

Chapter 3

Structure of Interest Rates

1. In general, securities with _____ characteristics will offer _____ yields.
A) favorable; higher
B) favorable; lower
C) unfavorable; lower
D) none of these

ANSWER: B

2. Default risk is likely to be highest for:
A) short-term Treasury securities.
B) AAA corporate securities.
C) long-term Treasury securities.
D) BBB corporate securities.

ANSWER: D

3. Some financial institutions, such as commercial banks, are required by law to invest only in:
A) junk bonds.
B) corporate stock.
C) Treasury securities.
D) investment-grade bonds.

ANSWER: D

4. If a security can easily be converted to cash without a loss in value, it:
A) is liquid.
B) has a high after-tax yield.
C) has high default risk.
D) is illiquid.

ANSWER: A

5. Securities that offer _____ liquidity will offer a _____ yield to be preferred.
A) lower; higher
B) lower; lower
C) higher; higher
D) higher; lower

ANSWER: A

6. If all other characteristics are similar, _____ would have to offer _____.
- A) taxable securities; a higher after-tax yield than tax-exempt securities
 - B) taxable securities; a higher before-tax yield than tax-exempt securities
 - C) tax-exempt securities; a higher after-tax yield than taxable securities
 - D) tax-exempt securities; a higher before-tax yield than taxable securities

ANSWER: B

7. Assume an investor's tax rate is 25 percent. The before-tax yield on a security is 12 percent. What is the after-tax yield?
- A) 16.00 percent
 - B) 9.25 percent
 - C) 9.00 percent
 - D) 3.00 percent
 - E) none of these

ANSWER: C

8. An investor's tax rate is 30 percent. What must the before-tax yield on a security be to have an after-tax yield of 11 percent?
- A) 7.7 percent
 - B) 15.71 percent
 - C) 130 percent
 - D) 11.00 percent
 - E) none of these

ANSWER: B

9. A firm in the 35 percent tax bracket is aware of a tax-exempt security that is paying a yield of 7 percent. To match this yield, taxable securities must offer a before-tax yield of _____ percent.
- A) 7.0
 - B) 10.8
 - C) 20.0
 - D) none of these

ANSWER: B

10. Holding other factors, such as risk constant, the relationship between the maturity and annualized yield of securities is called the _____ structure of interest rates.
- A) term
 - B) default
 - C) liquidity
 - D) tax
 - E) none of these

ANSWER: A

11. The term structure of interest rates defines the relationship between _____ and _____.
- A) risk; return
 - B) risk; maturity
 - C) maturity; yield
 - D) default risk ratings; maturity

ANSWER: C

12. If shorter term securities have higher annualized yields than longer term securities, the yield curve:
- A) is horizontal.
 - B) is upward sloping.
 - C) is downward sloping.
 - D) cannot be determined without additional information (such as the level of market interest rates).

ANSWER: C

13. Assume that annualized yields of short-term and long-term securities are equal. If investors suddenly believe interest rates will increase, their actions may cause the yield curve to:
- A) become inverted.
 - B) become flat.
 - C) become upward sloping.
 - D) be unaffected.

ANSWER: C

14. If issuers of securities (borrowers) and investors suddenly expect interest rates to decrease, their actions to benefit from their expectations should cause:
- A) long-term yields to rise.
 - B) short-term yields to decrease.
 - C) prices of long-term securities to decrease.
 - D) long-term yields to rise and short-term yields to decrease.
 - E) none of these.

ANSWER: E

15. Within the category of capital market securities, municipal bonds have the _____ before-tax yield, and their after-tax yield is typically _____ of Treasury bonds from the perspective of investors in high tax brackets.
- A) highest; below that
 - B) lowest; above that
 - C) highest; above that
 - D) lowest; below that

ANSWER: B