CFA Institute CFA-Level-II Practice Questions

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Question 1

Question Type: MultipleChoice

William Bow, CFA, is a risk manager for GlobeCorp, an international conglomerate with operations in the technology, consumer products, and medical devices industries. Exactly one year ago, GlobeCorp, under Bow's advice, entered into a 3-year payer interest rate swap with semiannual floating rate payments based on the London interbank offered rate (LIBOR) and semiannual fixed rate payments based on an annual rate of 2.75%. At the time of initiation, the swap had a value of zero and the notional principal was set equal to $150 million. The counterparty to GlobeCorp's swap is NVS Bank, a commercial bank that also serves as a swap dealer. Exhibit 1 below summarizes the current LIBOR term structure.

Exhibit 1: Current LIBOR Term Structure

	Days							
	90	180	270	360	450	540	630	720
LIBOR	2.25%	2.45%	3.20%	3.75%	4.20%	3.80%	3.10%	2.40%

Upper management at GlobeCorp feels that the original swap has served its intended purpose but that circumstances have changed and it is now time to offset the firm's exposure to the swap. Because they cannot find a counterparty to an offsetting swap transaction, management has asked Bow to come up with alternative measures to offset the swap exposure. Bow created a report for the management team which outlines several strategies to neutralize the swap exposure. Two of his strategies are included in Exhibit 2.

Exhibit 2: Swap Neutralization Strategies

Strategy 1	*Strategy 2*
Establish short positions in a series of off-market LIBOR forward rate agreements including a 6 × 12 FRA, 12 × 18 FRA, 18 × 24 FRA, and 24 × 30 FRA with a notional principal of $150 million for each contract.	Sell a floating rate note with a semiannual coupon payment based on 180 day LIBOR, a maturity of two years, and a par value of $150 million.

After examining its long-term liabilities, NVS Bank has decided that it currently needs to borrow $100 million over the next two years to finance its operations. For this type of funding need, NVS generally issues quarterly coupon short-term floating rate notes based on 90-day LIBOR. NVS is concerned, however, that interest rates may shift upward and the LIBOR curve may become upward sloping. To manage this risk, NVS is considering utilizing interest rate derivatives. Managers at the bank have collected quotes on over-the-counter interest rate caps and floors from a well known securities dealer. The quotes, which are based on a notional principal of $100 million, are provided in Exhibit 3.

Exhibit 3: Interest Rate Caps and Floors

			Interest Rate Cap		Interest Rate Floor	
Term (Years)	LIBOR	Settlement	Rate	Price	Rate	Price
1	90-day	Quarterly	3.50%	$2,000,000	2.55%	$1,900,000
1	180-day	Semiannual	3.50%	$2,000,000	2.55%	$1,900,000
2	90-day	Quarterly	3.65%	$2,200,000	2.70%	$2,090,000
2	180-day	Semiannual	3.65%	$2,200,000	2.70%	$2,090,000

One of the managers at NVS Bank, Lois Green, has expressed her distrust of the securities dealer quoting prices on the caps and floors. In a memo to the CFO, Green suggested that NVS use an alternative but equivalent approach to manage the interest rate risk associated with its two-year funding plan. Following is an excerpt from Green's memo:

"Rather than using a cap or floor, NVS Bank can effectively manage its exposure to interest rates resulting from the 2-year funding requirement by taking long positions in a series of put options on fixed-income instruments with expiration dates that coincide with the payment dates on the floating rate note."

"As a cheaper alternative, NVS can effectively manage its exposure to interest rates resulting from the 2-ycar funding requirement by creating a collar using long positions in a series of call options on interest rates and long positions in a series of call options on fixed income instruments all of which would have expiration dates that coincide with the payment dates on the floating rate note."

Evaluate Green's comments in her memo to the managers at NVS Bank. State whether Green is correct regarding the effectiveness of the alternative to using an interest rate cap or floor and regarding the effectiveness of creating an artificial interest rate collar.

Options:

A- Green is only correct with respect to the artificial collar.
B- Green is only correct with respect to the cap or floor alternative.
C- Green is correct with respect to both the artificial collar and the cap or floor alternative.

Answer:

B

Explanation:

NVS Bank is concerned that interest rates will rise, increasing the interest expense on their 2-

year Boating rate notes. To mitigate this risk, an appropriate strategy would be to buy an interest rate cap which would limit the exposure to rising interest rates. Other instruments can replicate the payoffs of a cap, however, if the cap itself is not desirable. An interest rate cap increases in value as interest rates rise since a payoff to the buyer of the cap becomes more probable. Put options on fixed income instruments have a similar response to interest rates. As interest rates rise, the value of the underlying fixed income instruments decreases. Since a put option gives the owner the right to sell a bond that has decreased in price at higher than market value, the value of the option increases as interest rates rise. With the right amount of long put options on fixed income instruments, NVS Bank could replicate the cap payoff without actually buying the cap. Greens alternative to the cap or floor is therefore correct. To create a collar, NVS Bank would need to purchase a cap and sell a floor. Doing so would give NVS protection from rising interest rates and would decrease the cost of gaining such protection. However, a collar would create exposure to decreasing interest rates through the short floor position. A long cap position can be replicated through cither long put options on fixed income instruments or long call options on interest rates. A short floor position can be replicated either through short call options on fixed income instruments or short put options on interest rates. Green has correctly stated the long cap position but has incorrectly stated the short floor position. Therefore, the collar replication strategy is incorrect. (Study Session 17,LOS62.b)

Question 2

Question Type: MultipleChoice

Mary Pierce, CFA, has just joined The James Group as a fixed income security analyst. Pierce has taken over for Katy Williams, who left The James Group to start her own investment firm. Pierce has been reviewing Williams's files, which include data on a number of securities that Williams had been reviewing.

The first file had information on several different asset-backed securities. A summary schedule that Williams had prepared is shown in Exhibit 1.

Exhibit 1: Summary Schedule

Security	*Rating*	*Nominal Spread (bp)*
GG Auto Loans	AA	124
KK Auto Loans	AA	118
CC Credit Card Receivables	AA	136
HH Home Equity Loans	AA	168
LL Home Equity Loans	AA	174

The second file included the following schedule of information relating to a specific CMO thai

Williams had been considering. Exhibit 2 reflects the results of a Monte Carlo simulation based on 15% volatility of interest rates. This security is stil! available, and Pierce needs to evaluate the investment merit of any or all of the listed tranches.

Tranche	*Par Amount ($ million)*	*OAS(bp)*	*Z-Spread (bp)*	*Effective Duration (years)*
PAC A	75.0	40	40	1.5
PAC B	40.0	43	95	4.2
PAC C	25.0	65	117	5.0
PAC D	50.0	72	140	7.9
Support S	100.0	51	142	11.8

A third file contained notes Williams had laken at a seminar a couple of months ago on valuing various types of asset-backed and mortgage-backed securities. These notes included the following comments that Pierce found interesting:

"Cash flow yield (CFY) is one method of valuing mortgage-backed securities. An advantage of the CFY is that it does not rely on any specific prepayment assumptions. An important weakness of CFY is the assumption that interim cash flows will be reinvested at the CFY. This is rarely true for mortgage-backed securities."

"Cash flow duration is similar to effective duration, but its weakness is that it fails to fully account for changes in prepayment rates as cash flow yields change. Empirical duration suffers two disadvantages as a measure of interest rate exposure: reliance on theoretical formulas and reliance on historical pricing data that may not exist for many mortgage-backed securities."

"The recent increase in the default rate for subprime adjustable rate mortgages can be traced to the structure of these loans. The negative amortization feature of these loans basically gave the borrower an at-the-money call option on their property. Once the property decreased in value, this call option was worthless, and the borrower had no incentive to make any additional payments."

Pierce is analyzing the data related to the CMO tranches. Based only on the information in Exhibit 2, the option cost (in bp) of the PAC C tranche is:

Options:

A- greater than the option cost of the PAC D tranche
B- greater than the option cost of the Support S tranche.
C- equal to the option cost of the PAC B tranche.

Answer:

C

Explanation:

The most The option cost for the PAC C tranche is the difference between the OAS and the zero volatility spread, or 117 - 65 = 52 bp. The PAC D option cost is 140 - 72 = 68 bp, Support S is 142 -51=91 bp, and PAC B is 95 - 43 = 52 bp. (Study Session 15, LOS 57.d,e)

Question 3

Question Type: MultipleChoice

For the past 15 years, Susan Luna, CFA, Kyle Lawson, CFA, and Matt Miller. CFA, have worked together as equity analysts and then equity portfolio managers in the investment management division (BIMCO) of the Broadway Life Insurance Company. For the past five years, the three associates have worked together managing the BIMCO Aggressive Growth Fund (BAGF). During their management tenure the BAGF had excellent performance and was well recognized in the financial press.

Just over one year ago, Broadway Life was acquired by a larger company, Gobble Insurance, and as part of the consolidation process BIMCO was closed. The closure allowed Luna, Lawson and Miller to start their own investment management firm, Trio Investment Management LLC (TIM). TIM focuses on the small capitalization growth equities area. This is the same investment focus as the BAGF, but TIM will have individually managed accounts. Several cases have arisen calling for interpretation as to consistency with CFA Institute Standards of Professional Conduct.

Case 1

TIM markets its investment management services by contracting with small, local bank trust departments. One of the newest bank trust clients for TIM is Shadow Mountain Bank and Trust. Judy Sampson, CFA, the trust officer for Shadow Mountain, has scheduled a meeting with a potential client. When Lawson arrives for the client meeting, he finds that all of the TIM marketing material, including biographies of TIM portfolio managers, has been relabeled by Sampson as the Shadow Mountain Wealth Management Team. Sampson has also added the performance of BAGF into the current TIM Equity Composite Index portfolio and relabeled the resultant combined graph, the Shadow Mountain Equity Composite Index. Sampson states that making such changes would probably please clients and improve the chances of acquiring additional trust management accounts for Shadow Mountain and TIM. Lawson goes along and makes the presentation to the potential client using the Shadow Mountain marketing material and the relabeled BAGF/TIM equity performance record.

Case 2

Susan Luna of TIM is meeting with Sol Wurtzel, an institutional salesman for Turn Byer, a large national brokerage firm. Luna complains that TIM*s technology costs are too high, especially their outside software services costs. TIM currently subscribes to two investment-related software services. The first software vendor is StockCal Software Services (StockCal), which

provides valuation and stock charting capabilities TIM uses in their equity research and selection process. The other vendor is Add-Invest Software (Add-Invest), a software program providing account management and performance evaluation reporting which TIM uses in developing monthly reports for all clients. In response to Luna, Wurtzel suggests that Turn Byer has an excellent soft dollar trading desk and would be willing to offer to cover TIM's StockCal and Add-Invest expenses through soft dollar commissions. Luna then reviews TIM's projected commission dollars for the year and decides there are more than enough soft dollars to pay the StockCal, AGF and Add-Invest Software bills combined. Luna believes she can be assured of excellent trade execution from Turn Byer and improved profitability for TIM because of the increased use of soft dollars. Luna then directs that the StockCal and Add-Invest software services be paid for with soft dollar or client brokerage dollars.

Case 3

Sol Wurtzel, the equity salesman for Turn Byer, has referred several clients to TIM over the past year. In fact, Wurtzel referrals currently account for almost 20% of the assets managed by TIM. The principals of TIM decide to reward Wurtzel, either by doubling the commissions paid on trades executed through Turn Byer on Wurtzel's referral accounts, or by paying Wurtzel a cash referral fee for each additional TIM account opened by a Wurtzel referral. The principals agree that any cash referral fee would need to be disclosed to clients in advance.

Case 4

Luna notes that her clients have become increasingly aware of the directed client brokerage / soft dollar commissions issue. At a recent meeting with one of her large pension clients. Service Workers Union Local #1418, the subject of directed commissions came up. Upon learning of the commission dollars available to their account, the Union trustees directed Luna to use their client brokerage of approximately $25,000 to donate to a think lank called the Hoover Study Center of Unions at Samford University. Service Workers trustees believed the Hoover study will increase the public awareness of the benefits unions offer to their members and increase union membership. Luna concurs with the trustee's judgment on increasing union enrollment as a great goal, and follows the client's instructions and makes the $25,000 contribution to the Hoover Study Center. Another client, Rosa Lutz, has asked Luna to credit the soft dollar client brokerage proceeds from her personal retirement accounts to Roswell Academy, to update their computer lab. Luna agrees that a new computer lab for Roswell Academy is greatly needed and she allocates 510,000 of Lutz's commission dollars to Roswell Academy.

Would either of the compensation arrangements to reward Wurtzel for client referrals be in violation of the CFA Institute Standards of Professional Conduct?

Options:

A- Both compensation arrangements would be violations, regardless of any disclosures to clients.
B- The increased commissions plan would be a violation, while the cash referral fees would not be a violation.
C- Doth compensation arrangements are allowed, as long as they are fully disclosed, in advance, to all clients and prospective clients.

Answer:

B

Explanation:

Standard III(A). The increased commission would be a violation, but the cash referral fee would nor. Doubling the commission paid to Wurtzcl would be a violation of Standard Iil(A) Duties to Clients - Loyalty, Prudence, and Care. Client brokerage is strictly an asset of the client, and must be used for the benefit of clients in research that will assist the investment manager in the investment decision-making process. Client brokerage cannot be used as a reward for bringing clients to TIM and to do so is a misappropriation of client assets. Cash referral fees are acceptable, so long as the referral arrangement is fully disclosed to the clients in advance of opening their accounts. The case mentions that this disclosure will be made. This disclosure allows the client to evaluate any potential conflict(s) of interest in the referral process. (Study Session 1, LOS 2.a)

Question 4

Question Type: MultipleChoice

The New York-based Irwin Goldreich Schmidt (IGS) is a mid-sized private equity firm with $300 million capital raised from its investors. Amid a turbulent year, the firm has recently dropped its unsuccessful $100 million bid for a Norwegian media company and is now aggressively searching for new venture or buyout investments in the Eurozone. After several months of intense search IGS believes it identified two potential investments:

1. Sverig, a rapidly expanding Swedish start-up construction company.

2. L'Offre, a struggling French department store in existence since the late 19th Century.

Following several rounds of successful negotiations, IGS makes a $20 million investment in Sverig and a $100 million leveraged buyout investment in L'Offre, committing to an additional $100 million for possible future capital drawdowns. It retains all of Sverig's managers but replaces L'Offre's management team with experienced IGS managers, many of whom are former company senior executives.

IGS also sets up Sverig-L'Offre Private Equity Fund (SLPEF), a fund to manage both firms. The fund manager's compensation is set at 20% of profits net of fees. IGS also specifies that the manager's profits are calculated on the entire portfolio when portfolio value exceeds invested capital by 30%.

Despite the market's recent turbulence, Sverig's original founders are extremely optimistic and believe the firm could be sold for $400 million in six years. To achieve this, they speculate the firm needs another capital infusion of $40 million in four years in addition to the $20 million capital investment today. Given the high risk of the firm, SLPEFs private equity investors decide

that a discount rate of 40% for the first four years and 30% for the last two years is appropriate. The founders of Sverig want to hold 5 million shares.

If total proceeds net of fees to SLPEF are worth $180 million upon exit in a year, the fund's general partner (GP) under the total return using invested capital method would receive a compensation of:

Options:

A- SO.
B- $12 million.
C- $36 million.

Answer:

B

Explanation:

Invested capital in the fund was $20 million + $100 million = $120 million. Committed capital was $120 million + $100 million = $220 million. Since the fund was sold for $ 180 million, the fund earned a profit of $ 180 million - $ 120 million = $60 million.

Under the total return using invested capital method, carried interest is paid to the GP only after the portfolio value exceeds invested capital (by 30% as specified by IGS). Since the $180 million exceeds ($120 million)(1.3) = $156 million, the GP is entitled to carried interest. Carried interest is calculated as:

$180 million- $120 million = $60 million. 20% of $60 million is $12 million.

(Study Session 13, LOS 47.h,i)

Question 5

Question Type: MultipleChoice

Andrew Carson is an equity analyst employed at Lee, Vincent, and Associates, an investment research firm. In a conversation with his supervisor, Daniel Lau, Carson makes the following two statements about defined contribution plans.

Statement I: Employers often face onerous disclosure requirements.

Statement 2: Employers often bear all the investment risk.

Carson is responsible for following Samilski Enterprises (Samilski), a publicly traded firm that produces motorcycles and other mechanical parts. It operates exclusively in the United States. At the end of its 2009 fiscal year, Samilski's employee pension plan had a projected benefit obligation (PBO) of $320 million. Also, unrecognized prior service costs were $35 million, the fair value of plan assets was $316 million, and the unrecognized actuarial gain was $21 million.

Carson believes the rate of compensation increase will be 5% as opposed to 4% in the previous year, and the discount rate will be 7% as opposed to 8% in the previous year.

This past year, Samilski began using special purpose entities (SPEs) for various reasons. In preparation for analyzing the SPE disclosures in the footnotes to the financial statements, Carson prepares a memo on SPEs. In the memo, he correctly concludes that the company will be required under new accounting rules to classify them as variable interest entities (VIE) and consolidate the entities on the balance sheet rather than report them using the equity method as in the past.

Is Carson correct with respect to defined contribution plans?

Options:

A- Both statements are incorrect.
B- Only Statement 1 is incorrect.
C- Only Statement 2 is incorrect.

Answer:

A

Explanation:

Statement 1: Employers often face onerous disclosure requirements---incorrect; the accounting is quite simple and the onerous disclosure requirements are more characteristic of defined benefit plans.

Statement 2: Employers often bear all the investment risk---incorrect; benefits received by each individual employee on retirement depends on the investment performance of each individuals personal retirement fund. Thus, the employees bear the investment risk.

Therefore, both statements arc incorrect. (Study Session 6, LOS 22.a)

Question 6

Question Type: MultipleChoice

Amie Lear, CFA, is a quantitative analyst employed by a brokerage firm. She has been assigned by her supervisor to cover a number of different equity and debt investments. One of the investments is Taylor, Inc. (Taylor), a manufacturer of a wide range of children's toys. Based on her extensive analysis, she determines that her expected return on the stock, given Taylor's risks, is 10%. In applying the capital asset pricing model (CAPM), the result is a 12% rate of return.

For her analysis of the returns of Devon, Inc. (Devon), a manufacturer of high-end sports apparel, Lear intends to use the Fama-French model (FFM). Devon is a small-cap growth stock that has traded at a low market-to-book value in recent years. Lear's analysis has provided a wealth of quantitative information to consider. The return on a value-weighted market index minus the risk-free rate is 5.5%, the small-cap return premium is 3.1%, the value return premium is 2.2%, and the liquidity premium is 3.3%. The risk-free rate is 3.4%. The market, size, relative value, and liquidity betas for Devon are 0.7, -0.3, 1.4, and 1.2, respectively. In estimating the appropriate equity risk premium, Lear has chosen to use the Gordon growth model.

Lear's assistant, Doug Saunders, presents her with a report on macroeconomic multifactor models that includes the following two statements:

Statement 1: Business cycle risk represents the unexpected change in the difference between the return of risky corporate bonds and government bonds.

Statement 2: Confidence risk represents the unexpected change in the level of real business activity.

Lear is also attempting to determine the most appropriate method for determining the required return for Densmore, Inc. (Densmore), a closely held company that is considering a debt issue within the next year. The company has not previously issued debt securities to the public, relying instead on bank financing. She realizes that there are a number of models to consider, including the CAPM, multifactor models, and build-up models.

Based on Lear's analysis, Taylor's stock is most likely to be:

Options:

A- correctly valued.
B- overvalued.
C- undervalued.

Answer:

B

Explanation:

Since the required return (12%) as determined by CAPM is greater than Lear's expected return

(10%), then Taylors stock is overvalued. (Study Session 10, LOS 35.a)

Question 7

Question Type: MultipleChoice

Ivan Johnson is reviewing the investment merits of BioTLab, a fast-growing biotechnology company. BioTLab has developed several drugs, which arc being licensed to major drug companies. BioTLab also has several drugs in phase III trials (phase III trials are the last testing stage before FDA approval). Johnson notes that two drugs recently received approval which should provide BioTLab solid revenue growth and generate predictable cash flow well into the future. Based on the potential for the two drugs, BioTLab's estimated annual cash flow growth rate for the next two years is 25%, and long-term growth is expected to be 12%. Because of BioTLab's attractive investment opportunities, the company does not pay a dividend. BioTLab's current weighted average cost of capital is 15% and its stock is currently trading at $50 per share. Financial information for BioTLab for the most recent 12 months is provided below:

* Net working capita! excluding cash increased from $7,460,000 to $9,985,000;

* Book value increased from $81,250,000 to $101,250,000.

* BioTLab currently has no debt.

* Research facilities and production equipment were purchased for $8,450,000.

* BioTLab held non-operating assets in the amount of $875,000.

* Net income for the 12 months was $20,000,000.

* BioTLab has a marginal tax rate of 40%.

* Noncash charges for depreciation and restructuring for the 12 months were $1,250,000.

BioTLab's management has indicated an interest in establishing a dividend and will fund new drug research by issuing additional debt.

Johnson also reviews a competitor to BioTLab, Groh Group, which has a larger segment operating in a highly cyclical business. The Groh Group has a debt to equity ratio of 1.0 and pays no dividends. In addition, Groh Group plans to issue bonds in the coming year.

Which of the following statements regarding free cash flow models is least likely correct?

Options:

A- Sensitivity analysis indicates that the FCFE model's valuation of BioTLab's common stock is most sensitive to the company's growth rate.

B- FCFE is net income plus depreciation minus net capital expenditures minus the increase in working capital plus net new debt financing.
C- FCFF can be inflated by increasing capital expenditures relative to depreciation.

Answer:

C

Explanation:

FCFF can be inflated by decreasing capital expenditures relative to depreciation. All other statements are true. (Study Session 12, LOS 41.f,h)

Question 8

Question Type: MultipleChoice

Erich Reichmann, CFA, is a fixed-income portfolio manager with Global Investment Management. A recent increase in interest rate volatility has caused Reichmann and his assistant, Mel O'Shea, to begin investigating methods of hedging interest rate risk in his fixed income portfolio.

Reichmann would like to hedge the interest rate risk of one of his bonds, a floating-rate bond (indexed to LIBOR). O'Shea recommends taking a short position in a Eurodollar futures contract because the Eurodollar contract is a more effective hedging instrument than a Treasury bill futures contract.

Reichmann is also analyzing the possibility of using interest rate caps and floors, as well as interest rate options and options on fixed income securities, to hedge the interest rate risk of his overall portfolio.

Reichmann uses a binomial interest rate model to value 1-year and 2-year 6% floors on 1-year LIBOR, both based on $30 million principal value with annual payments. He values the 1-year floor at $90,000 and the 2-year floor at $285,000.

Reichmann has also heard about using interest rate collars to hedge interest rate risk, but is unsure how to construct a collar.

Finally, Reichmann is interested in using swaptions to hedge certain investments. He evaluates the following comments about swaptions.

* If a firm anticipates floating rate exposure from issuing floating rate bonds at some future date, a payer swaption would lock in a fixed rate and provide floating-rate payments for the loan. It would be exercised if the yield curve shifted down.

* Swaptions can be used to speculate on changes in interest rates. The investor would buy a receiver swaption if he expects rates to fall.

Are the comments about swaptions correct?

Options:

A- No, because a payer swaption should be used if the investor anticipates a fixed rate exposure at some point in the future.
B- No, because a payer swaption would be exercised if the yield curve shifted up.
C- No, because an investor would buy a receiver swaption if he expects rates to rise.

Answer:

B

Explanation:

The last part of the first comment is incorrect. If a firm anticipates a floating rate exposure at some future date (e.g., it will be issuing bonds or getting a loan), a payer swaption would lock in a fixed rate and provide floating-rate payments for the loan. It would be exercised if the yield curve shifted up to give the investor (effectively) a loan at the fixed rate on the swaption. The second comment is correct. Swaptions also can be used to speculate on changes in interest rates. The investor would buy a payer swaption if he expects rates to rise, or buy a receiver swaption if he expects rates to fall. (Study Session 17, LOS 61.f)

Question 9

Question Type: MultipleChoice

Kylie Autumn, CFA, is a consultant with Tri-Vision Group. Robert Lullum, Senior Vice President ai Langsford Investments, has asked for assistance with the evaluation of mortgage-backed and collateralized mortgage obligation (CMO) derivative securities for potential inclusion in several client portfolios. Langsford Investments mainly deals with equity investments and REITs, but the company recently purchased a small firm that invests mainly in fixed-income securities.

Lullum has done some research on the appropriate spread measures and option valuation models for fixed-income securities and wants to clarify some points. He wants to know if the following statements are correct:

Statement 1: The proper spread measure for option-free corporate bonds is the nominal spread.

Statement 2: Callable corporate bonds and mortgage-backed securities should be measured

using the option-added spread.

Statement 3: The Z-spread is appropriate for credit card ABS and auto loan ABS.

While Lullum meets with Autumn, Janet Van Ark, CFA charterholder and equity-income portfolio manager for Langsford, is attempting to purchase bonds that may also provide her with equity exposure in the future. She has decided to analyze an 8% annual coupon bond with exactly 20 years to maturity. The bonds are convertible into 10 common shares for each $ 1,000 of par (face) value. The bond's market price is $920, and the common stock has a market price of $40. Van Ark estimates that the stock will increase in value to $70 within the next two years. The stock's annual dividend is $0.40 per share, and the market yield on comparable non-convertible bonds'is 9.5%.

Carl Leighton, a Langsford analyst and Level 2 CFA candidate, works with mortgage-backed and other asset-based securities. He provides Lullum with a list of credit enhancements for asset-backed securities, which includes letters of credit, excess servicing spread funds, overcollateralization, and bond insurance. Lullum then asks him for a status report of the firm's exposure to paythrough securities. He also asks Leighton to calculate the single-monthly mortality rate (SMM) and estimate the prepayment for the month for a seasoned mortgage pool with a $500,000 principal balance remaining. The scheduled monthly principal payment is $ 150 and the conditional prepayment rate (CPR) is 7%.

Van Ark computes the convertible bond's market conversion premium per share (MCPPS) using only the information given, and then wants to know how a sudden increase in the stock price of $2 would impact the bond price. Which of the following choices is most correct?

Options:

A- The original MCPPS is $60 per share.
B- The sudden $2 increase would have a small effect.
C- The sudden $2 increase would have a large effect.

Answer:

B

Explanation:

The MCPPS is the difference between the conversion value and the bond's current market price, on a per share basis.

$$\text{MCPPS} = \frac{920}{10} - 40 = \$52 \text{ per share}$$

Regarding the stock price increase, the convertible bond is essentially a straight bond (i.e., no conversion privilege), plus a call option on the underlying common stock. In this case, the option is far out of the money. So, while the increase in the stock price will have a positive impact on

the bond, the impact will be small because the delta is close to zero for options that arc far out of the money (Study Session 14, LOS 57.i)

Question 10

Question Type: MultipleChoice

Yummy Doughnuts (YD) sells a variety of doughnuts and other related items through both company-owned locations and franchise locations. YD has experienced significant growth over the past five years. However, barriers to entry are low and competition is increasing.

Linda Haas, CFA, follows YD for Gibraltar Capital. Gibraltar Capital prides itself on its thorough fundamental analysis of investment opportunities. The company uses a bottom-up approach to the investment process. Haas's security selection process utilizes residual income models to determine a stock's intrinsic value. Haas obtains YD's 2008 financial statements shown in Exhibit 1. In addition, Haas provides supporting information about YD's financials and other related material found in Exhibit 2.

In millions, except for per share items	*2008*
Revenue	$300
Cost of goods sold	$205
SG&A	$20
R&D Expense	$20
Depreciation Expense	$6
Income from operations	$49
Interest expense	$1
Pretax income	$48
Income tax (40% tax rate)	$19
Net Income	$29
Shares outstanding	18.6
EPS	$1.56

In millions	*2008*		*2008*
Assets		**Liabilities and Equity**	
Cash	$15	Accounts payable	$12
Accounts receivable	$27	Accrued expenses	$26
Inventory	$16	Current Liabilities	$38
Current Assets	$58		
Property and Equipment	$113	Total long-term debt (7% coupon, at par value)	$12
Long-term investments	$10	Equity	$131
Total assets	**$181**	**Total liabilities & equity**	**$181**

Exhibit 2: Additional Information

- YD uses the FIFO method of inventory valuation.
- The present value of YD's future operating leases is $57 million with interest expense of $4 million.
- 2008 cash operating taxes equal $15 million. This amount includes all appropriate tax adjustments.
- Haas believes that YD will have a 17% ROE and a 10% long-term growth rate over the foreseeable future.
- Haas estimates that R&D investments were made at the beginning of the year and that they have a five year useful life.
- Haas estimates YD's cost of equity to be 15.0%
- YD expects annual capital expenditures to remain at about $37 million.
- YD's stock currently trades at $15.50 per share.
- YD's bonds are currently trading at par value.

Haas makes the following statements during her YD presentation to the investment committee.

Statement 1: Based on ROE mean reversion, YD's continuing residual income is assumed to decline to zero over time.

Statement 2: The residual income model states that if YD's ROE equals its equity cost of capital, then YD's intrinsic value will equal its book value per share.

Haas notes that the multi-stage residual equity income model captures more detail in calculating YD's intrinsic value. An assumption of the model is that ROE fades to the cost of equity over time, which is known as a persistence factor (varying from 0 to 1). Identify which characteristic indicates a higher persistence of abnormal earnings.

Options:

A- Low dividend payout.
B- Low price to earnings ratio.
C- High dividend yield.

Answer:

A

Explanation:

It is difficult for a company to maintain a high ROE because of competition. The persistence factor will be lower for those companies. A company that has a low dividend payout has greater growth opportunities than a company with a high dividend payout. The greater growth opportunities should support a higher persistence factor. (Study Session 13, LOS 43.J)

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