SS 13 Equity: Market Organization, Market Indices, and Market Efficiency

Question #1 of 151

Question ID: 415208

Ken Miller, CFA, wants to compare the returns on government agency bonds to the returns on corporate bonds. Peg Egan, CFA, wants to compare the returns on high yield bonds in developed markets to the returns on investment grade bonds in emerging markets. Which of these analysts is *most likely* able to use bond indexes for their analysis?

- ✓ **A)** Both of these analysts.
- ✗ **B)** Only one of these analysts.
- ✗ **C)** Neither of these analysts.

Explanation

Because of the wide universe of bonds that trade in financial markets, indexes are available (or can be constructed) based on virtually any feature or classification of bonds.

References

Question From: Session 13 > Reading 46 > LOS i

Related Material:

- Key Concepts by LOS

Question #2 of 151

Question ID: 415219

In an informationally efficient market:

- ✗ **A)** share prices adjust rapidly when companies announce results in line with expectations.
- ✓ **B)** buying and holding a broad market portfolio is the preferred investment strategy.
- ✗ **C)** the conditions exist for active investment strategies to achieve superior risk-adjusted returns.

Explanation

If financial markets are informationally efficient, active investment strategies cannot consistently achieve risk-adjusted returns superior to holding a passively managed index portfolio. In addition, a passive investment strategy has lower transactions costs than an active management strategy. Share prices should not adjust when a company announces results in line with expectations in an informationally efficient market, because the market price already reflects the expected results.

References

Question From: Session 13 > Reading 47 > LOS a

Related Material:

- Key Concepts by LOS

Question #3 of 151

Question ID: 415151

An order placed to protect a short position is called a:

- ✗ **A)** stop loss sell.
- ✓ **B)** stop loss buy.
- ✗ **C)** protective call.

Explanation

A short position profits from declines in stock price and experiences losses as the price rises. A stop loss buy is a limit order that is placed above the market price. When the stock price reaches the stop price, the limit order is executed curtailing further loses.

References

Question From: Session 13 > Reading 45 > LOS g

Related Material:

- Key Concepts by LOS

Question #4 of 151

Question ID: 415198

The providers of the Smith 30 Stock Index remove Jones Company from the index because it has been acquired by another firm, and replace it with Johnson Company. This change in the index is *best* described as an example of:

- ✓ **A)** reconstitution.
- ✗ **B)** redefinition.
- ✗ **C)** rebalancing.

Explanation

Reconstitution refers to changing the securities that make up an index. Reconstitution of an index is required if one of its constituent securities goes out of existence (for example, a maturing bond or an expiring futures contract) or no longer meets the requirements to be included in the index.

References

Question From: Session 13 > Reading 46 > LOS f

Related Material:

- Key Concepts by LOS

Question #5 of 151

Question ID: 598995

An investor who is more risk averse with respect to potential negative outcomes than potential positive outcomes *most likely* exhibits:

- ✗ **A)** mental accounting.
- ✓ **B)** loss aversion.
- ✗ **C)** conservatism.

Explanation

Loss aversion is exhibited by an investor who dislikes a loss more than he likes an equal gain. That is, the investor's risk preferences are asymmetric. Mental accounting refers to mentally classifying investments in separate accounts rather than considering them from a portfolio perspective. In behavioral finance, conservatism refers to a tendency to maintain one's prior views even in the presence of new information.

References

Question From: Session 13 > Reading 47 > LOS g

Related Material:

- Key Concepts by LOS

Question #6 of 151

Question ID: 415161

Which of the following statements regarding primary and secondary markets is *least* accurate?

- ✓ **A)** Prevailing market prices are determined by primary market transactions and are used in pricing new issues.
- ✗ **B)** New issues of government securities can be sold on the primary market.
- ✗ **C)** Secondary market transactions occur between two investors and do not involve the firm that originally issued the security.

Explanation

Prevailing market prices are determined by the transactions that take place on the secondary market. This information is used to determine the price of new issues sold on primary markets.

References

Question From: Session 13 > Reading 45 > LOS i

Related Material:

- Key Concepts by LOS

Question #7 of 151

Question ID: 415178

An index provider maintains a price index and a total return index for the same 40 stocks. Assuming both indexes begin the year with the same value, the total return index at the end of the year will be:

✗ **A)** less than the price index if the price index increases and greater than the price index if the price index decreases.

✓ **B)** equal to the price index if the constituent stocks do not pay dividends.

✗ **C)** greater than the price index.

Explanation

A price index only includes the prices of the constituent securities in the calculation of the index value. A total return index includes the prices and the dividends paid in the calculation of the index value. If all of the constituents are non-dividend paying stocks, then the total return index will be the same as the price index at the end of the year. Otherwise the total return index will be greater than the price index.

References

Question From: Session 13 > Reading 46 > LOS b

Related Material:

- Key Concepts by LOS

Question #8 of 151

Question ID: 415144

An investor buys 400 shares of a stock for $25 a share. The initial margin requirement is 50%, and the maintenance margin requirement is 25%. At what price would an investor receive a margin call?

✗ **A)** $30.00.

✗ **B)** $21.88.

✓ **C)** $16.67.

Explanation

Margin call trigger price = [25(1 - 0.5)] / (1 - 0.25) = 16.67.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #9 of 151

Question ID: 415122

In contrast with a typical forward contract, futures contracts have:

✗ **A)** greater counterparty risk.

✗ **B)** less liquidity.

✓ **C)** standardized terms.

Explanation

Futures are forward contracts that trade on exchanges and have standardized terms, in contrast with forward contracts, which are customized instruments. A futures clearinghouse reduces counterparty risk by guaranteeing the performance of buyers and sellers. Futures contracts trade on organized exchanges and are more liquid than forward contracts.

References

Question From: Session 13 > Reading 45 > LOS c

Related Material:

- Key Concepts by LOS

Question #10 of 151

Question ID: 415159

Which of the following statements about securities markets is *least* accurate?

✗ **A)** A market that features low transactions costs is said to have operational efficiency.

✓ **B)** Initial public offerings (IPOs) are sold in the secondary market.

✗ **C)** In a continuous market, a security can trade any time the market is open.

Explanation

IPOs are sold in the primary market.

References

Question From: Session 13 > Reading 45 > LOS i

Related Material:

- Key Concepts by LOS

Question #11 of 151

Question ID: 415120

Which of the following assets are *best* characterized as contracts?

✓ **A)** Currency swaps.

✗ **B)** Depository receipts.

✗ **C)** Commercial paper.

Explanation

Contracts include forwards, futures, options, swaps, and insurance contracts. Commercial paper is a debt security. Depository receipts are shares in a pooled investment vehicle, such as a mutual fund or an exchange-traded fund.

References

Question From: Session 13 > Reading 45 > LOS c

Related Material:

- Key Concepts by LOS

Question #12 of 151

Question ID: 415231

The semi-strong form of efficient market hypothesis (EMH) asserts that:

✗ **A)** past and future prices exhibit little or no relationship to another.

✗ **B)** both public and private information is already incorporated into security prices.

✓ **C)** all public information is already reflected in security prices.

Explanation

Semi-strong EMH states that publicly available information cannot be used to consistently beat the market performance.

References

Question From: Session 13 > Reading 47 > LOS d

Related Material:

- Key Concepts by LOS

Question #13 of 151

Question ID: 485798

Shares in a publicly traded company that owns gold mines and mining operations are considered:

✓ **A)** financial assets.

✗ **B)** real assets.

✗ **C)** physical assets.

Explanation

Financial assets, such as shares of stock in a company, are claims against physical or real assets.

References

Question From: Session 13 > Reading 45 > LOS c

Related Material:

- Key Concepts by LOS

Question #14 of 151

Question ID: 415192

What is the market-cap weighted index of the following three stocks assuming the beginning index value is 100 and a base value of $150,000?

As of December 31		
Company	*Stock Price*	*Shares Outstanding*
X	$1	5,000
Y	$20	2,500
Z	$60	1,000

- ✗ **A)** 100.
- ✓ **B)** 77.
- ✗ **C)** 30.

Explanation

The market-cap weighted index = [(($1)(5,000) + ($20)(2,500) + ($60)(1,000))/$150,000](100)

= ($115,000/$150,000)(100)

= (0.767)(100)

= 76.67 or 77

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS

Question #15 of 151

Question ID: 415199

When a security is added to a widely followed market index, the security's price is *most likely* to:

- ✓ **A)** increase.
- ✗ **B)** decrease.
- ✗ **C)** be unaffected.

Explanation

Adding a security to a market index typically causes an increase in that security's price as portfolio managers who track the index purchase the security.

References

Question From: Session 13 > Reading 46 > LOS f

Related Material:

- Key Concepts by LOS

Question #16 of 151

Question ID: 415223

The value of an asset that a rational investor with full knowledge about the asset's characteristics would willingly pay is *best* described as the asset's:

✓ **A)** intrinsic value.

✗ **B)** theoretical value.

✗ **C)** market value.

Explanation

Intrinsic value is the price a rational investor with full knowledge about an asset's characteristics would willingly pay for the asset.

References

Question From: Session 13 > Reading 47 > LOS b

Related Material:

- Key Concepts by LOS

Question #17 of 151

Question ID: 415121

Equity securities *most likely* include:

✗ **A)** commercial paper and repurchase agreements.

✗ **B)** preferred stock and certificates of deposit.

✓ **C)** common stock and warrants.

Explanation

Common stock, preferred stock, and warrants are equity securities. Certificates of deposit, commercial paper, and repurchase agreements are debt securities.

References

Question From: Session 13 > Reading 45 > LOS c

Related Material:

- Key Concepts by LOS

Question #18 of 151

Question ID: 415148

Toby Jensen originally purchased 400 shares of CSC stock on margin at a price of $60 per share. The initial margin requirement is 50% and the maintenance margin is 25%. CSC stock price has fallen dramatically in recent months and it closed today with a sharp decline bringing the closing price to $40 per share. Will Jensen receive a margin call?

- ✓ **A)** No, he meets the minimum maintenance margin requirement.
- ✗ **B)** Yes, he does not meet the minimum maintenance margin requirement.
- ✗ **C)** No, he meets the minimum initial margin requirement.

Explanation

Total original value held by Jensen is 400 x $60 = $24,000.

Amount of equity is 50% ($24,000) = $12,000.

Current total value is 400 x $40 = $16,000.

So Jensen's equity is $16,000 - $12,000 = $4,000 which is 4,000/16,000 = 25% of the total market value.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #19 of 151

Question ID: 415168

A unique item such as fine art is *most likely* to be exchanged in a(n):

- ✓ **A)** brokered market.
- ✗ **B)** order-driven market.
- ✗ **C)** quote-driven market.

Explanation

Brokered markets are typically the best market structure for unique items. A broker adds value by locating a counterparty to take the opposite side of a trade of such an item.

References

Question From: Session 13 > Reading 45 > LOS j

Related Material:

- Key Concepts by LOS

Question #20 of 151

Question ID: 415241

Which of the following statements *least likely* describes the role of a portfolio manager in perfectly efficient markets? Portfolio managers should:

- ✗ **A)** construct diversified portfolios that include international securities to eliminate unsystematic risk.
- ✗ **B)** construct a portfolio that includes financial and real assets.
- ✓ **C)** quantify client's risk tolerance, communicate portfolio policies and strategies, and maintain a strict buy and hold policy avoiding any changes in the portfolio to minimize transaction costs.

Explanation

A portfolio manager should quantify each client's risk tolerance and communicate portfolio policies and strategies. However, portfolio managers should monitor client's needs and changing circumstances and make appropriate changes to the portfolio. Adhering to a strict buy and hold policy would not be in the client's best interest. Portfolios need to be rebalanced and changed to meet client's changing needs.

References

Question From: Session 13 > Reading 47 > LOS e

Related Material:

- Key Concepts by LOS

Question #21 of 151

Question ID: 415246

Which of the following statements *best* describes the overreaction effect?

- ✗ **A)** High returns over a one-year period are followed by low returns over the following three years.
- ✗ **B)** High returns over a one-year period are followed by high returns over the following year.
- ✓ **C)** Low returns over a three-year period are followed by high returns over the following three years.

Explanation

The overreaction effect refers to stocks with poor returns over three to five-year periods that had higher subsequent performance than stocks with high returns in the prior period. The result is attributed to overreaction in stock prices that reverses over longer periods of time. Stocks with high previous short-term returns that have high subsequent returns show a momentum effect.

References

Question From: Session 13 > Reading 47 > LOS f

Related Material:

- Key Concepts by LOS

Question #22 of 151

Question ID: 415239

Under the efficient market hypothesis (EMH), the major effort of the portfolio manager should be to:

- ✓ **A)** achieve complete diversification of the portfolio.
- ✗ **B)** follow a strict buy and hold strategy.
- ✗ **C)** minimize systematic risk in the portfolio.

Explanation

In an efficient market, portfolio managers must create and maintain the appropriate mix of assets to meet their client's needs. The portfolio should be diversified to eliminate unsystematic risk. The appropriate systematic risk will depend on the clients risk tolerance and return requirement. Over time the needs of the client and environment will justify changes to the portfolio. The manager should also try to minimize transaction costs and at least try to match the performance of a benchmark.

References

Question From: Session 13 > Reading 47 > LOS e

Related Material:

- Key Concepts by LOS

Question #23 of 151

Question ID: 415191

What is the price-weighted index of the following three stocks?

As of December 31, 2001		
Company	*Stock Price*	*Shares Outstanding*
A	$50	10,000
B	$35	20,000
C	$110	30,000

- ✗ **A)** 75.
- ✓ **B)** 65.
- ✗ **C)** 80.

Explanation

The price-weighted index equals [(50 + 35 + 110) / 3] = 65.

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS

Question #24 of 151

Question ID: 415183

Which of the following weighting schemes will produce a downward bias on the index due to the occurrence of stock splits by firms in the index?

- ✓ **A)** Price-weighted series.
- ✗ **B)** Market-cap weighted series.
- ✗ **C)** Equal weighted price indicator series.

Explanation

The price-weighting scheme sums the market price of each of the stocks contained in the index and then divides this sum by the number of stocks in the index. Thus if a firm executes a stock split thereby reducing its share price, this will cause a downward bias in the index.

References

Question From: Session 13 > Reading 46 > LOS d

Related Material:

- Key Concepts by LOS

Question #25 of 151

Question ID: 415211

Which of the following statements is *most accurate* regarding commodity indexes?

- ✓ **A)** Weighting methodology varies among index providers and leads to differences in index risk and returns.
- ✗ **B)** The return to commodity indexes consists of two major components: the risk-free rate of return and the roll yield.
- ✗ **C)** Commodity indexes are based on spot prices, while most investors purchase futures contracts.

Explanation

Weighting methodology is a major issue for commodity indexes. Several different methodologies are used, including equal weighting and global production values. Differences in weighting cause differing exposures for the indexes and lead to different risk and return profiles.

Commodity indexes represent futures contracts on commodities, not the actual spot prices of commodities. Commodity index returns come from three sources: the risk-free rate of return, changes in futures prices, and the roll yield.

References

Question From: Session 13 > Reading 46 > LOS j

Related Material:

- Key Concepts by LOS

Question #26 of 151

Question ID: 415250

In behavioral finance theory, how is loss aversion *most accurately* defined? For gains and losses of equal amounts, investors:

- ✗ **A)** dislike for losses and like for gains are proportionate.
- ✗ **B)** like gains more than they dislike losses.
- ✓ **C)** dislike losses more than they like gains.

Explanation

Behavioral finance proposes that investors are loss averse. Loss aversion means investors dislike losses more than they like gains of the same amount.

References

Question From: Session 13 > Reading 47 > LOS g

Related Material:

- Key Concepts by LOS

Question #27 of 151

Question ID: 498771

Which of the following is *least likely* required when defining a security market index? The:

- ✗ **A)** weighting method for the index.
- ✗ **B)** target market the index will represent.
- ✓ **C)** number of securities in the index.

Explanation

A market index does not necessarily have to consist of a fixed number of securities. For example, some indices are defined to include all the stocks that trade on a certain exchange, a number that can vary over time.

References

Question From: Session 13 > Reading 46 > LOS c

Related Material:

- Key Concepts by LOS

Question #28 of 151

Question ID: 415230

The strong-form efficient market hypothesis (EMH) asserts that stock prices fully reflect which of the following types of information?

- ✗ **A)** Market.

✗ **B)** Public, private, and future.

✓ **C)** Public and private.

Explanation

The strong-form EMH assumes that stock prices fully reflect all information from public and private sources.

References

Question From: Session 13 > Reading 47 > LOS d

Related Material:

- Key Concepts by LOS

Question #29 of 151

Question ID: 415128

Which of the following statements about selling a stock short is *least likely* accurate?

✗ **A)** The seller must inform their broker that the order is a short sale before completing the transaction.

✓ **B)** The short seller may withdraw the proceeds of the short sale.

✗ **C)** The seller must return the securities at the request of the lender.

Explanation

Proceeds from the short sale must remain in the brokerage account along with the required margin deposit.

References

Question From: Session 13 > Reading 45 > LOS e

Related Material:

- Key Concepts by LOS

Question #30 of 151

Question ID: 415152

Stop loss sell orders are:

✓ **A)** placed to protect the gains on a long position.

✗ **B)** placed to protect a short position.

✗ **C)** executed on an uptick only.

Explanation

Stop loss sell orders are limit sell orders that are placed below market price. When the share price drops to the designated price, a sell order is executed protecting the investor from further declines.

References

Question From: Session 13 > Reading 45 > LOS g

Related Material:

- Key Concepts by LOS

Question #31 of 151

Question ID: 415160

Which of the following is *least likely* a service provided by an underwriter in the primary market?

- ✗ **A)** Risk Bearing.
- ✗ **B)** Origination.
- ✓ **C)** Diversification.

Explanation

The underwriter provides the following services to the issuer:

- Origination, which involves the design, planning, and registration of the issue.
- Risk bearing, which means the underwriter guarantees the price by purchasing the securities.
- Distribution, which is the sale of the issue.

References

Question From: Session 13 > Reading 45 > LOS i

Related Material:

- Key Concepts by LOS

Question #32 of 151

Question ID: 415184

Which of the following statements *best* describes the investment assumption used to calculate an equal weighted price indicator series?

- ✗ **A)** An equal number of shares of each stock are used in the index.
- ✓ **B)** An equal dollar investment is made in each stock in the index.
- ✗ **C)** A proportionate market value investment is made for each stock in the index.

Explanation

An equal weighted price indicator series assumes that an equal dollar investment is made in each stock in the index. All stocks carry equal weight regardless of their price or market value.

References

Question From: Session 13 > Reading 46 > LOS d

Related Material:

- Key Concepts by LOS

Question #33 of 151

Question ID: 415141

Sonia Fennell purchases 1,000 shares of Xpressoh Inc. for $35 per share. One year later, she sells the stock for $42 per share. Xpressoh Inc. pays no dividends. The initial margin requirement is 50%. Fennell's one-year return assuming an all-cash transaction, and if she buys on margin (assume she pays no transaction or borrowing costs and has not had to post additional margin), are *closest* to:

	All-cash	50% margin
✓ **A)**	20%	40%
✗ **B)**	40%	80%
✗ **C)**	20%	80%

Explanation

All-cash return = 42/35 − 1 = 20%

Margin return = (42 − 35)/[(35)(0.5)] = 40%

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #34 of 151

Question ID: 415136

If an investor buys 100 shares of a $50 stock on margin when the initial margin requirement is 40%, how much money must she borrow from her broker?

✗ **A)** $2,000.

✗ **B)** $4,000.

✓ **C)** $3,000.

Explanation

An initial margin requirement of 40% would mean that the investor must put up 40% of the funds and brokerage firm may lend the 60% balance. Therefore, for this example (100 shares) * ($50) = $5,000 total cost. $5,000 * 0.60 = $3,000.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #35 of 151

Question ID: 415201

Contreras Fund is a mutual fund that invests in value stocks. The *most appropriate* type of equity index to use as a benchmark of manager performance for Contreras Fund is a:

- ✗ **A)** sector index.
- ✗ **B)** broad market index.
- ✓ **C)** style index.

Explanation

The index selected as a benchmark for manager performance should represent the investment universe from which the manager actually selects stocks. If the manager only invests in value stocks, then the most appropriate index is a style index that seeks to represent the returns from a value strategy. A sector index is appropriate for managers who invest in specific sectors (e.g., technology stocks, emerging market bonds).

References

Question From: Session 13 > Reading 46 > LOS g

Related Material:

- Key Concepts by LOS

Question #36 of 151

Question ID: 415149

Byron Campbell purchased 300 shares of Crescent, Inc., stock at a price of $80 per share. The purchase was made on margin with an initial margin requirement of 50%. Assuming the maintenance margin is 25%, the stock price of Crescent, Inc. has to fall below what level for Campbell to receive a margin call?

- ✓ **A)** $53.33.
- ✗ **B)** $40.00.
- ✗ **C)** $20.00.

Explanation

Trigger price (margin purchases) = P_o (1 − initial margin) / (1 − maintenance margin).

$80(1-.5)/(1-.25) = 40/.75 = $53.33.
P = $53.33

If Crescent, Inc. falls below $53.33 then Campbell will get a margin call.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #37 of 151

Question ID: 415165

A trading system that matches buyers and sellers based on price and time precedence is *most likely* a(n):

- ✗ **A)** brokered market.
- ✓ **B)** order-driven market.
- ✗ **C)** quote-driven market.

Explanation

In an order-driven market, buy orders and sell orders are matched up by the exchange according to order matching rules. In a quote-driven market, customers trade with dealers at bid and ask prices set by the dealers. In a brokered market, brokers organize trades among their clients.

References

Question From: Session 13 > Reading 45 > LOS j

Related Material:

- Key Concepts by LOS

Question #38 of 151

Question ID: 415134

Mark Ritchie purchased, on margin, 200 shares of TMX Corp. stock at a price of $35 per share. The margin requirement was 50%. The stock price has increased to $42 per share. What is Ritchie's return on investment before commissions and interest if he decides to sell his TMX holdings now?

- ✗ **A)** 20%.
- ✓ **B)** 40%.
- ✗ **C)** 10%.

Explanation

200 shares × $35 = $7000 Initial Market Value

$7000 × .50 = $3500 cash payment and $3500 borrowed.

The new market value of the stock after price increase is (200 × $42) = $8400. If Ritchie sold his holdings he would have $4900 ($8400 - $3500) left after the loan was paid. So Ritchie's return on his original $3500 investment is:

$4900/3500 - 1 = 1.4 - 1.0 = 0.40 = 40%.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #39 of 151

Question ID: 415244

The opportunity to take advantage of the downward pressure on stock prices that result from end-of-the-year tax selling is known as the:

- ✓ **A)** January anomaly.
- ✗ **B)** end-of-the-year effect.
- ✗ **C)** end-of-the-year anomaly.

Explanation

The January Anomaly is most likely the result of tax induced trading at year end. An investor can profit by buying stocks in December and selling them during the first week in January.

References

Question From: Session 13 > Reading 47 > LOS f

Related Material:

- Key Concepts by LOS

Question #40 of 151

Question ID: 485800

A trader pays $100 per share to buy 500 shares of a non-dividend-paying firm. The purchase is done on margin, and the leverage ratio at purchase is 3.0X. Three months later, the trader sells the shares for $90 per share. Ignoring transaction costs and interest paid on the margin loan, the trader's 3-month return was *closest to*:

- ✗ **A)** -10%.
- ✓ **B)** -30%.
- ✗ **C)** -40%.

Explanation

With a leverage ratio of 3 and a 10% decrease in share value, the investor's return is 3 × -10% = -30%.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #41 of 151

Question ID: 415126

Regarding the technical points affecting the short sales of a stock, which of the following statements is *most* accurate?

- ✗ **A)** The lender must deposit margin to guarantee the eventual return of the stock.
- ✗ **B)** Stocks can only be shorted in a down market.
- ✓ **C)** The short seller must pay all dividends due to the lender of the shorted stock.

Explanation

The short seller must pay any dividends on the stock to the owner of the borrowed shares. The short seller must also deposit margin money to guarantee the eventual repurchase of the security.

References

Question From: Session 13 > Reading 45 > LOS e

Related Material:

- Key Concepts by LOS

Question #42 of 151

Question ID: 415242

Which of the following is a limitation to fully efficient markets?

- ✓ **A)** The gains to be earned by information trading can be less than the transaction costs the trading would entail.
- ✗ **B)** Information is always quickly disseminated and fully embedded in a security's prices.
- ✗ **C)** There are no limitations to fully efficient markets because the trading actions of fundamental and technical analysts are continuously keeping prices at their intrinsic value.

Explanation

Market prices that are not precisely efficient can persist if the gains to be made by information trading are less than the transaction costs such trading would entail.

References

Question From: Session 13 > Reading 47 > LOS e

Related Material:

- Key Concepts by LOS

Question #43 of 151

Question ID: 415237

If the efficient markets hypothesis is true, portfolio managers should do all of the following EXCEPT:

- ✗ **A)** Minimize transaction costs.
- ✗ **B)** Work more with clients to better quantify their risk preferences.
- ✓ **C)** Spend more time working on security selection.

Explanation

In an efficient market all stocks are properly priced and reflect all publicly available information. Therefore, individual selection of stocks is not important the only thing that is relevant is the portfolio's beta.

References

Question From: Session 13 > Reading 47 > LOS e

Related Material:

- Key Concepts by LOS

Question #44 of 151

Question ID: 415174

A security market index is *best* described as a:

- ✗ **A)** value used to adjust nominal security prices for the effects of inflation.
- ✓ **B)** group of securities selected to represent the performance of a security market.
- ✗ **C)** directory of ticker symbols for the securities listed on a given market.

Explanation

A security market index is a group of securities (the constituent securities) designed to represent the performance of an asset class, security market, or market segment.

References

Question From: Session 13 > Reading 46 > LOS a

Related Material:

- Key Concepts by LOS

Question #45 of 151

Question ID: 415186

Which of the following statements about indexes is CORRECT?

- ✗ **A)** An equal weighted index assumes a proportionate market value investment in each company in the index.
- ✗ **B)** A market weighted series must adjust the denominator to reflect stock splits in the sample over time.

✓ **C)** A price-weighted index assumes an equal number of shares (one of each stock) represented in the index.

Explanation

The descriptions of value weighted and unweighted indexes are switched. The denominator of a price-weighted index must be adjusted to reflect stock splits and changes in the sample over time. A market value-weighted series assumes you make a proportionate market value investment in each company in the index.

References

Question From: Session 13 > Reading 46 > LOS d

Related Material:

- Key Concepts by LOS

Question #46 of 151

Question ID: 415150

An investor sold a stock short and is worried about rising prices. To protect himself from rising prices he would place a:

✗ **A)** stop order to sell.

✓ **B)** stop order to buy.

✗ **C)** limit order to buy.

Explanation

A limit order to buy is placed below the current market price.

A limit order to sell is placed above the current market price.

A stop (loss) order to buy is placed above the current market price.

A stop (loss) order to sell is placed below the current market price.

A stop order becomes a market order if the price is hit.

References

Question From: Session 13 > Reading 45 > LOS g

Related Material:

- Key Concepts by LOS

Question #47 of 151

Question ID: 415247

If the momentum effect persists over time, it would provide evidence against which of the following forms of market efficiency?

✗ **A)** Weak form only.

✓ **B)** Both weak form and semistrong form.

✗ **C)** Semistrong form only.

Explanation

The momentum effect suggests it is possible to earn abnormal returns using market data. All three forms of market efficiency (weak form, semistrong form, and strong form) assume that market prices fully reflect market data.

References

Question From: Session 13 > Reading 47 > LOS f

Related Material:

- Key Concepts by LOS

Question #48 of 151

Question ID: 415182

Assume a stock index consists of many firms who have recently split their stock. Which of the following weighting schemes will see a bias due to the impact of stock splits?

✗ **A)** Market value-weighted series.

✓ **B)** Price-weighted series.

✗ **C)** Unweighted price series.

Explanation

Firms that split their stock price will have the identical weight before and after the split in both the unweighted and the market value-weighted series. However, in the price-weighted series, large successful firms will lose weight within the index due to simply splitting their stock. This creates a downward bias in a price-weighted series. Standard and Poor's 500 Index is a market value-weighted index.

References

Question From: Session 13 > Reading 46 > LOS d

Related Material:

- Key Concepts by LOS

Question #49 of 151

Question ID: 415225

A market's efficiency is *most likely* to negatively affected by:

✗ **A)** a high amount of trading activity.

✓ **B)** a ban on short selling.

✗ **C)** substantial analyst coverage of the exchange listed companies

Explanation

Research supports the conclusion that short selling helps to prevent market prices from becoming overvalued, while limiting short selling has the opposite effect. More analyst coverage and more liquidity contribute to market efficiency.

References

Question From: Session 13 > Reading 47 > LOS c

Related Material:

- Key Concepts by LOS

Question #50 of 151

Question ID: 415153

Austin Bruno, CFA, places a fill or kill, limit buy order at 92 for a stock. Bruno's order specifies:

✗ **A)** clearing and validity instructions.

✗ **B)** execution and clearing instructions.

✓ **C)** validity and execution instructions.

Explanation

Fill or kill is a validity instruction as it indicates when the order can be filled (i.e. immediately or cancel the order). A limit buy order is an execution instruction as it indicates how the order should be filled (e.g. buy at $92 or less). Clearing instructions indicate how to settle the trade (i.e., how and when to transfer the cash and the security).

References

Question From: Session 13 > Reading 45 > LOS g

Related Material:

- Key Concepts by LOS

Question #51 of 151

Question ID: 415137

Becky Kirk contacted her broker and placed an order to purchase 1,000 shares of Bricko Corp. stock at a price of $60 per share. Kirk wishes to buy on margin. Assuming the margin requirement is 40%, how much money does Kirk have to pay up front to make the purchase?

✓ **A)** $24,000.

✗ **B)** $36,000.

✗ **C)** $60,000.

Explanation

The margin requirement represents the amount of money an investor must put down on the purchase. So Kirk must put $24,000 down ($60,000 x .40 = $24,000) and can borrow the balance.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #52 of 151

Question ID: 415232

Which of the following statements about market efficiency is *least* accurate?

- ✗ **A)** The semi-strong form EMH addresses market and non-market public information.
- ✗ **B)** The strong-form EMH assumes cost free availability of all information, both public and private.
- ✓ **C)** The weak-form EMH suggests that fundamental analysis will not provide excess returns while the semi-strong form suggests that technical analysis cannot achieve excess returns.

Explanation

The weak-form EMH suggests that *technical* analysis will not provide excess returns while the semi-strong form suggests that *fundamental* analysis cannot achieve excess returns. The weak-form EMH assumes the price of a security reflects all currently available *historical* information. Thus, the past price and volume of trading has no relationship with the future, hence technical analysis is not useful in achieving superior returns.

The other choices are correct. The strong-form EMH states that stock prices reflect all types of information: market, non-public market, and private. No group has monopolistic access to relevant information; thus no group can achieve excess returns. For these assumptions to hold, the strong-form assumes perfect markets - information is free and available to all.

References

Question From: Session 13 > Reading 47 > LOS d

Related Material:

- Key Concepts by LOS

Question #53 of 151

Question ID: 434375

A market that directs capital to its most productive use is *best* described as:

- ✗ **A)** informationally efficient.
- ✓ **B)** allocationally efficient.
- ✗ **C)** operationally efficient.

Explanation

Markets are said to be allocationally efficient when capital is directed to its most productive uses. Operationally efficient markets are those that have low trading costs. Informationally efficient markets are those in which security prices reflect all information associated with fundamental value in a timely fashion.

References

Question From: Session 13 > Reading 45 > LOS k

Related Material:

- Key Concepts by LOS

Question #54 of 151

Question ID: 415220

Hume Inc. announces fourth quarter earnings per share of $1.20, which is 15% higher than last year. Hume's earnings are equal to the consensus analyst forecast for the quarter. Assuming markets are efficient, the announcement will *most likely* cause the price of Hume's stock to:

✓ **A)** remain the same.
✗ **B)** increase.
✗ **C)** decrease.

Explanation

An efficient capital market would price Hume's stock based on the expectation for earnings per share. Since actual earnings equal expected earnings, the stock price should not change as a result of the announcement.

References

Question From: Session 13 > Reading 47 > LOS a

Related Material:

- Key Concepts by LOS

Question #55 of 151

Question ID: 434372

An investor purchases 200 shares of Rubble, Inc. on margin. The shares are trading at $40. Initial and maintenance margins are 50% and 25%. If the company pays a dividend of $0.75 and the investor sells the stock at year-end for $50 per share, the return on the investment would be *closest* to:

✓ **A)** 53.75%
✗ **B)** 15.75%
✗ **C)** 39.55%

Explanation

Dividend income = 0.75 × 200 = $150
Profit = 10,000 - 8,000 + 150 = 2,150
Return = 2,150 / 4,000 = 53.75%

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #56 of 151

Question ID: 415224

Which of the following would be *inconsistent* with an efficient market?

- ✗ **A)** Price changes are independent.
- ✗ **B)** Stock prices adjust rapidly to new information.
- ✓ **C)** Price adjustments are biased.

Explanation

Market efficiency assumes that investors adjust their estimates of security prices rapidly to reflect their unbiased interpretation of the new information. New information arrives randomly and independently. Therefore, price changes are independent.

References

Question From: Session 13 > Reading 47 > LOS c

Related Material:

- Key Concepts by LOS

Question #57 of 151

Question ID: 434373

An investor purchases 100 shares at $75 per share with an initial margin of 50%. Assume there is no interest on the call loan and no transactions fees. If the stock price rises to $112.50, the rate of return to the investor is:

- ✗ **A)** 200%.
- ✗ **B)** 50%.
- ✓ **C)** 100%.

Explanation

$75/share × 100 shares = $7,500.
50% margin means investor only pays half of the $7,500 in cash, or $3,750, and borrows the remaining $3,750.

Rate of return = (market value - initial investment - margin loan repayment) / initial equity
= ($11,250 - $3,750 - $3,750) / $3,750 = 100%.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #58 of 151

Question ID: 415162

Which of the following statements about primary and secondary markets is *least* accurate?

- ✗ **A)** A primary market is a market in which new securities are sold.
- ✓ **B)** The proceeds from a sale in the secondary market go to the issuer.
- ✗ **C)** The primary market benefits from the liquidity provided by the secondary market.

Explanation

Proceeds in a primary market go to the issuing firm. Proceeds from a sale in the secondary market go to the current owner who is selling the securities.

References

Question From: Session 13 > Reading 45 > LOS i

Related Material:

- Key Concepts by LOS

Question #59 of 151

Question ID: 415156

A buy limit order is said to be "inside the market" when:

- ✗ **A)** the limit is below the best bid.
- ✓ **B)** the limit is between the best bid and the best ask.
- ✗ **C)** it reaches the exchange floor and is entered in the limit book.

Explanation

A limit order with a limit price between the best bid and the best ask is said to be "inside the market" or "making a new market." A limit order that has not yet been executed is a "standing limit order."

References

Question From: Session 13 > Reading 45 > LOS h

Related Material:

- Key Concepts by LOS

Question #60 of 151

Question ID: 415204

Which type of security market index provides a measure of a market's overall performance and usually contains a significant portion of the market's total value?

- ✗ **A)** Sector indexes.
- ✗ **B)** Style indexes.
- ✓ **C)** Broad market indexes.

Explanation

A broad market index typically consists of securities that represent 90% or more of the total market capitalization for a given market. The object of a broad market index is to provide a measure for the performance of the total market. A sector index measures the returns for an industry sector such as financials. Style indexes measure the returns to strategies that are differentiated by market capitalization and by value or growth.

References

Question From: Session 13 > Reading 46 > LOS h

Related Material:

- Key Concepts by LOS

Question #61 of 151

Question ID: 415202

An analyst using the capital asset pricing model is *most likely* to use a security market index as a proxy for:

- ✗ **A)** the risk-free rate.
- ✗ **B)** beta.
- ✓ **C)** the market return.

Explanation

The return on a security market index can be used as a proxy for the market return in a pricing model such as the CAPM.

References

Question From: Session 13 > Reading 46 > LOS g

Related Material:

- Key Concepts by LOS

Question #62 of 151

Question ID: 415133

Lynne Hampton purchased 100 shares of $75 stock on margin. The margin requirement set by the Federal Reserve Board was 40%, but Hampton's brokerage firm requires a total margin of 50%. Currently the stock is selling at $62 per share. What is Hampton's return on investment *before* commission and interest if she sells the stock now?

- ✗ **A)** -17%.

✓ **B)** -35%.

✗ **C)** -40%.

Explanation

Hampton originally purchased 100 shares at $75 for a total value of $7500. Half of the value ($3750) was borrowed and Hampton paid cash for the other half. The current total market value of the stock is $6200. If Hampton sells her holdings she will have $2450 left after she pays off the loan. Hampton's return on her original investment is:

$2450/3750 - 1 = 0.65 - 1 = -0.35 = -35%.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #63 of 151

Question ID: 415125

Which type of financial intermediary is a corporation *most likely* to use if it wants to issue new common stock to investors?

✗ **A)** Block broker.

✗ **B)** Securitizer.

✓ **C)** Investment bank.

Explanation

Investment banks are financial intermediaries through which corporations and other entities issue new securities to investors. Securitizers create pools of securities or loans and sell interests in these pools to investors. Block brokers are typically used to execute large trades in the secondary market.

References

Question From: Session 13 > Reading 45 > LOS d

Related Material:

- Key Concepts by LOS

Question #64 of 151

Question ID: 415181

The target market for a security market index is *best* described as the:

✗ **A)** securities that are included in the index.

✗ **B)** consumers who will purchase the licensing rights for the index.

✓ **C)** market or segment the index is designed to measure.

Explanation

The target market of an index is the securities market or portion of a securities market that the index will be designed to represent. The securities from the target market that are included in the index are called its constituent securities.

References

Question From: Session 13 > Reading 46 > LOS c

Related Material:

- Key Concepts by LOS

Question #65 of 151

Question ID: 485802

Six months after inception, the price return and the total return of an equal-weighted index will be different if:

✓ **A)** constituent securities have paid dividends.

✗ **B)** capital gains exceed capital losses or vice versa.

✗ **C)** market prices have not changed.

Explanation

The difference between a price and total return index is that cash distributions are included in a total return index. The two will differ when the constituent securities make cash distributions over the period. Otherwise, the two versions will be the same.

References

Question From: Session 13 > Reading 46 > LOS b

Related Material:

- Key Concepts by LOS

Question #66 of 151

Question ID: 415140

An investor bought a stock on margin. The margin requirement was 60%, the current price of the stock is $80, and the stock price was $50 one year ago. If margin interest is 5%, how much equity did the investor have in the investment at year-end?

✗ **A)** 67.7%.

✓ **B)** 73.8%.

✗ **C)** 60.6%.

Explanation

Margin debt = 40% × $50 = $20; Interest = $20 × 0.05 = $1.

Equity % = [Value - (margin debt + interest)] / Value

$80 - $21 / $80 = 73.8%

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #67 of 151

Question ID: 485801

A stock's limit order book is as follows:

Bid Size	Limit Price (£)	Offer Size
700	25.25	
300	25.30	
100	25.40	
	25.50	500
	25.55	200
	25.75	500

A new sell limit order is placed for 250 shares at £25.45. This limit order is said to be:

✓ **A)** making a new market.

✗ **B)** behind the market.

✗ **C)** an iceberg order.

Explanation

The order being placed is between the best bid and best ask. It makes a new market with the new bid-ask of £25.40 - £25.45.

References

Question From: Session 13 > Reading 45 > LOS h

Related Material:

- Key Concepts by LOS

Question #68 of 151

Question ID: 415172

Peg Fisk, CFA, states that two of the objectives of market regulation which CFA Institute attempts to address are minimum standards of competence among investment professionals and ease of performance evaluation for investors. Fisk is accurate with regard to:

- ☓ **A)** only one of these objectives
- ☓ **B)** neither of these objectives.
- ✓ **C)** both of these objectives.

Explanation

CFA Institute attempts to address both of these objectives of market regulation. The CFA Program is part of the effort to encourage minimum standards of competency among finance professionals. Global Investment Performance Standards are part of the effort to make performance evaluation easier for investors.

References

Question From: Session 13 > Reading 45 > LOS l

Related Material:

- Key Concepts by LOS

Question #69 of 151

Question ID: 415238

Which of the following statements concerning market efficiency is *least* accurate?

- ☓ **A)** Tests of the semi-strong form of the EMH require that security returns be risk-adjusted using a market model.
- ☓ **B)** If weak-form market efficiency holds, technical analysis cannot be used to earn abnormal returns over the long-run.
- ✓ **C)** Market efficiency assumes that individual market participants correctly estimate asset prices.

Explanation

Market efficiency does not assume that individual market participants correctly estimate asset prices, but does assume that their estimates are unbiased. That is, some agents will over-estimate and some will under-estimate, but they will be correct, on average.

References

Question From: Session 13 > Reading 47 > LOS e

Related Material:

- Key Concepts by LOS

Question #70 of 151

Question ID: 415190

An index was recently begun with the following two stocks:

- Company A - 50 shares valued at $2 each.
- Company B - 10 shares valued at $10 each.

Given that the value-weighted index was originally set at 100 and Company A's stock is currently selling for $4 per share while Company B's stock is still at $10 per share, what is the current value of the price-weighted index and the market-cap-weighted index?

	Price-weighted	Market-cap-weighted
✗ **A)**	7	300
✗ **B)**	8	150
✓ **C)**	7	150

Explanation

Price weight = [(4) + (10)] / 2 = 7

Market-cap weight = [(4)(50) + (10)(10)] / [(2)(50) + (10)(10)](100) = 150

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS

Question #71 of 151

Question ID: 415245

Which of the following would provide evidence *against* the semistrong form of the efficient market theory?

- ✓ **A)** Low P/E stocks tend to have positive abnormal returns over the long run.
- ✗ **B)** Trend analysis is worthless in determining stock prices.
- ✗ **C)** All investors have learned to exploit signals related to future performance.

Explanation

P/E information is publicly available information and therefore this test relates to the semistrong-form EMH. Trend analysis is based on historical information and therefore relates to the weak-form EMH. In an efficient market one would expect 50% of pension fund managers to do better than average and 50% of pension fund managers to do worse than average. If all investors exploit the same information no excess returns are possible.

References

Question From: Session 13 > Reading 47 > LOS f

Related Material:

- Key Concepts by LOS

Question #72 of 151

Question ID: 415221

The measure of an asset's value that can *most likely* be determined without estimation is its:

- ✗ **A)** fundamental value.
- ✓ **B)** market value.
- ✗ **C)** intrinsic value.

Explanation

The current price of a traded asset is its market value. An asset's intrinsic or fundamental value is the price a rational investor with complete information about the asset would pay for it.

References

Question From: Session 13 > Reading 47 > LOS b

Related Material:

- Key Concepts by LOS

Question #73 of 151

Question ID: 415115

Markets for financial assets with maturities of one year or less are *best* characterized as:

- ✗ **A)** capital markets.
- ✓ **B)** money markets.
- ✗ **C)** primary markets.

Explanation

"Money markets" generally refers to markets for debt securities maturing in one year or less. Capital markets refer to markets for equities and for debt securities with maturities greater than one year. Primary markets are the markets for newly issued securities.

References

Question From: Session 13 > Reading 45 > LOS b

Related Material:

- Key Concepts by LOS

Question #74 of 151

Question ID: 415227

Which of the following is NOT an assumption behind efficient capital markets?

- ✗ **A)** Return expectations implicitly include risk.

✓ **B)** Market participants correctly adjust prices to reflect new information.

✗ **C)** New information occurs randomly, and the timing of announcements is independent of one another.

Explanation

The set of assumptions that imply an efficient capital market includes:

- There exists a large number of profit-maximizing market participants.
- New information occurs randomly.
- Market participants adjust their price expectations rapidly (but not necessarily correctly).
- Return expectations implicitly include risk.

References

Question From: Session 13 > Reading 47 > LOS d

Related Material:

- Key Concepts by LOS

Question #75 of 151

Question ID: 485803

Compared to a value-weighted index, the type of index *most likely* to have a value tilt is a(n):

✗ **A)** equal-weighted index.

✓ **B)** fundamental-weighted index.

✗ **C)** price-weighted index.

Explanation

An index based on company fundamentals, for example on earnings or book value, will assign more weight to stocks with low P/E or price-to-book ratios compared to a value-weighted index. This is similar to managing an equity portfolio using a value strategy.

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS

Question #76 of 151

Question ID: 415170

A financial system in which transactions have low costs is said to exhibit:

✗ **A)** informational efficiency.

✓ **B)** operational efficiency.

- ✗ **C)** allocational efficiency.

Explanation

Operational efficiency refers to low transactions costs. A financial system exhibits informational efficiency if prices quickly reflect all information relevant to fundamental value. A market exhibits allocational efficiency if it results in capital being directed to its most productive uses.

References

Question From: Session 13 > Reading 45 > LOS k

Related Material:

- Key Concepts by LOS

Question #77 of 151

Question ID: 415139

Which of the following statements regarding margin accounts is *most* accurate?

- ✗ **A)** The total equity in the margin account cannot fall below the initial margin requirement.
- ✗ **B)** Maintenance margin refers to the amount of funds the investor can borrow.
- ✓ **C)** Margin accounts can be used to purchase securities by borrowing part of the purchase price.

Explanation

Margin accounts are brokerage accounts that allow investors to borrow part of the purchase price from the broker.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #78 of 151

Question ID: 415129

A short seller:

- ✗ **A)** loses if the price of the stock sold short decreases.
- ✓ **B)** does not receive the dividends.
- ✗ **C)** often also places a stop loss sell order.

Explanation

The short seller pays all dividends to the lender, loses if stock prices *rise*, and is required to post a margin account. A short seller often places a *stop buy* order to protect the short sale position from a rising market.

References

Question From: Session 13 > Reading 45 > LOS e

Related Material:

- Key Concepts by LOS

Question #79 of 151

Question ID: 415179

The value of a security market index at the end of December is 1,200. The index returns for the next six months are:

Month	Return
January	3.89%
February	8.76%
March	−4.74%
April	6.88%
May	−5.39%
June	−8.12%

The index value at the end of June is *closest to*:

- ✗ **A)** 1,214.
- ✓ **B)** 1,200.
- ✗ **C)** 1,186.

Explanation

The index value at the end of June is
1,200(1.0389)(1.0876)(0.9526)(1.0688)(0.9461)(0.9188) = 1,200.

Note that the compound rate of return is
(1.0389)(1.0876)(0.9526)(1.0688)(0.9461)(0.9188)−1 = 0.

References

Question From: Session 13 > Reading 46 > LOS b

Related Material:

- Key Concepts by LOS

Question #80 of 151

Question ID: 415177

The value of a total return index:

- ✓ **A)** can be calculated by multiplying the beginning value by the geometrically linked series of periodic total returns.

- ✗ **B)** is determined by the price changes of the securities that constitute the index.
- ✗ **C)** may increase at either a faster or slower rate than the value of a price return index with the same constituent securities and weights.

Explanation

The value of a total return index can be calculated by multiplying the beginning value by the geometrically linked series of index total returns. The value of a total return index includes both the price changes of the securities that constitute the index and any cash flows from the securities (dividends, interest, and other distributions). A total return index cannot increase at a slower rate (or decrease at a faster rate) than an otherwise identical price return index because cash flows from the securities cannot be negative.

References

Question From: Session 13 > Reading 46 > LOS b

Related Material:

- Key Concepts by LOS

Question #81 of 151

Question ID: 415142

An investor purchases stock on 25% initial margin, posting $10 of the original stock price of $40 as equity. The position has a required maintenance margin of 20%. The investor later sells the stock for $45. Ignoring transaction costs and margin loan interest, which of the following statements is *most* accurate?

- ✗ **A)** Leverage ratio is 3:1.
- ✗ **B)** Margin call price is $36.
- ✓ **C)** Return on investment is 50%.

Explanation

Return on invested equity is ($45 - $40) / $10 - 1 = 50%.
The leverage ratio is purchase price / equity = $40 / $10 = 4.
Margin call price is $40 × [(1 - 0.25) / (1 - 0.20)] = $37.50.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #82 of 151

Question ID: 415188

James Investments is calculating an equally weighted index on a four stock portfolio.

Stock	*Number of Shares*	*Initial Cost*	*Current Cost*
W	100	5.00	5.00
X	1,000	10.00	12.50
Y	500	7.50	10.00
Z	1500	5.00	8.00

If the initial index value is 100, the current index is *closest* to:

- ✗ **A)** 142.6.
- ✓ **B)** 129.5.
- ✗ **C)** 137.9.

Explanation

First calculate the return relatives and then find the mean of the relatives. The number of shares is irrelevant in this question.

> 5/5 = 1
> 12.5/10 = 1.25
> 10/7.50 = 1.33
> 8/5 = 1.60

(1 + 1.25 + 1.33 + 1.60) / 4 = 1.295
100 × 1.295 = 129.5

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS

Question #83 of 151

Question ID: 415171

An objective of financial market regulation is to:

- ✓ **A)** reduce information gathering costs by requiring common financial reporting standards.
- ✗ **B)** ensure that inside information is made public in a timely manner.
- ✗ **C)** prevent uninformed investors from participating in financial markets.

Explanation

One of the objectives of market regulation is to require firms to report their financial performance according to a single set of standards, such as those of the IASB or FASB, thereby reducing market participants' cost of gathering information. Market regulation is not designed to prevent uninformed investors from trading, but to protect unsophisticated investors and thereby preserve trust in the financial markets. An objective of market regulation is to prevent those with non-public information from profiting at the expense of other investors, but not necessarily to make all inside information public.

References

Question From: Session 13 > Reading 45 > LOS l

Related Material:

- Key Concepts by LOS

Question #84 of 151

Question ID: 415117

A securities exchange where traders buy and sell long-term government bonds from and to other traders would *best* be described as part of the:

✓ **A)** capital market.

✗ **B)** primary market.

✗ **C)** money market.

Explanation

The exchange can be described as part of the secondary capital markets. A security is first issued in the primary market, and then it trades among investors in the secondary market. The money market refers to the market for short-term debt instruments (usually with maturities of less than one year) such as T-bills.

References

Question From: Session 13 > Reading 45 > LOS b

Related Material:

- Key Concepts by LOS

Question #85 of 151

Question ID: 415112

The main functions of the financial system *least likely* include:

✗ **A)** allocating financial resources to their most productive uses.

✗ **B)** bringing together savers and borrowers.

✓ **C)** preventing investors from generating abnormal profits by trading on information.

Explanation

One of the purposes of the financial system is to allow investors to trade on (public) information. Other purposes of the financial system include allocating financial capital to its most productive uses, and bringing together those who wish to save with those who wish to borrow.

References

Question From: Session 13 > Reading 45 > LOS a

Related Material:

- Key Concepts by LOS

Question #86 of 151

Question ID: 415207

Which of the following is NOT a reason bond market indexes are more difficult to create than stock market indexes?

- ✗ **A)** The universe of bonds is much broader than that of stocks.
- ✗ **B)** There is a lack of continuous trade data available for bonds.
- ✓ **C)** Bond deviations tend to be relatively constant.

Explanation

Bond prices are quite volatile as measured by the bond's duration.

References

Question From: Session 13 > Reading 46 > LOS i

Related Material:

- Key Concepts by LOS

Question #87 of 151

Question ID: 415212

Voluntary reporting of performance by hedge fund managers leads to:

- ✗ **A)** a downward bias in hedge fund index returns.
- ✓ **B)** an upward bias in hedge fund index returns.
- ✗ **C)** no appreciable bias in hedge fund index returns.

Explanation

Empirical studies have shown that since hedge fund managers have the option to report performance results only funds with good results will report. Since funds with poor performance do not report their results, the results of hedge fund indexes will be biased upwards.

References

Question From: Session 13 > Reading 46 > LOS j

Related Material:

- Key Concepts by LOS

Question #88 of 151

Question ID: 434371

An investor purchases 200 shares of Mertz, Inc. on margin. The shares are trading at $40. Initial and maintenance margins are 50% and 25%. If the investor sells the stock when the price rises to $50 at year-end, the return on the investment would be *closest* to:

- ✗ **A)** 25%.
- ✓ **B)** 50%.
- ✗ **C)** 20%.

Explanation

Profit = 10,000 - 8,000 = 2,000
Return = 2,000 / 4,000 = 50%

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #89 of 151

Question ID: 415169

Which of the following is *least* likely a characteristic of a well-functioning market?

- ✓ **A)** Prices change significantly from one transaction to the next.
- ✗ **B)** Reliable information is available on price and volume.
- ✗ **C)** Prices adjust quickly when new information becomes available.

Explanation

In a well-functioning market, prices should not typically change much from one transaction to the next because many buyers and sellers are willing to trade at prices near the current price. Characteristics of a well-functioning market include availability of reliable information on prices and transaction volume; liquidity (marketability and price continuity); prices that react quickly to new information; and low transactions costs.

References

Question From: Session 13 > Reading 45 > LOS k

Related Material:

- Key Concepts by LOS

Question #90 of 151

Question ID: 415240

In a perfectly efficient market, portfolio managers should do all of the following EXCEPT:

- ✗ **A)** monitor their client's needs and circumstances.
- ✗ **B)** quantify their risk and return needs within the bounds of the client's liquidity, income, time horizon, legal, and regulatory constraints.
- ✓ **C)** diversify to eliminate systematic risk.

Explanation

Portfolio managers cannot eliminate systematic risk (i.e., market risk) thru the use of diversification. Portfolio managers should try to eliminate unsystematic portfolio risk.

References

Question From: Session 13 > Reading 47 > LOS e

Related Material:

- Key Concepts by LOS

Question #91 of 151

Question ID: 415236

Which of the following forms of the EMH assumes that no group of investors has monopolistic access to relevant information?

- ✓ **A)** Strong-form.
- ✗ **B)** Weak-form.
- ✗ **C)** Both weak and semistrong form.

Explanation

According to the strong-form EMH, security prices reflect all information, which includes the privately available (monopolistic) information.

References

Question From: Session 13 > Reading 47 > LOS d

Related Material:

- Key Concepts by LOS

Question #92 of 151

Question ID: 500871

Which of the following is *most likely* an objective of market regulation?

- ✓ **A)** Preserve or increase liquidity.
- ✗ **B)** Limit downside risk to investors.
- ✗ **C)** Educate unsophisticated investors.

Explanation

Rules against insider trading and enforcement of laws regarding fraud and theft by corporate managers are intended to preserve trust in the markets of public investors. Trust in markets increases participation and, thereby, liquidity of markets. While clear and honest disclosure and fraud prevention are goals, limiting the downside risk of equities markets is not a likely objective of financial regulation. Neither is the education of unsophisticated investors.

References

Question From: Session 13 > Reading 45 > LOS l

Related Material:

- Key Concepts by LOS

Question #93 of 151

Question ID: 415166

Which of the following statements about securities exchanges is NOT correct?

- ✗ **A)** Securities exchanges may be structured as call markets or continuous markets.
- ✗ **B)** In call markets, there is only one negotiated price set to clear the market for a given stock.
- ✓ **C)** In continuous markets, prices are set only by the auction process.

Explanation

In continuous markets, the price is set by either the auction process or by dealer bid-ask quotes.

References

Question From: Session 13 > Reading 45 > LOS j

Related Material:

- Key Concepts by LOS

Question #94 of 151

Question ID: 415187

With regard to stock market indexes, it is *least likely* that:

- ✓ **A)** a market-cap weighted index must be adjusted for stock splits but not for dividends.
- ✗ **B)** the use of price weighting versus market value weighting produces a downward bias on the index.
- ✗ **C)** buying 100 shares of each stock in a price-weighted index will result in a portfolio that tracks the index quite well.

Explanation

A price-weighted index needs to be adjusted for stock splits, but a market-cap weighted index does not. Neither type of index considers dividend income unless it is designed as a total return index.

Price weighting produces a downward bias compared to market weighting because firms that split their stocks (which tend to be the more successful firms) decrease in weight within a price-weighted index. The returns on a price-weighted index can be matched by purchasing a portfolio with an equal number of shares of each stock in the index.

References

Question From: Session 13 > Reading 46 > LOS d

Related Material:

- Key Concepts by LOS

Question #95 of 151

Question ID: 415158

A primary market transaction involves:

- ✗ **A)** the direct trading of securities between institutional investors.
- ✗ **B)** primarily preferred stocks.
- ✓ **C)** the sale of new securities to investors.

Explanation

A primary market is a market for new issues of securities.

References

Question From: Session 13 > Reading 45 > LOS i

Related Material:

- Key Concepts by LOS

Question #96 of 151

Question ID: 415205

The Top Banking Index contains stocks in the finance industry that represent more than 90% of the total market capitalization for the finance industry. The index is *best* described as a:

- ✗ **A)** broad market index.
- ✓ **B)** sector index.
- ✗ **C)** style index.

Explanation

A sector index measures the returns for an industry sector such as financials. Style indexes measure the returns to strategies that are differentiated by market capitalization and by value or growth. A broad market index typically consists of constituent securities that represent 90% or more of the total market capitalization for a given market.

References

Question From: Session 13 > Reading 46 > LOS h

Related Material:

- Key Concepts by LOS

Question #97 of 151

Question ID: 415251

The idea that uninformed traders, when faced with unclear information, observe the actions of informed traders to make decisions, is referred to as:

- ✓ **A)** information cascades.
- ✗ **B)** herding behavior.
- ✗ **C)** narrow framing.

Explanation

"Information cascades" refers to uninformed traders watching the actions of informed traders when making investment decisions. Herding behavior is when trading occurs in clusters, not necessarily driven by information. Narrow framing refers to investors viewing events in isolation.

References

Question From: Session 13 > Reading 47 > LOS g

Related Material:

- Key Concepts by LOS

Question #98 of 151

Question ID: 415118

The prospectus for the Horizon Fund states that it invests only in real assets. Which of the following would the Horizon Fund *most likely* include in its portfolio?

- ✓ **A)** An investment in an apartment complex.
- ✗ **B)** Holdings of foreign currencies.
- ✗ **C)** Common stock of a technology company.

Explanation

Real assets are assets with a physical presence such as real estate, equipment, and commodities. Financial assets include stocks, bonds, derivatives, and currencies. An investment in an apartment complex is a real estate investment and therefore would be considered a real asset.

References

Question From: Session 13 > Reading 45 > LOS b

Related Material:

- Key Concepts by LOS

Question #99 of 151

Question ID: 485799

An investor purchased 725 shares of stock at $40 per share and posted initial margin of 60%. He subsequently sold the shares at $50 per share. Based only on this information, the investor's holding period return is *closest to*:

- ✗ **A)** 25%.
- ✗ **B)** 20%.
- ✓ **C)** 40%.

Explanation

(50 - 40) / (40 × 0.6) = 41.67%.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #100 of 151

Question ID: 415127

An investor can profit from a stock price decline by:

- ✗ **A)** placing a stop buy order.
- ✓ **B)** selling short.
- ✗ **C)** purchasing a call option.

Explanation

Short selling provides a way for an investor to profit from a stock price decline. In order to sell short, the broker borrows the security and then sells it for the short seller. Later, if the investor can replace the borrowed securities by repurchasing them at a lower price, then the investor will profit from the transaction.

References

Question From: Session 13 > Reading 45 > LOS e

Related Material:

- Key Concepts by LOS

Question #101 of 151

Question ID: 655687

An investor buys 200 shares of ABC at the market price of $100 and posts the required initial margin of $8,000. The maintenance margin requirement is 25%.

At what share price will the investor's account balance be reduced to the maintenance margin level?

- ✗ **A)** $112.
- ✓ **B)** $80.
- ✗ **C)** $48.

Explanation

The initial margin requirement is $8,000 / (200 × $100) = 0.40. In a long stock position, the equation to determine the margin call price is:

long = [(original price)(1 − initial margin %)] / [1 − maintenance margin %]
= $100(1 − 0.4) / (1 − 0.25) = $80

Alternatively, the margin loan is (200 × $100) − $8,000 = $12,000. The minimum value of the long position that meets the maintenance margin requirement is $12,000 / (1 − 0.25) = $16,000. The share price at which the long position has this value is $16,000 / 200 = $80.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #102 of 151

Question ID: 415213

Which of the following indexes is a price weighted index?

- ✗ **A)** The Standard and Poor's Index.
- ✓ **B)** The Nikkei Dow Index.
- ✗ **C)** The New York Stock Exchange Index.

Explanation

The Nikkei Dow Index is a price-weighted index. The other two are market value-weighted indexes.

References

Question From: Session 13 > Reading 46 > LOS k

Related Material:

- Key Concepts by LOS

Question #103 of 151

Question ID: 415203

An equity index comprised of value stocks, identified by their price-to-earnings ratios, is *best* described as a:

- ✗ **A)** sector index.
- ✗ **B)** fundamental weighted index.
- ✓ **C)** style index.

Explanation

An index of value stocks is an example of a style index. Sector indexes measure the performance of securities in specific industries or industry sectors. Fundamental weighting is used to weight indexes by a factor such as the size of the firms or economies represented in the index.

References

Question From: Session 13 > Reading 46 > LOS h

Related Material:

- Key Concepts by LOS

Question #104 of 151

Question ID: 415235

The semi-strong form of the efficient market hypothesis (EMH) asserts that stock prices:

- ✓ **A)** fully reflect all publicly available information.
- ✗ **B)** fully reflect all relevant information including insider information.
- ✗ **C)** fully reflect all historical price information.

Explanation

The semi-strong form of the EMH asserts that security prices fully reflect all publicly available information. This would include all historical information. The weak form relates to historical information only. The strong form relates to public and private information.

References

Question From: Session 13 > Reading 47 > LOS d

Related Material:

- Key Concepts by LOS

Question #105 of 151

Question ID: 415200

The *most* appropriate benchmark for measuring the relative performance of an investment manager is:

- ✗ **A)** the risk-adjusted return on the market portfolio.

- ✗ **B)** a broad market index.
- ✓ **C)** an index that closely matches the manager's investment approach.

Explanation

An index chosen as a benchmark for an investment manager's performance should include securities in the manager's investment universe. For example, the performance of an emerging market bond fund manager should be measured relative to the performance of an emerging market bond index.

References

Question From: Session 13 > Reading 46 > LOS g

Related Material:

- Key Concepts by LOS

Question #106 of 151

Question ID: 415113

The main functions of the financial system *most likely* include:

- ✗ **A)** determining the supply of money and determining equilibrium interest rates.
- ✓ **B)** determining equilibrium interest rates and allocating capital to its most productive uses.
- ✗ **C)** allocating capital to its most productive uses and determining the supply of money.

Explanation

The main functions of the financial system are to allow individuals and organizations to save, borrow, raise capital, and manage risks; to determine equilibrium rates of return that equate the amounts of lending and borrowing; and to allocate capital to its most productive uses. The money supply is typically controlled by countries' central banks.

References

Question From: Session 13 > Reading 45 > LOS a

Related Material:

- Key Concepts by LOS

Question #107 of 151

Question ID: 415214

Which of the following sets of indexes are price-weighted?

- ✗ **A)** S&P 500 Index and Dow Jones Industrial Average.
- ✓ **B)** Dow Jones Industrial Average and Nikkei Dow Jones Stock Market Average.
- ✗ **C)** Dow Jones World Stock Index and Russell Index.

Explanation

The Dow Jones World Stock Index, the Russell Index, the S&P 500 Index, and Morgan Stanley Capital International Index are all market-value weighted. Only the Dow Jones Industrial Average and the Nikkei Dow Jones Stock Market Averages are price-weighted.

References

Question From: Session 13 > Reading 46 > LOS k

Related Material:

- Key Concepts by LOS

Question #108 of 151

Question ID: 415173

When using a security market index to represent a market's performance, the performance of that market over a period of time is *best* represented by:

- ✗ **A)** the index value.
- ✗ **B)** the change in the index value.
- ✓ **C)** the percent change in the index value.

Explanation

Percentage changes in the value of a security market index over time represent the performance of the market, segment, or asset class from which the securities are chosen.

References

Question From: Session 13 > Reading 46 > LOS a

Related Material:

- Key Concepts by LOS

Question #109 of 151

Question ID: 415209

Which of the following statements regarding fixed income indexes is *most accurate*?

- ✗ **A)** It is typically easier for portfolio managers to replicate a fixed income index than an equity index.
- ✓ **B)** Because some fixed income securities are illiquid, indexes may include estimates of value.
- ✗ **C)** Compared to stock indexes, turnover is typically lower in fixed income indexes.

Explanation

Because some fixed income securities are illiquid, a lack of recent trade prices may result in indexes having to estimate values. Unlike stocks, bonds mature and must be replaced in fixed income indexes. As a result turnover is higher in fixed income indexes. Illiquidity, transaction costs, and high turnover make it more expensive and difficult for a portfolio manager to replicate a fixed income index than a stock index.

References

Question From: Session 13 > Reading 46 > LOS i

Related Material:

- Key Concepts by LOS

Question #110 of 151

Question ID: 415229

The statement, "Stock prices fully reflect all information from public and private sources," can be attributed to which form of the efficient market hypothesis (EMH)?

- ✗ **A)** Semistrong-form EMH.
- ✓ **B)** Strong-form EMH.
- ✗ **C)** Weak-form EMH.

Explanation

This is the definition of the strong-form EMH. Private sources include insider information, such as persons holding monopolistic access to information relevant to the formation of prices.

References

Question From: Session 13 > Reading 47 > LOS d

Related Material:

- Key Concepts by LOS

Question #111 of 151

Question ID: 415123

Financial intermediaries that issue securities which represent interests in a pool of similar financial assets are *best* characterized as:

- ✓ **A)** securitizers.
- ✗ **B)** arbitrageurs.
- ✗ **C)** block brokers.

Explanation

Securitizers are financial intermediaries that assemble large pools of similar financial assets, such as mortgages or loans, and issue securities that represent interests in the pool. Block brokers assist their clients with large trades of securities. Arbitrageurs simultaneously buy and sell the same asset in different markets to take advantage of different prices for the same asset.

References

Question From: Session 13 > Reading 45 > LOS d

Related Material:

- Key Concepts by LOS

Question #112 of 151

Question ID: 415147

Which of the following statements about the maintenance margin requirement is *least* accurate?

✓ **A)** The Federal Reserve sets the maximum maintenance margin.

✗ **B)** Generally the maintenance margin requirement is lower than the initial margin requirement.

✗ **C)** The purpose of the maintenance margin requirement is to protect the broker in the event of a large stock decline.

Explanation

The Federal Reserve sets the minimum maintenance margin and individual investment companies may set higher margins if they wish.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #113 of 151

Question ID: 415218

The implication of efficient capital markets and a lack of superior analysts have led to the introduction of:

✗ **A)** balanced funds.

✗ **B)** futures options.

✓ **C)** index funds.

Explanation

An index fund is designed to duplicate the composition of a specific index series or market segment. There is a strong argument suggesting that portfolio managers cannot beat the market after fees, therefore an index fund should be used to try to match the market.

References

Question From: Session 13 > Reading 47 > LOS a

Related Material:

- Key Concepts by LOS

Question #114 of 151

Question ID: 415234

Which of the following forms of the EMH assumes that no group of investors has monopolistic access to relevant information?

- ✗ **A)** Weak-form.
- ✓ **B)** Strong-form.
- ✗ **C)** Both weak and semistrong form.

Explanation

The strong-form EMH assumes that stock prices fully reflect all information from public and private sources. In addition, no group of investors has monopolistic access to information relevant to the formation of prices.

References

Question From: Session 13 > Reading 47 > LOS d

Related Material:

- Key Concepts by LOS

Question #115 of 151

Question ID: 415163

Which of the following is a difference between primary and secondary capital markets?

- ✗ **A)** Primary markets are where stocks trade while secondary markets are where bonds trade.
- ✗ **B)** Secondary capital markets relate to the sale of new issues of bonds, preferred, and common stock, while primary capital markets are where securities trade after their initial offering.
- ✓ **C)** Primary capital markets relate to the sale of new issues of bonds, preferred, and common stock, while secondary capital markets are where securities trade after their initial offering.

Explanation

Bonds and stocks are traded on both the primary and secondary markets.

References

Question From: Session 13 > Reading 45 > LOS i

Related Material:

- Key Concepts by LOS

Question #116 of 151

Question ID: 415206

Which of the following statements regarding bond market indexes is *least* accurate?

- ✓ **A)** The bond universe is more stable than the stock universe.
- ✗ **B)** Unlike stocks, bonds lack continuous price trading data.

✗ **C)** There are more bond issues than stocks.

Explanation

One reason why the creation of a bond index is more difficult than a stock index is due to the fact that the universe of bonds is constantly changing because of numerous new issues, bond maturities, calls, and bond sinking funds.

References

Question From: Session 13 > Reading 46 > LOS i

Related Material:

- Key Concepts by LOS

Question #117 of 151

Question ID: 415175

In one year, a security market index has the following quarterly price returns:

First quarter	3%
Second quarter	4%
Third quarter	-2%
Fourth quarter	5%

The price return for the year is *closest to*:

✓ **A)** 10.2%.

✗ **B)** 9.9%.

✗ **C)** 10.0%

Explanation

Return for the year = (1.03)(1.04)(0.98)(1.05) − 1 = 10.23%.

References

Question From: Session 13 > Reading 46 > LOS b

Related Material:

- Key Concepts by LOS

Question #118 of 151

Question ID: 415143

An investor buys 1,000 shares of a non-dividend-paying stock for $18. The initial margin requirement is 40% and the maintenance margin is 30%. After one year the investor sells the stock for $24 per share. The investor's rate of return on this investment (ignoring borrowing and transactions costs and taxes), and the price at which the investor would receive a margin call, are *closest to:*

	Rate of return	Margin call
✓ **A)**	83%	$15.43
✗ **B)**	33%	$15.43
✗ **C)**	83%	$21.00

Explanation

To obtain the result:

Part 1: Calculate Margin Return:

Margin Return % = [((Ending Value - Loan Payoff) / Beginning Equity Position) - 1] * 100 =

= [((([$24 × 1,000] - [$18 × 1,000 × 0.60]) / ($18 × 0.40 × 1,000)) - 1] × 100 =

= **83.33%**

Alternative (Check): Calculate the all cash return and multiply by the margin leverage factor.

= [(24,000 - 18,000)/18,000] × [1 / 0.40] = 33.33% × 2.5 = 83.33%

Part 2: *Calculate Margin Call Price:*

Since the investor is *long* (purchased the stock), the formula for the margin call price is:

Margin Call = (original price) × (1 - initial margin) / (1 - maintenance margin)

= $18 × (1 - 0.40) / (1 - 0.30) = **$15.43**

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #119 of 151

Question ID: 415124

Which of the following statements about financial intermediaries is *most* accurate?

✓ **A)** Brokers seek out traders that are willing to take the opposite sides of their clients' orders.

✗ **B)** Dealers buy a security in one market and simultaneously sell the same security in a different market.

✗ **C)** Arbitrageurs buy securities with the anticipation that they will be able to sell the securities in the future at higher prices.

Explanation

Brokers seek out traders that are willing to take the opposite side of their clients' orders. Arbitrageurs buy an instrument in one market and simultaneously sell the same instrument in a different market at a higher price. Dealers buy securities from clients, with the expectation that they will be able to sell the securities to other clients in the future at higher prices.

References

Question From: Session 13 > Reading 45 > LOS d

Related Material:

- Key Concepts by LOS

Question #120 of 151

Question ID: 415249

Investor overreaction that has been documented in securities markets is *most likely* attributable to investors exhibiting:

✓ **A)** loss aversion.

✗ **B)** conservatism.

✗ **C)** risk aversion.

Explanation

Loss aversion refers to the tendency for investors to dislike downside risks more than upside risks creating asymmetrical risk preferences. This dislike of losses may be a cause of investor overreaction. The standard economic notion of risk aversion assumes symmetric risk preferences. Conservatism is the behavioral bias whereby investors react slowly to new information and is unlikely to cause overreaction.

References

Question From: Session 13 > Reading 47 > LOS g

Related Material:

- Key Concepts by LOS

Question #121 of 151

Question ID: 415216

Which of the following equity indexes is an example of a market capitalization weighted index?

✗ **A)** Dow Jones Industrial Average.

✓ **B)** MSCI All Country World Index.

✗ **C)** Nikkei Stock Average.

Explanation

The MSCI All Country World Index is a market capitalization weighted index. The Dow Jones Industrial Average and the Nikkei Stock Average are price-weighted indexes.

References

Question From: Session 13 > Reading 46 > LOS k

Related Material:

- Key Concepts by LOS

Question #122 of 151

Question ID: 415157

Which of the following orders is said to be "behind the market"?

- ✗ **A)** Market sell order when the best bid is 38 and the best ask is 39.
- ✗ **B)** Limit sell order at 38 when the best ask is 39.
- ✓ **C)** Limit buy order at 38 when the best bid is 39.

Explanation

A limit buy order is behind the market if its limit price is below the best bid. A limit sell order is behind the market if its limit price is above the best ask. Market orders are never said to be behind the market.

References

Question From: Session 13 > Reading 45 > LOS h

Related Material:

- Key Concepts by LOS

Question #123 of 151

Question ID: 415217

An efficient capital market:

- ✗ **A)** does not fully reflect all of the information currently available about a given security, including risk.
- ✗ **B)** fully reflects all of the information currently available about a given security, excluding risk.
- ✓ **C)** fully reflects all of the information currently available about a given security, including risk.

Explanation

An efficient capital market fully reflects all of the information currently available about a given security, including risk.

References

Question From: Session 13 > Reading 47 > LOS a

Related Material:

- Key Concepts by LOS

Question #124 of 151

Question ID: 656238

The table below lists information on price per share and shares outstanding for three companies-Lair Enterprises, Kurlew, Inc., and Mowe, Ltd.

	As of Beginning of Year		*As of End of Year*	
Stock	*Price Per Share ($)*	*# Shares Outstanding*	*Price Per Share ($)*	*# Shares Outstanding*
Lair	15	10,000	10	10,000
Kurlew	45	5,000	60	5,000
Mowe	90	500	110	500

Assume that at the beginning of the year, the value of the market-weighted index was 100. The one-year return on the market-cap weighted index is *closest* to:

- ✗ **A)** 13.33%.
- ✓ **B)** 8.33%.
- ✗ **C)** 30.0%.

Explanation

Expand the table as follows:

	As of Beginning of Year 1			*As of End of Year 1*		
Stock	*Price Per Share (in $)*	*# Shares Outstanding*	*Market Capitalization (in $)*	*Price Per Share (in $)*	*# Shares Outstanding*	*Market Capitalization (in $)*
Lair	15	10,000	150,000	10	10,000	100,000
Kurlew	45	5,000	225,000	60	5,000	300,000
Mowe	90	500	45,000	110	500	55,000
Total	*150*		*420,000*	*170*		*455,000*

First, we will calculate the year-end market-cap weighted index value, then we will calculate the return percentage.

Value of market-cap weighted index = [(market capitalization$_{\text{year-end}}$) / (market capitalization$_{\text{beginning of year}}$)] × Beginning index value
= (455,000 / 420,000) × 100 = 108.33

One-Year Return = [(Index value$_{\text{year-end}}$ / Index value$_{\text{beginning of year}}$) − 1] × 100
= [(108.33 / 100) − 1] × 100 = **8.33%**.

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS

Question #125 of 151

Question ID: 415185

In a market-capitalization weighted index firms with:

- ✗ **A)** higher stock prices have greater impacts on the index.
- ✓ **B)** greater market caps have greater impacts on the index.
- ✗ **C)** larger market caps have lesser impacts on the index.

Explanation

In a value weighted index, firms with greater market caps have a greater impact on the index than firms with lower market caps. A higher stock price does not necessarily mean a higher market cap.

References

Question From: Session 13 > Reading 46 > LOS d

Related Material:

- Key Concepts by LOS

Question #126 of 151

Question ID: 415164

Which of the following statements regarding secondary markets is *least* accurate? Secondary markets are important because they provide:

- ✗ **A)** firms with greater access to external capital.
- ✓ **B)** regulators with information about market participants.
- ✗ **C)** investors with liquidity.

Explanation

Secondary markets are important because they provide liquidity and continuous information to investors. The liquidity of the secondary markets adds value to both the investor and firm because more investors are willing to buy issues in the primary market, when they know these issues will later become liquid in the secondary market. Therefore, the secondary market makes it easier for firms to raise external capital.

References

Question From: Session 13 > Reading 45 > LOS i

Related Material:

- Key Concepts by LOS

Question #127 of 151

Question ID: 415131

When using margin to invest in equities, which of the following defines initial margin and what level will the margin be brought back to in the event of a margin call?

	Initial Margin	Margin Call Action
✗ **A)**	minimum amount of equity required of the investor	a deposit must be made to bring the margin back to the initial margin
✗ **B)**	amount of borrowed funds in the transactions	a deposit must be made to bring the margin back to the maintenance margin
✓ **C)**	minimum amount of equity required of the investor	a deposit must be made to bring the margin back to the maintenance margin

Explanation

The initial margin requirement refers to the minimum amount of equity required of the investor.

With equities, if the margin falls below the maintenance margin, funds must be deposited to bring it back up to the maintenance margin level.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #128 of 151

Question ID: 415119

Jorman Inc. stock is cross-listed on exchanges in Tokyo and New York. Jorman stock is *best* described as a:

✗ **A)** private security.

✗ **B)** primary market security.

✓ **C)** public security.

Explanation

Jorman stock is a public security because it is traded on public exchanges that are subject to regulatory oversight. A private security is a security that is not offered for sale on a public exchange and is not subject to regulation. Securities are issued in the primary market (i.e., initial public offerings) and subsequently trade in the secondary market (e.g., stock exchanges).

References

Question From: Session 13 > Reading 45 > LOS b

Related Material:

- Key Concepts by LOS

Question #129 of 151

Question ID: 415210

Commodity price indexes are based on the prices of:

- ✗ **A)** real assets such as grains, oil, and precious metals.
- ✗ **B)** commodities.
- ✓ **C)** futures contracts.

Explanation

The constituent securities of commodity price indexes are commodity futures contracts. As a result, the return on a commodity index can be different than the returns from holding the constituent commodities themselves.

References

Question From: Session 13 > Reading 46 > LOS j

Related Material:

- Key Concepts by LOS

Question #130 of 151

Question ID: 415222

A stock is said to be undervalued if its market price is:

- ✓ **A)** less than its intrinsic value.
- ✗ **B)** greater than its intrinsic value.
- ✗ **C)** less than its book value.

Explanation

A security with a market price less than its intrinsic value is undervalued.

References

Question From: Session 13 > Reading 47 > LOS b

Related Material:

- Key Concepts by LOS

Question #131 of 151

Question ID: 415154

An order to sell a security at the best price available is *most likely* a:

- ✗ **A)** limit order.
- ✗ **B)** stop order.
- ✓ **C)** market order.

Explanation

A market order is an order to buy or sell a security immediately at the best available price. A limit order is an order to buy at the specified limit price or lower, or to sell at the limit price or higher. A stop order is an order to buy if the market price increases to the specified stop price, or to sell if the market price decreases to the stop price.

References

Question From: Session 13 > Reading 45 > LOS h

Related Material:

- Key Concepts by LOS

Question #132 of 151

Question ID: 415116

The "real assets" classification *most likely* includes:

- ✗ **A)** bonds.
- ✗ **B)** stocks.
- ✓ **C)** commodities.

Explanation

Real assets include commodities, real estate, durable equipment, and other physical assets. Bonds and stocks are classified as financial assets.

References

Question From: Session 13 > Reading 45 > LOS b

Related Material:

- Key Concepts by LOS

Question #133 of 151

Question ID: 415132

Using the following assumptions, calculate the rate of return on a margin transaction for an investor who purchases the stock and the stock price at which the investor would have received a margin call.

- Market Price Per Share: $32

- Number of Shares Purchased: 1,000
- Holding Period: 1 year
- Ending Share Price: $34
- Initial Margin Requirement: 40%
- Maintenance margin: 25%
- Transaction and borrowing costs: $0
- The company pays no dividends

		Margin Return	Margin Call Price
✗	**A)**	15.6%	$17.07
✗	**B)**	6.3%	$25.60
✓	**C)**	15.6%	$25.60

Explanation

Part 1: Calculate Margin Return:

Margin Return %

> = [((Ending Value - Loan Payoff) / Beginning Equity Position) - 1] × 100
> = [(([$34 × 1,000] - [$32 × 1,000 × 0.60]) / ($32 × 0.40 × 1,000)) - 1] × 100
> = **15.6%**

Alternative (Check): Calculate the all cash return and multiply by the margin leverage factor.
[(34,000 - 32,000) / 32,000] × [1 / 0.40] = 6.35% × 2.5 = **15.6%**

Part 2: Calculate Margin Call Price:

> The formula for the margin call price is:
> Margin Call = (original price) × (1 - initial margin) / (1 - maintenance margin)
> = $32 × (1 - 0.40) / (1 - 0.25) = approximately **$25.60**

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #134 of 151

Question ID: 415226

An increase in which of the following factors would *most likely* improve a market's efficiency?

✓ **A)** Number of participants.

✗ **B)** Restrictions on short selling.

✗ **C)** Bid-ask spreads.

Explanation

As the number of market participants increases, the speed at which markets adjust to new information is likely to increase. Restrictions on short selling limit the ability of arbitrage to correct pricing anomalies. High bid-ask spreads increase transaction costs and decrease efficiency.

References

Question From: Session 13 > Reading 47 > LOS c

Related Material:

- Key Concepts by LOS

Question #135 of 151

Question ID: 415167

Which of the following statements about securities exchanges is *most* accurate?

✗ **A)** Continuous markets are markets where trades occur 24 hours per day.

✓ **B)** Call markets are markets in which the stock is only traded at specific times.

✗ **C)** Setting a negotiated price to clear the market is a method used to set the closing price in major continuous markets.

Explanation

Continuous markets are markets where trades occur at any time the market is open (i.e. they do not need to be open 24 hours per day). Setting one negotiated price is a method used in major continuous markets to set the opening price.

References

Question From: Session 13 > Reading 45 > LOS j

Related Material:

- Key Concepts by LOS

Question #136 of 151

Question ID: 415145

An investor purchases 100 shares of Lloyd Computer at $26 a share. The initial margin requirement is 50%, and the maintenance margin requirement is 25%. The price below which the investor would receive a margin call is *closest* to:

✗ **A)** 19.45.

✓ **B)** 17.33.

✗ **C)** 15.25.

Explanation

26 * (1 - 0.5)/(1 - 0.25) = $17.33.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #137 of 151

Question ID: 496423

Which of the following statements about a security market index is *most accurate*?

✗ **A)** If an index increases by 5% in one year, the market return for the year is 5%.

✗ **B)** An index must use actual prices from market transactions.

✓ **C)** An index may reflect dividends paid by its constituent securities.

Explanation

An index that is designed to measure total return will include dividends in its calculation. Some security market indices use estimated prices when actual prices are not available. The percent change in a security market index is the return on a portfolio of its constituent securities. Whether this represents an estimate of the market return depends on the nature and purpose of the index (for example, a security market index may be designed to represent a particular industry or asset class).

References

Question From: Session 13 > Reading 46 > LOS a

Related Material:

- Key Concepts by LOS

Question #138 of 151

Question ID: 434374

Which of the following statements about securities markets is *least* accurate?

✓ **A)** A limit buy order and a stop buy order are both placed below the current market price.

✗ **B)** Characteristics of a well-functioning securities market *include*: many buyers and sellers, low bid-ask spreads, timely information on price and volume of past transactions, and accurate information on supply and demand.

✗ **C)** Secondary markets, such as the over-the-counter (OTC) market, provide liquidity and price continuity.

Explanation

A limit buy is placed below the current market price, but a stop buy order is placed *above* the current market price (stop buy orders are often placed to protect a short sale from a rising market).

The other choices are true. A well-functioning securities market includes the following characteristics:

- timely and accurate information on price and volume of past transactions.
- timely and accurate information on the supply and demand for current transactions.
- liquidity (as indicated by low bid-ask spreads).
- marketability.
- price continuity.
- depth (many buyers and sellers).
- operational efficiency (low transaction costs).
- informational efficiency (rapidly adjusting prices).

References

Question From: Session 13 > Reading 45 > LOS h

Related Material:

- Key Concepts by LOS

Question #139 of 151

Question ID: 415176

The measure of return on a security market index that includes any dividends or interest paid by the securities in the index is known as the:

✗ **A)** price return.

✓ **B)** total return.

✗ **C)** cash flow return.

Explanation

The total return on a security market index includes cash flows from the securities (dividends and interest) as well as price changes.

References

Question From: Session 13 > Reading 46 > LOS b

Related Material:

- Key Concepts by LOS

Question #140 of 151

Question ID: 415189

The table below lists information on price per share and shares outstanding for three stocks.

	As of Beginning of Year		*As of End of Year*	
Stock	*Price per Share ($)*	*# Shares Outstanding*	*Price per Share ($)*	*# shares Outstanding*
Mertz	10	10,000	15	10,000
Norton	50	5,000	50	5,000
Rubble	100	500	85	500

At the beginning of the year, the value of a market-cap weighted index of these three stocks was 100. The index value at year-end is *closest to:*

- ✓ **A)** 110.6
- ✗ **B)** 44.3
- ✗ **C)** 93.8

Explanation

Market-cap weighted index = (ending market capitalization / beginning market capitalization) × beginning index value.

Beginning market capitalization = (10)(10,000) + (50)(5,000) + (100)(500) = 400,000

Ending market capitalization = (15)(10,000) + (50)(5,000) + (85)(500) = 442,500

Index value = (442,500 / 400,000) × 100 = 110.625

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS

Question #141 of 151

Question ID: 485804

Octagon Advisors believes that the market is semi-strong efficient. The firm's portfolio managers *most likely* will use:

- ✗ **A)** active portfolio management strategies.
- ✓ **B)** passive portfolio management strategies.
- ✗ **C)** an enhanced indexing strategy that relies on trading patterns.

Explanation

If the market is semi-strong efficient, portfolio managers should use passive management because neither technical analysis nor fundamental analysis will generate positive abnormal returns on average over time.

References

Question From: Session 13 > Reading 47 > LOS e

Related Material:

- Key Concepts by LOS

Question #142 of 151

Question ID: 415197

Reconstitution of an index refers to:

✓ **A)** removing some securities from the index and adding others.

✗ **B)** adjusting the weights of the securities that constitute the index.

✗ **C)** changing the methodology used to calculate the value of the index.

Explanation

Reconstitution begins with evaluating the securities in an index against the index's criteria. Securities that are no longer representative of the index are removed and replaced with different securities that do meet the criteria. Adjusting the weights of the securities that constitute an index is termed rebalancing.

References

Question From: Session 13 > Reading 46 > LOS f

Related Material:

- Key Concepts by LOS

Question #143 of 151

Question ID: 415243

David Farrington is an analyst at Farrington Capital Management. He is aware that many people believe that the capital markets are fully efficient. However, he is not convinced and would like to disprove this claim. Which of the following statements would support Farrington in his effort to demonstrate the limitations to fully efficient markets?

✗ **A)** Technical analysis has been rendered useless by many academics who have shown that analyzing market trends, past volume and trading data will not lead to abnormal returns.

✗ **B)** Stock prices adjust to their new efficient levels within hours of the release of new information.

✓ **C)** Processing new information entails costs and takes at least some time, so security prices are not always immediately affected.

Explanation

If market prices are efficient there are no returns to the time and effort spent on fundamental analysis. But if no time and effort is spent on fundamental analysis there is no process for making market prices efficient. To resolve this apparent conundrum one can look to the time lag between the release of new value-relevant information and the adjustment of market prices to their new efficient levels. Processing new information entails costs and takes at least some time, which is a limitation of fully efficient markets.

References

Question From: Session 13 > Reading 47 > LOS e

Related Material:

- Key Concepts by LOS

Question #144 of 151

Question ID: 415130

Which of the following option positions is said to be a long position?

- ✗ **A)** Writer of a put option.
- ✗ **B)** Writer of a call option.
- ✓ **C)** Buyer of a put option.

Explanation

The buyer of an option (either a call or put) is said to be long the option and the writer of an option is said to be short the option. Note that with put options, the long (put option holder) benefits when the price of the underlying asset decreases, while the short (put option writer) benefits when the price of the underlying asset increases. We say that a put buyer is long the option but has short exposure to the underlying asset price.

References

Question From: Session 13 > Reading 45 > LOS e

Related Material:

- Key Concepts by LOS

Question #145 of 151

Question ID: 415114

Which of the following conditions is *most likely* necessary for capital to be allocated to its most valuable uses?

- ✗ **A)** Financial markets are frictionless (i.e., free of taxes or transactions costs).
- ✓ **B)** Investors are well informed about the risk and return of various investments.
- ✗ **C)** There are no barriers to the flow of complete information to the financial markets.

Explanation

Capital will flow to its most valuable uses if markets function well and investors are well informed about the risk and return characteristics of various investments. Allocation of capital to its most valuable uses does not require that all investors have complete information or that financial markets are frictionless.

References

Question From: Session 13 > Reading 45 > LOS a

Related Material:

- Key Concepts by LOS

Question #146 of 151

Question ID: 415135

An investor buys 200 shares of ABC at the market price of $100 on full margin. The initial margin requirement is 40% and the maintenance margin requirement is 25%.

If the shares of stock later sold for $200 per share, what is the rate of return on the margin transaction?

- ✗ **A)** 400%.
- ✓ **B)** 250%.
- ✗ **C)** 100%.

Explanation

One quick (and less than intensive) way to calculate the answer to this on the examination (and it is very important to save time on the examination) is to first calculate the return if all cash, then calculate the margin leverage factor and then finally, multiply the leverage factor times the all cash return to obtain the margin return.

Calculations:

Step 1: Calculate All Cash Return:

> Cash Return % = [(Ending Value / Beginning Equity Position) - 1] × 100
>
> = [(($200 × 200) / ($100 × 200)) - 1] × 100 = 100%

Step 2: Calculate Leverage Factor:

> Leverage Factor = 1 / Initial Margin % = 1 / 0.40 = 2.50

Step 3: Calculate Margin Return:

> Margin Transaction Return = All cash return × Leverage Factor = 100% × 2.50 = 250%
>
> *Note:* You can verify the margin return as follows:
>
> Margin Return % = [((Ending Value − Loan Payoff) / Beginning Equity Position) - 1] × 100
>
> = [((($200 × 200] - [$100 × 200 × 0.60]) / ($100 × 0.40 × 200)) - 1] × 100
>
> = [((40,000 − 12,000) / 8,000) − 1] × 100 = 250%

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #147 of 151

Question ID: 415215

Equal weighting is the most common weighting methodology for indexes of which of the following types of assets?

- ✓ **A)** Hedge funds.
- ✗ **B)** Equities.
- ✗ **C)** Fixed income securities.

Explanation

Most hedge fund indexes are equal-weighted. Equity and fixed income indexes are predominately market capitalization weighted.

References

Question From: Session 13 > Reading 46 > LOS k

Related Material:

- Key Concepts by LOS

Question #148 of 151

Question ID: 415138

The initial margin is the:

- ✗ **A)** amount of cash that an investor must maintain in his/her margin account.
- ✓ **B)** minimum amount of funds that must be supplied when purchasing a security on margin.
- ✗ **C)** equity represented in the margin account at any time.

Explanation

Margin is the amount of equity in the account at a given time. Initial margin is the amount of equity required initially to execute an order.

References

Question From: Session 13 > Reading 45 > LOS f

Related Material:

- Key Concepts by LOS

Question #149 of 151

Question ID: 415180

The first step in developing a security market index is choosing the index's:

- ✗ **A)** weighting method.
- ✓ **B)** target market.
- ✗ **C)** constituent securities.

Explanation

The first decision that must be made is choosing the target market the index will represent. Only then can the index provider determine which constituent securities should be included and which weighting scheme is most appropriate to measure the target market's returns.

References

Question From: Session 13 > Reading 46 > LOS c

Related Material:

- Key Concepts by LOS

Question #150 of 151

Question ID: 415228

Which of the following statements on the forms of the efficient market hypothesis (EMH) is *least* accurate?

- ✗ **A)** The semi-strong form EMH addresses market and non-market public information.
- ✗ **B)** The strong-form EMH assumes perfect markets.
- ✓ **C)** The weak-form EMH states that stock prices reflect current public market information and expectations.

Explanation

The weak-form EMH assumes the price of a security reflects all currently available *historical* information. Thus, the past price and volume of trading has no relationship with the future, hence technical analysis is not useful in achieving superior returns.

The other statements are true. The strong-form EMH states that stock prices reflect all types of information: market, non-public market, and private. No group has monopolistic access to relevant information; thus no group can achieve excess returns. For these assumptions to hold, the strong-form assumes perfect markets - information is free and available to all.

References

Question From: Session 13 > Reading 47 > LOS d

Related Material:

- Key Concepts by LOS

Question #151 of 151

Question ID: 415193

Use the data below to determine which of the statements is *most* accurate?

As of December 31		
Company	*Stock Price*	*Shares Outstanding*
A	$25	20,000
B	$50	20,000
C	$100	10,000

✓ **A)** A 100% increase in the stock price of Company A will have a smaller impact on the price-weighted index than a 100% increase in the stock price of Company C.

✗ **B)** For a given percentage change in the stock price, Company B will have less of an impact on the market-cap weighted index as Company C.

✗ **C)** For a given percentage change in the stock price, Company A will have a greater impact on the market-cap weighted index than Companies B or C.

Explanation

A 100% change in the stock price of Company C will have a larger impact than a 100% change in either stocks A or B on the price-weighted index. A price-weighted index adds together the market price of each stock in the index and then divides this total by the number of stocks in the index. The price-weighted index assumes you purchase one share of each stock represented in the index. The price-weighted index is influenced most by given percentage changes in the higher priced stocks.

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS