Chapter 1
The Investment Environment

1.1 Learning Goal 1

1) Almost half of Americans own stock or stock mutual funds.

Answer: TRUE
Question Status: New

2) A United States Savings Bond is an example of an investment as defined in the text.

Answer: TRUE
Question Status: New

3) An example of a direct investment is the purchase of mutual fund shares.

Answer: FALSE
Question Status: Previous Edition

4) Which of the following is an investment as defined in the text?

A) automobile insurance

B) a new automobile

C) a United States Saving Bond

D) All of the above

Answer: C
Question Status: New

5) Stocks are a(n) ________ investment representing ________ of a business.

A) direct; ownership

B) direct; debt

C) indirect; ownership

D) indirect; debt

Answer: A
Question Status: Previous Edition

6) Debt represents funds loaned in exchange for

A) dividend income and the repayment of the loan principal.

B) dividend income and an ownership interest in the firm.

C) interest income and a partial ownership interest in the firm.

D) interest income and the repayment of the loan principal.

Answer: D
Question Status: Previous Edition

1.2 Learning Goal 2

1) Institutional investors manage money for businesses and nonprofit organizations, but not for individuals.

Answer: FALSE

Question Status: New

2) In the financial markets, individuals are net suppliers of funds.

Answer: TRUE
Question Status: Revised

3) The government is generally

A) not involved in the financial markets.

B) the owner of the financial market.

C) a supplier of funds to the financial market.

D) a demander of funds in the financial market.

Answer: D
Question Status: Previous Edition

4) On a net basis, funds in the financial markets are generally supplied by

A) individuals.

B) both individuals and business firms.

C) business firms.

D) the government.

Answer: A
Question Status: Previous Edition

5) A forum in which suppliers and demanders of funds make financial transactions is called a financial

A) institution.

B) bank.

C) instrument.

D) market.

Answer: D
Question Status: Previous Edition

6) Which of the following are true concerning institutional investors?
   I. Institutional investors are professionals who manage money for other people.
   II. Banks, insurance companies and mutual funds are all institutional investors.
   III. Institutional investors are very knowledgeable about the financial markets.
   IV. Institutional investors invest large sums of money.

   A) I and II only

   B) I, II and IV only

   C) II, III and IV only

   D) I, II, III and IV

   Answer: D
   Question Status: Previous Edition

7) Explain the differences between stocks, bonds, and options.

   Answer: Stocks are equity securities and represent ownership of a business. Bonds are debt securities and represent a liability of a business. Options are derivative securities and represent neither ownership nor debt of a business. While stocks are issued by corporations, and bonds are issued by corporations and governmental units, options are issued by individual investors.
   Question Status: Previous Edition

1.3 Learning Goal 3

1) Common stock is a type of debt instrument.

   Answer: FALSE
   Question Status: Previous Edition

2) A collection of securities designed to meet an investment goal is called a portfolio.

   Answer: TRUE
   Question Status: Previous Edition

3) The value of a derivative security is based on the value of an underlying security.

   Answer: TRUE
   Question Status: Previous Edition

4) An option is a type of equity security.

   Answer: FALSE
   Question Status: Previous Edition

5) Bonds represent a higher level of risk than do stocks in the same company.

   Answer: FALSE
   Question Status: Previous Edition

6) Speculation refers to high-risk investments which offer highly uncertain returns and future value.

Answer: TRUE
Question Status: Previous Edition

7) Some foreign investments may provide higher returns or lower risk than purely domestic investments.

Answer: TRUE
Question Status: Previous Edition

8) Bond prices decline as interest rates decline.

Answer: FALSE
Question Status: Previous Edition

9) The periodic payment that a corporation pays to its shareholders from net earnings is called a capital gain.

Answer: FALSE
Question Status: Previous Edition

10) Real estate, stocks, and gold coins are all examples of tangible assets.

Answer: FALSE
Question Status: Previous Edition

11) Diversification in a portfolio increases risks.

Answer: FALSE
Question Status: Previous Edition

12) Which one of the following would be the LEAST liquid investment?

A) stock

B) series EE bond

C) money market mutual fund

D) real estate

Answer: D
Question Status: Previous Edition

13) As the number of investments in a portfolio increases, the risk of the portfolio ________

A) increases.

B) decreases.

C) stays the same.

D) is eliminated.

Answer: B
Question Status: New

14) Susie purchased a stock one year ago at a price of $24 a share. In the past year, she has received four quarterly dividends of $0.50 each. Today she sold the stock for $27 a share. The amount of capital gain per share is

A) $2.00.

B) $3.00.

C) $4.00.

D) $5.00.

Answer: B
Question Status: Previous Edition

15) American Depository Receipts os ADR's are a way for:
I. Americans to invest in foreign stocks.
II. Foreigners to invest in American stocks.
III. Accounts held by foreigners in American banks.
IV. Accounts held by Americans in foreign banks.

A) I only

B) I and II only

C) III only

D) III and IV only

Answer: A
Question Status: New

1.4 Learning Goal 4

1) Short-term capital gains are taxed at the taxpayer's marginal tax rate.

Answer: TRUE
Question Status: Previous Edition

2) Earning a high rate of return with little or no risk is a realistic investment goal.

Answer: FALSE
Question Status: New

3) All earnings other than wages are classified as capital gains.

Answer: FALSE
Question Status: New

4) Investors can postpone or avoid income taxes by investing through Individual Retirement Accounts.

Answer: TRUE
Question Status: New

5) Which of the following represent investment goals?
I. saving money for the down payment on a home
II. sheltering income from taxes
III. increasing current income
IV. saving funds for retirement

A) I and IV only

B) I, III and IV only

C) III and IV only

D) I, II, III and IV

Answer: D
Question Status: Previous Edition

6) In selecting investments consistent with your goals, you should consider

A) rates of return and taxes only.

B) the pre-tax rate of return only.

C) annual dividends and taxes only.

D) risks, returns, and taxes.

Answer: D
Question Status: Previous Edition

7) Monitoring and restructuring your investments is called

A) diversification.

B) valuation.

C) portfolio management.

D) financial planning.

Answer: C
Question Status: Previous Edition

8) Wages, tips, pension income and alimony are examples of

A) portfolio income.

B) active income.

C) non-taxable income.

D) passive income.

Answer: B
Question Status: Previous Edition

Use the following tax rates and income brackets to answer the following question(s).

Tax Rates	Individual Returns	Joint Returns
10%	$0 to $7,550	$0 to $15,100
15%	$7,551 to $30,650	$15,101 to $61,300
25%	$30,651 to $74,200	$61,301 to $123,700
28%	$74,201 to $154,800	$123,701 to $188,450
33%	$154,801 to $336,550	$188,451 to $336,550
35%	Over $336,551	Over $336,551

9) Kurt and Faith earn a combined taxable income of $112,800 from employment and file a joint tax return. If they earn $1,000 in short-term capital gains, how much tax will they owe on those gains?

A) $100

B) $150

C) $250

D) $280

Answer: C
Question Status: Previous Edition

10) Isaac earned $69,700 in taxable income and files an individual tax return. What is the amount of Isaac's taxes for the year?

A) $11,045

B) $14,262

C) $17,425

D) $19,516

Answer: B
Question Status: Previous Edition

11) For a taxpayer in the 25% marginal tax bracket, a long-term capital gain will be taxed at

A) 5%.

B) 10%.

C) 15%.

D) 25%.

Answer: C
Question Status: Previous Edition

12) Thomas and Isabelle are in the 28% marginal tax bracket. Three years ago they purchased 100 shares of stock at $18 a share. Today they sold the 100 shares for $29 a share. What is the amount of federal income tax they owe as a result of this sale?

A) $55

B) $110

C) $165

D) $308

Answer: C
Question Status: Previous Edition

13) What is the maximum amount of net capital loss that can be applied against ordinary income in any one year for federal income taxes?

A) $0

B) $3,000

C) $5,000

D) $7,500

Answer: B
Question Status: Previous Edition

14) Under current tax law, dividend income is taxed at the same rate as

A) ordinary income.

B) short-term capital gains.

C) long-term capital gains.

D) interest income.

Answer: C
Question Status: New

15) Tax planning

A) guides investment activities to maximize after-tax returns over the long term for an acceptable level of risk.

B) ignores the source of income and concentrates solely on the amount of income.

C) is primarily done by individuals with incomes below $200,000.

D) is limited to reviewing income for the current year and determining how to minimize current taxes.

Answer: A
Question Status: Previous Edition

1.5 Learning Goal 5

1) Retirement plans, such as a 401(k), allow employees to defer taxes on the plan contributions until such time as the funds are withdrawn from the retirement plan.

Answer: TRUE
Question Status: Previous Edition

2) You should spend money on housing, clothing and basic insurance before investing.

Answer: TRUE
Question Status: Previous Edition

3) Growth oriented investments and speculative vehicles are preferred by

A) young investors.

B) middle-aged investors.

C) retired investors.

D) any age investor who prefers low risk.

Answer: A
Question Status: Previous Edition

4) Retirees seeking income prefer

A) growth-oriented common stock and certificates of deposit.

B) growth-oriented common stock and preferred stock.

C) preferred stock and options.

D) government bonds and low-risk income stocks.

Answer: D
Question Status: Previous Edition

5) Which one of the following statements about the economy is correct?

A) It is difficult to accurately predict movements in the stock market when the economy is at a peak.

B) A strong economy is associated with a declining business cycle.

C) Stocks tend to perform well in a weak economy.

D) The economic cycle has little effect on stocks.

Answer: A
Question Status: Previous Edition

6) Which of the following economic conditions is most difficult to identify:

A) recovery

B) expansion

C) recession

D) change in direction

Answer: D
Question Status: New

7) Explain the various states of the business cycle and explain how the cycle affects equity securities.

Answer: The business cycle consists of a trough, recovery/expansion, peak, and a decline/recession. Stocks perform well during improving economic periods and poorly during declining economic periods.
Question Status: Previous Edition

8) Discuss the general investment philosophy and the types of investments preferred by investors in each phase of the life cycle.

Answer:

Life Cycle Phase	**Philosophy**	**Types of Investments**
Young investors	Growth	Growth stocks, options, and futures
Middle-aged investors	Growth and income	Higher quality stocks, preferred stocks, convertibles, high-grade bonds, and mutual funds
Retired investors	Preservation of capital and current income	Low risk stocks, short-term bonds, certificates of deposit

Question Status: Previous Edition

1.6 Learning Goal 6

1) Liquidity is the ability to convert an investment into cash quickly with little or no loss of value.

Answer: TRUE
Question Status: Previous Edition

2) Money market accounts, certificates of deposit, bonds and commercial paper are all forms of short–term investment vehicles.

Answer: FALSE
Question Status: Previous Edition

3) Short–term investments are defined as those maturing in six months or less.

Answer: FALSE
Question Status: Previous Edition

4) Short–term investments generally provide liquidity, safety, and a high rate of return.

Answer: FALSE
Question Status: Previous Edition

5) Short–term investments
I. provide liquidity.
II. fill an important part of most investment programs.
III. provide a high rate of return with low risk.
IV. provide resources for emergencies.

A) I and IV only

B) II and IV only

C) I, II and IV only

D) I, II, III and IV

Answer: C
Question Status: Previous Edition

6) The primary risk associated with a short–term investment is

A) purchasing power risk.

B) default risk.

C) interest rate risk.

D) economic risk.

Answer: A
Question Status: Previous Edition

7) Which one of the following has the lowest level of risk?

A) commercial paper

B) money market mutual fund account

C) banker's acceptance

D) U.S. Treasury bill

Answer: D
Question Status: Previous Edition