

Test Bank for Introduction to Derivatives and Risk Management 11th Chance

Chapter 1 - Introduction

True / False

1. Options, forwards, swaps, and futures are financial assets.

- a. True
- b. False

ANSWER: False

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

2. A risk premium is the additional return investors expect for assuming risk.

- a. True
- b. False

ANSWER: True

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.05 - Identify the role that derivative markets play through their four main advantages.

KEYWORDS: Bloom's: Remember

3. Derivatives permit investors to manage their risk more efficiently.

- a. True
- b. False

ANSWER: True

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

KEYWORDS: Bloom's: Remember

4. The law of one price states that the price of an asset cannot change.

- a. True
- b. False

ANSWER: False

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.4 - Fundamental Linkages Between Spot and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.04 - Explain the relationship between spot and derivative markets through the mechanisms of arbitrage, storage, and delivery.

Chapter 1 - Introduction

KEYWORDS: Bloom's: Remember

5. Derivative markets make stock and bond markets more efficient.

- a. True
- b. False

ANSWER: True

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.05 - Identify the role that derivative markets play through their four main advantages.

KEYWORDS: Bloom's: Understand

6. Swaps, like options, trade on organized exchanges.

- a. True
- b. False

ANSWER: False

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

KEYWORDS: Bloom's: Remember

7. The theoretical fair value is the only value an asset can have.

- a. True
- b. False

ANSWER: False

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.03 - Define the important concept of theoretical fair value, which will be used throughout the book.

KEYWORDS: Bloom's: Understand

8. Short selling is a high risk activity.

- a. True
- b. False

ANSWER: True

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.02 - Review the concepts of risk preference, short selling, repurchase agreements, the risk–return relationship, and market efficiency.

KEYWORDS: Bloom's: Understand

Chapter 1 - Introduction

9. Uncertainty of future sales and cost of inputs are examples of financial risks businesses may face.

- a. True
- b. False

ANSWER: False

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.02 - Review the concepts of risk preference, short selling, repurchase agreements, the risk–return relationship, and market efficiency.

KEYWORDS: Bloom's: Understand

10. A call option on a futures contract gives the buyer the right to buy a futures contract.

- a. True
- b. False

ANSWER: True

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

KEYWORDS: Bloom's: Remember

Multiple Choice

11. Cash markets are also known as

- a. speculative markets.
- b. spot markets.
- c. derivative markets.
- d. dollar markets.
- e. equity markets.

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

KEYWORDS: Bloom's: Remember

12. A call option gives the holder

- a. the right to buy something.
- b. the right to sell something.
- c. the obligation to buy something.
- d. the obligation to sell something.
- e. the right to sell something and the obligation to buy something.

ANSWER: a

Chapter 1 - Introduction

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

KEYWORDS: Bloom's: Understand

13. Which of the following instruments are contracts but are not securities?

- a. Stocks
- b. Options
- c. Swaps
- d. Futures contracts
- e. Forward contracts

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

KEYWORDS: Bloom's: Understand

14. The positive relationship between risk and expected return is known as

- a. the risk–return tradeoff.
- b. diversification.
- c. market efficiency.
- d. arbitrage.
- e. the law of one price.

ANSWER: a

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.02 - Review the concepts of risk preference, short selling, repurchase agreements, the risk–return relationship, and market efficiency.

KEYWORDS: Bloom's: Understand

15. A transaction in which an investor holds a position in the spot market and sells a futures contract or writes a call is

- a. a gamble.
- b. a speculative position.
- c. a hedge.
- d. a risk-free transaction.
- e. a short position..

ANSWER: c

POINTS: 1

DIFFICULTY: Moderate

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

Chapter 1 - Introduction

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.05 - Identify the role that derivative markets play through their four main advantages.

KEYWORDS: Bloom's: Remember

16. Which of the following is an advantage of derivatives?
- Lower transaction costs than securities and commodities
 - Reveal information about expected prices and volatility
 - Help control risk
 - Make spot prices stay closer to their true values
 - Lower transaction costs than securities and commodities, reveal information about expected prices and volatility, help control risk, and make spot prices stay closer to their true values

ANSWER: e

POINTS: 1

DIFFICULTY: Moderate

REFERENCES: 1.5 - Role of Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.05 - Identify the role that derivative markets play through their four main advantages.

KEYWORDS: Bloom's: Understand

17. A forward contract has which of the following characteristics?
- Has a buyer and a seller
 - Trades on an organized exchange
 - Has a daily settlement
 - Gives the right but not the obligation to buy
 - Has a buyer and a seller, trades on an organized exchange, has a daily settlement, and gives the right but not the obligation to buy

ANSWER: a

POINTS: 1

DIFFICULTY: Moderate

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

KEYWORDS: Bloom's: Understand

18. Which feature distinguishes futures contracts from forward contracts?
- Futures contracts are customized agreements negotiated privately.
 - Futures contracts involve daily settlement of gains and losses (marking to market).
 - Forward contracts require daily margin payments to an exchange.
 - Futures contracts cannot be used to hedge risk.
 - Forward contracts always trade on organized exchanges.

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward

Chapter 1 - Introduction

contracts, futures contracts, and swaps.

KEYWORDS: Bloom's: Remember

19. Investors who do not consider risk in their decisions are said to be

- a. speculating.
- b. short selling.
- c. risk neutral.
- d. traders.
- e. hedgers.

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.02 - Review the concepts of risk preference, short selling, repurchase agreements, the risk–return relationship, and market efficiency.

KEYWORDS: Bloom's: Remember

20. Which of the following statements is not true about the law of one price?

- a. Investors prefer more wealth to less.
- b. Investments that offer the same return in all states must pay the risk-free rate.
- c. If two investment opportunities offer equivalent outcomes, they must have the same price.
- d. Investors are risk neutral.
- e. Given two investments, investors prefer one that performs at least as well in all states and better in at least one state.

ANSWER: d

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.4 - Fundamental Linkages Between Spot and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.04 - Explain the relationship between spot and derivative markets through the mechanisms of arbitrage, storage, and delivery.

KEYWORDS: Bloom's: Remember

21. Which of the following contracts obligates a buyer to buy or sell something at a later date?

- a. Call
- b. Futures
- c. Cap
- d. Put
- e. Swaption

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

KEYWORDS: Bloom's: Remember

Chapter 1 - Introduction

22. The process of selling borrowed assets with the intention of buying them back at a later date and lower price is referred to as

- a. longing an asset.
- b. asset flipping.
- c. shorting.
- d. anticipated price fall arbitrage.
- e. longing an asset and also as asset flipping.

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.02 - Review the concepts of risk preference, short selling, repurchase agreements, the risk–return relationship, and market efficiency.

KEYWORDS: Bloom's: Remember

23. In which one of the following types of contract between a seller and a buyer does the seller agree to sell a specified asset to the buyer today and then buy it back at a specified time in the future at an agreed future price?

- a. Repurchase agreement
- b. Short selling
- c. Swap
- d. Call
- e. Forward contract

ANSWER: a

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.02 - Review the concepts of risk preference, short selling, repurchase agreements, the risk–return relationship, and market efficiency.

KEYWORDS: Bloom's: Understand

24. The expected return minus the risk-free rate is called

- a. the risk premium.
- b. the percentage return.
- c. the asset's beta.
- d. the return premium.
- e. the discount rate

ANSWER: a

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.02 - Review the concepts of risk preference, short selling, repurchase agreements, the risk–return relationship, and market efficiency.

KEYWORDS: Bloom's: Remember

Chapter 1 - Introduction

25. When the law of one price is violated in that the same good is selling for two different prices, an opportunity for what type of transaction is created?

- a. Return-to-equilibrium transaction
- b. Risk-assuming transaction
- c. Speculative transaction
- d. Arbitrage transaction
- e. Hedging transaction

ANSWER: d

POINTS: 1

DIFFICULTY: Moderate

REFERENCES: 1.4 - Fundamental Linkages Between Spot and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.04 - Explain the relationship between spot and derivative markets through the mechanisms of arbitrage, storage, and delivery.

KEYWORDS: Bloom's: Analyze

26. Cash (spot) markets are characterized by

- a. delivery at a later date at a price agreed today
- b. no payment until expiration.
- c. immediate (or near-immediate) delivery and usually immediate payment.
- d. the right but not the obligation to transact.
- e. exchange of cash flows without exchanging the underlying.

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

27. Which of these best describes a derivative market?

- a. A market for ownership of real assets only
- b. A market for contractual instruments whose performance depends on another factor
- c. A market where securities create wealth directly
- d. A market where delivery must occur immediately
- e. A market limited to exchange-traded instruments only

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Understand

Chapter 1 - Introduction

28. An option is best described as

- a. an obligation to buy or sell later at a price set today.
- b. a right, but not an obligation, to buy or sell later at a price set today.
- c. a standardized exchange-traded forward with daily settlement.
- d. an agreement to exchange cash flows over time.
- e. a tradable claim on a group of assets.

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

29. A call option gives the buyer the right to

- a. sell the underlying at a fixed price.
- b. buy the underlying at a fixed price.
- c. exchange cash flows with a dealer.
- d. avoid paying any premium.
- e. settle daily based on price changes.

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

30. A put option gives the buyer the right to

- a. buy the underlying at a fixed price.
- b. sell the underlying at a fixed price.
- c. enter a forward contract with no obligation.
- d. swap interest-rate payments.
- e. trade only in spot markets.

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

Chapter 1 - Introduction

31. Compared with options, a forward contract requires
- a. the buyer to have a right but no obligation.
 - b. both parties to have an obligation to transact at the future date.
 - c. standardization and exchange trading.
 - d. daily settlement of gains and losses.
 - e. payment of a premium to the seller.

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDR.M.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

32. Which feature most clearly distinguishes futures from forwards?
- a. Futures give rights but not obligations.
 - b. Futures are customized OTC contracts.
 - c. Futures trade on organized exchanges and are subject to daily settlement.
 - d. Futures always require physical delivery of the underlying.
 - e. Futures are a claim on a group of assets.

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDR.M.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

33. A swap is best described as a contract in which two parties
- a. agree to exchange cash flows.
 - b. exchange ownership of a group of assets.
 - c. buy and sell immediately in the spot market.
 - d. obtain the right (but not obligation) to transact later.
 - e. must settle gains and losses daily on an exchange.

ANSWER: a

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.1 - Derivative Markets and Instruments

LEARNING OBJECTIVES: IDR.M.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

Chapter 1 - Introduction

34. In derivatives markets, the word “underlying” is used as a noun mainly because
- a. all derivatives are written on stocks and bonds.
 - b. the underlying must always be a tradable security.
 - c. it avoids implying the reference item is always an “asset.”
 - d. it makes derivatives legally enforceable contracts.
 - e. it guarantees the derivative has intrinsic value.

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.2 - The Underlying Asset

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

35. Which of the following is NOT necessarily an “asset” yet can still serve as the underlying of a derivative?
- a. Common stock
 - b. Corporate bond
 - c. Foreign currency
 - d. Weather (e.g., temperature)
 - e. Gold

ANSWER: d

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.2 - The Underlying Asset

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.01 - Explain the different types of derivatives: options, forward contracts, futures contracts, and swaps.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

36. Which set of presuppositions is identified as necessary for well-functioning financial markets?
- a. Low inflation, balanced budgets, and free trade
 - b. Clear rule of law, well-defined property rights, and a culture of trust
 - c. High stock returns, deep capital markets, and flexible exchange rates
 - d. Strong unions, government ownership, and strict price controls
 - e. Low interest rates, high savings, and rapid population growth

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.02 - Review the concepts of risk preference, short selling, repurchase agreements, the risk–return relationship, and market efficiency.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

Chapter 1 - Introduction

37. A game pays \$8 with probability 0.5 and \$4 with probability 0.5. What is the expected payoff?

- a. \$4.00
- b. \$5.00
- c. \$6.00
- d. \$7.00
- e. \$8.00

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.02 - Review the concepts of risk preference, short selling, repurchase agreements, the risk–return relationship, and market efficiency.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Apply

38. If the expected payoff is \$6.00 but you would only pay \$5.60 to play, the risk premium is

- a. \$0.00
- b. \$0.40
- c. \$0.60
- d. \$1.40
- e. \$5.60

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.02 - Review the concepts of risk preference, short selling, repurchase agreements, the risk–return relationship, and market efficiency.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Apply

39. Which of these best describes short selling?

- a. Buying a stock and holding it for the long run
- b. Selling a stock you do not own by borrowing it, hoping to buy it back later at a lower price
- c. Buying a call option to profit from a price increase
- d. Selling stock only after you have received dividends
- e. Purchasing stock on margin to increase expected return

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.02 - Review the concepts of risk preference, short selling, repurchase agreements, the risk–return relationship, and market efficiency.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Understand

Chapter 1 - Introduction

40. Which of the following is an example of having the equivalent of a short sale, even if you did not borrow stock?
- a. Owning a stock outright (a long position)
 - b. Buying a bond and holding it to maturity
 - c. Having an obligation to purchase an asset at a later date at a set price
 - d. Buying a put option
 - e. Receiving dividends on a stock you own

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.02 - Review the concepts of risk preference, short selling, repurchase agreements, the risk–return relationship, and market efficiency.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

41. Which of these best describes a repurchase agreement (repo)?
- a. A contract where a buyer purchases an asset and the seller has no future obligation
 - b. A contract where a seller sells an asset today and agrees to repurchase it later at a pre-agreed price
 - c. A contract that gives the buyer the right, but not the obligation, to buy an asset later
 - d. A permanent exchange of one asset for another with no cash involved
 - e. A contract used only for high-risk securities like junk bonds

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.02 - Review the concepts of risk preference, short selling, repurchase agreements, the risk–return relationship, and market efficiency.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

42. In derivative pricing, the repo rate is important because it
- a. equals the stock's expected return.
 - b. measures the volatility of the underlying asset.
 - c. approximates a dealer's marginal cost of borrowing/lending and is often close to a government rate due to collateral.
 - d. guarantees arbitrage profits for traders.
 - e. replaces the need for risk-free rates in valuation models.

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.02 - Review the concepts of risk preference, short selling, repurchase agreements, the risk–return relationship, and market efficiency.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

Chapter 1 - Introduction

43. A market is considered efficient when

- a. investors can consistently earn above-average returns with little effort.
- b. prices fully reflect instruments' true economic values, so abnormal risk-adjusted profits are not consistently possible.
- c. prices change slowly and predictably over time.
- d. only professional investors can trade successfully.
- e. government regulation sets prices near their intrinsic values.

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.03 - Define the important concept of theoretical fair value, which will be used throughout the book.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

44. In this text, the term used for an asset's "true economic value" is

- a. book value.
- b. liquidation value.
- c. theoretical fair value.
- d. par value.
- e. face value.

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.03 - Define the important concept of theoretical fair value, which will be used throughout the book.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

45. The effectiveness of valuation models (e.g., CAPM, APT, derivative pricing models) in producing "fair value" depends largely on the assumption that

- a. investors are always risk seeking.
- b. markets are inefficient and mispricing is common.
- c. the underlying market is efficient and information is quickly incorporated into prices.
- d. interest rates are constant over time.
- e. dividends are predictable.

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.3 - Important Concepts in Financial and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.03 - Define the important concept of theoretical fair value, which will be used throughout the book.

Chapter 1 - Introduction

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

46. Arbitrage is best described as

- a. buying a risky asset and holding it for the long run.
- b. profiting from the same good selling at two different prices by buying low and selling high.
- c. earning a high return by taking on high risk.
- d. buying an asset because its price is expected to rise.
- e. reducing risk by holding many different assets.

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.4 - Fundamental Linkages Between Spot and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.04 - Explain the relationship between spot and derivative markets through the mechanisms of arbitrage, storage, and delivery.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

47. Asset A1 pays \$120 in state 1 and \$90 in state 2. Asset A2 pays \$40 in state 1 and \$30 in state 2. Based on the law of one price, which statement is correct?

- a. A1 should be priced lower than A2 because it is riskier.
- b. A1 is equivalent to three shares of A2.
- c. A2 is equivalent to three shares of A1.
- d. A1 and A2 must have the same price.
- e. A1 and A2 are not comparable because states are uncertain.

ANSWER: b

POINTS: 1

DIFFICULTY: Moderate

REFERENCES: 1.4 - Fundamental Linkages Between Spot and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.04 - Explain the relationship between spot and derivative markets through the mechanisms of arbitrage, storage, and delivery.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Apply

48. Suppose A1 sells for \$95 and A2 sells for \$31. Which trade is an arbitrage (risk-free profit) according to the passage?

- a. Buy 1 share of A1 and sell 3 shares of A2.
- b. Buy 3 shares of A2 and short-sell 1 share of A1.
- c. Buy 1 share of A1 and buy 1 share of A2.
- d. Short-sell 3 shares of A2 and buy 1 share of A1.
- e. Do nothing because the prices are close.

ANSWER: b

POINTS: 1

DIFFICULTY: Moderate

REFERENCES: 1.4 - Fundamental Linkages Between Spot and Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.04 - Explain the relationship between spot and derivative markets

Chapter 1 - Introduction

through the mechanisms of arbitrage, storage, and delivery.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Apply

49. Derivative market participants who use derivatives to reduce the risk of owning spot items are called
- arbitrageurs.
 - dealers.
 - hedgers.
 - speculators.
 - market makers.

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.5 - Role of Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.05 - Identify the role that derivative markets play through their four main advantages.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

50. Derivative markets often have greater liquidity than spot markets mainly because
- derivatives always trade on a single exchange.
 - derivatives require less capital, so markets can absorb high-volume trades more easily.
 - spot markets are illegal for large trades.
 - liquidity is created by dividends paid on derivatives.
 - liquidity is higher only when interest rates are falling.

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.5 - Role of Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.05 - Identify the role that derivative markets play through their four main advantages.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

51. One role of derivative markets is to facilitate short selling because
- short selling is banned in spot markets but allowed in derivatives.
 - derivatives impose fewer restrictions than securities markets for taking short positions.
 - short selling always produces risk-free profits.
 - only hedgers are allowed to sell short.
 - short selling is unnecessary when markets are efficient.

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.5 - Role of Derivative Markets

Chapter 1 - Introduction

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.05 - Identify the role that derivative markets play through their four main advantages.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

52. How do derivative markets support price discovery?

- a. Options prices directly forecast future spot prices.
- b. Spot markets use futures prices to set accounting values.
- c. Derivative prices are fixed by regulators to reduce volatility.
- d. Price discovery occurs only when markets are inefficient.
- e. Futures markets aggregate dispersed spot-market information into a consensus price, often using the nearby contract.

ANSWER: e

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.5 - Role of Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.05 - Identify the role that derivative markets play through their four main advantages.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

53. Derivative markets can improve market efficiency by

- a. preventing arbitrage activity.
- b. raising transaction costs to deter trading.
- c. enabling low-cost arbitrage that quickly corrects temporary mispricing between spot and derivative prices.
- d. ensuring all investors hold identical beliefs.
- e. removing uncertainty about future spot prices.

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.5 - Role of Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.05 - Identify the role that derivative markets play through their four main advantages.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

54. Derivative markets primarily allow the

- a. creation of new wealth through productive investment.
- b. transfer of risk from one party to another.
- c. elimination of risk from the economy.
- d. permanent increase of risk in the economy.
- e. replacement of financial markets.

ANSWER: b

POINTS: 1

DIFFICULTY: Easy

Chapter 1 - Introduction

REFERENCES: 1.6 - Criticisms of Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.06 - Address some criticisms.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

55. For hedgers to reduce risk in derivative markets, these markets typically require

- a. auditors willing to verify contracts.
- b. regulators willing to set prices.
- c. market makers who only hedge.
- d. speculators willing to assume risk.
- e. insurers who provide guarantees.

ANSWER: d

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.6 - Criticisms of Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.06 - Address some criticisms.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

56. Compared with stock markets, derivative markets generally

- a. create wealth by funding new business ideas.
- b. destroy wealth through negative-sum trading.
- c. neither create nor destroy wealth, but redistribute risk.
- d. always increase total risk in the economy.
- e. reduce the need for any underlying transactions.

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.6 - Criticisms of Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.06 - Address some criticisms.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

57. A key characteristic of derivative markets is that

- a. one party's gains are another's losses.
- b. everyone can gain at the same time.
- c. losses are always capped for both parties.
- d. they add new capital directly to firms.
- e. they function only when participants hold the underlying good.

ANSWER: a

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.6 - Criticisms of Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.06 - Address some criticisms.

Chapter 1 - Introduction

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Understand

58. The text argues that derivatives differ from gambling because derivatives
- benefit only the participants who trade.
 - have no effect on market efficiency.
 - always guarantee profits to hedgers.
 - primarily involve people who know nothing about the underlying.
 - can improve market efficiency and expand risk-management opportunities that spill over to society.

ANSWER: e

POINTS: 1

DIFFICULTY: Moderate

REFERENCES: 1.6 - Criticisms of Derivative Markets

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.06 - Address some criticisms.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Understand

59. Derivatives are described as “powerful instruments” primarily because they
- eliminate risk from the economy.
 - guarantee profits to hedgers.
 - have high leverage, so small price changes can cause large gains or losses.
 - require owning the underlying asset to trade.
 - always increase market liquidity.

ANSWER: c

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.7 - Misuses of Derivatives

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.06 - Address some criticisms.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Remember

60. Even knowledgeable users face risk because they may
- refuse to hedge and only diversify.
 - confuse spot markets with futures markets.
 - underestimate taxes on derivative gains.
 - speculate when they should be hedging, often due to overconfidence in forecasts.
 - avoid efficient-market assumptions entirely by holding cash.

ANSWER: d

POINTS: 1

DIFFICULTY: Easy

REFERENCES: 1.7 - Misuses of Derivatives

LEARNING OBJECTIVES: IDRM.CHANCE.27.01.06 - Address some criticisms.

NATIONAL STANDARDS: United States - BUSPROG: Analytic

KEYWORDS: Bloom's: Understand

Chapter 1 - Introduction