Question #1 of 26

Value stocks are *most likely* to be characterized by:

A) Low price multiples.

B) Immature markets.

C) High earnings growth.

Explanation

Value stocks tend to have low price multiples, high dividend yield and tend to be in mature industries with low earnings growth.

(Study Session 17, Module 49.2, LOS 49.k)

Related Material

SchweserNotes - Book 5

Question #2 of 26

The real rate of return is *most likely* higher:

A) Higher the utility investors attach to future consumption relative to current consumption.

B) Lower the expectations of lower income in the future.

C) Higher the expectations of lower income in the future.

Explanation

Real rate of return is higher, higher the utility of current consumption relative to future consumption. If investors expect lower incomes in the future, the utility of future consumption relative to current consumption will be higher and real rate will be lower.

(Study Session 17, Module 49.1, LOS 49.c)

Related Material

SchweserNotes - Book 5

Question #3 of 26

The price of a zero-coupon, inflation indexed, risk-free bond that pays $1 in one period is:

A) The expected value of the investors' inter-temporal rate of substitution between current period and one period from now.

B) Uncertain.

C) $1.00

Explanation

The price of a The price of a zero-coupon, inflation indexed, risk-free bond that pays $1 in one period is the expected value of the investors' inter-temporal rate of substitution between current period and one period from now. This value is less than $1 as the utility of current consumption is greater than consumption in one period in the future.

(Study Session 17, Module 49.1, LOS 49.c)

Related Material

SchweserNotes - Book 5

Question #4 of 26

Market values of assets are *most likely* to be affected when either:

A) Real risk-free rates, inflation premium, timing/magnitude of expected cash flows change.

B) Risk free interest rates, risk premiums, timing and/or magnitude of expected cash flows change.

C) Real risk-free rates, risk premiums, timing/magnitude of expected cash flows change.

Explanation

Market values of assets are affected when the expected cash flows or discount rate changes. The discount rate can change either due to changes in risk-free rate or due to changes in risk premiums.

(Study Session 17, Module 49.1, LOS 49.a)

Related Material

SchweserNotes - Book 5

Question #5 of 26

Which of the following is *least likely* to explain a decline in the S&P 500 index:

A) An increase in Treasury yields.

B) A decrease in expectations about corporate earnings.

C) A decline in expected inflation.

Explanation

Equity market prices are positively related to expected earnings/cash flows and negatively related to discount rate. Discount rate is positively related to inflation expectations and treasury yields (risk-free rate).

(Study Session 17, Module 49.1, LOS 49.a)

Related Material

SchweserNotes - Book 5

Question #6 of 26

Which of the following assets provides a most effective hedge against bad consumption outcomes?

A) Real estate

B) Equity

C) Risk-free bonds.

Explanation

Risk-free bonds (especially long maturity bonds) provide an effective hedge against bad consumption outcomes. Equity prices and real estate values tend to be positively related to the state of the economy and hence do not provide good hedges against bad consumption outcomes.

(Study Session 17, Module 49.2, LOS 49.i)

Related Material

SchweserNotes - Book 5

Question #7 of 26

Jeff Dentmat is expecting overall credit spreads to narrow over the next few years. Which of the following conclusions can Dentmat most appropriately make?

A) Risky bonds will outperform risk-free bonds.

B) High rated corporate bonds will outperform low-rated corporate bonds.

C) Government bonds will outperform low-rated corporate bonds.

Explanation

When credit spreads narrow, lower rated bonds outperform higher rated bonds.

(Study Session 17, Module 49.1, LOS 49.f)

Related Material

SchweserNotes - Book 5

Question #8 of 26

Price multiples are *least likely* to increase when:

A) Equity risk premium increases.

B) Inflation expectations decline.

C) Earnings growth increases.

Explanation

Price multiples are positively related to earnings growth and negatively related to each of the components of the discount rate (i.e., real rate, inflation premium, equity risk premium).

(Study Session 17, Module 49.2, LOS 49.j)

Related Material

SchweserNotes - Book 5

Question #9 of 26

The break-even inflation rate is expected to be 2% over the next year. What is the credit spread for a 2% annual pay corporate bond maturing in one year with a market price of $96.91 ($100 par) if the real risk-free rate of return over the next year is 1%?

A) 2.25%

B) 2.00%

C) 0.19%

Explanation

The YTM on the corporate bond is (102/96.91) – 1 = 5.25%.

Credit spread = Yield - BEI - R = 5.25% - 2% - 1% = 2.25%

(Study Session 17, Module 49.1, LOS 49.f)

Related Material

SchweserNotes - Book 5

Question #10 of 26

Janet Grange's current one-period inter-temporal rate of substitution is 0.95. Janet is *most likely* to invest in a default-free inflation indexed one-period bond if:

A) The bond's return is 5.26% or more.

B) The bond's return is 5% or more.

C) The bond's return is 4.89% or more.

Explanation

Real risk-free rate = (1/E(inter-temporal rate of substitution)-1 = (1/0.95))-1 = 0.0526 or 5.26%

(Study Session 17, Module 49.1, LOS 49.c)

Related Material

SchweserNotes - Book 5

Question #11 of 26

ABC Inc. stock's price is inversely related to the business cycle; it is higher during economic downturns. Which of the following appropriately characterizes the consumption hedging property of an investment in ABC stock and the equity risk premium demanded by investors for an investment in it?

A) Due to its desirable consumption hedging ability, an investment in ABC stock would command a lower equity risk premium.

B) Due to its desirable consumption hedging ability, an investment in ABC stock would command a higher equity risk premium.

C) Due to its poor consumption hedging ability, an investment in ABC stock would command a higher equity risk premium.

Explanation

Assets that pay off during times of scarcity provide desirable consumption hedging property. Investors will demand a lower equity risk premium on such assets.

(Study Session 17, Module 49.2, LOS 49.i)

Related Material

SchweserNotes - Book 5

Question #12 of 26

Sector rotation strategies are *least likely* to seek to:

A) relate business cycle to sector performance.

B) earn higher risk premium than any of the individual sectors.

C) Invest in better performing sector as soon as the shift starts materializing.

Explanation

Sector rotation strategies seek to understand the relationship between performance of different sectors and business cycle and forecast the shifts in business cycle so as to rotate money out before the shift in performance occurs. Such strategies want to earn higher risk premiums (returns over risk-free rate).

(Study Session 17, Module 49.2, LOS 49.l)

Related Material

SchweserNotes - Book 5

Question #13 of 26

As compared to an investment in equities, the difference in discount rate for valuation of commercial real estate is *most likely* due to:

A) lack of liquidity.

B) inflation uncertainty.

C) the break-even inflation rate.

Explanation

The additional risk-premium for real estate is due to lack of liquidity.

(Study Session 17, Module 49.2, LOS 49.m)

Related Material

SchweserNotes - Book 5

Question #14 of 26

Credit spreads are *most likely* to:

A) Rise with policy rates.

B) Rise during recessions.

C) Rise during expansions.

Explanation

Credit losses (probability of default and loss given default) tend to be higher during recessions and hence credit spreads are higher during recessions.

(Study Session 17, Module 49.1, LOS 49.f)

Related Material

SchweserNotes - Book 5

Question #15 of 26

Corporate earnings from which of the following sectors would be most sensitive to business cycle?

A) Consumer durable

B) non-cyclical

C) Consumer non-discretionary

Explanation

Earnings of companies in cyclical industries such as consumer durable or consumer discretionary would be more sensitive to business cycle as opposed to companies in non-cyclical industries such as consumer non-discretionary.

(Study Session 17, Module 49.2, LOS 49.h)

Related Material

SchweserNotes - Book 5

Question #16 of 26

Investors are *least likely* to increase their savings rate when:

A) Expected rates of returns increase.

B) Uncertainty about their future income increases.

C) Uncertainty about their future income decreases.

Explanation

Investors would increase their savings rate when uncertainty about future income increases and/or expected rates of return increase.

(Study Session 17, Module 49.1, LOS 49.c)

Related Material

SchweserNotes - Book 5

Question #17 of 26

The real rate of return is *most likely* higher:

A) Higher the utility investors attach to future consumption relative to current consumption.

B) Higher the expectations of lower income in the future.

C) Lower the utility investors attach to future consumption relative to current consumption.

Explanation

Real rate of return is higher, higher the utility of current consumption relative to future consumption. If investors expect lower incomes in the future, the utility of future consumption relative to current consumption will be higher and real rate will be lower.

(Study Session 17, Module 49.1, LOS 49.c)

Related Material

SchweserNotes - Book 5

Question #18 of 26

Rapidly developing economies like India and China have high GDP growth rates and therefore are *most likely* to have a:

A) High real rate, low inter-temporal rate of substitution and a high rate of current borrowing by investors. ✓

B) Low real rate, high inter-temporal rate of substitution and a low rate of current borrowing by investors. ✗

C) High real rate, low inter-temporal rate of substitution and a high rate of borrowing by investors. ✗

Explanation

High GDP growth leads to higher future expected incomes and therefore high rate of current consumption (low savings, high borrowings) and a low inter-temporal rate of substitution.

(Study Session 17, Module 49.1, LOS 49.c)

Related Material

SchweserNotes - Book 5

Question #19 of 26

Differences in credit spreads across sectors are *least likely* due to:

A) Differences in leverage typical of the sector. ✗

B) Differences in ratings. ✓

C) Differences in services and products that an industry produces. ✗

Explanation

Differences in credit spreads across sectors is related to differences in products/services the sector produces and leverage typically used in the sector.

(Study Session 17, Module 49.2, LOS 49.g)

Related Material

SchweserNotes - Book 5

Question #20 of 26

Market values of assets are *most likely* to be affected when:

A) New information reveals that market's expectations about earnings were accurate.

B) New information confirms markets expectations of future earnings.

C) New information reveals that market's expectations about earnings were inaccurate.

Explanation

Market values change when new information differs from expectations that are currently priced in.

(Study Session 17, Module 49.1, LOS 49.b)

Related Material

SchweserNotes - Book 5

Question #21 of 26

Break-even inflation rate is *most appropriately* described as the:

A) The difference in yields between long-dated and short-dated government bonds.

B) The difference in yields of non-inflation indexed and inflation indexed risk-free bonds.

C) The difference between market's expectation of the inflation rate and the risk premium for inflation uncertainty.

Explanation

Break-even inflation is the difference in nominal and real risk-free rates. It comprises premium for inflation and the risk premium for uncertainty in inflation.

(Study Session 17, Module 49.1, LOS 49.e)

Related Material

SchweserNotes - Book 5

Question #22 of 26

The marginal utility of current consumption is *most likely* higher:

A) During economic contractions.

B) During economic expansions.

C) Higher the wealth.

Explanation

Diminishing marginal utility of wealth means that an investor's marginal utility of consumption declines as wealth increases. This suggests that marginal utility of consumption is higher during periods of scarcity, such as during economic contractions.

(Study Session 17, Module 49.1, LOS 49.c)

Related Material

SchweserNotes - Book 5

Question #23 of 26

If the market expects inflation to decrease over the next few years but the uncertainty about inflation was increasing, the break-even inflation rate is *most likely* to:

A) Be uncertain.

B) Decrease.

C) Increase.

Explanation

BEI = expected inflation + risk premium for uncertainty about inflation. While inflation is expected to decrease, the higher inflation uncertainty increases the risk premium. Hence the overall impact is uncertain.

(Study Session 17, Module 49.1, LOS 49.e)

Related Material

SchweserNotes - Book 5

Question #24 of 26

Which of the following is *most likely* to be the shape of the yield curve during recessions?

A) Downward sloping ✗

B) Flat ✗

C) Upward sloping ✓

Explanation

During recessions, policy rates tend to be low. Over a longer period, investor's expect inflation to be higher as the economy comes out of recession and hence longer-term rates tend to be higher resulting in an upward sloping yield curve.

(Study Session 17, Module 49.1, LOS 49.d)

Related Material

SchweserNotes - Book 5

Question #25 of 26

The risk-premium for uncertainty in inflation is *most likely* to be:

A) negatively related to the term spread. ✗

B) positively related to the term spread. ✓

C) unrelated to the term spread. ✗

Explanation

Term spread (i.e., difference in yield between long dated government bonds and short-dated government bonds) is normally positive. Given that longer-term government bonds have a higher risk premium for uncertainty in inflation; term spread would be higher resulting in a positive relationship.

(Study Session 17, Module 49.1, LOS 49.d)

Related Material

SchweserNotes - Book 5

Question #26 of 26

Spreads for issuers in the consumer cyclical sector are *most likely* to:

A) Decrease during economic downturns. ✗

B) Be unrelated to business cycle. ✗

C) Increase during economic downturns. ✓

Explanation

Spreads on issues from the consumer cyclical sectors tend to rise during economic downturns and fall during expansions reflecting cyclicality in earnings of the companies in the sector.

(Study Session 17, Module 49.2, LOS 49.g)

Related Material

SchweserNotes - Book 5