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SKU: 9781337090582-SOLUTIONS

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CHAPTER 2
THE DOMESTIC AND INTERNATIONAL FINANCIAL MARKETPLACE

ANSWERS TO QUESTIONS:

1. The saving-investment cycle consists of net savers (surplus spending units) transferring funds to net investors (deficit spending units). The transfer can be made through either financial middlemen or financial intermediaries. For a given time period, actual savings equals actual investment.

2. Financial middlemen and intermediaries facilitate the transfer of funds during the saving-investment cycle. When financial middlemen aid in the transfer of funds, primary claims are issued to surplus spending units. When financial intermediaries are involved in the funds transfer process, secondary claims are issued to surplus spending units. These secondary claims are normally less risky than the primary claims received by the financial intermediaries.

3. Money markets deal in short-term securities having maturities of approximately one year or less, whereas capital markets deal in longer-term securities having maturities greater than one year. Primary markets are financial markets in which new securities are bought and sold for the first time, whereas secondary markets are financial markets in which existing securities are offered for resale.

4. Financial intermediaries:

- Commercial banks - Sources of funds are demand and time deposits. Uses of these funds are loans to individuals, businesses (short-term credit and term loans), and governments.

- Thrift institutions - These include savings and loan associations, mutual savings banks, and credit unions. Sources of funds are demand and time deposits. Savings and loan associations and mutual savings banks invest most of their funds in home mortgages and credit unions are engaged primarily in consumer loans.

- Investment companies - These include mutual funds and real estate investment trusts (REIT's). Mutual funds pool the funds of many savers and invest in financial assets, such as stocks, bonds, and money market instruments. REIT's invest in commercial and residential real estate.

- Pension funds - These intermediaries pool the contributions of employees (and/or employers) and invest these funds in both financial and real assets.

- Insurance companies - Sources of funds are premiums (payments) from individuals and organizations (policyholders). In exchange for these premiums, the insurance companies

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agree to make certain future contractual payments, such as death and disability benefits and compensation for financial losses arising from fire, theft, accident, or illness. The premiums are used to build reserves, which are invested in various types of financial and real assets.

- Finance companies - These intermediaries obtain funds by issuing their own securities and through loans from commercial banks. The funds then are loaned to individuals and businesses.

5. Factors that should be considered when determining the optimal form of organization for a business enterprise include the control desires of owner/managers, the future growth potential and the need for external capital, the possibility of conflicts between owners and managers, the tax consequences of the organizational structure, and the desire for a limited liability exposure by the owners.

6. In primary financial markets, new securities from an issuing firm are bought and sold for the first time. Hence, firms actually raise the capital they need in the primary financial markets. In secondary markets, existing securities are offered for resale. The issuing firm does not receive any new funds when securities trade in a secondary market, such as the New York Exchange. Secondary markets provide an important service of making securities liquid, and thereby the existence of secondary markets lowers the cost of raising funds in the primary markets.

7. The New York Stock Exchange is a physical location where buyers and sellers of securities meet to exchange assets. The New York Stock Exchange works through a specialist system and complex computer linkages that match buyers and sellers and maintain an orderly market. In contrast, the over-the-counter markets are not represented by any physical place of doing business. Rather, brokerage firms around the country are linked together in a computer network which lists the securities that are for sale (or desired for purchase), by whom, and at what price. When an investor wishes to buy or sell stocks over-the-counter, that investor's broker will check the computer network to see what other broker has the desired security for sale, in what quantity, and at what price. When an agreeable match occurs, the security is bought for the investor.

8. In an efficiently functioning capital market, security prices will be bid to a level where the security's expected return just equals its required return. New information about the expected return and risk of a security will be reflected quickly, and in an unbiased fashion, in its price. In an efficient capital market, shareholders can measure the performance of a firm's managers by observing the firm's stock price. Actions that increase a firm's stock price are contributing directly to the goal of maximizing shareholder wealth.

9. It is much easier and cheaper for a firm to raise capital in the marketplace if that marketplace operates in an informationally efficient manner. When the capital markets are informationally efficient, all relevant information regarding the prospects of a firm's securities is reflected in the price of those securities. Investors can buy securities with the comfort of knowing that these securities are likely to be "fairly" priced, given their risk and return characteristics.

10. a. A *multinational corporation* is a firm that has investments in manufacturing and/or

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distribution facilities in more than one country.

b. The *spot exchange rate* is the rate of exchange for currencies being bought and sold for immediate delivery.

c. The *forward exchange rate* is the rate of exchange between currencies to be delivered at a future date, such as 30, 90, or 180 days from today.

d. A *direct quote* is the come currency price of one unit of a foreign currency. An indirect quote is the foreign currency price of one unit of home currency.

e. An *option* is a contract or security that gives the option buyer the *right, but not the obligation,* to either buy or sell a fixed amount of another good or security, such as foreign currency, at a fixed price at a time up to, or at, the expiration date of the option..

f. The *London interbank offer rate (LIBOR)* is the interest rate at which banks in the Eurodollar market lend to each other.

g. The *Euro* is a composite currency whose value is based on the weighted value of 19 European currencies. On January 1, 2002, the euro replaced the individual currencies of the original 11 member European countries and became a common currency of these 11 counties. Since 2002, 8 other European countries have adopted the euro as their currency, as well as several micro countries, such as Monaco and the Vatican City, and two non-EU countries.

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SOLUTIONS TO PROBLEMS:

1. Returns over the past 12 months:
   a. +0.3%
   b. -4.6%
   c. +10.2%
   d. +1.2%

2. Percentage Holding Period (HP) Return
   = [(4400 - 4000 + 4(40))/4000] x 100%
   = **14%**
   Note: This problem ignores transaction costs. Also, since the stock has been sold, next year's expected price performance is irrelevant.

3. Percentage HP Return = [(9500 - 10,000 + 2(600))/10,000] x100%
   = **7%**
   Note: This solution ignores interest the investor may have received from reinvesting the first $600 interest payment. The information about the common stock purchases is not relevant in computing bond returns.

4. Percentage Holding Period Return:
   = [($100,000 - $99,500)/$99,500] x 100% = **0.5025%**
   On an annual basis, this is slightly greater than 6%.

5. Percentage Holding Period Return:
   = [($1,000 - $975 + $60)/$975] x 100% = **8.72%**

6.a. *Expected* Percentage Holding Period Return =
   [(65 - 60 + 4)/60] x 100% = **15.0%**
   b. *Realized* Percentage Holding Period Return =
   [(75 - 60 + 4)/60] x 100% = **31.67%**
   c. *Realized* Percentage Holding Period Return =
   [(58 - 60 + 4)/60] x 100% = **3.33%**
   d. *Realized* Percentage Holding Period Return =
   [(50 - 60 + 4)/60] x 100% = **-10.0%**

7. Percentage Holding Period (HP) Return
   = [($12,800 - $14,000)/$14,000] x 100%
   = **-8.57%**
   Note: The information about Treasury bill yields is not needed to solve this problem.

8. Percentage Holding Period (HP) Return (based on equity investment only)
   = [($190,000 - $110,000)/$33,000] x 100%
   = **242.42% for 6 months**

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Percentage Holding Period (HP) Return (based on total original cost)
= [($190,000 - $110,000)/$110,000] x 100%
= **72.73%**

9. Percentage Holding Period Return
= [($45 - $35)/$35] x 100% = **28.57%**

The stock appears to be a good investment because the expected return exceeds the required rate of return.

			Costs of Automobile	
10.	Date	Exchange Rate	U.S. Dollar	Japanese Yen
	Feb 25, 2013	$0.010891/Yen	**$**20,000	1,836,379*
	Nov 18, 2015	$0.008088/Yen	**$14,853****	1,836,379

* $20,000 ÷ $0.010891/Yen = 1,836,379 Yen

** 1,836,379 Yen x $0.008088/Yen = **$14,853**

				Cost per watch	
	Date	Exchange rate	No. of watches	U.S. Dollar	Swiss Francs
a.	02/25/13	$1.0728/franc	10,000	135.17**	126.0
b.	11/18/15	$0.9805/franc	12,000	**123.54**†	126.0

	Total Cost	
	U. S. Dollars	Swiss Francs
a.	**$1,351,728***	1,260,000
b.	**$1,482,516**††	1,512,000

* 1,260,000 francs x $1.0728/franc = $1,351,728

**$1,351,728/10,000 watches = $135.17/watch

† 126.0 francs x $0.9805/franc = $123.54/watch

†† $123.54/watch x 12,000 watches = $1,482,516

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12. Exchange Rate

	Country	Currency	11/18/15	2/25/13
a.	India	Rupee	0.01514	0.01845
b.	UK	Pound	1.5236	1.5165
c.	Japan	Yen	0.008088	0.010891
d.	EuroArea	Euro	1.0660	1.3062
e.	Canada	Dollar	0.7517	0.9745

a. [(0.01514 - 0.01845)(100)]/0.01845 = **-17.94%**

b. [(1.5236 - 1.5165)(100)]/1.5165 = **+0.47%**

c. [(0.008088 - 0.010891)(100)]/0.010891 = **-25.74%**

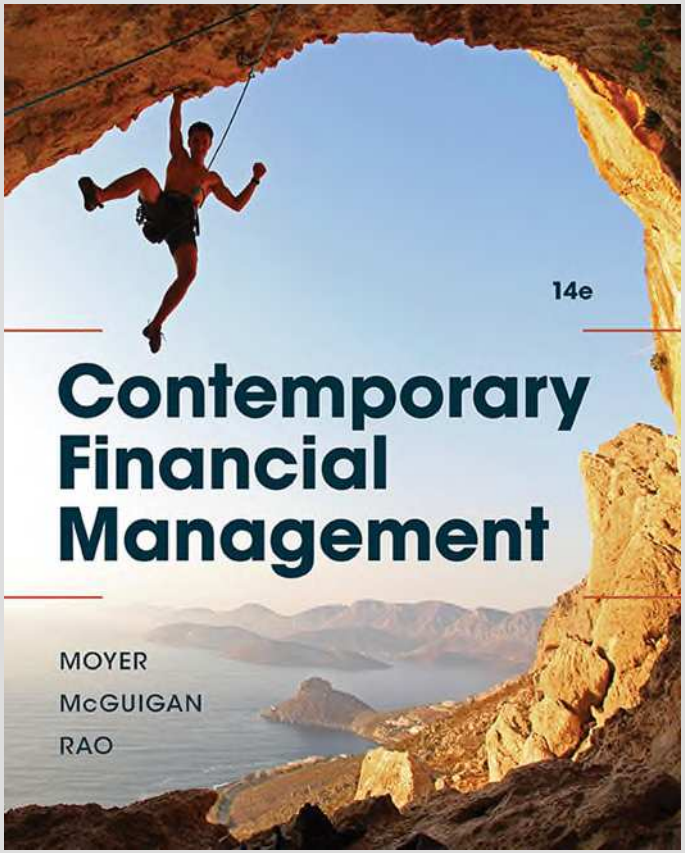
d. [(1.0660 – 1.3062)(100)]/1.3062 = **-18.39%**

e. [(0.7517 - 0.9745)(100)]/0.9745 = **-22.86%**

13. Holding Period Return (HPR):

HPR = [$45,000 - $15,000 - 10($500) - $400] / $15,000 = **164%**

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Chapter 2

The Domestic and International Financial Marketplace

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An Overview of the U.S. Financial System (slide 1 of 4)

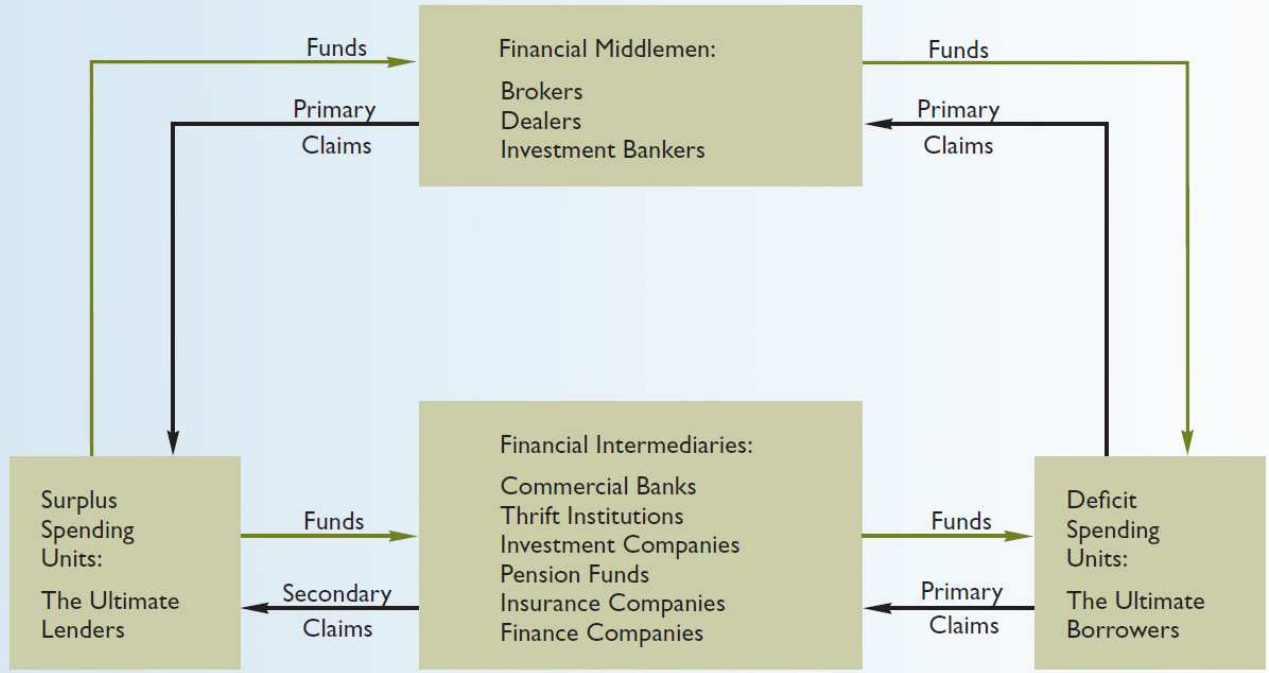
- Saving-Investment Cycle
  - **Surplus Spending Units**
  - **Deficit Spending Units**

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An Overview of the U.S. Financial System (slide 2 of 4)

FIGURE 2.1

Flow-of-Funds Diagram



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An Overview of the U.S. Financial System (slide 3 of 4)

- Financial Assets
  - **Money**
  - **Debt Securities**
  - **Equity Securities**
- Financial Markets
  - **Money and Capital Markets**
  - **Primary and Secondary Markets**

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An Overview of the U.S. Financial System (slide 4 of 4)

- Financial Intermediaries
  - **Commercial Banks**
  - **Thrift Institutions**
  - **Investment Companies**
  - **Pension Funds**
  - **Insurance Companies**
  - **Finance Companies**

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The Structure and Operation of U.S. Security Markets (slide 1 of 4)

- Security Exchanges and Stock Market Indexes
  - **Listed Security Exchanges**
    - **NYSE**
      - Floor brokers
      - Designated market makers
  - **Over-the-Counter (OTC) Markets**
    - **NASDAQ**
      - Bid price
      - Ask price
      - Spread

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The Structure and Operation of U.S. Security Markets (slide 2 of 4)

- Security Exchanges and Stock Market Indexes
  - **Stock Market Indexes**
    - **Dow Jones Industrial Average**
    - **Standard & Poor's 500**

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The Structure and Operation of U.S. Security Markets (slide 3 of 4)

- Regulation of the Security Markets
  - **Blue Sky Laws**
  - **Securities and Exchange Commission (SEC)**
    - **10-K**
      - Annual Report
    - **10-Q**
      - Quarterly Report
    - **14-A**
      - Proxy Statements
    - **Insider Trading**

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The Structure and Operation of U.S. Security Markets (slide 4 of 4)

- Regulation of the Security Markets
  - **Sarbanes-Oxley Act**
    - **Top management is directly responsible for the accuracy of the firm's financial statements**
    - **Strengthened the independence and accountability of the audit committee**
    - **Created the Public Company Accounting Standards Board**
    - **Requires that auditors now certify a firm's financial control system**
    - **Ensures independence of financial analysts**

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The Global Economy and Multinational Enterprises

- Goods and Services Trade Balance
  - **Import**
  - **Export**
  - **Trade Surplus/Deficit**
- Multinational Corporation
  - **Direct investments in manufacturing and/or distribution facilities in more than one country**

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Foreign Currency Markets and Exchange Rates (slide 1 of 7)

- Exchange Rate
- The Eurocurrency Market
  - **Eurocurrency**
  - **Eurodollars**
  - **LIBOR**
- The Euro: A Common European Currency
  - **European Union**
  - **European Central Bank**

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How are foreign exchange rates quoted?

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Foreign Currency Markets and Exchange Rates (slide 2 of 7)

- Direct Quote
  - **Home currency price of one unit of foreign currency**
    - **$1.30/€**
- Indirect Quote
  - **Foreign currency price of one unit of home currency**
    - **€0.7692/$**

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Foreign Currency Markets and Exchange Rates (slide 3 of 7)

- Spot Rates
- Forward Rates
  - **Premium**
  - **Discount**

$$\text{Annualized forward premium or discount} = \left(\frac{F - S_0}{S_0}\right)\left(\frac{12}{n}\right)(100\%)$$

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Foreign Currency Markets and Exchange Rates (slide 4 of 7)

TABLE 2.1

Spot Foreign Exchange Rates (Direct Quotes)

Country	Currency	Exchange Rate (U.S. Dollars) February 25, 2013	Exchange Rate (U.S. Dollars) November 18, 2015
Australia	Dollar	$1.0258	$0.7111
U.K.	Pound	$1.5165	$1.5236
Canada	Dollar	$0.9745	$0.7517
India	Rupee	$0.01845	$0.01514
Japan	Yen	$0.010891	$0.008088
South Africa	Rand	$0.1129	$0.0706
Switzerland	Franc	$1.0728	$0.9805
Euro area	Euro	$1.3062	$1.0660

Source: *The Wall Street Journal* (February 26, 2013 and November 19, 2015).

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Foreign Currency Markets and Exchange Rates (slide 5 of 7)

TABLE 2.2

Forward Foreign Exchange Rates

	Exchange Rate (U.S. Dollars) February 25, 2013		
Currency	**1-Month Forward**	**3-Month Forward**	**6-Month Forward**
U.K. pound	$1.5162	$1.5158	$1.5152
Japanese yen	0.010893	0.010898	0.010908
Swiss franc	1.0731	1.0739	1.0752

Source: *The Wall Street Journal* (February 26, 2013).

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Foreign Currency Markets and Exchange Rates (slide 6 of 7)

- Foreign Currency Futures
  - **Forward Contract**
  - **Futures Contract**
    - **Exchange traded**
    - **Standardized amount**
    - **Standardized maturity date**
    - **"Marked to market"**

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Foreign Currency Markets and Exchange Rates (slide 7 of 7)

- Foreign Currency Options
  - **Call Option**
  - **Put Option**
  - **American Option**
  - **European Option**

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Market Efficiency (slide 1 of 5)

- Efficient Capital Markets
  - **Stock prices:**
    - **Provide an unbiased estimate of the true value of an enterprise**
    - **Reflect a present value estimate of the firm's expected cash flows, evaluated at an appropriate required rate of return**

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Market Efficiency (slide 2 of 5)

- Information and Capital Market Efficiency
  - **Capital markets are efficient if security prices instantaneously reflect in an unbiased manner all economically relevant information about a security's prospective returns and the risk of those returns**
  - **Short-Selling**

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Market Efficiency (slide 3 of 5)

- Degrees of Market Efficiency
  - **Weak-Form Efficiency**
  - **Semistrong-Form Efficiency**
  - **Strong-Form Efficiency**

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Market Efficiency (slide 4 of 5)

- Implications of Market Efficiency for Financial Managers
  - **Timing or Gambling**
  - **An Expected NPV of Zero**
  - **Expensive and Unnecessary Corporate Diversification**
  - **Security Price Adjustments**

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Market Efficiency (slide 5 of 5)

- Behavioral Finance Perspectives on the Financial Marketplace
  - **Psychological considerations may lead to market inefficiencies**
    - **Investor's refusal to sell a losing stock**
    - **Fixating on a price target for a stock, filtering out evidence that investor may be wrong**
    - **Tendency to focus too heavily on up or down price trends**

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Holding Period Returns

- Holding Period Return
  - **Also called**
    - **Holding Period Yield**
    - **Realized Rate of Return**

$$\text{Holding period return (\%)} = \frac{\text{Ending price} - \text{Beginning price} + \text{Distributions received}}{\text{Beginning price}} \times (100\%)$$

  - **Realized/Ex Post**
  - **Expected/Ex Ante**

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What caused the financial crisis that began in 2007?

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Overview of the Financial Crisis beginning in 2007 (slide 1 of 5)

- Causes of the Financial Crisis
  - **Real Estate Bubble**
  - **Very Low Interest Rates**
  - **Increased Use of Leverage**
  - **Securitization of Subprime Mortgages**

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Overview of the Financial Crisis beginning in 2007 (slide 2 of 5)

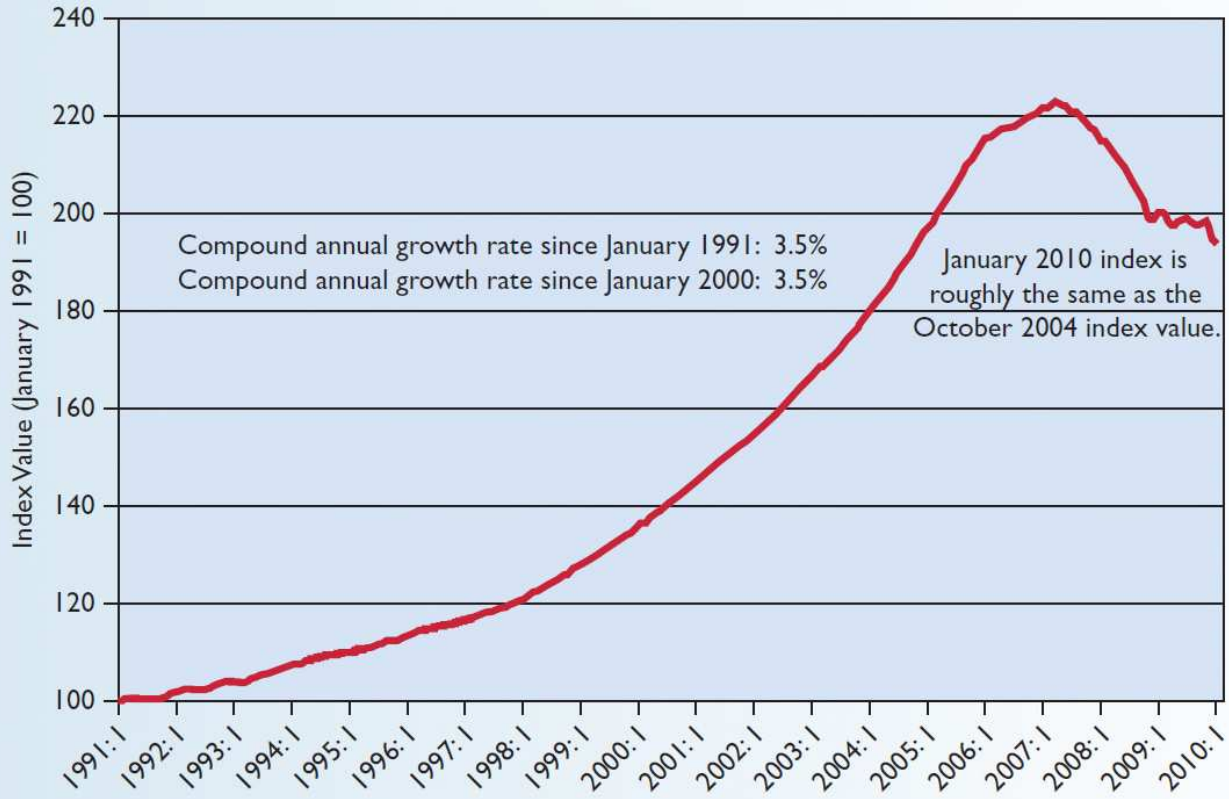
- How Firms Were Affected by the Financial Crisis
  - **Recession**
    - **Higher Unemployment**
    - **Business Cut Back**
  - **Nimble firms with low business risk and tight controls on costs weathered the storm better**

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Overview of the Financial Crisis beginning in 2007 (slide 3 of 5)

FIGURE 2.5

Index of U.S. Home Prices (Purchase-Only, Seasonally Adjusted Index, January 1991–January 2010)



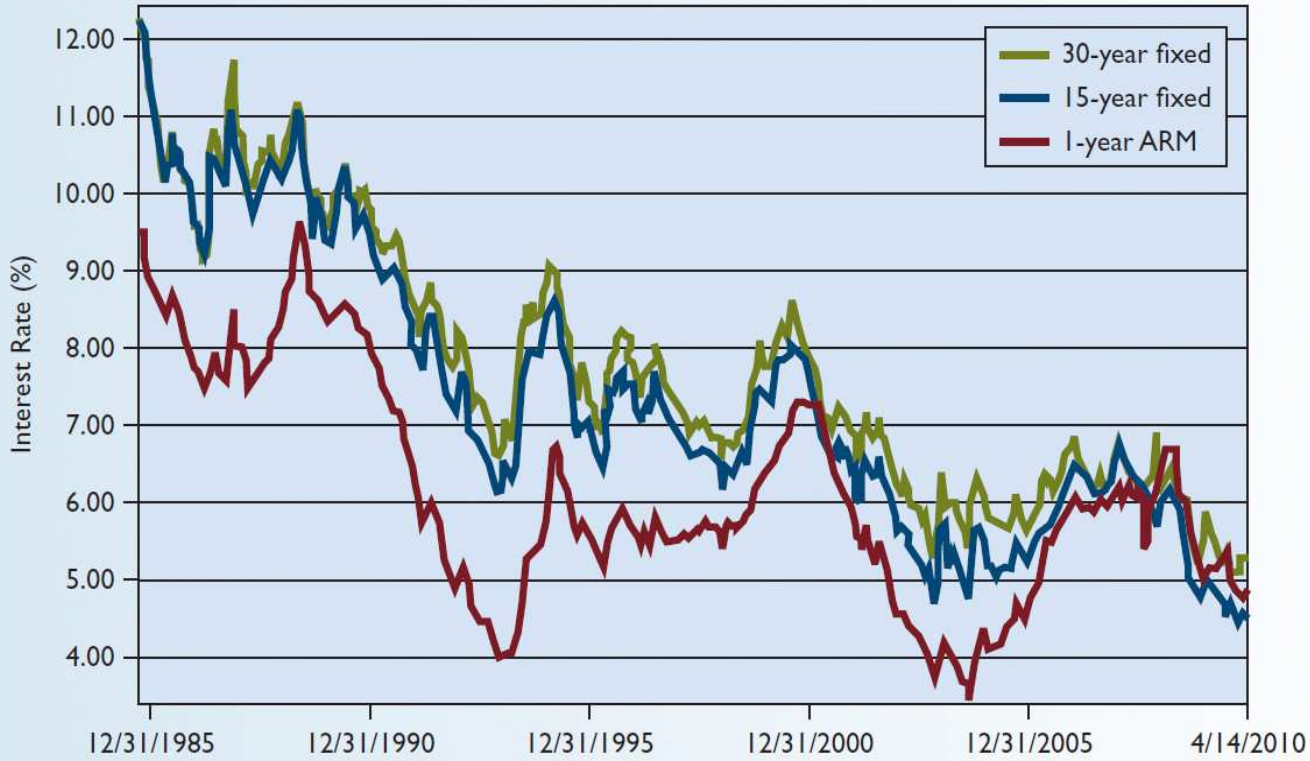
Source: Federal Housing Finance Agency.

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Overview of the Financial Crisis beginning in 2007 (slide 4 of 5)

FIGURE 2.6

U.S. Mortgage Interest Rates



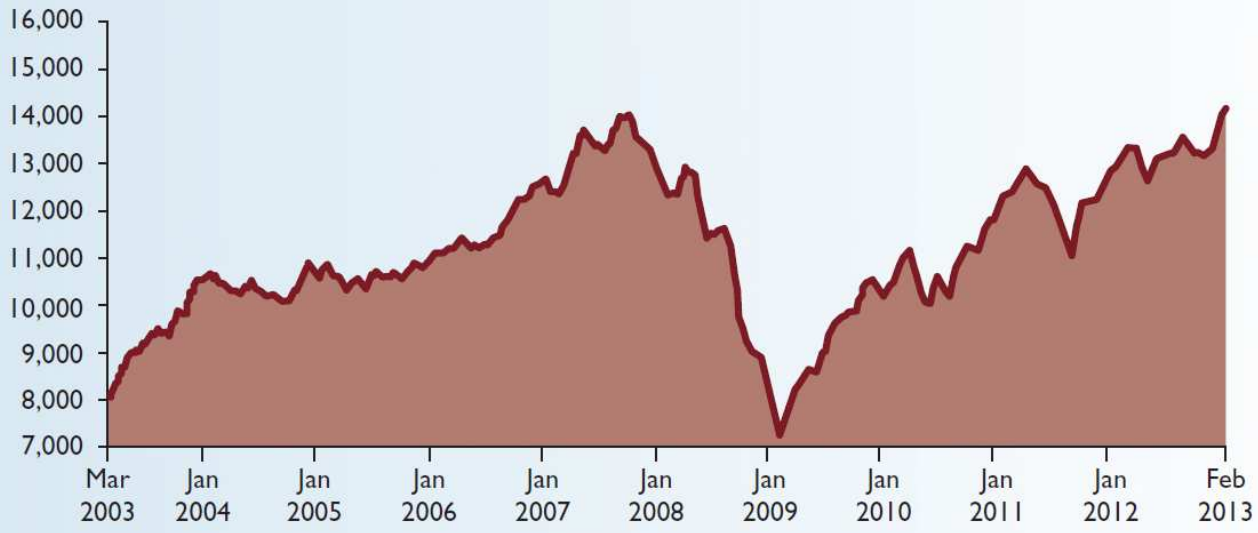
Source: Bankrate.com.

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Overview of the Financial Crisis beginning in 2007 (slide 5 of 5)

FIGURE 2.7

Dow Jones Industrial Average Index (2003–2013)



Source: money.msn.com (February 26, 2013).

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Income Taxes and Financial Management

- Implications of Income Taxes for Financial Managers
  - **Capital Structure Policy**
  - **Dividend Policy**
  - **Capital Budgeting**
  - **Leasing**

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Appendix: Corporate Income Taxes
(slide 1 of 3)

- Capital Gains Income
- Dividend Income
- Loss Carrybacks and Carryforwards

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Appendix: Corporate Income Taxes

(slide 2 of 3)

TABLE 2A.1

2015 Corporate Tax Rates

Taxable Income	Marginal Tax Rate	Tax Calculation Base Tax + (Marginal Tax Rate × Amount over Base Income)
Up to $50,000	15%	$ 0 + (15% × Amount over $0)
$50,001–$75,000	25%	$ 7,500 + (25% × Amount over $50,000)
$75,001–$100,000	34%	$ 13,750 + (34% × Amount over $75,000)
$100,001–$335,000	39%*	$ 22,250 + (39% × Amount over $100,000)
$335,001–$10,000,000	34%	$ 113,900 + (34% × Amount over $335,000)
$10,000,001–$15,000,000	35%	$ 3,400,000 + (35% × Amount over $10,000,000)
$15,000,001–$18,333,333	38%**	$ 5,150,000 + (38% × Amount over $15,000,000)
Over $18,333,333	35%	35% × Taxable Income

*Includes additional 5% "recapture" tax under the Tax Reform Act of 1986.

**Includes additional 3% "recapture" tax under the Revenue Reconciliation Act of 1993.

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Appendix: Corporate Income Taxes

(slide 3 of 3)

TABLE 2A.2

Computation of Corporate Income Taxes

Taxable Income ($)	Marginal Tax Rate (%)	Tax Calculation	Average Tax Rate (%)
25,000	15%	$0 + (.15 × $25,000) = $3,750	15.0
75,000	25	$7,500 + (.25 × $25,000) = $13,750	18.33
100,000	34	$13,750 + (.34 × $25,000) = $22,250	22.25
250,000	39	$22,250 + (.39 × $150,000) = $80,750	32.3
1,250,000	34	$113,900 + (.34 × $915,000) = $425,000	34.0
2,500,000	34	$113,900 + (.34 × $2,165,000) = $850,000	34.0
12,500,000	35	$3,400,000 + (.35 × $2,500,000) = $4,275,000	34.2
17,500,000	38	$5,150,000 + (.38 × $2,500,000) = $6,100,000	34.86
25,000,000	35	.35 × $25,000,000 = $8,750,000	35.0
125,000,000	35	.35 × $125,000,000 = $43,750,000	35.0

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