in which all information about any securities for sale in primary and secondary markets is continuously and freely available to investors **3** d. the sale of government-owned firms to individuals **4**

Definitional Problems

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

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

3. When security prices fully reflect all available information, the market for these securities is said to be **perfect/ efficient**.

4. The fee charged by a(n) **dealer** is reflected in the difference between her bid and ask quotes.

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

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. **T**

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

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

____ **4.** A broker executes securities transactions between two parties and charges a fee reflected in the bid-ask spread. **F**

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

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 A instruments in favor of B instruments places **_____________** pressure on the yields of A securities and **_____________** on the yields of B 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 **_____Strong ___** demand for money market securities, which placed **____down_____** 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 higher_, lower__________ price than projected, their cost of raising
funds will be _lower, __higher_______ than what they initially anticipated.
A) higher; higher
B) lower; lower
C) higher; lower
D) lower; higher
E) Answers c and d are correct.

Interpreting Financial News

"Interpreting Financial News" tests your ability to comprehend common statements made by Wall Street analysts and portfolio managers who participate in the financial markets. Interpret the following:

1. "The price of IBM stock will not be affected by the announcement that its earnings have increased as expected."

   The earnings level was anticipated by investors, so that IBM's stock price already reflected this anticipation.

2. "The lending operations at Bank of America should benefit from strong economic growth."

   High economic growth encourages expansion by firms which results in a strong demand for loans provided by Bank of America.

3. "The brokerage and underwriting performance at Goldman Sachs should benefit from strong economic growth."

   High economic growth may result in a large volume of stock transactions in which Goldman Sachs may serve as a broker. Also, Goldman Sachs underwriters new securities that are issued when firms raise funds to support expansion; firms are more willing to issue new securities to expand during periods of high economic growth.

Managing in Financial Markets

As a financial manager of a large firm, you plan to borrow $70 million over the next year.

1. What are the more likely three alternatives/institutios for you to borrow $70 million?

   You could attempt to borrow $70 million from commercial banks, savings institutions, or finance companies in the form of commercial loans. Alternatively, you may issue debt securities.

2. Assuming that you represent Apple Inc. company and decide to issue debt securities, describe five the types of financial institutions that may purchase these securities.

Financial institutions such as mutual funds, pension funds, and insurance companies commonly purchase debt securities that are issued by firms. Other financial institutions such as commercial banks and savings institutions may also purchase debt securities.

3. How do individuals indirectly provide the financing for your firm? (Two examples)

   Individuals provide funds to financial institutions in the form of bank deposits, investment in mutual funds, purchases of insurance policies, or investment in pensions. The financialv securities) that were issued by large corporations, such as the one where you work.