

Question #1 of 164

Question ID: 416006

Which of the following statements regarding call options is *most* accurate? The:

- ☐ A) call holder will exercise (at expiration) whenever the strike price exceeds the stock price.
- ☐ B) breakeven point for the seller is the strike price minus the option premium.
- ☒ C) breakeven point for the buyer is the strike price plus the option premium.

Explanation

The breakeven for the buyer and the seller is the strike price plus the premium. The call holder will exercise if the market price exceeds the strike price.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS

Question #2 of 164

Question ID: 415794

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

- ☐ A) The futures exchange specifies the minimum price fluctuation of a futures contract.
- ☒ B) The exchange-mandated uniformity of futures contracts reduces their liquidity.
- ☐ C) Futures contracts have a maximum daily allowable price limit.

Explanation

The exchange-mandated uniformity of futures contracts *increases* their liquidity.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS

Question #3 of 164

Question ID: 416012

Al Steadman receives a premium of \$3.80 for shorting a put option with a strike price of \$64. If the stock price at expiration is \$84, Steadman's profit or loss from the options position is:

- ✓ **A)** \$3.80.
- X **B)** \$23.80.
- X **C)** \$16.20.

Explanation

The put option will not be exercised because it is out-of-the-money, $\text{MAX}(0, X-S)$. Therefore, Steadman keeps the full amount of the premium, \$3.80.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #4 of 164

Question ID: 472445

One of the principal characteristics of swaps is that swaps:

- X **A)** are highly regulated over-the-counter agreements.
- X **B)** are standardized derivative instruments.
- ✓ **C)** may be likened to a series of forward contracts.

Explanation

A swap agreement often requires that both parties agree to a series of transactions. Each transaction is similar to a forward contract, where a party is paying a fixed price to offset the risk associated with an unknown future value. Swaps are over-the-counter agreements but are not highly regulated. One of the benefits of swaps is that they can be customized to fit the needs of the counterparties. Thus, they are not standardized.

References

Question From: Session 17 > Reading 58 > LOS g

Related Material:

- Key Concepts by LOS
-

Question #5 of 164

Question ID: 416029

An investor buys a share of stock at \$33 and simultaneously writes a 35 call for a premium of \$3. What is the maximum gain and loss?

	<u>Maximum Gain</u>	<u>Maximum Loss</u>
✓ A) \$5		\$30
X B) unlimited		\$33
X C) \$2		\$35

Explanation

The maximum gain on the stock itself is \$2 ($\$35 - \33). At stock prices above the exercise price, the stock will be called away from the investor. The gain from writing the call is \$3 so the total maximum gain is \$5. If the stock ends up worthless, the call writer still has the call premium of \$3 to offset the \$33 loss on the stock so the total maximum loss is \$30.

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS

Question #6 of 164

Question ID: 415712

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

- X **A)** Bond option.
- ✓ **B)** Equity index futures contract.
- X **C)** Currency forward contract.

Explanation

Futures are exchange-traded derivatives. Forward contracts and swaps are over-the-counter derivatives. Bond options are traded almost entirely in the over-the-counter market.

References

Question From: Session 17 > Reading 57 > LOS a

Related Material:

- Key Concepts by LOS

Question #7 of 164

Question ID: 500875

Bea Moran wants to establish a long derivatives position in a commodity she will need to acquire in six months. Moran observes that the six-month forward price is 45.20 and the six-month futures price is 45.10. This difference *most likely* suggests that for this commodity:

- X **A)** long investors should prefer futures contracts to forward contracts.
- X **B)** there is an arbitrage opportunity among forward, futures, and spot prices.
- ✓ **C)** futures prices are negatively correlated with interest rates.

Explanation

Differences may exist between forward and futures prices for otherwise identical contracts if futures prices are correlated with interest rates. If futures prices are negatively correlated with interest rates, daily settlement of long futures contracts will require cash when interest rates are increasing and produce cash when interest rates are decreasing. As a result the futures price will be lower than the forward price. The difference in price does not provide an arbitrage opportunity or suggest that investors should prefer forward or futures contracts.

References

Question From: Session 17 > Reading 58 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #8 of 164

Question ID: 415735

Any rational quoted price for a financial instrument should:

- X **A)** be low enough for most investors to afford.
- X **B)** provide an opportunity for investors to make a profit.
- ✓ **C)** provide no opportunity for arbitrage.

Explanation

Since any observed pricing errors will be instantaneously corrected by the first person to observe them, any quoted price must be free of all known errors. This is the basis behind the text's *no-arbitrage principle*, which states that any rational price for a financial instrument must exclude arbitrage opportunities. The no-arbitrage opportunity assumption is the basic requirement for rational prices in the financial markets. This means that markets and prices are efficient. That is, all relevant information is impounded in the asset's price. With arbitrage and efficient markets, you can create the option and futures pricing models presented in the text.

References

Question From: Session 17 > Reading 57 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #9 of 164

Question ID: 415926

An increase in the riskless rate of interest, other things equal, will:

- X **A)** decrease call option values and increase put option values.
- ✓ **B)** increase call option values and decrease put option values.
- X **C)** decrease call option values and decrease put option values.

Explanation

An increase in the risk-free rate of interest will increase call option values and decrease put option values.

References

Question From: Session 17 > Reading 58 > LOS k

Related Material:

- Key Concepts by LOS
-

Question #10 of 164

Question ID: 415726

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

- ✓ **A)** narrow the amount of trading opportunities to a more manageable range.
- X **B)** engage in high risk speculation.
- X **C)** increase market efficiency through the use of arbitrage.

Explanation

Financial derivatives increase the opportunities to either speculate or hedge on the value of underlying assets. This adds to market completeness by increasing the range of identifiable payoffs that can be used by traders to fulfill their needs. Financial derivatives such as market index futures can also be easier and cheaper than trading in a diversified portfolio, thereby adding to the opportunities available to traders.

References

Question From: Session 17 > Reading 57 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #11 of 164

Question ID: 415916

Which of the following statements about long positions in put and call options is *most* accurate? Profits from a long call:

- X **A)** and a long put are positively correlated with the stock price.
- ✓ **B)** are positively correlated with the stock price and the profits from a long put are negatively correlated with the stock price.
- X **C)** are negatively correlated with the stock price and the profits from a long put are positively correlated with the stock price.

Explanation

For a call, the buyer's (or the long position's) potential gain is unlimited. The call option is in-the-money when the stock price (S) exceeds the strike price (X). Thus, the buyer's profits are positively correlated with the stock price. For a put, the buyer's (or the long position's) potential gain is equal to the strike price less the premium. A put option is in-the-money when $X > S$. Thus, a put buyer wants a high exercise price and a low stock price. Thus, the buyer's profits are negatively correlated with the stock price.

References

Question From: Session 17 > Reading 58 > LOS k

Related Material:

- Key Concepts by LOS
-

Question #12 of 164

Question ID: 415744

Default risk in a forward contract:

- ✓ **A)** is the risk to either party that the other party will not fulfill their contractual obligation.
- X **B)** only applies to the short, who must make the cash payment at settlement.
- X **C)** only applies to the long, and is the probability that the short can not acquire the asset for delivery.

Explanation

Default risk in forward contracts is the risk to either party that the other party will not perform, whether that means pay cash or deliver the asset.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #13 of 164

Question ID: 415891

An option's intrinsic value is equal to the amount the option is:

- X **A)** out of the money, and the time value is the market value minus the intrinsic value.
- X **B)** in the money, and the time value is the intrinsic value minus the market value.

✓ **C)** in the money, and the time value is the market value minus the intrinsic value.

Explanation

Intrinsic value is the amount the option is in the money. In effect it is the value that would be realized if the option were at expiration. Prior to expiration, the option's market value will normally exceed its intrinsic value. The difference between market value and intrinsic value is called time value.

References

Question From: Session 17 > Reading 58 > LOS j

Related Material:

- Key Concepts by LOS
-

Question #14 of 164

Question ID: 416014

A stock is trading at \$18 per share. An investor believes that the stock will move either up or down. He buys a call option on the stock with an exercise price of \$20. He also buys two put options on the same stock each with an exercise price of \$25. The call option costs \$2 and the put options cost \$9 each. The stock falls to \$17 per share at the expiration date and the investor closes his entire position. The investor's net gain or loss is:

- X **A)** \$4 gain.
- ✓ **B)** \$4 loss.
- X **C)** \$3 loss.

Explanation

The total cost of the options is $\$2 + (\$9 \times 2) = \$20$.

At expiration, the call is worth $\text{Max}[0, 17-20] = 0$. Each put is worth $\text{Max}[0, 25-17] = \$8$. The investor made \$16 on the puts but spent \$20 to buy the three options, for a net loss of \$4.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #15 of 164

Question ID: 492031

If futures prices are positively correlated with interest rates, futures prices will be:

- X **A)** unaffected relative to forward prices.
- X **B)** less than forward prices.
- ✓ **C)** greater than forward prices.

Explanation

Futures prices will be greater than forward prices if interest rates are positively correlated with futures prices, because daily settlement of long futures positions will produce excess margin when interest rates are high and require margin deposits when interest rates are low.

References

Question From: Session 17 > Reading 58 > LOS f

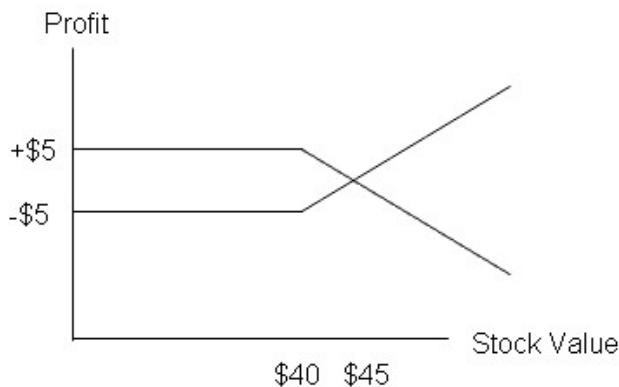
Related Material:

- Key Concepts by LOS

Question #16 of 164

Question ID: 434441

Given the profit and loss diagram of two options at expiration shown below which of the following statements is *most* accurate?



- X **A)** Between a stock price of \$40 and \$45 the long call's profit is between \$0 and \$5.
- X **B)** The maximum profit to the short put is \$5.
- ✓ **C)** The stock price would have to increase above \$45 before the seller of the call starts losing money.

Explanation

This is a graph of a long call and a short call at expiration with a \$5 option premium and a strike price of \$40. Between a stock price of \$40 and \$45 the long call's profit is between -\$5 and \$0. The maximum profit to the short call is \$5. Neither of the lines on this graph is the payoff of a short put.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #17 of 164

Question ID: 415729

All of the following are benefits of derivatives markets EXCEPT:

- ✓ **A)** derivatives markets help keep interest rates down.
- X **B)** derivatives allow the shifting of risk to those who can most efficiently bear it.
- X **C)** transactions costs are usually smaller in derivatives markets, than for similar trades in the underlying asset.

Explanation

The existence of derivatives markets does not affect the level of interest rates. The other statements are true.

References

Question From: Session 17 > Reading 57 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #18 of 164

Question ID: 415859

Basil, Inc., common stock has a market value of \$47.50. A put available on Basil stock has a strike price of \$55.00 and is selling for an option premium of \$10.00. The put is:

- X **A)** out-of-the-money by \$2.50.
- X **B)** in-the-money by \$10.00.
- ✓ **C)** in-the-money by \$7.50.

Explanation

The put allows a trader to sell Basil common stock for \$7.50 more than the current market value ($\$55.00 - \47.50). The trade is normally closed out with a cash settlement, but the trader could buy 100 shares for \$47.50 per share and immediately sell them to the option writer for \$55.00.

References

Question From: Session 17 > Reading 58 > LOS j

Related Material:

- Key Concepts by LOS
-

Question #19 of 164

Question ID: 496435

The *most likely* use of a forward rate agreement is to:

- ☐ A) exchange a floating-rate obligation for a fixed-rate obligation.
- ☐ B) obtain the right, but not the obligation, to borrow at a certain interest rate.
- ☒ C) lock in an interest rate for future borrowing or lending.

Explanation

The purpose of a forward rate agreement (FRA) is to lock in an interest rate for future borrowing or lending. An FRA is a forward commitment rather than a contingent claim. An interest rate swap is used to exchange a floating-rate obligation for a fixed-rate obligation.

References

Question From: Session 17 > Reading 58 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #20 of 164

Question ID: 415719

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

- ☒ A) is not legally binding.
- ☐ B) can involve a stock index.
- ☐ C) is a contractual promise.

Explanation

A forward commitment is a legally binding promise to perform some action in the future and can involve a stock index or portfolio.

References

Question From: Session 17 > Reading 57 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #21 of 164

Question ID: 416021

In October, James Knight owned stock in Valerio, Inc., that was valued at \$45 per share. At that time, Knight sold a call option on Valerio with an exercise price of \$60 for \$1.45. In December, at expiration, the stock is trading at \$32. What is Knight's profit (or loss) from his covered call strategy? Knight:

- ☐ A) gained \$11.55.

X **B)** gained \$1.45.

✓ **C)** lost \$11.55.

Explanation

Since the option is out-of-the-money at expiration ($\text{MAX}(0, S-X)$), the option is worthless. Also, the stock decreased in value from \$45 per share to \$32 per share, creating a \$13 loss. The \$13 loss is partially offset by the \$1.45 premium Knight received. Therefore, the total loss from the covered call position is \$11.55 ($-\$13 + \1.45).

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #22 of 164

Question ID: 415865

Which of the following statements about uncovered call options is *least* accurate?

X **A)** The loss potential to the writer is unlimited.

X **B)** The profit potential to the holder is unlimited.

✓ **C)** The most the writer can make is the premium plus the difference between the exercise price (X) and the stock price (S).

Explanation

The most the writer can make is the premium. If the writer wrote a covered out of the money call, then the writer would make the premium plus the increase in the stock's price $X-S$.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #23 of 164

Question ID: 500874

Derivatives valuation is based on risk-neutral pricing because:

X **A)** this method provides an intrinsic value to which investors apply a risk premium.

X **B)** risk tolerances of long and short investors are assumed to offset.

✓ **C)** the risk of a derivative is based entirely on the risk of its underlying asset.

Explanation

Because the risk of a derivative is based entirely on the risk of its underlying asset, we can construct a perfectly hedged portfolio of a derivative and its underlying asset. The future payoff of a perfectly hedged position is certain and can therefore be discounted at the risk-free rate.

References

Question From: Session 17 > Reading 58 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #24 of 164

Question ID: 416017

Jasper Quartermaine is interested in using the options market to create "insurance" against a severe drop in the value of a stock portfolio that he owns. How could he *best* accomplish this goal and what is this type of strategy called?

<u>Type of option</u>	<u>Strategy</u>
-----------------------	-----------------

- | | |
|-------------------------|----------------|
| ✓ A) buy put options | protective put |
| X B) write call options | protective put |
| X C) write call options | covered call |

Explanation

An investor can simulate portfolio insurance by purchasing put options. Losses in the underlying portfolio are offset by gains in the put position. The investor is already long his portfolio and if he buys a long put for his portfolio he is replicating a protective put strategy.

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #25 of 164

Question ID: 472447

The price of a fixed-for-floating interest rate swap contract:

- ✓ A) is established at contract initiation.
- X B) is directly related to changes in the floating rate.
- X C) may vary over the life of the contract.

Explanation

The price of a swap contract is set such that the contract has a value of zero at initiation. The *value* of a fixed-for-floating interest rate swap contract may vary over its life as the floating rate changes.

References

Question From: Session 17 > Reading 58 > LOS h

Related Material:

- Key Concepts by LOS
-

Question #26 of 164

Question ID: 683892

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

- X **A)** daily margin.
- ✓ **B)** initial margin.
- X **C)** maintenance margin.

Explanation

In futures trading, a margin call requires the investor to restore the account to the initial margin level or close the position.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #27 of 164

Question ID: 415813

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

- ✓ **A)** additional payment is required if margin falls below the maintenance margin.
- X **B)** the value of the security is the collateral for the loan.
- X **C)** interest is charged on the margin loan balance.

Explanation

Both futures accounts and equity margin accounts have minimum margin requirements that, if violated, require the deposit of additional funds. There is no loan in a futures account; the margin deposit is a performance guarantee. The seller does not receive the margin deposit in futures trades. The seller must also deposit margin in order to open a position.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #28 of 164

Question ID: 415724

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

- ✓ **A)** can be likened to gambling.
- X **B)** shift risk among market participants.
- X **C)** increase investor transactions costs.

Explanation

Derivatives are often likened to gambling due to the high leverage involved in the payoffs. One of the benefits of derivatives is that they reduce transactions costs. Another benefit of derivatives is that they allow risk to be managed and shifted among market participants.

References

Question From: Session 17 > Reading 57 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #29 of 164

Question ID: 456305

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

- X **A)** Both parties to a forward contract have potential default risk.
- ✓ **B)** A forward contract can be exercised at any time.
- X **C)** The long promises to purchase the asset.

Explanation

Forward contracts typically require a purchase/sale of the asset on the expiration/delivery date specified in the contract. The other statements are true.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS

Question #30 of 164

Question ID: 415773

A forward rate agreement (FRA):

- ☐ A) is settled by making a loan at the contract rate.
- ☐ B) is risk-free when based on the Treasury bill rate.
- ☒ C) can be used to hedge the interest rate exposure of a floating-rate loan.

Explanation

An FRA settles in cash and carries both default risk and interest rate risk, even when based on an essentially risk-free rate. It can be used to hedge the risk/uncertainty about a future payment on a floating rate loan.

References

Question From: Session 17 > Reading 58 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #31 of 164

Question ID: 415868

Bidco Corporation common stock has a market value of \$30.00. Which statement about put and call options available on Bidco common is *most* accurate?

- ☒ A) A put with a strike price of \$35.00 is in-the-money.
- ☐ B) A call with a strike price of \$25.00 is at-the-money.
- ☐ C) A put with a strike price of \$20.00 has intrinsic value.

Explanation

A put is in-the-money when its exercise price is higher than the market value of the underlying asset. A put with a \$35.00 strike price allows the trader to sell 100 shares of stock for \$35.00 per share, which is \$5.00 higher than the prevailing market value. This gives the put a value, hence, it is in-the-money. For a call to be in-the-money, its strike price would have to be lower than the market value of the underlying common stock, allowing the trader to purchase 100 shares at a price below the prevailing market value. At-the-money is when the strike price and asset market value are equal. A put with a strike price of \$20.00 does not have intrinsic value because it is below the \$30 price of the stock. It does have time value meaning it is worth something because there is the possibility the put will come into the money before it expires.

References

Question From: Session 17 > Reading 58 > LOS j

Related Material:

- Key Concepts by LOS
-

Question #32 of 164

Question ID: 456309

A put option is in the money when:

- ✓ **A)** the stock price is lower than the exercise price of the option.
- X **B)** there is no put option with a lower exercise price in the expiration series.
- X **C)** the stock price is higher than the exercise price of the option.

Explanation

The put option is in-the-money if the stock price is below the exercise price.

References

Question From: Session 17 > Reading 58 > LOS j

Related Material:

- Key Concepts by LOS
-

Question #33 of 164

Question ID: 415853

A European option can be exercised by:

- X **A)** either party, at contract expiration.
- X **B)** its owner, anytime during the term of the contract.
- ✓ **C)** its owner, only at the expiration of the contract.

Explanation

A European option can be exercised by its owner only at contract expiration.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #34 of 164

Question ID: 415895

The intrinsic value of an option is equal to:

- ✓ **A)** zero or the amount that it is in the money.
- X **B)** its speculative value.
- X **C)** the amount that it is in or out of the money.

Explanation

The intrinsic value of an option is equal to the amount that it is in the money or zero, if it is out of the money. Option value equals speculative (time) value only for out-of-the-money options.

References

Question From: Session 17 > Reading 58 > LOS j

Related Material:

- Key Concepts by LOS
-

Question #35 of 164

Question ID: 415941

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

- ☐ A) The notional principal is swapped.
- ☒ B) Only the net interest payments are made.
- ☐ C) The notional principal is returned at the end of the swap.

Explanation

The plain vanilla interest rate swap involves trading fixed interest rate payments for floating rate payments. Swaps are a zero sum game, what one party gains the other party loses. In interest rate swaps, only the *net* interest rate payments actually take place because the notional principal swapped is the same for both counterparties and in the same currency units, there is no need to actually exchange the cash.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #36 of 164

Question ID: 415722

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

- ☐ A) call option.
- ☐ B) swap.
- ☒ C) put option.

Explanation

A put option gives the holder the right to sell an asset at a specified price on a specific future date. A call option gives the holder

the right to buy an asset at a specified price on a specific future date. A swap is an obligation to both parties.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #37 of 164

Question ID: 415927

A decrease in the riskless rate of interest, other things equal, will:

- X **A)** increase call option values and decrease put option values.
- ✓ **B)** decrease call option values and increase put option values.
- X **C)** decrease call option values and decrease put option values.

Explanation

A decrease in the risk-free rate of interest will decrease call option values and increase put option values.

References

Question From: Session 17 > Reading 58 > LOS k

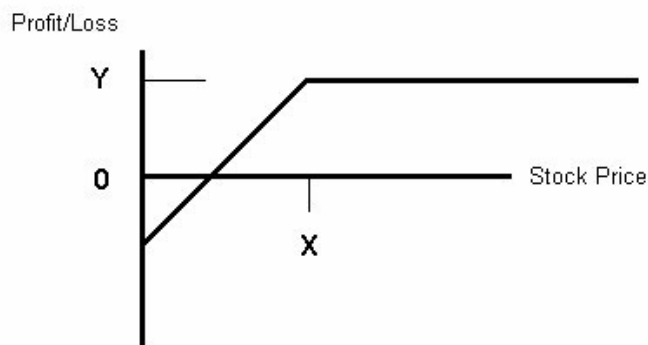
Related Material:

- Key Concepts by LOS
-

Question #38 of 164

Question ID: 434446

Given the covered call option diagram below and the following information, what are the dollar values for points X and Y? The market price of the stock is \$70, the strike price of the call is \$80, and the call premium is \$5.



Point X

Point Y

- X **A)** \$80 \$5
- ✓ **B)** \$80 \$15
- X **C)** \$75 \$15

Explanation

The kink in the diagram of a covered call is always at the exercise price of the option. Therefore, point X is \$80. As the stock price rises above \$80, the stock is called away and the maximum gain is the call premium plus the stock price gain ($\$80 - \70). The maximum gain, then, at point Y is ($\$5 + \$10 = \$15$).

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #39 of 164

Question ID: 500877

The price of a pay-fixed receive-floating interest rate swap is:

- X **A)** negative when floating rates are highly volatile.
- X **B)** zero when floating rates and fixed rates are equal.
- ✓ **C)** determined by expected future short-term rates.

Explanation

The price of an interest rate swap refers to the fixed rate specified in the swap. This price is calculated as a function of expected future short-term rates.

References

Question From: Session 17 > Reading 58 > LOS h

Related Material:

- Key Concepts by LOS
-

Question #40 of 164

Question ID: 415738

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

- X **A)** A put option on a share of stock has the same price as a call option on an identical share.
- ✓ **B)** A portfolio of two securities that will produce a certain return that is greater than the risk-free rate of interest.
- X **C)** A stock with the same price as another has a higher rate of return.

Explanation

An arbitrage opportunity exists when a combination of two securities will produce a certain payoff in the future that produces a return that is greater than the risk-free rate of interest. Borrowing at the riskless rate to purchase the position will produce a certain future amount greater than the amount required to repay the loan.

References

Question From: Session 17 > Reading 57 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #41 of 164

Question ID: 415857

An American option is:

- X **A)** an option on a U.S. stock or bond.
- X **B)** exercised only at expiration.
- ✓ **C)** exercisable at any time up to its expiration date.

Explanation

There is no geographical significance given to American (style) options. It simply refers to the fact that they can be exercised at any time, up to and including the expiration date. European-style options can be exercised only on their expiration dates.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #42 of 164

Question ID: 415746

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

- X **A)** take-and-pay contract.
- ✓ **B)** deliverable forward contract.
- X **C)** physicals-only contract.

Explanation

A deliverable forward contract can be settled at expiration only by actual delivery of the asset in exchange for the contract value. The other terms are made up.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #43 of 164

Question ID: 456307

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

- ☐ A) guarantee performance of futures contract obligations.
- ☒ B) choose which assets will have futures contracts.
- ☐ C) act as a counterparty in futures contracts.

Explanation

The *exchange* decides which contracts will be traded and their specifications. The clearinghouse acts as the counterparty to every contract and guarantees performance.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #44 of 164

Question ID: 472436

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

Statement 1: A futures contract is an exchange traded instrument with standardized features.

Statement 2: Forward contracts are marked to market on a daily basis to reduce credit risk to both counterparties.

Are Ferguson's statements accurate?

- ☐ A) Both of these statements are accurate.
- ☐ B) Neither of these statements is accurate.
- ☒ C) Only one of these statements is accurate.

Explanation

Statement 1 is correct. A futures contract is a standardized instrument that is traded on an exchange, unlike a forward contract which is a customized transaction. Statement 2 is incorrect. A forward contract is not marked to market.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #45 of 164

Question ID: 415912

For two European put options that differ only in their time to expiration, which of the following is *most* accurate? The longer-term option:

- X **A)** is worth more than the shorter-term option.
- X **B)** is worth at least as much as the shorter-term option.
- ✓ **C)** can be worth less than the shorter-term option.

Explanation

For European puts, it is possible that the longer term option can be less valuable than a shorter-term option.

References

Question From: Session 17 > Reading 58 > LOS k

Related Material:

- Key Concepts by LOS
-

Question #46 of 164

Question ID: 415817

The settlement price for a futures contract is:

- X **A)** the price of the asset in the future for all trades made in the same day.
- X **B)** the price of the last trade of a futures contract at the end of the trading day.
- ✓ **C)** an average of the trade prices during the 'closing period'.

Explanation

The margin adjustments are made based on the settlement price, which is calculated as the average trade price over a specific closing period at the end of the trading day. The length of the closing period is set by the exchange.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #47 of 164

Question ID: 415888

When calculating the payoff for a stock option, if the stock price is greater than the strike price at expiration:

- X **A)** the payoff to a put option is equal to the strike price.
- X **B)** a call option expires worthless.
- ✓ **C)** the payoff to a call option is the difference between the stock price and the strike price.

Explanation

If the stock price is greater than the strike price at expiration, the payoff to a call option on the stock equals the stock price minus the strike price, while a put option on the stock expires worthless.

References

Question From: Session 17 > Reading 58 > LOS j

Related Material:

- Key Concepts by LOS
-

Question #48 of 164

Question ID: 415855

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

- X **A)** American and European options are never written on the same underlying asset.
- ✓ **B)** The American option can be exercised at anytime on or before its expiration date.
- X **C)** The European option can only be traded on overseas markets.

Explanation

American and European options are virtually identical, except exercising the European option is limited to its expiration date only. The American option can be exercised at anytime on or before its expiration date. For the exam, the key concept relating to this difference is the value of the American option must be equal or greater than the value of the corresponding European option, all else being equal.

References

Question From: Session 17 > Reading 57 > LOS c

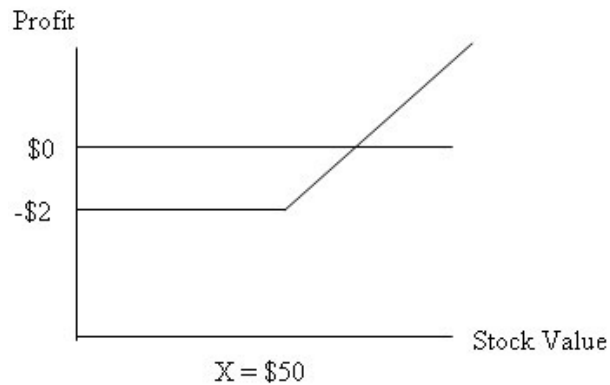
Related Material:

- Key Concepts by LOS
-

Question #49 of 164

Question ID: 434447

Given the payoff diagram shown below of an option combined with a long position in a stock, which of the following statements *most* accurately describes the profit or loss potential to the holder of the combined position?



- ☐ A) The maximum profit on the long call is unlimited.
- ☒ B) The maximum loss on the long put is its cost.
- ☐ C) The maximum profit on the short put is \$2.

Explanation

This is a graph of a protective put, which is a combination of owning the stock and purchasing a put on the same stock. The maximum loss on the put is its \$2 cost. The statements regarding the maximum profit on a long call or a short put are true, but neither of these positions are held by the owner of the protective put.

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS

Question #50 of 164

Question ID: 415995

A call option has a strike price of \$35 and the stock price is \$47 at expiration. What is the expiration day value of the call option?

- ☐ A) \$35.
- ☐ B) \$0.
- ☒ C) \$12.

Explanation

A call option has an expiration day value of $\text{MAX}(0, S - X)$. Here, X is \$35 and S is \$47.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #51 of 164

Question ID: 416010

Suppose the price of a share of Stock A is \$100. A European call option that matures one month from now has a premium of \$8, and an exercise price of \$100. Ignoring commissions and the time value of money, the holder of the call option will earn a profit if the price of the share one month from now:

- ☐ A) increases to \$106.
- ☒ B) increases to \$110.
- ☐ C) decreases to \$90.

Explanation

The breakeven point is the strike price plus the premium, or $\$100 + \$8 = \$108$. Any price greater than this would result in a profit, and the only choice that exceeds this amount is \$110.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #52 of 164

Question ID: 500876

When interest rates and futures prices for an asset are uncorrelated and forwards are less liquid than futures, it is *most likely* that the price of a forward contract is:

- ☐ A) less than the price of a futures contract.
- ☐ B) greater than the price of a futures contract.
- ☒ C) equal to the price of a futures contract.

Explanation

When interest rates and futures prices are uncorrelated the prices of forward and futures on the same asset will be equal. Liquidity is not an issue as no-arbitrage prices are based on riskless hedges that are held until settlement of the derivative security.

References

Question From: Session 17 > Reading 58 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #53 of 164

Question ID: 415804

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

- ☐ A) standardization results in less trading activity.
- ☐ B) standardization of the futures contract stabilizes the market price of the underlying commodity.
- ☒ C) uniformity of the contract terms broadens the market for the futures by appealing to a greater number of traders.

Explanation

Although a forward may have value to someone other than the original counterparties, the non-standardized terms limit the level of interest, hence its marketability and liquidity. The standardized terms of a future give it far more flexibility to traders, giving rise to a strong secondary market and greater liquidity.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #54 of 164

Question ID: 472440

As a forward contract approaches its expiration date, its value:

- ☐ A) approaches zero.
- ☐ B) increases to the forward contract price.
- ☒ C) depends on the price of the underlying asset.

Explanation

The value of a forward contract is zero at initiation, and during its life its value depends on changes in the spot price of the underlying asset. At expiration its value is based on the difference between the spot price of the underlying asset and the price specified in the forward contract.

References

Question From: Session 17 > Reading 58 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #55 of 164

Question ID: 415725

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

- X **A)** efficient markets.
- ✓ **B)** inefficient markets.
- X **C)** speculation.

Explanation

A critical element of efficient markets is that asset prices respond immediately to any new information that will affect their value. Large numbers of traders responding in similar fashion to the new information will create a temporary imbalance in supply and demand, and this will adjust asset market values.

References

Question From: Session 17 > Reading 57 > LOS d

Related Material:

- Key Concepts by LOS

Question #56 of 164

Question ID: 492035

An analyst is determining the value of a put option with a one-period binomial model. Using an up-move size of 25% and a risk-free rate of 3%, the analyst calculates the following:

Down-move size = 0.80

Up-move probability = 0.51

Down-move probability = 0.49

Value after up-move = \$1.07

Value after down-move = \$5.01

Probability-weighted average = $0.49(\$1.07) + 0.51(\$5.01) = \$3.00$

The analyst should determine that the value of the put option is:

- ✓ **A)** less than \$3.00.
- X **B)** equal to \$3.00.

X **C)** greater than \$3.00.

Explanation

The probability-weighted average is an estimate of the option's expected value after one period. To determine the option's value the analyst must discount this expected value by one period.

References

Question From: Session 17 > Reading 58 > LOS n

Related Material:

- Key Concepts by LOS
-

Question #57 of 164

Question ID: 415723

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

- X **A)** swap.
- ✓ **B)** futures contract.
- X **C)** forward contract.

Explanation

Futures contracts are standardized forward contracts that trade on organized exchanges. Other types of forward contracts, as well as swaps, are custom instruments that are generally not exchange-traded.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #58 of 164

Question ID: 415902

Compared to European put options on an asset with no cash flows, an American put option:

- X **A)** will have the same minimum value.
- ✓ **B)** will have a higher minimum value.
- X **C)** will have a lower minimum value.

Explanation

Early exercise of an in-the-money American put option on an asset with no cash flows can generate more, $X - S$, than the minimum value of the European option, $X / (1 + R)^T - S$. The possibility of profitable early exercise leads to a higher minimum value on the price of the American put option.

References

Question From: Session 17 > Reading 58 > LOS o

Related Material:

- Key Concepts by LOS
-

Question #59 of 164

Question ID: 472446

For a series of forward contracts to replicate a swap contract, the forward contracts must have:

- ✓ **A)** values at swap initiation that sum to zero.
- X **B)** values at swap expiration that sum to zero.
- X **C)** values at swap initiation that are equal to zero.

Explanation

When replicating a swap with a series of forward contracts, each forward contract is likely to be off-market (i.e., have a non-zero value at initiation), but they can replicate a swap with a value of zero at initiation if the values of the forward contracts sum to zero at swap initiation.

References

Question From: Session 17 > Reading 58 > LOS g

Related Material:

- Key Concepts by LOS
-

Question #60 of 164

Question ID: 416007

An investor buys a call option that has an option premium of \$5 and a strike price of \$22.50. The current market price of the stock is \$25.75. At expiration, the value of the stock is \$23.00. The net profit/loss of the call position is *closest* to:

- ✓ **A)** -\$4.50.
- X **B)** -\$5.00.
- X **C)** \$4.50.

Explanation

The option is in-the-money by \$0.50 (\$23.00 - \$22.50). The investor paid \$5.00 for the call option, thus the net loss is -\$4.50 (\$0.50 - \$5.00).

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #61 of 164

Question ID: 416028

The shape of a protective put payoff diagram is most similar to a:

- ✓ **A)** long call.
- X **B)** short call.
- X **C)** covered call.

Explanation

The payoff diagram for a protective put is like that of a call option but shifted upward by the exercise price of the put.

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #62 of 164

Question ID: 416020

George Mote owns stock in IBM currently valued at \$112 per share. Mote writes a call option on IBM with an exercise price of \$120. The call option is sold for \$1.80. At expiration, the price of IBM is \$115. What is Mote's profit (or loss) from his covered call strategy? Mote:

- ✓ **A)** gained \$4.80.
- X **B)** lost \$3.20.
- X **C)** gained \$3.00.

Explanation

Since the option is out-of-the-money at expiration ($\text{MAX}(0, S - X)$), the option is worthless. Also, the stock increased in value from \$112 per share to \$115 per share, creating a \$3 gain. The \$3 gain in the stock price is added to the \$1.80 gain from writing the (unexercised) call option. Therefore, the total gain is \$4.80 (\$3 + \$1.80).

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #63 of 164

Question ID: 500880

The relationship referred to as put-call-forward parity states that at time = 0, if there is no arbitrage opportunity, the value of a call at X on an asset that has no holding costs or benefits plus the present value of X is equal to:

- ✓ **A)** the value of a put option at X plus the present value of the forward contract price.
- X **B)** the forward contract price plus the value of a put option at X.
- X **C)** the asset price minus the value of a put option at X.

Explanation

The put-call-forward parity relationship is:

$$c_0 + X/(1 + R_f)^T = p_0 + F_0(T)/(1 + R_f)^T$$

The value of a call at X plus the present value of X is equal to the value of a put option at X plus the present value of the forward contract price.

References

Question From: Session 17 > Reading 58 > LOS m

Related Material:

- Key Concepts by LOS
-

Question #64 of 164

Question ID: 415822

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

- X **A)** stabilize the market price fluctuations of the underlying commodity.
- ✓ **B)** guarantee that all obligations by traders, as set forth in the contract, will be honored.
- X **C)** maintain private insurance that can be used to provide funds if a trader defaults.

Explanation

The clearinghouse does not originate trades, it acts as the opposite party to all trades. In other words, it is the buyer to every seller and the seller to every buyer. This action guarantees that all obligations under the terms of the contract will be fulfilled.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #65 of 164

Question ID: 415996

A put option has a strike price of \$65, and the stock price is \$39 at expiration. The expiration day value of the put option is:

- ☐ A) \$65.
- ☒ B) \$26.
- ☐ C) \$0.

Explanation

A put option has an expiration day value of $\text{MAX}(0, X-S)$. Here, X is \$65 and S is \$39.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #66 of 164

Question ID: 415714

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

- ☐ A) A forward contract.
- ☒ B) A futures contract.
- ☐ C) A bond option.

Explanation

Futures contracts are exchange-traded; forwards and most bond options are OTC derivatives.

References

Question From: Session 17 > Reading 57 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #67 of 164

Question ID: 456308

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

- ☐ A) over-the-counter instruments.
- ☒ B) standardized.
- ☐ C) larger than forward contracts.

Explanation

As opposed to forward contracts, futures contracts are traded over an organized exchange and are standardized in size, maturity, quality of deliverable, etc.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #68 of 164

Question ID: 500879

At expiration, the value of a European call option is:

- ☐ **A)** equal to the asset price minus the present value of the exercise price.
- ☒ **B)** equal to its intrinsic value.
- ☐ **C)** less than that of an otherwise identical American call option.

Explanation

The intrinsic value of a call, either European or American, at expiration is $\text{Max}(0, S - X)$, which is its intrinsic value. The asset price minus the present value of the exercise price can be negative, but options cannot have a negative value.

References

Question From: Session 17 > Reading 58 > LOS i

Related Material:

- Key Concepts by LOS
-

Question #69 of 164

Question ID: 416019

James Jackson currently owns stock in PNG, Inc., valued at \$145 per share. Thinking that PNG is overbought and will decrease in price soon, Jackson writes a call option on PNG with an exercise price of \$148 for a premium of \$2.40. At expiration of the option, PNG stock is valued at \$152 per share. What is the profit or loss from Jackson's covered call strategy? Jackson:

- ☒ **A)** gained \$5.40.
- ☐ **B)** gained \$9.40.
- ☐ **C)** lost \$4.60.

Explanation

The option is in-the-money at expiration ($\text{MAX}(0, S - X)$) and the PNG stock will be called away from Jackson at \$148 per share, limiting Jackson's gain from owning the stock to \$3 (\$148-145). However, Jackson also gains the \$2.40 from writing the call

option. Therefore, Jackson's gain from the covered call strategy is \$5.40 (\$3.00+\$2.40).

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #70 of 164

Question ID: 416009

A put on Stock X with a strike price of \$40 is priced at \$3.00 per share; while a call with a strike price of \$40 is priced at \$4.50. What is the maximum per share loss to the writer of the uncovered put and the maximum per share gain to the writer of the uncovered call?

	<u>Maximum Loss to Put Writer</u>	<u>Maximum Gain to Call Writer</u>
✓ A) \$37.00		\$4.50
X B) \$40.00		\$4.50
X C) \$37.00		\$35.50

Explanation

The maximum *loss* to the uncovered put writer is the strike price less the premium, or $\$40.00 - \$3.00 = \$37.00$. The maximum *gain* to the uncovered call writer is the premium, or \$4.50.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #71 of 164

Question ID: 415851

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

- ✓ A) Buying a put option.
- X B) Writing a call option.
- X C) Writing a put option.

Explanation

A long position is always the buying position. Remember that the buyer of an option is said to have gone long the position, while the writer (seller) of the option is said to have gone short the position.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #72 of 164

Question ID: 415732

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

- ✓ **A)** Market efficiency refers to the low cost of trading derivatives because of the lower expense to traders.
- X **B)** The concept of rationally priced financial instruments preventing arbitrage opportunities is the basis behind the no-arbitrage principle.
- X **C)** Investors acting on arbitrage opportunities help keep markets efficient.

Explanation

Market efficiency is achieved when all relevant information is reflected in asset prices, and does not refer to the cost of trading. One necessary criterion for market efficiency is rapid adjustment of market values to new information. Arbitrage, trading on a price difference between identical assets, causes changes in demand for and supply of the assets that tends to eliminate the pricing difference.

References

Question From: Session 17 > Reading 57 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #73 of 164

Question ID: 415713

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

- X **A)** An arbitrage opportunity is the chance to make a riskless profit with no investment.
- X **B)** An option writer is the seller of an option.
- ✓ **C)** A call option gives the owner the right to sell the underlying good at a specific price for a specified time period.

Explanation

A call option gives the owner the right to *buy* the underlying good at a specific price for a specified time period.

References

Question From: Session 17 > Reading 57 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #74 of 164

Question ID: 492030

Which of the following is a nonmonetary benefit of holding an asset?

- ✓ **A)** Convenience yield.
- X **B)** Storage and insurance.
- X **C)** Dividends.

Explanation

Convenience yield refers to the nonmonetary benefits of holding an asset. Dividends are a monetary benefit. Storage and insurance are costs of holding an asset.

References

Question From: Session 17 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #75 of 164

Question ID: 472439

During its life the value of a long position in a forward or futures contract:

- X **A)** can differ in size from the value of the short position.
- X **B)** is equal to the value of the short position.
- ✓ **C)** is opposite to the value of the short position.

Explanation

The long and short positions in a forward or futures contract have opposite values. A gain for one is an equal-sized loss for the other.

References

Question From: Session 17 > Reading 58 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #76 of 164

Question ID: 492034

Consider a European call option and put option that have the same exercise price, and a forward contract to buy the same underlying asset as the two options. An investor buys a risk-free bond that will pay, on the expiration date of the options and the forward contract, the difference between the exercise price and the forward price. According to the put-call-forward parity relationship, this bond can be replicated by:

- ✓ **A)** writing the call option and buying the put option.
- X **B)** buying the call option and writing the put option.
- X **C)** writing the call option and writing the put option.

Explanation

The put-call-forward parity relationship may be expressed as:

$$p_0 - c_0 = [X - F_0(T)] / (1 + R_f)^T$$

That is, at initiation of a forward contract on the underlying asset, buying a put option and writing a call option with exercise price X will have the same cost as a risk-free bond which, at expiration of the forward and options, will pay the difference between X and the forward price.

References

Question From: Session 17 > Reading 58 > LOS m

Related Material:

- Key Concepts by LOS
-

Question #77 of 164

Question ID: 415715

Over-the-counter derivatives:

- ✓ **A)** are customized contracts.
- X **B)** have good liquidity in the over-the-counter (OTC) market.
- X **C)** are backed by the OTC Clearinghouse.

Explanation

OTC derivative contracts (securities) are customized and have poor liquidity. The contract is with a specific counterparty and there is default risk since there is no clearinghouse to guarantee performance.

References

Question From: Session 17 > Reading 57 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #78 of 164

Question ID: 415999

An investor buys 5 calls on Stock XYZ with a strike price of \$10 for a price of \$1 per call. Three months later, Stock XYZ is trading for \$15 per share. Each call entitles the owner to buy 2 shares of Stock XYZ. What is the investor's net profit?

- X A) \$20.
- ✓ B) \$45.
- X C) \$0.

Explanation

$(\$15 - \$10) \times (5 \times 2) - (\$1 \times 5 \text{ calls})$. The gross payoff is $(15 - 10) \times 10 = \$50$. The net profit is $\$50 - \text{price of calls } (\$5) = \$45$.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #79 of 164

Question ID: 498774

Which of the following will increase the value of a call option?

- X A) An increase in the exercise price.
- X B) A dividend on the underlying asset.
- ✓ C) An increase in volatility.

Explanation

Increased volatility of the underlying asset increases both put values and call values. A higher exercise price or an increase in cash flows on the underlying asset decrease the value of a call option.

References

Question From: Session 17 > Reading 58 > LOS k

Related Material:

- Key Concepts by LOS
-

Question #80 of 164

Question ID: 415802

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

- ✓ A) Both forward contracts and futures contracts trade on organized exchanges.

- X **B)** Futures contracts are highly standardized.
- X **C)** Forwards require no cash transactions until the delivery date, while futures require a margin deposit when the position is opened.

Explanation

Forward contracts are custom-tailored contracts and are not exchange traded while futures contracts are standardized and are traded on an organized exchange.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #81 of 164

Question ID: 415733

Which of the following statements about arbitrage opportunities is CORRECT?

- X **A)** Engaging in arbitrage requires a large amount of capital for the investment.
- X **B)** When an opportunity exists to profit from arbitrage, it usually lasts for several trading days.
- ✓ **C)** Pricing errors in securities are instantaneously corrected by the first arbitrageur to recognize them.

Explanation

Arbitrage is the opportunity to trade in identical assets that are momentarily selling for different prices. Arbitrageurs act quickly to make a riskless profit, causing the price discrepancy to be instantaneously corrected. No capital is required, because opposite trades are made simultaneously.

References

Question From: Session 17 > Reading 57 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #82 of 164

Question ID: 416001

An investor bought a 40 put on a stock trading at 43 for a premium of \$1. What is the maximum gain on the put and the value of the put at expiration if the stock price is \$41?

<u>Maximum Gain on Put</u>	<u>Value of the Put at Expiration</u>
----------------------------	---------------------------------------

- | | |
|------------------|-----|
| X A) \$42 | \$2 |
| ✓ B) \$39 | \$0 |

X C) \$40

\$2

Explanation

The maximum gain on a long put is the strike price minus the premium, $40 - 1 = \$39$. The value at expiration is zero because the put is out-of-the-money.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #83 of 164

Question ID: 500878

A European call option on a stock has an exercise price of 42. On the expiration date, the stock price is 40. The value of the option at expiration is:

- X A) positive.
- X B) negative.
- ✓ C) zero.

Explanation

For a call option, the value at expiration is zero if the price of the underlying is less than or equal to the exercise price. The holder will allow the option to expire unexercised.

References

Question From: Session 17 > Reading 58 > LOS i

Related Material:

- Key Concepts by LOS
-

Question #84 of 164

Question ID: 472441

It is possible to profit from cash-and-carry arbitrage when there are no costs or benefits to holding the underlying asset and the forward contract price is:

- X A) greater than the present value of the spot price.
- ✓ B) less than the future value of the spot price.
- X C) less than the present value of the spot price.

Explanation

An opportunity for cash-and-carry arbitrage exists if the forward price is not equal to the future value of the spot price, compounded at the risk-free rate over the period of the forward contract.

References

Question From: Session 17 > Reading 58 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #85 of 164

Question ID: 415863

Given the following data regarding Printer, Inc.'s call options, which of the following statements is *least* accurate?

<i>Stock Price</i>	<i>Expiration</i>	<i>Strike</i>	<i>Option Prem. (Last)</i>
50	June	45	6
50	June	50	2
50	June	55	0.50

- X **A)** The intrinsic value of the June \$45.00 call is \$5.00.
- ✓ **B)** The June \$55.00 call is an in-the-money option.
- X **C)** The June \$45.00 call is an in-the-money option.

Explanation

The June \$55.00 call option is out-of-the money. It gives the purchaser the right to buy Printer, Inc. for \$55.00 when they would only have to pay \$50.00 in the market.

References

Question From: Session 17 > Reading 58 > LOS j

Related Material:

- Key Concepts by LOS
-

Question #86 of 164

Question ID: 415716

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

- X **A)** Derivatives have no default risk.
- X **B)** Exchange-traded derivatives are created and traded by dealers in a market with no central location.
- ✓ **C)** Derivative values are based on the value of another security, index, or rate.

Explanation

Derivatives "derive" their value from the value or return of another asset or security. Exchange-traded derivatives are standardized and backed by a clearinghouse. An over-the-counter derivative, such as a forward contract or a swap, exposes the derivative holder to the risk that the counterparty may default.

References

Question From: Session 17 > Reading 57 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #87 of 164

Question ID: 415850

Which of the following statements about put and call options at expiration is *least* accurate?

<u>Put</u>	<u>Call</u>
X A) The maximum gain to the buyer is limited to the exercise price less the premium.	The maximum gain to the buyer is unlimited.
✓ B) The maximum gain to the buyer is unlimited.	The maximum loss to the writer is the premium.
X C) The maximum loss to a writer is the exercise price less the premium.	The maximum gain to the buyer is unlimited.

Explanation

The maximum gain to the buyer of a put is limited to the exercise price less the premium.

The maximum loss to the writer of a call is unlimited.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #88 of 164

Question ID: 415929

Greater volatility in the price of the underlying asset will have what effect on the value of a call option and the value of a put option?

<u>Value of a call option</u>	<u>Value of a put option</u>
X A) Increase	Decrease
✓ B) Increase	Increase
X C) Decrease	Increase

Explanation

Greater volatility in the price of the underlying asset increases the values of both puts and calls because options are "one-sided." Since an option's value can fall no lower than zero (it expires out of the money), increased volatility increases an option's upside potential but does not increase its downside exposure.

References

Question From: Session 17 > Reading 58 > LOS k

Related Material:

- Key Concepts by LOS

Question #89 of 164

Question ID: 492028

For an underlying asset that has no holding costs or benefits, the value of a forward contract to the long during the life of the contract is the:

- X **A)** difference between the spot price and the forward price.
- X **B)** present value of the difference between the spot price and the forward price.
- ✓ **C)** spot price minus the present value of the forward price.

Explanation

During the life of a forward contract on an underlying asset with no holding costs or benefits, the value to the long equals the spot price minus the present value of the forward price:

$$V_t(T) = S_t - F_0(T) / (1 + R_f)^{T-t}.$$

References

Question From: Session 17 > Reading 58 > LOS c

Related Material:

- Key Concepts by LOS

Question #90 of 164

Question ID: 472450

Dividends or interest paid by the asset underlying a call option:

- X **A)** increase the value of the option.
- ✓ **B)** decrease the value of the option.
- X **C)** have no effect on the value of the option.

Explanation

Dividends or interest paid by the underlying asset decrease the value of call options.

References

Question From: Session 17 > Reading 58 > LOS k

Related Material:

- Key Concepts by LOS
-

Question #91 of 164

Question ID: 492029

A net benefit from holding the underlying asset of a forward contract will:

- X **A)** increase the value of the forward contract during its life.
- ✓ **B)** decrease the no-arbitrage forward price at initiation.
- X **C)** decrease the value of the forward contract at expiration.

Explanation

Compared to an underlying asset with no net holding cost or benefit, a net benefit from holding the underlying asset will decrease the no-arbitrage forward price at initiation and the value of a forward contract during its life. Holding costs and benefits have no effect on the value of a forward contract at expiration.

References

Question From: Session 17 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #92 of 164

Question ID: 415848

Which of the following statements about the *potential* profits and losses from selling a call is *most* accurate?

- ✓ **A)** Losses are theoretically unlimited.
- X **B)** Profits are theoretically unlimited.
- X **C)** Losses are limited to the strike price plus the premium.

Explanation

The following table provides the potential payoffs from puts and calls.

	Buyer/Holder		Seller/Writer	
	Potential Gain	Potential Loss	Potential Gain	Potential Loss
Call	Unlimited	Premium	Premium	Unlimited
Put	Strike P - Premium	Premium	Premium	Strike P - Premium

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #93 of 164

Question ID: 415739

The process of arbitrage does all of the following EXCEPT:

- ✓ **A)** insure that risk-adjusted expected returns are equal.
- X **B)** promote pricing efficiency.
- X **C)** produce *riskless* profits.

Explanation

Arbitrage does not insure that the risk-adjusted expected returns to two risky assets will be equal. Arbitrage is based on risk-free portfolios and promotes efficient pricing of assets. When an arbitrage opportunity is presented by a mispricing of assets, the increased supply of the 'overpriced' asset and the increased demand for the 'underpriced' asset by arbitrageurs, will move the prices toward equality and act to correct the mispricing.

References

Question From: Session 17 > Reading 57 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #94 of 164

Question ID: 416008

An investor purchases a stock for \$40 a share and simultaneously sells a call option on the stock with an exercise price of \$42 for a premium of \$3/share. Ignoring dividends and transactions cost, what is the maximum profit that the writer of this covered call can earn if the position is held to expiration?

- X A) \$2.
- ✓ B) \$5.
- X C) \$3.

Explanation

This is an out of the money covered call. The stock can go up \$2 to the strike price and then the writer will get \$3 for the premium, total \$5.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #95 of 164

Question ID: 415952

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

- ✓ A) In a swap contract, the counterparties usually swap the notional principal.
- X B) The time frame covered by the swap is called the tenor of the swap.
- X C) The settlement dates are when the interest payments are to be made.

Explanation

The notional principal is generally *not* swapped, as it is usually the same for both parties in the swap deal.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #96 of 164

Question ID: 500881

A one-period binomial model is useful for valuing options because it:

- X A) does not require an assumption about volatility.
- ✓ B) can account for contingent payoffs of options.
- X C) considers the additional risk inherent in options.

Explanation

Binomial models are used to value options because they can account for contingent payoffs (i.e., the exercise value after an

up-move or down-move in the underlying asset price). The size of an up-move in a binomial model represents an assumption about the volatility of the underlying asset price. Binomial models can use risk-neutral pseudo-probabilities and thereby use the risk-free rate to discount the expected future payoff.

References

Question From: Session 17 > Reading 58 > LOS n

Related Material:

- Key Concepts by LOS
-

Question #97 of 164

Question ID: 434443

Shigeo Kishiro recently purchased an American put option and Lendon Grey recently wrote an American call option on the same underlying stock, Tackel Sports (currently trading at \$40 per share). Kishiro paid \$2.75 for an exercise price of \$38.00 and Grey received \$3.75 for a strike price of \$42. Assume that there are no transaction costs to exercise. Which of the following statements about the investors is *least accurate*?

- ☐ A) Kishiro's maximum gain is the strike price minus the premium.
- ☒ B) Grey's maximum gain and Kishiro's maximum loss sum to zero.
- ☐ C) Grey's maximum loss is unlimited.

Explanation

Although options are a zero-sum game, it is the counterparty exposures that net to zero. For example, the put buyer's maximum loss = put writer's maximum gain = the premium. The other statements are true. Note that the reason why Grey's loss is unlimited is that he does not currently own the stock. In other words, he has a naked position. If the stock were to rise, Grey would be forced to buy the stock in the open market to settle the exercise of the option. Because the potential for the stock to rise is unlimited, the potential loss for the naked call writer is also unlimited.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #98 of 164

Question ID: 415734

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

- ☒ A) There are no commissions.
- ☐ B) There is no risk.
- ☐ C) There is no initial investment.

Explanation

In order to be considered arbitrage there must be no risk in the trade.

It doesn't matter if commissions are paid as long as the amount of the price discrepancy is enough to offset the amount paid in commissions.

In order to be considered arbitrage there must be no initial investment of one's own capital. One must finance any cash outlay through borrowing.

References

Question From: Session 17 > Reading 57 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #99 of 164

Question ID: 415998

A put option has a strike price of \$80, and the stock price is \$75 at expiration. The expiration day value of the put option is:

- X **A)** \$80.
- X **B)** \$0.
- ✓ **C)** \$5.

Explanation

A put option has an expiration day value of $\text{MAX}(0, X - S)$. Here, X is \$80 and S is \$75.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #100 of 164

Question ID: 434442

Shigeo Kishiro recently purchased an American put option and Lendon Grey recently wrote an American call option on the same underlying stock, Tackel Sports (currently trading at \$40 per share). Kishiro paid \$2.75 for an exercise price of \$38.00 and Grey received \$3.75 for a strike price of \$42. Assume that there are no transaction costs to exercise. At a stock price of \$43:

- X **A)** if Grey exercises, he will have gained a total of \$4.75.
- X **B)** the put is at-the-money.
- ✓ **C)** the intrinsic value of the call is \$1.

Explanation

The intrinsic value of a call is $\max [0, S - X]$, where S = stock price and X = strike price. Here, $\max [0, 43 - 42] = \max [0, 1] = 1$.

The other answers are incorrect. Grey wrote the option and thus cannot exercise. The put is out-of-the money at a stock price of \$43. The put would be at-the-money if the stock price was equal to the strike price, or \$38.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #101 of 164

Question ID: 415867

James Anthony has a short position in a put option with a strike price of \$94. If the stock price is below \$94 at expiration, what will happen to Anthony's short position in the option?

- ☐ A) He will let the option expire.
- ☒ B) He will have the option exercised against him at \$94 by the person who is long the put option.
- ☐ C) The person who is long the put option will not exercise the put option.

Explanation

Anthony has *sold the right to sell the stock* at \$94. That is, he received a payment upfront for the payer to have the right but not the obligation to sell the stock at \$94. Because the option is in-the-money at expiration, $\max (0, X-S)$, the holder will exercise his right to sell at \$94.

References

Question From: Session 17 > Reading 58 > LOS j

Related Material:

- Key Concepts by LOS
-

Question #102 of 164

Question ID: 472451

A synthetic European put option includes a short position in:

- ☐ A) a risk-free bond.
- ☒ B) the underlying asset.
- ☐ C) a European call option.

Explanation

A synthetic European put option consists of a long position in a European call option, a long position in a risk-free bond that pays the exercise price on the expiration date, and a short position in the underlying asset.

References

Question From: Session 17 > Reading 58 > LOS I

Related Material:

- Key Concepts by LOS
-

Question #103 of 164

Question ID: 472452

A synthetic European call option includes a short position in:

- ✓ **A)** a risk-free bond.
- X **B)** the underlying asset.
- X **C)** a European put option.

Explanation

A synthetic European call option consists of a long position in the underlying asset, a long position in a European put option, and a short position in a risk-free bond (i.e., borrowing at the risk-free rate).

References

Question From: Session 17 > Reading 58 > LOS I

Related Material:

- Key Concepts by LOS
-

Question #104 of 164

Question ID: 416013

Linda Reynolds pays \$2.45 to buy a call option with a strike price of \$42. The stock price at which Reynolds earns \$3.00 from her call option position is:

- X **A)** \$2.45.
- X **B)** \$42.00.
- ✓ **C)** \$47.45.

Explanation

To earn \$3.00, the stock price must be above the strike price by \$3.00 plus the premium Reynolds paid to buy the option (\$42.00+\$3.00+\$2.45).

References

Question From: Session 17 > Reading 59 > LOS a

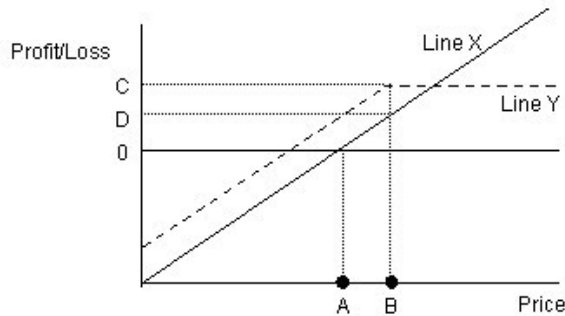
Related Material:

- Key Concepts by LOS

Question #105 of 164

Question ID: 434445

Donner Foliette holds stock in Hamilton Properties, which is currently trading at \$25.70 per share. On the advice of this investment advisor, he conducts a covered call transaction at a strike price of \$30 and at a premium of \$3.50. The advisor drew the following graph to help explain the transaction.



Which of the following statements about this transaction is *least* accurate?

- ✓ **A)** Foliette believes the stock will appreciate significantly in the near future.
- X **B)** If the stock price falls to \$23, Foliette will gain \$0.80 per share.
- X **C)** The call buyer paid \$3.50 for the right to any gain above \$30.

Explanation

One reason for an investor to conduct a covered call transaction is that he believes that the stock's upside potential is limited and he wants to collect some option premiums. The call writer thus trades the stock's upside potential for the premium. An investor is less likely to write a covered call if he believes the stock's upside potential is significant because he would be giving up the expected gains if the stock is called away.

The information about Foliette's gains is correct. If the stock price decreases to \$23.70, Foliette can realize a gain of \$0.80 if he sells the stock ($\$23.0 \text{ value} - \$25.70 + \$3.50 \text{ premium}$).

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS

Question #106 of 164

Question ID: 416023

The profit/loss diagram for a covered call strategy looks like what other type of profit/loss diagram?

- ✓ **A)** Short put.

X **B)** Short call.

X **C)** Long put.

Explanation

The profit/loss diagram for the covered call looks like the profit/loss diagram for a short put position. Both option positions have limited profit potential, with the potential loss equal to the strike price less the premium.

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #107 of 164

Question ID: 415721

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

- X **A)** issues a security that is paid using the cash flows from an underlying bond.
- ✓ **B)** makes a series of payments to a credit protection seller.
- X **C)** exchanges the return on a bond for a fixed or floating rate return.

Explanation

In a credit default swap (CDS), the buyer of credit protection makes a series of payments to a credit protection seller. The credit protection seller promises to make a fixed payment to the buyer if an underlying bond or loan experiences a credit event, such as a default. In a total return swap, the buyer of credit protection exchanges the return on a bond for a fixed or floating rate return. A security that is paid using the cash flows from an underlying bond is known as a credit-linked note.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #108 of 164

Question ID: 415896

A call option's intrinsic value:

- ✓ **A)** increases as the stock price increases above the strike price, while a put option's intrinsic value increases as the stock price decreases below the strike price.
- X **B)** decreases as the stock price increases above the strike price, while a put option's intrinsic value increases as the stock price decreases below the strike price.

- X **C)** increases as the stock price increases above the strike price, while a put option's intrinsic value decreases as the stock price decreases below the strike price.

Explanation

For a call option, as the underlying stock price increases above the strike price, the option moves farther into the money, and the intrinsic value is increasing. For a put option, as the underlying stock price decreases below the strike price, the option moves farther into the money, and the intrinsic value is increasing.

References

Question From: Session 17 > Reading 58 > LOS k

Related Material:

- Key Concepts by LOS
-

Question #109 of 164

Question ID: 415997

A call option has a strike price of \$120, and the stock price is \$105 at expiration. The expiration day value of the call option is:

- X **A)** \$15.
X **B)** \$105.
✓ **C)** \$0.

Explanation

A call option has an expiration day value of $\text{MAX}(0, S - X)$. Here, X is \$120 and S is \$105. Because the call option is *out of the money* at expiration, its value is zero.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #110 of 164

Question ID: 415797

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

- ✓ **A)** require weekly settlement of gains and losses.
X **B)** are backed by the clearinghouse.
X **C)** are traded in an active secondary market.

Explanation

Futures contracts require *daily* settlement of gains and losses. The other statements are accurate.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #111 of 164

Question ID: 415858

An investor would exercise a put option when the:

- ☐ A) price of the stock is equal to the strike price.
- ☐ B) price of the stock is above the strike price.
- ☒ C) price of the stock is below the strike price.

Explanation

A put option gives its owner the right to sell the underlying good at a specified price (strike price) for a specified time period. When the stock's price is less than the strike price a put option has value and is said to be *in-the-money*.

References

Question From: Session 17 > Reading 58 > LOS j

Related Material:

- Key Concepts by LOS
-

Question #112 of 164

Question ID: 416015

Which of the following statements about put options is *least* accurate? The most the:

- ☐ A) writer can lose is the strike price less the premium.
- ☒ B) buyer can gain is unlimited.
- ☐ C) writer can gain is the put premium.

Explanation

The most the put buyer can gain is the strike price of the stock less the premium.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #113 of 164

Question ID: 415710

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

- ☐ A) future.
- ☐ B) option.
- ☒ C) derivative security.

Explanation

Options and futures are examples of types of derivative securities.

References

Question From: Session 17 > Reading 57 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #114 of 164

Question ID: 472453

Which of the following instruments is a component of the put-call-forward parity relationship?

- ☐ A) The future value of the forward price of the underlying asset.
- ☒ B) The present value of the forward price of the underlying asset.
- ☐ C) The spot price of the underlying asset.

Explanation

The put-call-forward parity relationship is: $F_0(T) / (1 + RFR)^T + p = c + X / (1 + RFR)^T$, where $F_0(T)$ is the forward price of the underlying asset.

References

Question From: Session 17 > Reading 58 > LOS m

Related Material:

- Key Concepts by LOS
-

Question #115 of 164

Question ID: 416018

In June, Todd Puckett bought stock in SBC Communications for \$30 per share. At that time, Puckett sold an equivalent number of call options on SBC with an exercise price of \$35 for \$2.75. In September, at expiration, the stock is trading at \$26. What is Puckett's profit per share from his covered call strategy? Puckett:

- ☐ A) gained \$4.00.

X **B)** gained \$1.25.

✓ **C)** lost \$1.25.

Explanation

Since the option is out-of-the-money at expiration ($\text{MAX}(0, S - X)$), the options are worthless. Also, the stock decreased in value from \$30 per share to \$26 per share, creating a \$4 loss. The \$4 loss is partially offset by the \$2.75 premium Puckett received. Therefore, the loss per share from the covered call position is $\$1.25 = (-\$4 + \$2.75)$.

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #116 of 164

Question ID: 472442

Other things equal, the no-arbitrage forward price of an asset will be higher if the asset has:

✓ **A)** storage costs.

X **B)** dividend payments.

X **C)** convenience yield.

Explanation

Costs of holding an asset increase its no-arbitrage forward price. Benefits from holding the asset, such as dividends or convenience yield, decrease its no-arbitrage forward price.

References

Question From: Session 17 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #117 of 164

Question ID: 415717

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

X **A)** bonds.

X **B)** equities.

✓ **C)** inflation.

Explanation

Forward commitments can be customized and *could* be written on some measure of inflation, but typically they are not. The volume of forward commitments, including forward contracts and futures contracts, on bonds, equities, and interest rates is in the many billions of dollars.

References

Question From: Session 17 > Reading 57 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #118 of 164

Question ID: 492027

For an underlying asset that has no holding costs or benefits, the no-arbitrage forward price at initiation of a forward contract is:

- ✓ **A)** the future value of the spot price.
- X **B)** equal to the spot price.
- X **C)** zero.

Explanation

At initiation of a forward contract on an underlying asset with no holding costs or benefits, the no-arbitrage forward price is the future value of the spot price, compounded at the risk-free rate to the expiration date of the forward contract: $F_0(T) = S_0(1 + R_f)^T$. The forward contract has a *value* of zero at initiation if the forward price in the contract is equal to the no-arbitrage forward price.

References

Question From: Session 17 > Reading 58 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #119 of 164

Question ID: 415869

Consider a put option on Deter, Inc., with an exercise price of \$45. The current stock price of Deter is \$52. What is the intrinsic value of the put option, and is the put option at-the-money or out-of-the-money?

<u>Intrinsic Value</u>	<u>Moneyness</u>
------------------------	------------------

- | | |
|-----------------|------------------|
| X A) \$7 | At-the-money |
| ✓ B) \$0 | Out-of-the-money |
| X C) \$7 | Out-of-the-money |

Explanation

The option has an intrinsic value of \$0, because the stock price is above the exercise price. Put value is $\text{MAX}(0, X-S)$. Equivalently, the option is out-of-the-money.

References

Question From: Session 17 > Reading 58 > LOS j

Related Material:

- Key Concepts by LOS
-

Question #120 of 164

Question ID: 415887

The payoff of a call option on a stock at expiration is equal to:

- ☐ A) the minimum of zero and the stock price minus the exercise price.
- ☐ B) the maximum of zero and the exercise price minus the stock price.
- ☒ C) the maximum of zero and the stock price minus the exercise price.

Explanation

The payoff on a call option on a stock is $\text{Max}(0, S - X)$.

References

Question From: Session 17 > Reading 58 > LOS j

Related Material:

- Key Concepts by LOS
-

Question #121 of 164

Question ID: 415919

Using put-call parity, it can be shown that a synthetic European call can be created by a portfolio that is:

- ☐ A) long the stock, long the put, and long a pure discount bond that pays the exercise price at option expiration.
- ☒ B) long the stock, long the put, and short a pure discount bond that pays the exercise price at option expiration.
- ☐ C) long the stock, short the put, and short a pure discount bond that pays the exercise price at option expiration.

Explanation

A stock and a put combined with borrowing the present value of the exercise price will replicate the payoffs on a call at option expiration.

References

Question From: Session 17 > Reading 58 > LOS I

Related Material:

- Key Concepts by LOS
-

Question #122 of 164

Question ID: 472448

At expiration, the value of a call option is the greater of zero or the:

- ☐ A) exercise price minus the exercise value.
- ☐ B) underlying asset price minus the exercise value.
- ☒ C) underlying asset price minus the exercise price.

Explanation

The value of a call option at expiration is its exercise value, which is $\text{Max}[0, S - X]$.

References

Question From: Session 17 > Reading 58 > LOS i

Related Material:

- Key Concepts by LOS
-

Question #123 of 164

Question ID: 492033

On the expiration date of a European put option, if the spot price of the underlying asset is less than the exercise price, the value of the option is:

- ☐ A) negative.
- ☒ B) positive.
- ☐ C) zero.

Explanation

Put options are in the money (have positive value) at expiration if the spot price of the underlying asset is less than the exercise price, because the put option holder has the right to sell the asset for the higher exercise price. The value of an option cannot be negative; at expiration its value is the greater of zero or its intrinsic value.

References

Question From: Session 17 > Reading 58 > LOS i

Related Material:

- Key Concepts by LOS
-

Question #124 of 164

Question ID: 415736

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

- ✓ **A)** There is no free money.
- X **B)** There is no way you can find an opportunity to make a profit.
- X **C)** The information flow is quick in the financial market.

Explanation

An *arbitrage opportunity* is the chance to make a riskless profit with no investment. *In essence, finding an arbitrage opportunity is like finding free money.* As you recall, in arbitrage, you observe two identical assets with different prices. Your immediate response should be to buy the cheaper one and sell the expensive one short. You can then deliver the cheap one to cover your short position. Once you take the initial arbitrage position, your arbitrage profit is locked in. The *no-investment statement* referenced in the text refers to the assumption that when you short the expensive asset, you will be given access to the cash created by the short sale. With this cash, you now have the money to buy the cheaper asset. The no-investment assumption means that the first person to observe a market pricing error will have the financial resources to correct the pricing error instantaneously all by themselves.

References

Question From: Session 17 > Reading 57 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #125 of 164

Question ID: 472443

The underlying instrument in a forward rate agreement is:

- ✓ **A)** an interest rate.
- X **B)** a fixed-income security.
- X **C)** an asset.

Explanation

A forward rate agreement is a forward contract with an interest rate, such as 30-day LIBOR, as its underlying instrument.

References

Question From: Session 17 > Reading 58 > LOS e

Related Material:

- Key Concepts by LOS

Question #126 of 164

Question ID: 415920

Using put-call parity, it can be shown that a synthetic European put can be created by a portfolio that is:

- ☐ A) short the stock, long the call, and short a pure discount bond that pays the exercise price at option expiration.
- ☒ B) short the stock, long the call, and long a pure discount bond that pays the exercise price at option expiration.
- ☐ C) long the stock, short the call, and short a pure discount bond that pays the exercise price at option expiration.

Explanation

A short position in the stock combined with a long call and lending the present value of the exercise price will replicate the payoffs on a put at option expiration.

References

Question From: Session 17 > Reading 58 > LOS I

Related Material:

- Key Concepts by LOS
-

Question #127 of 164

Question ID: 472444

If the price of a forward contract is greater than the price of an identical futures contract, the most likely explanation is that:

- ☒ A) the futures contract requires daily settlement.
- ☐ B) the forward contract is more liquid.
- ☐ C) the futures contract is more difficult to exit.

Explanation

The reason there may be a difference in price between a forward contract and an identical futures contract is that a futures position has daily settlement and so makes or requires cash flows during its life.

References

Question From: Session 17 > Reading 58 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #128 of 164

Question ID: 416011

Jimmy Casteel pays a premium of \$1.60 to buy a put option with a strike price of \$145. If the stock price at expiration is \$128, Casteel's profit or loss from the options position is:

- ✓ **A) \$15.40.**
- X **B) \$18.40.**
- X **C) \$1.60.**

Explanation

The put option will be exercised and has a value of $\$145 - \$128 = \$17$ [MAX (0, X-S)]. Therefore, Casteel receives \$17 minus the \$1.60 paid to buy the option. Therefore, the profit is \$15.40 (\$17 less \$1.60).

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #129 of 164

Question ID: 416004

Consider a call option with a strike price of \$32. If the stock price at expiration is \$41, the value of the call option is:

- X **A) \$0.**
- X **B) \$41.**
- ✓ **C) \$9.**

Explanation

The call has a \$9 ($\$41 - \32) value at expiration, because the holder of the call can exercise his right to buy the stock at \$32 and then sell the stock on the open market for \$41. Remember, the intrinsic value of a call at expiration is MAX (0, S-X).

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #130 of 164

Question ID: 415745

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

- X **A) at contract expiration, the long can buy the asset from the short or pay the difference between the market price of the asset and the contract price.**
- X **B) at settlement, the long purchases the asset from the short for cash.**

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

Explanation

In a cash settlement forward contract there is a cash payment at settlement by either the long or the short depending on whether the market price of the asset is below or above the contract price at expiration. The underlying asset is not purchased or sold at settlement.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #131 of 164

Question ID: 415737

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

- X **A)** the law of one price.
- X **B)** exchange parity.
- ✓ **C)** arbitrage.

Explanation

If two securities have identical payoffs regardless of events, the process of arbitrage will move prices toward equality. Arbitrageurs will buy the lower priced position and sell the higher priced position, for an immediate profit without any future liability. The law of one price (for securities with identical payoffs) is not a process; it is 'enforced' by arbitrage.

References

Question From: Session 17 > Reading 57 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #132 of 164

Question ID: 416003

Mosaks, Inc., has a put option with a strike price of \$105. If Mosaks stock price is \$115 at expiration, the value of the put option is:

- X **A)** \$10.
- X **B)** \$105.
- ✓ **C)** \$0.

Explanation

The put has a value of \$0 because it will not be exercised. Put value is $\text{MAX}(0, X-S)$.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #133 of 164

Question ID: 415921

A fiduciary call is a portfolio that is made up of:

- ✓ **A)** a call option and a bond that pays the exercise price of the call at option expiration.
- X **B)** a call that is synthetically created from other instruments.
- X **C)** a call option and a share of stock.

Explanation

A fiduciary call combines a call option and a bond that pays the exercise price of the call at option expiration.

References

Question From: Session 17 > Reading 58 > LOS I

Related Material:

- Key Concepts by LOS
-

Question #134 of 164

Question ID: 492026

Which of the following *most accurately* states an example of replication in derivatives pricing?

- ✓ **A)** Risky asset + derivative = risk-free asset.
- X **B)** Derivative position - risk-free asset = risky asset.
- X **C)** Risky asset + risk-free asset = (- derivative position).

Explanation

Replications of future payoffs, composed of a risky asset, a risk-free asset, and a derivative on the risky asset, are as follows:

Risky asset + derivative = risk-free asset

Risky asset - risk-free asset = (- derivative position)

Derivative position - risk-free asset = (- risky asset).

References

Question From: Session 17 > Reading 58 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #135 of 164

Question ID: 416030

An investor buys a 30 put on a share of stock for a premium of \$7 and simultaneously buys a share of stock for \$26. The breakeven price on the position and the maximum gain on the position are:

	<u>Breakeven price</u>	<u>Maximum gain</u>
X A) \$21		\$11
X B) \$37		\$11
✓ C) \$33		unlimited

Explanation

To break even, the stock price should rise as high as the amount invested, \$33 (\$26 + \$7). The maximum gain is unlimited, as the gain will be as high as the increase in the stock price.

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #136 of 164

Question ID: 415866

A call option that is in the money:

- ✓ A) has an exercise price less than the market price of the asset.
- X B) has an exercise price greater than the market price of the asset.
- X C) has a value greater than its purchase price.

Explanation

A call option is in the money when the exercise price is less than the market price of the asset.

References

Question From: Session 17 > Reading 58 > LOS j

Related Material:

- Key Concepts by LOS
-

Question #137 of 164

Question ID: 415743

The short in a forward contract:

- ☐ A) has the right to deliver the asset upon expiration of the contract.
- ☒ B) is obligated to deliver the asset upon expiration of the contract.
- ☐ C) is obligated to deliver the asset anytime prior to expiration of the contract.

Explanation

The short in a forward contract is obligated to deliver the asset (in a deliverable contract) on (or close to) the expiration date.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #138 of 164

Question ID: 416027

A covered call position is:

- ☒ A) the purchase of a share of stock with a simultaneous sale of a call on that stock.
- ☐ B) the purchase of a share of stock with a simultaneous sale of a put on that stock.
- ☐ C) the simultaneous purchase of the call and the underlying asset.

Explanation

The covered call: *stock plus a short call*. The term covered means that the stock covers the inherent obligation assumed in writing the call. Why would you write a covered call? You feel the stock's price will not go up any time soon, and you want to increase your income by collecting some call option premiums. To add some insurance that the stock won't get called away, the call writer can write out-of-the money calls. You should know that this strategy for enhancing one's income is not without risk. The call writer is trading the stock's upside potential for the call premium. The desirability of writing a covered call to enhance income depends upon the chance that the stock price will exceed the exercise price at which the trader writes the call.

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #139 of 164

Question ID: 415727

Which of the following statements about arbitrage is NOT correct

- ✓ **A)** Arbitrage can cause markets to be less efficient.
- X **B)** If an arbitrage opportunity exists, making a profit without risk is possible.
- X **C)** No investment is required when engaging in arbitrage.

Explanation

Arbitrage is defined as the existence of riskless profit without investment and involves selling an asset and simultaneously buying the same asset for a lower price. Since the trades cancel each other, no investment is required. Because it is done simultaneously, a profit is guaranteed, making the transaction risk free. Arbitrage actually helps make markets more efficient because price discrepancies are immediately eradicated by the actions of arbitrageurs.

References

Question From: Session 17 > Reading 57 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #140 of 164

Question ID: 460708

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

- X **A)** The holder of a call option has the obligation to sell to the option writer if the stock's price rises above the strike price.
- X **B)** The writer of a put option has the obligation to sell the asset to the holder of the put option.
- ✓ **C)** The holder of a put option has the right to sell to the writer of the option.

Explanation

The holder of a put option has the right to sell to the writer of the option. The writer of the put option has the obligation to buy, and the holder of the call option has the right, but not the obligation to buy.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #141 of 164

Question ID: 415849

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

- X **A)** call option is taking a long position and the buyer of a put option is taking a short position.
- ✓ **B)** call option is taking a long position while the seller of a put is taking a short position.
- X **C)** put option is taking a short position and the seller of a call option is taking a short position.

Explanation

The buyers of both puts and calls are taking long positions in the options contracts (but the buyer of a put is establishing a potentially short exposure to the underlying), while writers (sellers) of each are taking short positions in the options contracts.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #142 of 164

Question ID: 415988

In a plain vanilla interest rate swap:

- ✓ **A)** one party pays a floating rate and the other pays a fixed rate, both based on the notional amount.
- X **B)** each party pays a fixed rate of interest on a notional amount.
- X **C)** payments equal to the notional principal amount are exchanged at the initiation of the swap.

Explanation

A plain vanilla swap is a fixed-for-floating swap.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #143 of 164

Question ID: 415708

Which of the following statements regarding exchange-traded derivatives is NOT correct? Exchange-traded derivatives:

- X **A)** often trade in a physical location.
- ✓ **B)** are illiquid.
- X **C)** are standardized contracts.

Explanation

Derivatives that trade on exchanges have good liquidity in most cases. They have the other characteristics listed.

References

Question From: Session 17 > Reading 57 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #144 of 164

Question ID: 415740

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

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

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

- X **A)** 6%.
- X **B)** 7%.
- ✓ **C)** 5%.

Explanation

If the no-arbitrage condition is met, a riskless portfolio (a portfolio with zero standard deviation of returns) will yield the risk-free rate of return.

References

Question From: Session 17 > Reading 57 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #145 of 164

Question ID: 472437

The calculation of derivatives values is based on an assumption that:

- ✓ **A)** arbitrage opportunities are exploited rapidly.
- X **B)** arbitrage opportunities do not arise in real markets.
- X **C)** investors are risk neutral.

Explanation

Derivatives valuation is based on the assumption that any arbitrage opportunities in financial markets are exploited rapidly so that assets with identical cash flows are forced toward the same price. It does not assume arbitrage opportunities do not arise or that investors are risk neutral.

References

Question From: Session 17 > Reading 58 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #146 of 164

Question ID: 415742

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

- ✓ **A)** long.
- X **B)** receiver.
- X **C)** short.

Explanation

The long in a forward contract is obligated to buy the asset (in a deliverable contract). The term receiver is used with swaps.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #147 of 164

Question ID: 415818

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

- ✓ **A)** a deposit is required to return the account margin to the initial margin level.
- X **B)** a deposit is required which will bring the account to the maintenance margin level.
- X **C)** a margin deposit equal to the maintenance margin is required within two business days.

Explanation

Once account margin (based on the daily settlement price) falls below the maintenance margin level, it must be returned to the initial margin level, regardless of subsequent price changes.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #148 of 164

Question ID: 416002

An investor bought a 15 call for \$14 on a stock trading at \$20. If the stock is trading at \$24 at option expiration, what is the profit and the value of the call at option expiration?

<u>Profit</u>	<u>Value of the Call</u>
✓ A) -\$5	\$9
X B) \$1	\$9
X C) -\$5	\$5

Explanation

The potential gains on a call purchase are unlimited. With a stock price of \$24, the call at 15 is \$9 in the money. By subtracting out the 14 call price a loss of \$5 results.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #149 of 164

Question ID: 415720

Credit derivatives are *least accurately* characterized as:

- X A) contingent claims.
- ✓ B) forward commitments.
- X C) insurance.

Explanation

Credit derivatives are contingent claims and not forward commitments because their payoff depends on a future event taking

place. Credit derivatives are essentially insurance against a credit event.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #150 of 164

Question ID: 710167

A covered call position has the same shape of its payoff diagram as:

- X **A)** owning the stock and a call.
- X **B)** owning the stock and a put.
- ✓ **C)** writing a put.

Explanation

A covered call (stock plus writing a call) has the same shape payoff diagram as writing a put, a line sloped upward at a 45 degree angle that goes flat at the exercise price.

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #151 of 164

Question ID: 472438

The value of a forward or futures contract is:

- ✓ **A)** typically zero at initiation.
- X **B)** specified in the contract.
- X **C)** equal to the spot price at expiration.

Explanation

The value of a forward or futures contract is typically zero at initiation, and at expiration is the difference between the spot price and the contract price. The *price* of a forward or futures contract is defined as the price specified in the contract at which the two parties agree to trade the underlying asset on a future date.

References

Question From: Session 17 > Reading 58 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #152 of 164

Question ID: 415862

Which of the following statements about moneyness is *most* accurate? When the stock price is:

- ☐ A) above the strike price, a put option is in-the-money.
- ☐ B) below the strike price, a call option is in-the-money.
- ☒ C) above the strike price, a put option is out-of-the-money.

Explanation

When the stock price is above the strike price, a put option is *out-of-the-money*.

When the stock price is below the strike price, a call option is *out-of-the-money*.

References

Question From: Session 17 > Reading 58 > LOS j

Related Material:

- Key Concepts by LOS
-

Question #153 of 164

Question ID: 416025

The potential profits from writing a covered call position on a stock are:

- ☐ A) limited to the premium.
- ☒ B) limited to the premium plus stock appreciation up to the exercise price.
- ☐ C) greater than the potential profits from owning the stock.

Explanation

The covered call: *stock plus a short call, or a short put*. The term covered means that the stock covers the inherent obligation assumed in writing the call. Why would you write a covered call? You feel the stock's price will not go up any time soon, and you want to increase your income by collecting some call option premiums. To add some insurance that the stock won't get called away, the call writer can write out-of-the money calls. You should know that this strategy for enhancing one's income is not without risk. *The call writer is trading the stock's upside potential for the call premium*. The desirability of writing a covered call to enhance income depends upon the chance that the stock price will exceed the exercise price at which the trader writes the call. The owner of a stock has the rights to *all* upside potential. The profits for a short call are limited to the premium.

For example, say that a stock owner writes a covered call at a stock price (S) of \$50 and an exercise price (X) of \$55 for a premium of \$4. If at expiration, the price of the stock is more than \$50 but less than \$55, the buyer will not exercise, and the writer will "gain" the premium plus any stock appreciation between \$50 and \$55. If at expiration, the price of the stock is more than \$55, the buyer will exercise for \$55 and the writer's gain is limited to the premium plus the appreciation from \$50 to \$55.

References

Question From: Session 17 > Reading 59 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #154 of 164

Question ID: 415730

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

- ☐ A) derivatives expire.
- ☒ B) they are complex instruments and sometimes hard to understand.
- ☐ C) derivatives have too much default risk.

Explanation

The fact that derivative securities are sometimes complex and often hard for non-financial commentators to understand has led to criticism of derivatives and derivative markets.

References

Question From: Session 17 > Reading 57 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #155 of 164

Question ID: 492032

Which of the following is typically equal to zero at the initiation of an interest rate swap contract?

- ☒ A) Its value.
- ☐ B) Neither its value nor its price.
- ☐ C) Its price.

Explanation

As with other derivatives, the price of an interest rate swap (the fixed rate specified in the contract) is typically set such that the value of the swap is zero at initiation.

References

Question From: Session 17 > Reading 58 > LOS h

Related Material:

- Key Concepts by LOS
-

Question #156 of 164

Question ID: 496436

Compared to an American call option on a stock that does not pay a dividend, an otherwise identical European call option will have:

- ☐ A) a higher value.
- ☒ B) the same value.
- ☐ C) a lower value.

Explanation

For call options on an underlying asset that does not pay cash flows, the right to exercise early is not valuable and therefore American and European options that are otherwise identical will have the same value.

References

Question From: Session 17 > Reading 58 > LOS o

Related Material:

- Key Concepts by LOS
-

Question #157 of 164

Question ID: 710166

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

- ☐ A) hedge.
- ☐ B) futures contract.
- ☒ C) forward commitment.

Explanation

This is a forward commitment because the contract requires an action in the future. It is not necessarily a hedge of an existing risk. . It is not necessarily a futures contract as it could be a forward contract as well.

References

Question From: Session 17 > Reading 57 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #158 of 164

Question ID: 415709

A derivative security:

- ☐ A) is like a callable bond.

- X **B)** has a value dependent on the shape of the yield curve.
- ✓ **C)** is one that is based on the value of another security.

Explanation

A derivative security is one that 'derives' its value from that of another security.

References

Question From: Session 17 > Reading 57 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #159 of 164

Question ID: 416000

An investor writes a July 20 call on a stock trading at 23 for premium of \$4. The breakeven price on the trade and the maximum gain on the trade are, respectively:

	<u>Breakeven Price</u>	<u>Maximum Gain</u>
✓ A) \$24	\$4	
X B) \$27	\$4	
X C) \$24	\$3	

Explanation

The breakeven price is the premium received on the call plus the strike price. For a writer of an option, the maximum gain is the premium received.

References

Question From: Session 17 > Reading 59 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #160 of 164

Question ID: 415711

A derivative security:

- ✓ **A)** has a value based on another security or index.
- X **B)** has a value based on stock prices.
- X **C)** has no default risk.

Explanation

This is the definition of a derivative security. Those based on stock prices are equity derivatives.

References

Question From: Session 17 > Reading 57 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #161 of 164

Question ID: 456306

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

- X **A)** guarantees that traders in the futures market will honor their obligations.
- ✓ **B)** has defaulted on one half of one percent of futures trades.
- X **C)** requires the daily settlement of all margin accounts.

Explanation

In the history of U.S. futures trading, the clearinghouse has never defaulted.

The clearinghouse guarantees that traders in the futures market will honor their obligations. The clearinghouse does this by splitting each trade once it is made and acting as the opposite side of each position. The clearinghouse acts as the buyer to every seller and the seller to every buyer. By doing this, the clearinghouse allows either side of the trade to reverse positions later without having to contact the other side of the initial trade. This allows traders to enter the market knowing that they will be able to reverse their position any time that they want. Traders are also freed from having to worry about the other side of the trade defaulting, since the other side of their trade is now the clearinghouse.

To safeguard the clearinghouse, the exchange requires traders to post margin and settle their accounts on a daily basis.

References

Question From: Session 17 > Reading 57 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #162 of 164

Question ID: 472455

Which of the following statements about American and European options is most accurate?

- X **A)** European options allow for exercise on or before the option expiration date.
- X **B)** There will always be some price difference between American and European options because of exchange-rate risk.
- ✓ **C)** Prior to expiration, an American option may have a higher value than an equivalent European option.

Explanation

American and European options both give the holder the right to exercise the option at expiration. An American option also gives the holder the right of early exercise, so American options will be worth more than European options when the right to early exercise is valuable, and they will have equal value when it is not.

References

Question From: Session 17 > Reading 58 > LOS o

Related Material:

- Key Concepts by LOS
-

Question #163 of 164

Question ID: 472454

In a one-period binomial model for option pricing:

- X **A)** the size of an up-move and the size of a down-move must sum to one.
- X **B)** the risk-neutral probability of a down-move is the reciprocal of the risk-neutral probability of an up-move.
- ✓ **C)** the exercise price of the option is one of the required inputs.

Explanation

The exercise price of the option is needed to determine the option's values given an up-move and a down-move in the price of the underlying asset. The risk-neutral probabilities of an up-move and a down-move must sum to one and the size of a down-move is the reciprocal of the size of an up-move.

References

Question From: Session 17 > Reading 58 > LOS n

Related Material:

- Key Concepts by LOS
-

Question #164 of 164

Question ID: 415728

Which of the following is a common criticism of derivatives?

- X **A)** Derivatives are too illiquid.
- ✓ **B)** Derivatives are likened to gambling.

X **C)** Fees for derivatives transactions are relatively high.

Explanation

Derivatives are often likened to gambling by those unfamiliar with the benefits of options markets and how derivatives are used.

References

Question From: Session 17 > Reading 57 > LOS d

Related Material:

- Key Concepts by LOS