**CHAPTER 2**

**ASSET CLASSES AND FINANCIAL INSTRUMENTS**

1. Common stock is an ownership share in a publicly held corporation. Common shareholders have voting rights and may receive dividends. Preferred stock represents nonvoting shares in a corporation, usually paying a fixed stream of dividends. While corporate bonds are long-term debt issued by corporations, the bonds typically pay semi-annual coupons and return the face value of the bond at maturity.
2. While the DJIA has 30 large corporations in the index, it does not represent the overall market nearly as well as the more than 5000 stocks contained in The Wilshire index. The DJIA is simply too small.
3. Money market securities are short-term, relatively low risk, and highly liquid. Also, their unit value almost never changes.
4. The major components of the money market are Treasury bills, certificates of deposit, commercial paper, bankers’ acceptances, Eurodollars, repos, reserves, federal funds, and brokers’ calls.
5. American Depository Receipts, or ADRs, are certificates traded in U.S. markets that represent ownership in shares of a foreign company. Investors may also purchase shares of foreign companies on foreign exchanges. Lastly, investors may use international mutual funds to own shares indirectly.
6. The coupons paid by municipal bonds are exempt from federal income tax and from state tax in many states. Therefore, the higher the tax bracket that the investor is in, the more valuable the tax-exempt feature to the investor.
7. The London Interbank Offer Rate (LIBOR) is the rate at which large banks in London are willing to lend money among themselves. The Fed funds rate is the rate of interest on very short-term loans among financial institutions in the U.S.
8. General obligation bonds are backed by the taxing power of the local governments, while revenue bonds have proceeds attached to specific projects. A revenue bond has fewer guarantees, it is riskier in terms of default, and, therefore, you expect it to have a higher yield.
9. Corporations may exclude 70% of dividends received from domestic corporations in the computation of their taxable income.
10. Limited liability means that the most shareholders can lose in event of the failure of the corporation is their original investment.
11. (a) A repurchase agreement is the sale of a security with a commitment to repurchase the same security at a specified future date and a designated price.
12. Money market securities are referred to as “cash equivalents” because of their great liquidity. The prices of money market securities are very stable, and they can be converted to cash (i.e., sold) on very short notice and with very low transaction costs.
13. Equivalent taxable yield = = = = .0.1333 or 13.33%
14. After-tax yield = Rate on the taxable bond x (1 － Tax rate)
    1. The taxable bond. With a zero tax bracket, the after-tax yield for the taxable bond is the same as the before-tax yield (5%), which is greater than the 4% yield on the municipal bond.
    2. The taxable bond. The after-tax yield for the taxable bond is: 0.05 x (1 – 0.10) = 0.045 or 4.50%.
    3. Neither. The after-tax yield for the taxable bond is: 0.05 x (1 – 0.20) = 0.4 or 4%. The after-tax yield of taxable bond is the same as that of the municipal bond.
    4. The municipal bond. The after-tax yield for the taxable bond is: 0.05 x (1 – 0.30) = 0.035 or 3.5%. The municipal bond offers the higher after-tax yield for investors in tax brackets above 20%.
15. The after-tax yield on the corporate bonds is: 0.0775 x (1 – 0.40) = 0.0465 or 4.65%. Therefore, the municipals must offer at least 4.65% yields.
16. Using the formula of Equivalent taxable yield (r) = , we get:
    1. r = = 0.04 or 4.00%
    2. r = = 0.0444 or 4.44%

* 1. r = = 0.05 or 5.00%
  2. r = = 0.0571 or 5.71%
  3. You would have to pay the asked price of:

98 = 98% of par = $980.00

* 1. The coupon rate is 4.25%, implying coupon payments of $42.5 annually or, more precisely, $21.25 (= 42.5/2) semiannually.
  2. Given the asked price and coupon rate, we can calculate current yield with the formula:

Current yield = = 4.25/98 = 0.0434 = 4.34%

1. 1. The closing price today is $75.60, which is $0.97 above yesterday’s price. Therefore, yesterday’s closing price was: $75.60 － $0.97 = $74.63.
   2. You would buy 66 shares: $5,000/$75.60 = 66.14.
   3. Your annual dividend income on 66 shares would be 66 x $1.88 = $124.08.
   4. Earnings per share can be derived from the price-earnings (PE) ratio:

Given price/Earnings = 10.92 and Price = $75.60, we know that Earnings per Share = $75.60/10.92 = $6.92.

* 1. At *t* = 0, the value of the index is: ($85 + $45 + $90)/3 = 73.33

At *t* = 1, the value of the index is: ($90 + $40 + $100)/3 = 76.67

The rate of return is: － 1 = (76.67/73.33) – 1 = 0.0455 or 4.55%

* 1. In the absence of a split, stock C would sell for $100, and the value of the index would be the average price of the individual stocks included in the index: ($90 + $40 + $100)/3 = $76.67.

After the split, stock C sells at $50; however, the value of the index should not be affected by the split. We need to set the divisor (d) such that:

76.67 = ($90 + $40 + $50)/d

d = 2.35

* 1. The rate of return is zero. The value of the index remains unchanged since the return on each stock separately equals zero.
  2. Total market value at *t* = 0 is:

($85 x 100) + ($45 x 200) + ($200 x 90) = $35,500

Total market value at *t* = 1 is:

($90 x 100) + ($40 x 200) + ($100 x 200) = $37,000

Rate of return = － 1 = ($37,000/$35,500) – 1 = 0.0423 or 4.23%

* 1. The return on each stock is as follows:

RA = － 1 = ($90/$100) – 1 = 0.0588 or 5.88%

RB = － 1 = ($40/$45) – 1 = –0.1111 or –11.11%

RC = － 1 = ($100/$90) – 1 = 0.1111 or 11.11%

The equally-weighted average is: [5.88% + (–11.11%) + 11.11%]/3 = 1.96%

1. The fund would require constant readjustment since every change in the price of a stock would bring the fund asset allocation out of balance.
2. In this case, the value of the divisor will increase by an amount necessary to maintain the index value on the day of the change. For example, if the index was comprised of only one stock, it would increase by 2.06 points: ($95 – $31) / $31 = 2.06.
3. Bank discount of 90 days: 0.037 x = 0.009250

Price: $10,000 x (1 – 0.009250) = $9,907.50

Bond equivalent yield =

= = 0.0379 or 3.79%

1. 1. The higher coupon bond: The 8-year T-bond with a 8.5% coupon
   2. The call with the lower exercise price: The call with the exercise price of $38
   3. The put option on the lower priced stock: The put on the stock selling at $58
   4. The May maturity futures price is $6.5625 per bushel. If the contract closes at $6.6625 per bushel in May, your profit / loss on each contract (for delivery of 5,000 bushels of corn) will be: ($6.6625 – $6.5625) x 5000 = $ 500.00 gain.
   5. There are 24,787 contracts outstanding, representing 123,935,000 bushels of corn.
   6. Yes. As long as the stock price at expiration exceeds the exercise price, it makes sense to exercise the call.

Gross profit is: ($378 **–** $360) x 100 shares = $1,800

Net profit = ($18 – $19.41) x 100 shares = $141 loss

Rate of return = –$1.41/$19.41 = –0.0726 or 7.26% loss

* 1. Yes, exercise.

Gross profit is: ($378 **–** $360) x 100 shares = $1800

Net profit = ($18 – $21.98) x 100 shares = $398 loss

Rate of return = –$3.98/$21.98 = 0.1811 or 18.11 % loss

* 1. A put with an exercise price of $360 would expire worthless for any stock price equal to or greater than $360. An investor in such a put would have a rate of return over the holding period of –100%.
  2. Long call
  3. Long put
  4. Short put
  5. Short call

1. There is always a chance that the option will expire in the money. Investors will pay something for this chance of a positive payoff.
2. Long call for $3.50:

|  |  |  |  |
| --- | --- | --- | --- |
|  | Value of call at expiration | Initial Cost | Profit |
| a. | 0 | 3.50 | -3.50 |
| b. | 0 | 3.50 | -3.50 |
| c. | 0 | 3.50 | -3.50 |
| d. | 5 | 3.50 | 1.50 |
| e. | 10 | 3.50 | 6.50 |

Long put for $6.50:

|  |  |  |  |
| --- | --- | --- | --- |
|  | Value of put at expiration | Initial Cost | Profit |
| a. | 10 | 6.50 | 3.50 |
| b. | 5 | 6.50 | -1.50 |
| c. | 0 | 6.50 | -6.50 |
| d. | 0 | 6.50 | -6.50 |
| e. | 0 | 6.50 | -6.50 |

1. The spread will widen. Deterioration of the economy increases credit risk, that is, the likelihood of default. Investors will demand a greater premium on debt securities subject to default risk.
2. Ten stocks have a 52 week high at least 50% above the 52 week low. Individual stocks are much more volatile than a group of stocks.

|  |  |  |
| --- | --- | --- |
| **52-wk high** | **52-wk low** | **Price ratio (High-Low)/Low** |
| 18.93 | 11.65 | 0.62 |
| 23.73 | 16.62 | 0.43 |
| 88.7 | 44.24 | 1.00 |
| 43.39 | 22.89 | 0.90 |
| 42.84 | 25.4 | 0.69 |
| 38.22 | 22.45 | 0.70 |
| 7.09 | 4.3 | 0.65 |
| 18.08 | 6.28 | 1.88 |
| 21.1 | 11.7 | 0.80 |
| 49.32 | 21.68 | 1.27 |
| 78.27 | 55.46 | 0.41 |
| 21.65 | 13.96 | 0.55 |

1. The total before-tax income is $4. The corporations may exclude 70% of dividends received from domestic corporations in the computation of their taxable income; the taxable income is therefore: $4 x 30% = $1.20.

Income tax in the 30% tax bracket: $1.2 x 30% = $0.36

After-tax income = $4 – $0.36 = $3.64

After-tax rate of return = $3.64/$38 = 0.0958 or 9.58%

1. A put option conveys the right to sell the underlying asset at the exercise price. A short position in a futures contract carries an obligation to sell the underlying asset at the futures price.
2. A call option conveys the right to buy the underlying asset at the exercise price. A long position in a futures contract carries an obligation to buy the underlying asset at the futures price.

CFA 1

Answer: c. Taxation

**Global Questions**

1. The asked price is:  or €999.06

The bond equivalent yield is: = 1.07%.

1. Yesterday’s bid price was 104:15 and asked price was 104:19, which means that with this sum you could buy exactly 4.7 bonds.
2. a. The dividend yield for stock ABC and XYZ was 5.43% (1.7/31.3\*100) and 2.24% (2.02/90\*100) respectively.

b. The earnings per share for stock ABC and XYZ was 2.845% (31.3/11) and 12.857% (90/7) respectively.

c. The percentage change in the market value-weighted index is -6.3%.

In a stock split, the number of shares is increased and the stock price is proportionately decreased so that the stock’s market value remains the same. As such, the stock split of XYZL will not affect a market value-weighted index. Thus the only change in value for the index will come from the change in the market values of ABC and XYZ because of the changes in their prices:

Total market value before split: (30.58 x21,000,000) + (200 x 7,500,000) = 2,142,180,000

Total market value after split: (31.3 x21,000,000) + (90 x15,000,000) = 2,007,300,000

Percentage change of market value-weight index: -6.3%