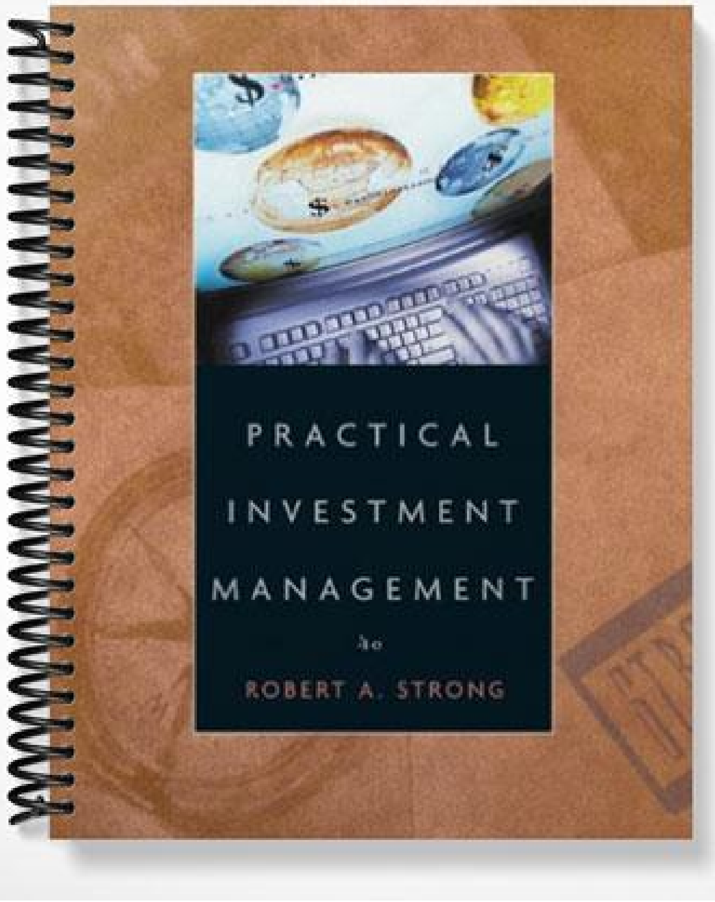
TEST BANK



Test Bank
Chapter 1

There are no test questions for this chapter.

Chapter 2
Understanding Risk and Return

MULTIPLE CHOICE

1. A holding period return is defined as
   a. (ending price - beginning price)/beginning price
   b. (ending price - beginning price + income)/beginning price
   c. (beginning price - ending price + income)/ending price
   d. (beginning price - ending price)/ending price
   ANSWER: B

2. Jones bought stock for $5000, sold it for $6500, and received no dividends. His holding period return is
   a. 0%
   b. 23.08%
   c. 30.00%
   d. 41.15%
   ANSWER: C

3. Jones bought stock for $5000, sold it for $6500, and received $235 in dividends. His holding period return is
   a. 4.70%
   b. 26.69%
   c. 34.70%
   d. 42.23%
   ANSWER: C

4. Jones bought stock for $5000, sold it for $4600, and received $400 in dividends. His holding period return is
   a. 0%
   b. - 8.00%
   c. + 8.00%%
   d. + 8.70%
   ANSWER: A

5. Jones bought stock for $5000, sold it for $6500, and received $235 in dividends. His income yield was
   a. 4.70%
   b. 26.69%
   c. 34.70%
   d. 42.23%
   ANSWER: A

6. The holding period return is a function of all of the following *except*
   a. purchase price.
   b. sales price.
   c. income received.
   d. the time the security was held.
   ANSWER: D

7. Smith sold 100 shares of Microsoft (which pays no dividends) for $120 each. Her three-year holding period return was about 77%. At what price did she purchase the stock?
   a. $155.84
   b. $77.00
   c. $92.40
   d. $67.80
   ANSWER: D

8. What is the most you would pay for a $100 per year ordinary annuity over ten years using an 8% annual interest rate.
   a. $671
   b. $800
   c. $1000
   d. $2159
   ANSWER: A

9. Calculate the present value of a $100 per year ordinary annuity over five years using a 7% annual interest rate.
   a. $355
   b. $410
   c. $456
   d. $140
   ANSWER: B

10. A bank pays 6% interest per year, compounded quarterly. What is the effective annual rate?
    a. 5.76%
    b. 6.00%
    c. 6.14%
    d. 6.23%
    ANSWER: C

11. A bank pays 6% interest per year, compounded quarterly. How much will $100 grow to after two years?
    a. $112.36
    b. $112.55
    c. $112.65
    d. $112.75
    ANSWER: C

12. Tom purchased 100 shares of EDS at $34 and sold it for $41 two years later. If EDS paid a $.15/share dividend over the eight quarters of investment, what was the annualized annual rate of return that Tom earned on the investment?

a. 2.78%
b. 22.2%
c. 24%
d. 9.8%
ANSWER: B

13. Another name for the effective annual rate is the
a. compound annual return.
b. nominal rate.
c. real rate.
d. holding period return.
ANSWER: A

14. A stock rises 2.5% in one week. What is the annualized return?
a. 13%
b. 25%
c. 89%
d. 130%
ANSWER: D

15. An investor purchased stock priced at $30 and sold the stock for $34 two years later. The holding period return on the stock was _______ and the effective annual rate was _____?

a. 11.8%; 6.46%
b. 13.3%; 13.3%
c. 13.3%; 6.46%
d. $4; 6.65%
ANSWER: C

16. All of the following statements are true *except*
a. the standard deviation is the square root of the variance.
b. the variance is always larger than the standard deviation.
c. the standard deviation is always positive.
d. the variance is always positive.
ANSWER: B

17. A data series has a variance of 64%. The standard deviation is
a. 8%
b. 32%
c. 56%
d. 80%
ANSWER: A

18. Which one of the following statements is true?
    a. Sample variance is greater than population variance.
    b. Sample variance is twice population variance.
    c. Sample variance is the square root of population variance.
    d. Population variance is twice sample variance.
    ANSWER: A

19. An investment earns 10% during the first six months of the year, and then loses 10% during the second six months. For the year, the holding period return was
    a. 0%
    b. 20%
    c. - 1%
    d. - 5%
    ANSWER: C

20 Which of the following statements is most accurate?
    a. A risk averse person will not take a risk.
    b. A risk averse person seldom takes a risk.
    c. A risk averse person prefers not to take a risk if it can be avoided.
    d. A risk averse person only takes a risk if the potential reward justifies it.
    ANSWER: D

21. The short-term interest rate is 5%. A person buys stock at $34 and sells it at the same price four months later. Ignoring commissions, this person
    a. broke even.
    b. lost money.
    c. incurred an opportunity cost.
    d. incurred an opportunity gain.
    ANSWER: C

22. The two principal components of total risk are
    a. business risk and market risk.
    b. diversifiable risk and market risk.
    c. purchasing power and interest rate risk.
    d. foreign exchange risk and market risk.
    ANSWER: B

23. There is a(n) _____ relationship between risk and expected return.
    a. direct
    b. inverse
    c. exponential
    d. logarithmic
    ANSWER: A

24. Which of the following statements is most accurate?
    a. A dominated investment is desirable.
    b. Dominated investments are rare.
    c. A safe security with the same expected return as a riskier security dominates the riskier security.
    d. An investor should only purchase a dominated stock.
    ANSWER: C

25. The notion that equivalent securities should sell for the same price is the
    a. equivalence theorem.
    b. law of one price.
    c. law of large numbers.
    d. central limit theorem.
    ANSWER: B

26. A U.S. investor owns a 15-year yen-denominated bond from the Central Bank of Japan. The investor will incur *all but one of the following* risks?

    a. financial risk
    b. interest rate risk
    c. foreign exchange risk
    d. purchasing power risk
    ANSWER: A

27. _______ is the increase in value of an investment.

    a. Appreciation
    b. Holding period return
    c. Yield
    d. None of the above.
    ANSWER: A

28. Which of the following produces the highest effective annual rate?

    a. 6% compounded annually
    b. 6% compounded monthly
    c. 6% compounded daily
    d. 6% compounded continuously.
    ANSWER: D

TRUE/FALSE

1. The two key concepts in finance are the time value of money and the concept of present and future values.
   ANSWER: False

2. Holding period returns are normally calculated for one-year periods.
   ANSWER: False

3. The annualized equivalent of 10% for 35 days is 104.29%.
ANSWER: True

4. For a common stock, the current yield is equivalent to the dividend yield.
ANSWER: True

5. The earning of interest on interest is called compounding.
ANSWER: True

6. The price of a bond equals the present value of the coupon annuity.
ANSWER: False

7. The more frequent the compounding, the greater the amount of interest earned.
ANSWER: True

8. The compound annual return takes account of the time value of money, but fails to account for the fact that investment horizons are not always the same.
ANSWER: False

9. It is especially important to annualize returns from holding periods of less than three months.
ANSWER: False

10. Theoretically, a risky situation must involve a chance of loss.
ANSWER: True

11. If the variance is 25%, the standard deviation is 5%.
ANSWER: False

12. Historical rates of return should usually be averaged using arithmetic rather than geometric rates.
ANSWER: False

13. A risk averse person will normally not take a risk.
ANSWER: False

14. An opportunity cost is what you give up in exchange for a chance at something better.
ANSWER: True

15. There is an inverse relationship between risk and expected return.
ANSWER: False

16. Riskier securities have higher returns.
ANSWER: False

17. An investment portfolio should contain at least one security that is dominated by another.
ANSWER: False

18. Equivalent securities should sell for the same price.
ANSWER: True

19. The future risk of an equity security can be accurately estimated by considering the past series of security returns.
ANSWER: False

20. Total risk is composed of two broad classes: diversifiable and unsystematic risk.
ANSWER: False

21. Purchasing power risk is associated with the increase in purchasing power of a fixed amount of principal caused by inflation.
ANSWER: False

22. The public's changing values associated with nutrition is a social risk for McDonalds Corporation.
ANSWER: True

23. The higher the risk, the higher the return.
ANSWER: False