# Chapter 9 - Test Bank

### Multiple-choice questions

[Go to ⇨ Multiple choice questions - Memorandum](#AC9MCQ)

*Answer the following questions by selecting the appropriate answer from the list below.*

**What is the primary distinguishing factor between the money market and the bond market?**

1. Minimum investment amount
2. Source of income from instruments
3. Method of trading
4. Maturity of instruments

**John submits an order to buy shares in company A at R25 each. His order is immediately matched against an opposite order identical in price. In which ONE of the following types of market is John trading?**

1. Continuous quote market
2. Continuous auction market
3. Call quote market
4. Call auction market

**Karabo buys previously traded shares in company A on the JSE. The price at which Karabo bought the shares is referred to as the**

1. par value
2. market value
3. book value
4. intrinsic value

**Which ONE of the following measures of risk determines the degree to which the return of a security is correlated with the return of the market as a whole?**

1. Variance
2. Standard deviation
3. Alpha
4. Beta

**The yield quoted on a 182-day RSA-denominated security is 8 per cent per annum. What is the equivalent yield expressed on an ACT/360-day basis?**

1. 7,49%
2. 7,89%
3. 8,11%
4. 8,42%

**Which of the following are functions performed by the Society for Worldwide Interbank Financial Telecommunications (SWIFT)?**

1. Dematerialised script custodial services
2. Clearing and settlement of securities
3. Sending of payment orders to members
4. Supply of interface software for payment systems
5. (i) and (ii) only
6. (iii) and (iv) only
7. (i), (ii) and (iii) only
8. (i), (iii) and (iv) only

**Jane invested R25 000 for 181 days. The investment grew to R28 000 after the investment period. What is the simple interest annual rate of return for this investment?**

1. 12%
2. 18,37%
3. 20%
4. 24,20%

**What would be the money market yield earned at maturity of a six-month bill issued at a discount rate of 10 per cent?**

1. 9,22%
2. 9,52%
3. 10%
4. 10,53%

**Which of the following are underlying concepts of the efficient market hypothesis?**

1. Market prices reflect all available information.
2. Market price movements do not follow patterns and trends.
3. Market psychology determines market prices.
4. Market anomalies occur from time to time.
5. (i) and (ii) only
6. (iii) and (iv) only
7. (i), (ii) and (iii) only
8. (i), (iii) and (iv) only

**Which of the following statements with regard to financial market theories are correct?**

1. According to the irrelevance theory, a firm’s capital structure is unrelated to its share market value.
2. According to Sharpe’s index model, alpha represents excess returns produced from market anomalies.
3. The arbitrage pricing theory states that expected return of an asset is related to the market return.
4. Portfolios on the efficient frontier are equally valued in terms of the expected risk and return.
5. (i) and (ii) only
6. (iii) and (iv) only
7. (i), (ii) and (iii) only
8. (i), (iii) and (iv) only

### Written questions

[Go to ⇨ Written questions - Memorandum](#AC9WQ)

*Answer the following questions.*

**Define the capital market.**

**Briefly explain how prices of securities are determined in the over-the-counter (OTC) market.**

**Company A has shareholders’ equity to the value of R5 million. The company has a total of 100 000 outstanding shares. The shares were originally issued at R35 per share but are currently trading at R52,50.**

1. **Calculate the book value of the share.**
2. **Is the share currently trading at a discount or at a premium? Explain your answer.**

**Thandi is contemplating selling her shareholding in company A at the current market price of R52. She bought 1 000 shares at R60 per share and during the two years she held the shares, the company paid a dividend of R2,00 per share in the first year and R1,70 in the second year.**

1. **Calculate the holding period rate of return (HPR) for the investment.**
2. **Calculate the effective annual rate of return (EAR) for the investment.**

**The shares of company A have an annual rate of return of 15 per cent and a beta of 1,5. What will the expected rate of return for the share be should the market return decrease by 20 per cent?**

#### 

**Distinguish between brokers and dealers.**

#### 

**What does it mean when we say a dealer or investor has a “short position”. When is an investor likely to enter into such a position?**

**Discuss the disadvantages of bearer instruments to both the issuer and holder of securities.**

**Andy invests R 10 000 in a long-term fixed account compounded semi-annually at an interest rate of 10 per cent for a period of two years.**

1. **Calculate the value of the investment at the end of the two-year period.**
2. **Determine the effective rate of return (EAR) for the investment.**

**Discuss the three essential forms of the efficient markets hypothesis (EMH) and the implication of each on technical and fundamental analysis.**

### True or false questions

[Go to ⇨ True/False questions - Memorandum](#AC9TFQ)

*Read the statements below and indicate whether they are true or false.*

**Dark liquidity refers to orders and quotes that remain unmatched on the central order book of an exchange.**

#### 

**The larger the variance of a security, the higher the probability that actual returns will be close to expected returns.**

#### 

**A bank’s trading book consists, inter alia, of positions in financial instruments and commodities held in order to hedge other elements of the trading book.**

**An annuity of which the payments are made at the end of each period is called an ordinary annuity.**

**The Black and Scholes option pricing model can be adjusted to be applicable to all types of options.**

### Choose the correct term

[Go to ⇨ Choose the correct term - Memorandum](#AC9CTCT)

*Select the correct term to make the statement accurate.*

**In a quote-driven market, investors must transact through a dealer/an exchange.**

#### 

**Hedgers/speculators attempt to make a profit by taking a view on price movements in the markets over a relatively short time.**

**The price at which a market maker is willing to buy a security is called the bid/offer price.**

**A security that is issued (and traded) without a physical certificate where ownership of a security exists only as an electronic accounting record is referred to as being dematerialised/immobilised.**

**The money market discount rate is an interest rate that is applied on a simple/compound basis.**

# Chapter 9 - Memorandum

### Multiple-choice questions

[Go back to ⇦ Multiple choice questions](#C9MCQ)

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### Written questions

[Go back to ⇦ Written questions](#C9WQ)

*Answer the following questions.*

**Define the capital market.**

**The capital market is the market in which corporations, financial institutions and governments raise long-term funds to finance capital investments and expansion projects. Equity and bond markets are grouped together under the term “capital market”.**

**Briefly explain how prices of securities are determined in the over-the-counter (OTC) market.**

**Prices in the OTC market are determined either between the two principals or by a market maker acting as intermediary.**

**Company A has shareholders’ equity to the value of R5 million. The company has a total of 100 000 outstanding shares. The shares were originally issued at R35 per share but are currently trading at R52,50.**

1. **Calculate the book value of the share.**
2. **Is the share currently trading at a discount or at a premium? Explain your answer.**
3. **R50 per share = shareholders’ equity/outstanding shares = 5 000 000/100 000**
4. **The share is currently trading at a premium as the market value of R52,50 is higher than the book value of R50.**

**Thandi is contemplating selling her shareholding in company A at the current market price of R52. She bought 1 000 shares at R60 per share and during the two years she held the shares, the company paid a dividend of R2,00 per share in the first year and R1,70 in the second year.**

1. **Calculate the holding period rate of return (HPR) for the investment.**
2. **Calculate the effective annual rate of return (EAR) for the investment.**
3. **[(End value + total return)/start value] – 1**
   * + 1. **= {[(52 ) + (2 × ) + (1,70 × )]/(60 × )} – 1**
       2. **= [(52 + 2 + 1,7)/60] – 1**
       3. **= – 7,17%**
4. **EAR = (1 + HPR)1/n – 1**
   * + 1. **= (1 – 0,0717)1/2 – 1**
       2. **= – 3,65%**

**The shares of company A have an annual rate of return of 15 per cent and a beta of 1,5. What will the expected rate of return for the share be should the market return decrease by 20 per cent?**

**The share will decrease by 30 per cent (1,5 × 20)% to a rate of return of 10,5 per cent.**

#### 

**Distinguish between brokers and dealers.**

**Brokers act as agents or conduits between lenders and borrowers or buyers and sellers in return for a commission by matching the orders of buyers and sellers without taking ownership of the securities. However, dealers take ownership of securities, and buy and sell them at predetermined prices in order to profit from the difference (spread) in the bid price (buying price) and offer price (selling price).**

#### 

**What does it mean when we say a dealer or investor has a“short position”. When is an investor likely to enter into such a position?**

**A short position refers to a situation where a security has been sold and has to be cancelled out or covered by a corresponding purchase. This is often done in anticipation of a fall in prices.**

**Discuss the disadvantages of bearer instruments to both the issuer and holder of securities.**

**The issuer of a bearer instrument only has a record of the owner (investor) of such instrument on initial issue and again at the end of the term of the instrument, upon presentation of the certificate for payment of any coupon and/or maturity amount. The issuer is highly unlikely to be aware of any change in ownership of such securities arising from trading activity between these intervals.**

**The holder of securities carries the risk of fraud, loss or theft of the bearer certificate, and ownership is extremely difficult to prove and indemnity cover is very expensive.**

**Andy invests R 10 000 in a long-term fixed account compounded semi-annually at an interest rate of 10 per cent for a period of two years.**

1. **Calculate the value of the investment at the end of the two-year period.**
2. **Determine the effective rate of return (EAR) for the investment.**
3. **FV = PV(1 + i/f)f x n**
   * + 1. **= 10 000 (1 + 0,10/2)2 x 2**
       2. **= 10 000(1,05)4**
       3. **= R12 155,06**
4. **EAR = (1 + i/f)f – 1**
5. **= (1 + 0,10/2)2 – 1**
6. **= 10,25%**

**Discuss the three essential forms of the efficient markets hypothesis (EMH) and the implication of each on technical and fundamental analysis.**

* **The weak form of the EMH claims that all past market prices and data are fully reflected in asset prices. The implication of this is that technical analysis will not be able to consistently produce excess returns, though some forms of fundamental analysis may still provide them.**
* **The semi-strong form of the EMH asserts that all publicly available information is fully reflected in asset prices. The implication of this is that neither technical nor fundamental analysis can be used to produce excess returns.**
* **The strong form of the EMH states that all information – public and private – is fully reflected in asset prices. The implication of this is that even insider information cannot be used to beat the market.**

### True or false questions

[Go back to ⇦ True/False questions](#C9TFQ)

*Read the statements below and indicate whether they are true or false.*

**Dark liquidity refers to orders and quotes that remain unmatched on the central order book of an exchange.**

**False – dark liquidity refers to orders and quotes that are not pre-trade transparent – that is, they cannot be seen by other market participants until the trade is complete.**

#### 

**The larger the variance of a security, the higher the probability that actual returns will be close to expected returns.**

**False – the larger the variance of a security, the *lower* the probability that actual returns will be close to expected returns.**

#### 

**A bank’s trading book consists, inter alia, of positions in financial instruments and commodities held in order to hedge other elements of the trading book.**

**True**

**An annuity of which the payments are made at the end of each period is called an ordinary annuity.**

**True**

**The Black and Scholes option pricing model can be adjusted to be applicable to all types of options.**

**False – the Black and Scholes option pricing model is only applicable to European options.**

### Choose the correct term

[Go back to ⇦ Choose the correct term](#C9CTCT)

*Select the correct term to make the statement accurate.*

**In a quote-driven market, investors must transact through a dealer/an exchange.**

**a dealer**

#### 

**Hedgers/speculators attempt to make a profit by taking a view on price movements in the markets over a relatively short time.**

**Speculators**

**The price at which a market maker is willing to buy a security is called the bid/offer price.**

**bid**

**A security that is issued (and traded) without a physical certificate where ownership of a security exists only as an electronic accounting record is referred to as being dematerialised/immobilised.**

**dematerialised**

**The money market discount rate is an interest rate that is applied on a simple/compound basis.**

**Simple**