Reading 56: Derivative Markets and Instruments

Question #1 of 60

Question ID: 415715

Over-the- counter derivatives:

A) have good liquidity in the over-the-counter (OTC) market.

B) are backed by the OTC Clearinghouse.

C) are customized contracts.

Question #2 of 60

Question ID: 415712

Which of the following is *most likely* an exchange-traded derivative?

A) Bond option.

B) Equity index futures contract.

C) Currency forward contract.

Question #3 of 60

Question ID: 415802

Which of the following statements regarding futures and forward contracts is *least* accurate?

A) Futures contracts are highly standardized.

B) Both forward contracts and futures contracts trade on organized exchanges.

C) Forwards require no cash transactions until the delivery date, while futures require a margin deposit when the position is opened.

Question #4 of 60

Question ID: 415797

Which of the following is *least likely* a characteristic of futures contracts? Futures contracts:

A) are traded in an active secondary market.

B) require weekly settlement of gains and losses.

C) are backed by the clearinghouse.

Question #5 of 60

Question ID: 415822

In the trading of futures contracts, the role of the clearinghouse is to:

A) stabilize the market price fluctuations of the underlying commodity.

B) guarantee that all obligations by traders, as set forth in the contract, will be honored.

C) maintain private insurance that can be used to provide funds if a trader defaults.

Question #6 of 60

Question ID: 415743

The short in a forward contract:

A) has the right to deliver the asset upon expiration of the contract.

B) is obligated to deliver the asset anytime prior to expiration of the contract.

C) is obligated to deliver the asset upon expiration of the contract.

Question #7 of 60

Question ID: 415716

Which of the following is *most* accurate regarding derivatives?

A) Derivatives have no default risk.

B) Exchange-traded derivatives are created and traded by dealers in a market with no central location.

C) Derivative values are based on the value of another security, index, or rate.

Question #8 of 60

Question ID: 415813

A similarity of margin accounts for both equities and futures is that for both:

A) interest is charged on the margin loan balance.

B) the value of the security is the collateral for the loan.

C) additional payment is required if margin falls below the maintenance margin.

Question #9 of 60

Question ID: 415709

A derivative security:

A) is one that is based on the value of another security.

B) has a value dependent on the shape of the yield curve.

C) is like a callable bond.

Question #10 of 60

Question ID: 415745

Some forward contracts are termed *cash settlement* contracts. This means:

A) either the long or the short in the forward contract will make a cash payment at contract expiration and the asset is not delivered.

B) at settlement, the long purchases the asset from the short for cash.

C) at contract expiration, the long can buy the asset from the short or pay the difference between the market price of the asset and the contract price.

Question #11 of 60

Question ID: 415735

Any rational quoted price for a financial instrument should:

A) be low enough for most investors to afford.

B) provide an opportunity for investors to make a profit.

C) provide no opportunity for arbitrage.

Question #12 of 60

Question ID: 415849

Regarding buyers and sellers of put and call options, which of the following statements concerning the resulting option position is *most* accurate? The buyer of a:

A) call option is taking a long position while the seller of a put is taking a short position.

B) put option is taking a short position and the seller of a call option is taking a short position.

C) call option is taking a long position and the buyer of a put option is taking a short position.

Question #13 of 60

Question ID: 456307

The clearinghouse, in U.S. futures markets is *least likely* to:

A) choose which assets will have futures contracts.

B) guarantee performance of futures contract obligations.

C) act as a counterparty in futures contracts.

Question #14 of 60

Question ID: 415724

Derivatives are often criticized by investors with limited knowledge of complex financial securities. A common criticism of derivatives is that they:

A) increase investor transactions costs.

B) shift risk among market participants.

C) can be likened to gambling.

Question #15 of 60

Question ID: 415723

A standardized and exchange-traded agreement to buy or sell a particular asset on a specific date is *best* described as a:

A) swap.

B) forward contract.

C) futures contract.

Question #16 of 60

Question ID: 415725

MBT Corporation recently announced a 15% increase in earnings per share (EPS) over the previous period. The consensus expectation of financial analysts had been an increase in EPS of 10%. After the earnings announcement the value of MBT common stock increased each day for the next five trading days, as analysts and investors gradually reacted to the better than expected news. This gradual change in the value of the stock is an example of:

A) inefficient markets.

B) speculation.

C) efficient markets.

Question #17 of 60

Question ID: 415855

What is the primary difference between an American and a European option?

A) The American option can be exercised at anytime on or before its expiration date.

B) American and European options are never written on the same underlying asset.

C) The European option can only be traded on overseas markets.

Question #18 of 60

Question ID: 415738

Which of the following is an example of an arbitrage opportunity?

A) A portfolio of two securities that will produce a certain return that is greater than the risk-free rate of interest.

B) A stock with the same price as another has a higher rate of return.

C) A put option on a share of stock has the same price as a call option on an identical share.

Question #19 of 60

Question ID: 415857

An American option is:

A) exercised only at expiration.

B) an option on a U.S. stock or bond.

C) exercisable at any time up to its expiration date.

Question #20 of 60

Question ID: 415740

An analyst determines that a portfolio with a 35% weight in Investment P and a 65% weight in Investment Q will have a standard deviation of returns equal to zero.

- Investment P has an expected return of 8%.
- Investment Q has a standard deviation of returns of 7.1% and a covariance with the market of 0.0029.
- The risk-free rate is 5% and the market risk premium is 7%.

If no arbitrage opportunities are available, the expected rate of return on the combined portfolio is *closest to*:

A) 7%.

B) 6%.

C) 5%.

Question #21 of 60

Question ID: 460708

Which of the following statements about options is *most accurate*?

A) The holder of a put option has the right to sell to the writer of the option.

B) The holder of a call option has the obligation to sell to the option writer if the stock's price rises above the strike price.

C) The writer of a put option has the obligation to sell the asset to the holder of the put option.

Question #22 of 60

Question ID: 415988

In a plain vanilla interest rate swap:

A) one party pays a floating rate and the other pays a fixed rate, both based on the notional amount.

B) each party pays a fixed rate of interest on a notional amount.

C) payments equal to the notional principal amount are exchanged at the initiation of the swap.

Question #23 of 60

Question ID: 683892

A futures investor receives a margin call. If the investor wishes to maintain her futures position, she must make a deposit that restores her account to the:

A) initial margin.

B) daily margin.

C) maintenance margin.

Question #24 of 60

Question ID: 415721

In a credit default swap (CDS), the buyer of credit protection:

A) makes a series of payments to a credit protection seller.

B) exchanges the return on a bond for a fixed or floating rate return.

C) issues a security that is paid using the cash flows from an underlying bond.

Question #25 of 60

Question ID: 415818

If the margin balance in a futures account with a long position goes below the maintenance margin amount:

A) a deposit is required to return the account margin to the initial margin level.

B) a deposit is required which will bring the account to the maintenance margin level.

C) a margin deposit equal to the maintenance margin is required within two business days.

Question #26 of 60

Question ID: 710166

A legally binding promise to buy 140 oz. of gold two months from now at a price agreed upon today is *most likely* a:

A) forward commitment.

B) futures contract.

C) hedge.

Question #27 of 60

Question ID: 415733

Which of the following statements about arbitrage opportunities is CORRECT?

A) Engaging in arbitrage requires a large amount of capital for the investment.

B) When an opportunity exists to profit from arbitrage, it usually lasts for several trading days.

C) Pricing errors in securities are instantaneously corrected by the first arbitrageur to recognize them.

Question #28 of 60

Question ID: 415851

Which of the following represents a long position in an option?

A) Buying a put option.

B) Writing a put option.

C) Writing a call option.

Question #29 of 60

Question ID: 415804

Standardized futures contracts are an aid to increased market liquidity because:

A) standardization of the futures contract stabilizes the market price of the underlying commodity.

B) uniformity of the contract terms broadens the market for the futures by appealing to a greater number of traders.

C) standardization results in less trading activity.

Question #30 of 60

Question ID: 415717

Typically, forward commitments are made with respect to all the following EXCEPT:

A) equities.

B) bonds.

C) inflation.

Question #31 of 60

Question ID: 415726

Financial derivatives contribute to market completeness by allowing traders to do all of the following EXCEPT:

A) engage in high risk speculation.

B) narrow the amount of trading opportunities to a more manageable range.

C) increase market efficiency through the use of arbitrage.

Question #32 of 60

Question ID: 415853

A European option can be exercised by:

A) its owner, anytime during the term of the contract.

B) its owner, only at the expiration of the contract.

C) either party, at contract expiration.

Question #33 of 60

Question ID: 415729

All of the following are benefits of derivatives markets EXCEPT:

A) transactions costs are usually smaller in derivatives markets, than for similar trades in the underlying asset.

B) derivatives allow the shifting of risk to those who can most efficiently bear it.

C) derivatives markets help keep interest rates down.

Question #34 of 60

Question ID: 415734

Which of the following is *least likely* one of the conditions that must be met for a trade to be considered an arbitrage?

A) There is no initial investment.

B) There are no commissions.

C) There is no risk.

Question #35 of 60

Question ID: 415732

Which of the following relationships between arbitrage and market efficiency is *least* accurate?

A) The concept of rationally priced financial instruments preventing arbitrage opportunities is the basis behind the no-arbitrage principle.

B) Market efficiency refers to the low cost of trading derivatives because of the lower expense to traders.

C) Investors acting on arbitrage opportunities help keep markets efficient.

Question #36 of 60

Question ID: 415710

A financial instrument that has payoffs based on the price of an underlying physical or financial asset is a(n):

A) derivative security.

B) option.

C) future.

Question #37 of 60

Question ID: 415817

The settlement price for a futures contract is:

A) an average of the trade prices during the 'closing period'.

B) the price of the asset in the future for all trades made in the same day.

C) the price of the last trade of a futures contract at the end of the trading day.

Question #38 of 60

Question ID: 415941

Which of the following regarding a plain vanilla interest rate swap is *most* accurate?

A) Only the net interest payments are made.

B) The notional principal is swapped.

C) The notional principal is returned at the end of the swap.

Question #39 of 60

Question ID: 415719

Which of the following statements regarding a forward commitment is NOT correct? A forward commitment:

A) is not legally binding.

B) is a contractual promise.

C) can involve a stock index.

Question #40 of 60

Question ID: 456306

Which of the following statements about futures and the clearinghouse is *least* accurate? The clearinghouse:

A) has defaulted on one half of one percent of futures trades.

B) requires the daily settlement of all margin accounts.

C) guarantees that traders in the futures market will honor their obligations.

Question #41 of 60

Question ID: 456305

Which of the following statements about forward contracts is *least* accurate?

A) Both parties to a forward contract have potential default risk.

B) A forward contract can be exercised at any time.

C) The long promises to purchase the asset.

Question #42 of 60

Question ID: 415722

An agreement that gives the holder the right, but not the obligation, to sell an asset at a specified price on a specific future date is a:

A) put option.

B) call option.

C) swap.

Question #43 of 60

Question ID: 415728

Which of the following is a common criticism of derivatives?

A) Derivatives are likened to gambling.

B) Derivatives are too illiquid.

C) Fees for derivatives transactions are relatively high.

Question #44 of 60

Question ID: 415714

Which of the following is NOT an over-the-counter (OTC) derivative?

A) A futures contract.

B) A bond option.

C) A forward contract.

Question #45 of 60

Question ID: 415713

Which of the following definitions involving derivatives is *least* accurate?

A) An arbitrage opportunity is the chance to make a riskless profit with no investment.

B) A call option gives the owner the right to sell the underlying good at a specific price for a specified time period.

C) An option writer is the seller of an option.

Question #46 of 60

Question ID: 415730

One reason that criticism has been leveled at derivatives and derivatives markets is that:

A) derivatives expire.

B) they are complex instruments and sometimes hard to understand.

C) derivatives have too much default risk.

Question #47 of 60

Question ID: 415739

The process of arbitrage does all of the following EXCEPT:

A) produce *riskless* profits.

B) promote pricing efficiency.

C) insure that risk-adjusted expected returns are equal.

Question #48 of 60

Question ID: 415744

Default risk in a forward contract:

A) only applies to the short, who must make the cash payment at settlement.

B) only applies to the long, and is the probability that the short can not acquire the asset for delivery.

C) is the risk to either party that the other party will not fulfill their contractual obligation.

Question #49 of 60

Question ID: 415952

Which of the following statements regarding plain-vanilla interest rate swaps is *least* accurate?

A) The settlement dates are when the interest payments are to be made.

B) The time frame covered by the swap is called the tenor of the swap.

C) In a swap contract, the counterparties usually swap the notional principal.

Question #50 of 60

Question ID: 415736

Which of the following is the *best* interpretation of the no-arbitrage principle?

A) There is no way you can find an opportunity to make a profit.

B) There is no free money.

C) The information flow is quick in the financial market.

Question #51 of 60

Question ID: 415727

Which of the following statements about arbitrage is NOT correct

A) Arbitrage can cause markets to be less efficient.

B) If an arbitrage opportunity exists, making a profit without risk is possible.

C) No investment is required when engaging in arbitrage.

Question #52 of 60

Question ID: 472436

Sally Ferguson, CFA, is a hedge fund manager. Ferguson utilizes both futures and forward contracts in the fund she manages. Ferguson makes the following statements about futures and forward contracts:

> Statement 1: A futures contract is an exchange traded instrument with standardized features.
> Statement 2: Forward contracts are marked to market on a daily basis to reduce credit risk to both counterparties.

Are Ferguson's statements accurate?

A) Both of these statements are accurate.

B) Only one of these statements is accurate.

C) Neither of these statements is accurate.

Question #53 of 60

Question ID: 415746

A forward contract that must be settled by a sale of an asset by one party to the other party is termed a:

A) physicals-only contract.

B) deliverable forward contract.

C) take-and-pay contract.

Question #54 of 60

Question ID: 415737

The process that ensures that two securities positions with identical future payoffs, regardless of future events, will have the same price is called:

A) the law of one price.

B) exchange parity.

C) arbitrage.

Question #55 of 60

Question ID: 415794

Which of the following statements about futures is *least* accurate?

A) The futures exchange specifies the minimum price fluctuation of a futures contract.

B) Futures contracts have a maximum daily allowable price limit.

C) The exchange-mandated uniformity of futures contracts reduces their liquidity.

Question #56 of 60

Question ID: 456308

Which of the following is a difference between futures and forward contracts? Futures contracts are:

A) standardized.

B) larger than forward contracts.

C) over-the-counter instruments.

Question #57 of 60

Question ID: 415711

A derivative security:

A) has a value based on stock prices.

B) has no default risk.

C) has a value based on another security or index.

Question #58 of 60

Question ID: 415742

The party to a forward contract that is obligated to purchase the asset is called the:

A) short.

B) receiver.

C) long.

Question #59 of 60

Question ID: 415720

Credit derivatives are *least accurately* characterized as:

A) contingent claims.