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Question 1

Question Type: MultipleChoice

It is October. A grower of crops is concerned that January temperatures might be too low and destroy his crop. A heating-degree-days futures contract (HDD futures contract) is available for his city. What would be the best course of action for the grower?

Options:

A- In October, sell January HDD contracts

B- In October, buy January HDD contracts

C- In October, buy September HDD contracts

D- In January, buy January HDD contracts

Answer:

B

Explanation:

This question is based upon a weather derivative contract traded on the CME in the US. For each day, 'Heating-Degree-Days' (HDD) is calculated as equal to 65 degrees Fahrenheit minus the daily average temperature. The daily average temperature is based upon the temperature reported by the Earth Satellite Corporation using a specified automated weather station. Based upon daily values of HDD, an aggregated number called the 'CME degree days index' is calculated for each contract month. In other words, the index for a particular month is just the aggregation of the 'HDD' value for each of the days of that month. Each contract settles at the end of the month at a value equal to $20 x Degree Days Index. (In a similar way, 'Cooling Degree Days' are also calculated and a futures contract offered, except that CDD is equal to the average daily temperature minus 65 degrees). (Source: CME's website at CMEGroup.com)

In the given question, we are interested in hedging against the possibility of the temperature being too low. This means we should buy the HDD futures contract (the lower the temperature, the higher the difference of the average temperature from 65 degrees, and the higher the settlement). Therefore Choice 'b' is the correct answer. The lower the actual temperature turns out to be, the higher the payout to the grower. It would not be wise to wait till January to buy the contract as by then the prices of the contract would have already risen if the grower's fears of a colder January appear to be coming true. He can hedge his exposure by immediately locking in the January prices.

Question 2

Question Type: MultipleChoice

A refiner may use which of the following instruments to simultaneously protect against a fall in the prices of its products and a rise in the prices of its inputs:

Options:

A- crude oil swaps

B- options on the crack spread

C- crude oil futures

D- calendar spread options

Answer:

B

Explanation:

The crack spread is the difference between the price of refined products and crude oil. An option on the crack spread can protect a refiner from both a fall in the price of its output and a rise in the price of its inputs. Calendar spreads are options with different maturities. Crude oil futures and swaps only protect against an adverse change in the price of crude, and not that of refined products. Choice 'b' is the correct answer.

Question 3

Question Type: MultipleChoice

The greatest risk in energy derivatives trading comes from:

Options:

A- interest rate risks

B- risk of default by derivatives' counterparties

C- hedging risk

D- price volatility

Answer:

D

Explanation:

Energy derivative markets are still not very liquid, and experience high price volatility. This high volatility is responsible for most of the risk in these markets. Choice 'd' is the correct answer.

Question 4

Question Type: MultipleChoice

Which of the following is NOT a historical event which serves as an example of a short squeeze that happened in the markets?

Options:

A- The great Chicago fire, 1872

B- The CDO squeeze, 2008

C- The wheat squeeze, 1866

D- The great silver squeeze, 1979-80

Answer:

B

Explanation:

There was no event such as the CDO squeeze in 2008. (Quite on the contrary, securitized products were selling at distressed prices.).

The silver squeeze of 1979-80 (Hunt brothers), the Chicago fire of 1872 (leading to a short squeeze on wheat), and the wheat squeeze (Hutchingson) of 1866 are real historical events that led to short squeezes in commodity markets. Choice 'b' is therefore the correct answer.

For the PRM exam, you should try to remember the event broadly, and the commodity involved.

Question 5

Question Type: MultipleChoice

The two components of risk in a commodities futures portfolio are:

Options:

A- Changes in the convenience yield and storage costs

B- Changes in spot prices and carrying costs, also called commodity lease rates

C- Changes in interest rates and spot prices

D- The risk from change in basis and interest rates

Answer:

B

Explanation:

Commodity futures prices can be expressed as the summation of their spot prices and the carrying costs. Therefore any changes in either of these two would be a risk to the futures prices, and Choice 'b' is the correct answer. It is common to decompose complex commodity portfolios into underlying equivalent spot positions and the carrying costs, which includes interest, convenience yield and storage costs. For liquid commodities such as gold where changes of a short squeeze are low, interest costs dominate the carryings costs. Choice 'b' is the correct answer as it is most complete and covers the elements in the other choices. The 'lease rate' for a commodity is equivalent to (Fwd Price - Spot Price)/Spot Price, and comprises the interest and storage costs and the convenience yield. The other choices do not represent complete answers.

Question 6

Question Type: MultipleChoice

The volatility of commodity futures prices is affected by

Options:

A- the volatility of the convenience yields

B- the volatility of spot prices

C- the volatility of interest rates that drive the funding cost of the futures positions

D- all of the above

Answer:

D

Explanation:

All the choices list inputs into the determination of futures prices. Therefore volatility in any of them affects the volatility of futures prices. Of course, the largest contributor to the volatility is the volatility of the spot price of the underlying. Choice 'd' is the correct answer.

Question 7

Question Type: MultipleChoice

Backwardation can happen in markets where

Options:

A- convenience yield is less than the total interest and carrying costs

B- convenience yields are greater than the total interest, storage and other carrying costs

C- convenience yields are positive

D- convenience yields are zero

Answer:

B

Explanation:

Convenience yield is the benefit from having access to the commodity - and if the convenience yield is very high, for example in a market where manufacturers must never run out of a particular raw material, then these can switch the total cost of carry (which include interest and storage costs, less convenience yields) to being negative. This causes forward prices to become lower than spot prices, a phenomenon known as backwardation.

Therefore Choice 'b' is the correct answer. If convenience yields are less than other carrying costs, then backwardation will not happen. The sign of convenience yields does not matter, what matters is their relative magnitude when compared to the other costs of carry.

To understand this in an intuitive way, consider that forward prices are nothing but spot prices, plus interest, plus storage costs, less convenience yields. If interest and storage costs are less than the convenience yield, the market will be backwarded.

Question 8

Question Type: MultipleChoice

A 'short squeeze' refers to a situation where

Options:

A- a sharp increase in spot prices due to a shortage in the spot market as shorts try to cover their positions

B- a sharp drop in spot prices as shorts try to drive down prices

C- sharp swings in forward basis caused due to normal market movements

D- an increase in forward prices due to factors underlying a contango market overwhelming the factors that take the market into backwardation

Answer:

A

Explanation:

A short squeeze results when short sellers are trying to cover their short positions by buying in the spot markets, which do not have adequate supply. This results in sharp spikes in spot prices, which further forces any other shorts to try cut their losses. The result is a sharp rise in spot prices.

Choice 'a' is the correct answer, the other choices do not describe a short squeeze.

Question 9

Question Type: MultipleChoice

Which of the following are valid reasons that explain an upward sloping yield curve?

1. The market expects interest rates to increase in the future

II. The market expects interest rates to decline in the future

III. Investors prize liquidity over illiquidity

IV. Investors believe the economy is likely to enter recession

Options:

A- I, III and IV

B- II and III

C- II and IV

D- I and III

Answer:

D

Explanation:

There are two main theories that explain an upward sloping yield curve. The first is the market expectations hypothesis (called 'pure expectations'). According to this explanation, the yield curve represents investor expectations of future yields, and forward rates are predictors of future interest rates. The yield curve slopes upwards when investors expect interest rates to go up in the future. Thus, statement I is correct. By the same logic, statement II is incorrect.

The second explanation for an upward sloping yield curve is the liquidity preference theory - according to which investors value liquidity and are prepared to pay more for instruments that mature earlier. Having their money tied up in longer maturity instruments increases all kinds of risks, and therefore longer term instruments are priced lower than instruments maturing earlier. Since the price of instruments that mature earlier is higher, their yield is lower than that of longer dated securities, thereby leading to an upward sloping yield curve. Therefore statement III is correct.

Statement IV actually explains why an yield curve may be downward sloping - in fact an inverted yield curve is considered an indicator of an upcoming recession. Therefore statement IV does not explain an upward sloping yield curve, and is therefore not a correct choice for

the answer.

Thus statements I and III correctly explain an upward sloping yield curve. Other choices are incorrect.

Question 10

Question Type: MultipleChoice

Which of the following indicate a long position on the TED (treasury-Eurodollar) spread?

Options:

A- A long position in treasury bill futures and a short position in Eurodollar futures

B- A long position in treasury bill futures and a long position in Eurodollar futures

C- A short position in treasury bill futures and a short position in Eurodollar futures

D- A short position in treasury bill futures and a long position in Eurodollar futures

Answer:

A

Explanation:

The TED spread is a bet on the spread between treasury bill futures and Eurodollar futures. T-bill rates are lower than Eurodollar rates, as the former carries no risk. Eurodollars deposits, which are interbank deposits between the highest rated banks, carry very little risk as well. Therefore both these instruments generally trade at very narrow spreads. The spread widens, ie the Eurodollar rates rise in comparison to treasury bill rates when the market has credit risk fears.

A trader is said to be 'long' the spread when he benefits from the spread increasing, and 'short' the TED spread when he gains from the spread decreasing. A trader can buy the spread by being long t-bill futures and short Eurodollar futures. Similarly he can be short the spread by being short t-bill futures and long Eurodollar futures.