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Question 1

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 2

Question Type: MultipleChoice

The 'transformation line' expresses the relationship between

Options:

- A) Expected risk and return for a portfolio comprising a riskless asset and a risky bundle
- B) The risk free rate and expected market risk premiums
- C) Asset beta and expected return
- D) Expected risk and return for all portfolios lying on the efficient frontier

Answer:

A

Explanation:

The transformation line represents the various possible combinations of the 'risky bundle' and the risk free asset. Investors can choose different combinations of the risky and risk-free asset depending upon their risk appetite. The transformation line meets the y-axis (portfolio returns) at the point equal to the risk free rate. Choice 'a' is the correct answer and the rest are incorrect.

The highest possible transformation line, ie the transformation line with the maximum slope, is the transformation line joining the risk free rate on the y-axis and the portfolio with the maximum Sharpe ratio on the efficient frontier. This line is called the 'capital markets line'. Investors can pick any point on this line according to their risk appetite, and doing so would maximize the return they can obtain for their desired level of risk. The capital markets line is tangential to the efficient frontier. The Sharpe ratio stays constant throughout the CML.

Remember that the transformation line and the capital markets lines are different from each other - there is only one CML for an efficient frontier, whereas there can be multiple transformation lines.

Question 3

Question Type: MultipleChoice

In the context of futures contracts traded on an exchange, the term 'open interest' refers to:

Options:

- A) The total number of contracts traded during the day
- B) The total number of long contracts net of the number of short contracts
- C) The total number of outstanding contracts
- D) The total number of contracts expiring in the near month

Answer:

C

Explanation:

Open interest refers to the number of outstanding contracts, which is the same as the number of long positions or short positions held by market participants. Note that since for every long futures contract position held there is a seller who holds the short side, the open interest that is long is identical to the open interest that is short. (This is unlike the spot market where one could have long positions without anyone else needing to be symmetrically short).

The total number of contracts traded refers to traded volumes, and not open interest. Other choices are irrelevant in the context.

Question 4

Question Type: MultipleChoice

Which of the following correctly describes a 'reverse repo'?

Options:

- A) An asset swap that is offset by an identical but opposite swap
- B) Lending cash with securities as a collateral
- C) Borrowing cash while posting securities as a collateral
- D) A repo with an undefined maturity period

Answer:

B

Explanation:

A repo, or a repurchase agreement, is the lending of securities in return for cash, with an agreement to buy the securities back at a later date at the borrowed amount plus interest. It is a form of collateralized borrowing. A 'reverse repo' is exactly the opposite of a repo transaction, ie where cash is lent and securities borrowed. Therefore Choice 'b' is the correct answer. In any repo transaction, the

counterparty will therefore always have a 'reverse repo' position.

A reverse repo is a useful transaction - not merely for the purpose of lending short term funds, but more importantly to enable short positions. For example, if an investor wishes to short a bond, he can borrow the bond on a 'reverse repo' and sell it. Of course, he will have to return the bond when the reverse repo matures, but hopefully by that time prices of the bond would have fallen to allow him to do so profitably. Short positions in physical bonds are nearly always facilitated by reverse repos.

Question 5

Question Type: MultipleChoice

The 'transformation line' expresses the relationship between

Options:

- A) Expected risk and return for a portfolio comprising a riskless asset and a risky bundle
- B) The risk free rate and expected market risk premiums
- C) Asset beta and expected return
- D) Expected risk and return for all portfolios lying on the efficient frontier

Answer:

A

Explanation:

The transformation line represents the various possible combinations of the 'risky bundle' and the risk free asset. Investors can choose different combinations of the risky and risk-free asset depending upon their risk appetite. The transformation line meets the y-axis (portfolio returns) at the point equal to the risk free rate. Choice 'a' is the correct answer and the rest are incorrect.

The highest possible transformation line, ie the transformation line with the maximum slope, is the transformation line joining the risk free rate on the y-axis and the portfolio with the maximum Sharpe ratio on the efficient frontier. This line is called the 'capital markets line'. Investors can pick any point on this line according to their risk appetite, and doing so would maximize the return they can obtain for their desired level of risk. The capital markets line is tangential to the efficient frontier. The Sharpe ratio stays constant throughout the CML.

Remember that the transformation line and the capital markets lines are different from each other - there is only one CML for an efficient frontier, whereas there can be multiple transformation lines.

Question 6

Question Type: MultipleChoice

Which of the following correctly describes a 'reverse repo'?

Options:

- A) An asset swap that is offset by an identical but opposite swap
- B) Lending cash with securities as a collateral
- C) Borrowing cash while posting securities as a collateral
- D) A repo with an undefined maturity period

Answer:

B

Explanation:

A repo, or a repurchase agreement, is the lending of securities in return for cash, with an agreement to buy the securities back at a later date at the borrowed amount plus interest. It is a form of collateralized borrowing. A 'reverse repo' is exactly the opposite of a repo transaction, ie where cash is lent and securities borrowed. Therefore Choice 'b' is the correct answer. In any repo transaction, the counterparty will therefore always have a 'reverse repo' position.

A reverse repo is a useful transaction - not merely for the purpose of lending short term funds, but more importantly to enable short positions. For example, if an investor wishes to short a bond, he can borrow the bond on a 'reverse repo' and sell it. Of course, he will have to return the bond when the reverse repo matures, but hopefully by that time prices of the bond would have fallen to allow him to do so profitably. Short positions in physical bonds are nearly always facilitated by reverse repos.

Question 7

Question Type: MultipleChoice

In the context of futures contracts traded on an exchange, the term 'open interest' refers to:

Options:

- A) The total number of contracts traded during the day
- B) The total number of long contracts net of the number of short contracts
- C) The total number of outstanding contracts
- D) The total number of contracts expiring in the near month

Answer:

C

Explanation:

Open interest refers to the number of outstanding contracts, which is the same as the number of long positions or short positions held by market participants. Note that since for every long futures contract position held there is a seller who holds the short side, the open interest that is long is identical to the open interest that is short. (This is unlike the spot market where one could have long positions without anyone else needing to be symmetrically short).

The total number of contracts traded refers to traded volumes, and not open interest. Other choices are irrelevant in the context.

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.

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