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QUESTION 1

The major difference between venture capital and conventional financing is that

A. the interest rate of venture capital is much higher than conventional financing.

B. venture capital is more than investing, it builds companies.

C. All of these answers are correct.

D. None of these answers.

E. venture capital will provide equity ownership, conventional financing will not.

Correct Answer: B

The difference between venture capital and conventional financing is that venture capital is more than investing and more than building personal wealth, it builds companies.

QUESTION 2

With regard to real estate, all properties must be included in at least one _____.

A. account

B. investment type

C. composite

D. sector

E. portfolios

Correct Answer: C

Consistent with the general requirements for all composites, all properties with discretionary fee-paying investors must be included in at least one account. Because of the unique nature of individual real estate investments, however, composites containing single properties are appropriate in many cases.

QUESTION 3

What is the value of a preferred stock with company earnings of $30 and a required rate of return of 10%?

A. $600

B. $283

C. $129

D. $300

E. Not enough information

Correct Answer: E

The value of a preferred stock is the present value of its dividends, which is equal to the annual dividend divided by the required rate of return. Since the annual dividend is not given, one cannot answer this question.

QUESTION 4

Delphinium Inc.\\'s target capital structure has a debt ratio of 60 percent. The firm can raise up to $100,000 in new debt at a before-tax cost of 8.5 percent. If more than $100,000 of debt is required, the cost will be 9 percent. Net income last year was $100,000, and it is expected to continue to grow each year at a rate of 10 percent indefinitely. The firm expects to maintain its dividend payout ratio of 40 percent on the 10,000 shares of common stock outstanding. If it must sell new common stock, it would encounter a 15 percent flotation cost on the first $400,000, and a 20 percent cost if more than $400,000 of new outside equity is required. Delphinium\\'s tax rate is 30 percent, and its current stock price is $88 per share. The firm has an unlimited number of projects, which will earn a 10.25 percent return. What is this year\\'s capital budget if the firm invests to the point where the Marginal Cost of Capital (MCC) intersects the Investment Opportunity Schedule (IOS)?

A. The company has an infinite capital budget.

B. $1,000,000

C. $1,165,000

D. $400,000

E. $1,150,000

Correct Answer: C

Step 1 Find the break points for the problem. There will be three break points: one for retained earnings,

one for debt, and one for the change in flotation costs of new stock.

Step 2 Calculate the component costs of capital:

We know NI = $100,000 and there are 10,000 shares, therefore E(0) = $100,000/10,000 = $10. Also, the

payout ratio is 40% so D(0) is $4. D(1) = D(0)(1 + g) = $4(1.1) = $4.40.

k(s) = D1/P0 + g = $4.40/$88 + 10% = 15%.

ke(1) = D1/P0(1 - F1) + g = $4.40/$88(1 - 0.15) + 10% = 15.88%.

ke(2) = D1/P0(1 - F2) + g = $4.40/$88(1 - 0.20) + 10% = 16.25%.

kd(1) = 8.5%(1 - T) = 8.5%(0.7) = 5.95%.

kd(2) = 9%(1 - T) = 9%(0.7) = 6.30%.

Step 3 Calculate the marginal costs of capital:

MCC(1) = w(ce)k(s) + w(d)k(d1) = 0.4(15.00%) + 0.6(5.95%) = 9.57%.

MCC(2) = w(ce)k(e1) + w(d)k(d1) = 0.4(15.88%) + 0.6(5.95%) = 9.92%.

MCC(3) = w(ce)k(e1) + w(d)k(d2) = 0.4(15.88%) + 0.6(6.30%) = 10.13%.

MCC(4) = w(ce)k(e2) + w(d)k(d2) = 0.4(16.25%) + 0.6(6.30%) = 10.28%.

MCC Applicable Range

1$0 through $165,000

2$165,000 - $166,667

3$166,667 - $1,165,000

4over $1,165,000

Since the IRR of all projects is given as 10.25% the point where the MCC intersects the IOS is $1,165,000,

where the MCC jumps from 10.13% to 10.28%.

QUESTION 5

A random variable can take on four values: 12, 36, 78, 111, each with probability 0.25. The standard deviation of the random variable equals _____.

A. 152.4

B. 49.3

C. 1,451

D. 38.1

Correct Answer: D

Since all the observations occur with equal probability, the mean of the observations is (12 + 36 + 78 + 111)*0.25 = 59.25. The variance is then given by 0.25*([12-59.25]^2 + [36-59.25]^2 + [78-59.25]^2 + [11159.25]^2) = 1451. The standard deviation is equal to sqrt(1451) = 38.1.

QUESTION 6

Greg Burns, CFA, manages a portfolio, P, with expected return equal to 10% and standard deviation equal to 20%. The risk-free rate is 5%. Burns advises Victoria Hull to invest 40% in portfolio P and the remainder in the risk-free asset. The standard deviation for Hull\\'s overall investment will be:

A. 7%.

B. 8%.

C. 12%.

Correct Answer: B

QUESTION 7

Howard Keane is a strategist for Dove Investments. His models indicate that the expected inflation rate will be 3.0%. The real rate of return on the SandP 500 index is expected to be 8.7%, while the real rate of return on U.S. Treasury notes is expected to be 1.0%. Howard is interested in the current equity risk premium. Based on the information above, the equity risk premium is closest to:

A. 4%.

B. 6%.

C. 8%.

Correct Answer: C

QUESTION 8

Suppose the average stock price in the above example were 40. How many shares will be used in the calculation of Diluted EPS now?

A. none of these answers

B. 1,250,000

C. 1,208,333

D. 1,300,000

Correct Answer: C

Since the average stock price now exceeds the strike price, the warrants are assumed converted. The proceeds from the exercise equal 800,000*35 = 28 million. The Treasury Stock method assumes a purchase of shares at 40 using these proceeds. Thus, the number of shares repurchased = 28,000,000/40 = 700,000. Thus, the additional shares arising from warrant exercise equals 800,000 - 700,000 = 100,000. Now, in the Treasury Stock method, options and warrants are assumed to be exercised at the beginning of the period or at the time of issuance, whichever is later. Thus, in this case, the addition 100,000 shares have been outstanding since May 31, 1998. So the weighted number of shares for Diluted EPS = 1 million

+ 200,000*9/12 + 100,000*7/12 = 1,208,333 shares.

QUESTION 9

The Oneonta Chemical Company is evaluating two mutually exclusive pollution control systems. Since the company\\'s revenue stream will not be affected by the choice of control systems, the projects are being evaluated by finding the PV of each set of costs. The firm\\'s required rate of return is 13 percent, and it adds or subtracts 3 percentage points to adjust for project risk differences. System A is judged to be a high-risk project (it might end up costing much more to operate than is expected). System A\\'s risk-adjusted cost of capital is

A. 16 percent; since A is more risky, its cash flows should be discounted at a higher rate, because this correctly penalizes the project for its high risk.

B. indeterminate, or, more accurately, irrelevant, because for such projects we would simply select the process that meets the requirements with the lowest required investment.

C. 13 percent; the firms cost of capital should not be adjusted when evaluating outflow only projects.

D. somewhere between 10 percent and 16 percent, with the answer depending on the riskiness of the relevant inflows.

E. 10 percent; this might seem illogical at first, but it correctly adjusts for risk where outflows, rather than inflows, are being discounted.

Correct Answer: E

k(A) = 13% - 3% = 10%. If the cash flows are cost only outflows, and the analyst wants to correctly reflect their risk, the discount rate should be adjusted downward (in this case by subtracting 3 percentage points) to make the discounted flows comparatively larger.

QUESTION 10

Given the following choices, what is the optimal capital structure for Chip Co.? (Assume that the company\\'s growth rate is 2 percent.)

Debt Ratio Dividends Per Share ($) Cost of Equity 0%5.5011.5% 256.0012.0 406.5013.0 507.0014.0 757.5015.0

A. 50% debt; 50% equity

B. 40% debt; 60% equity

C. 25% debt; 75% equity

D. 75% debt; 25% equity

E. 0% debt; 100% equity

Correct Answer: C

First, calculate the stock price for each debt level using the dividend growth model, Po = D1/(ks - g).

Debt Div/share ksPo

0%$5.5011.5% $5.50/(0.115 - 0.02) = $57.89.

25%6.0012%$6.00/(0.12 - 0.02) = $60.00.

40%6.5013%$6.50/(0.13 - 0.02) = $59.09.

50%7.0014%$7.00/(0.14 - 0.02) = $58.33.

75%7.5015%$7.50/(0.15 - 0.02) = $57.69.

Clearly, $60.00 is the highest price, so 25% debt and 75% equity is the optimal capital structure.

QUESTION 11

Which of the following statements about Arbitrage Pricing Theory (APT) and the Capital Asset Pricing Model (CAPM) is FALSE?

A. APT can equal CAPM.

B. In both the APT and the CAPM, the risk-free rate is added to a premium for risk factor (X) and the responsiveness of the asset\\'s returns to factor (X).

C. If zero-investment arbitrage does not hold, the APT does not hold.

D. APT is a multi-factored model with restrictive assumptions.

Correct Answer: D

Arbitrage Pricing Theory is a multifactored model with few limiting assumptions. More than one risk factor is able to influence security prices. The other statements are true. Arbitrage Pricing Theory can equal the Capital Asset Pricing Model (CAPM) if there is only one risk factor ?market risk. Zero-investment arbitrage is an assumption of the APT. More specifically, zero-investment arbitrage means that if an investor buys an overpriced security, the investor has access to the short-sale money needed to buy an underpriced security.

QUESTION 12

What is the value of a preferred stock with a par value of $150, an annual dividend equal to 15% of par value, and a required rate of return of 12%?

A. $150.00

B. $187.50

C. Not enough information

D. $123.49

E. 230.54

Correct Answer: B

The value of a preferred stock is the present value of its dividends, which is equal to the annual dividend divided by the required rate of return. In this question, the annual dividend is equal to 150 x .15 = $22.5, and the preferred stock is worth $22.5/0.12 = $187.50

QUESTION 13

Kruskal Meriwether is a senior research analyst with Bellwether Advisors. He has been following Crystals and Candles a publicly traded firm which makes high-quality diamond jewelry. Kruskal, after extensive interviews with senior management at Crystals, has inferred that the firm is about to take over a diamond-mining firm in South Africa at a rock-bottom price. The Crystal management has refused to explicitly confirm or deny this but Kruskal firmly believes that such a deal is in the works. He has not used any inside information; just pieced together information from various avenues to come to this conclusion. In his reports, he states, "All my research seems to indicate that Crystal and Candles is likely to buy a South African diamond producer at a bargain price. Clearly, now is the time to buy Crystal and Candles\\' stock." 2 weeks after his report is released, Crystal\\'s management announces that it has no intentions of making any acquisitions in the near future. This leads to a 7% decline in Crystal\\'s stock, causing a large decline in the accounts of Kruskal\\'s clients. Kruskal has

A. violated Standard IV (A.1) - Reasonable Basis and Representation.

B. not violated any AIMR code in this incident.

C. violated Standard IV (B.2) - Portfolio Investment Recommendations and Actions.

D. violated Standard IV (B.1) - Fiduciary Duties.

Correct Answer: B

Kruskal\\'s recommendations were not based on whim, unsubstantiated rumors or inside information. It is clear that he put in much research behind his recommendation. The fact that his recommendation turned out to an incorrect choice ex post does not mean he was negligent. An investment advisor cannot be expected to be correct 100% of the time. What is expected of them is professional competence and diligence (Code of Ethics). Nothing in this incident indicates that Kruskal lacked either of these.

QUESTION 14

The contents of the section of the annual report entitled "Management\\'s Discussion and Analysis" (MDandA) are

A. mandated by regulations of the SEC.

B. mandated by pronouncements of the Financial Accounting Standards Board (FASB).

C. reviewed by independent auditors.

D. mandated by regulations of the Internal Revenue Service.

E. none of these answers.

Correct Answer: A

The contents of the MDandA section are mandated by the SEC and not FASB.

QUESTION 15

Chances are 50-50 that a newborn baby will be a girl. For families with five children, what is the probability that all the children are girls?

A. 0.100

B. None of these answers

C. 0.250

D. 0.001

E. 0.031

Correct Answer: E

This is a binomial probability. The probability of getting r successes out of n trials where the probability of success each trial is p and probability of failure each trial is q (where q = 1-p) is given by: n!(p^r)[q^(n-r)]/r! (n-r)!. Here n = 5, r = 5,p =

0.5 and q = 0.5. Therefore we have 5!(0.5^5)(0.5^0)/5!0! = 0.03125.