Personal Finance, 6e **(Madura)**
Chapter 16   Investing in Bonds

16.1   Background on Bonds

1) Bonds are equity investments issued by corporations or government agencies.
Answer: FALSE
Diff: 2
Question Status: Previous edition

2) A bond's par value or face value is the amount the investor will get paid when the bond matures.
Answer: TRUE
Diff: 1
Question Status: Revised

3) Generally, bonds have maturities between 10 and 30 years and pay interest annually.
Answer: FALSE
Diff: 2
Question Status: Previous edition

4) If you want to receive periodic income from your investments, you should consider investing in bonds rather than stocks.
Answer: TRUE
Diff: 1
Question Status: Previous edition

5) A call feature on bonds allows the issuer to buy back the bonds from investors before the maturity date.
Answer: TRUE
Diff: 1
Question Status: Previous edition

6) Bonds that have a call feature are less desirable to investors and therefore pay a slightly higher rate than bonds without this feature.
Answer: TRUE
Diff: 1
Question Status: Previous edition

7) Bonds are issued with a callable feature when the issuers expect interest rates to rise.
Answer: FALSE
Diff: 2
Question Status: Previous edition

8) A convertible bond allows the investor to exchange that bond for another issue of bonds within the convertible period.
Answer: FALSE
Diff: 2
Question Status: Previous edition

9) A bond's yield to maturity is the annualized percentage return of both interest and capital gains or losses if the bond were held until it matured.
Answer: TRUE
Diff: 1
Question Status: Previous edition

10) Because convertibility is a desirable feature for investors, convertible bonds tend to offer a higher return than nonconvertible bonds.
Answer: FALSE
Diff: 1
Question Status: Revised

11) When a bond has a par or face value of $1,000 and a 6% coupon rate, the semiannual payment would be $60.
Answer: FALSE
Diff: 1
Question Status: Revised

12) During their lifetime, bonds can be sold for more or less than their face value depending on the demand for these particular bonds.
Answer: TRUE
Diff: 1
Question Status: Previous edition

13) An advantage to owning bonds is that investors can sell them to other investors in the primary market before the bonds reach maturity.
Answer: FALSE
Diff: 2
Question Status: Previous edition

14) The ________ is the amount returned to the investor at the maturity date when the bond is due.
A) principal
B) interest gain
C) capital gain
D) terminal value
Answer: A
Diff: 2
Question Status: Previous edition

15) Which of the following is **not always** a true statement?
A) The par value of a bond is its face value.
B) The par value of a bond is its market value.
C) The par value of a bond will be paid to the bondholder at maturity.
D) The par value multiplied by the coupon rate equals the interest paid to investors annually.
Answer: B
Diff: 1
Question Status: Revised

16) Bonds usually pay interest
A) annually.
B) semiannually.
C) quarterly.
D) monthly.
Answer: B
Diff: 2
Question Status: Revised

17) You should consider investing in bonds rather than stock if you
A) are willing to take more risk.
B) wish to receive income from your investment.
C) are willing to tie up your investment for a long period.
D) think interest rates will increase significantly in the near future.
Answer: B
Diff: 1
Question Status: Previous edition

18) Which of the following is **not** a reason investors purchase bonds?
A) Conservative investment
B) Pay periodic income
C) May be convertible
D) Have high risk and return
Answer: D
Diff: 1
Question Status: Previous edition

19) Investors purchase corporate bonds because
A) they are a risk-free investment.
B) they pay interest income.
C) they pay dividends.
D) the returns are higher than the returns from stocks.
Answer: B
Diff: 1
Question Status: Revised

20) All of the following may be a feature of a bond, **except**
A) convertible.
B) dividends.
C) tax-free.
D) callable.
Answer: B
Diff: 1
Question Status: Revised

21) Investing in bonds gives you the possibility of all of the following **except**
A) having a capital gain.
B) losing your investment if the company goes bankrupt.
C) receiving dividends.
D) receiving the face value at maturity.
Answer: C
Diff: 1
Question Status: Previous edition

22) Investors are willing to purchase bonds with a call feature only if the bonds offer a(n)
A) slightly lower return than similar bonds without a call feature.
B) slightly higher number of shares of the issuer's stock.
C) slightly higher return than similar bonds without a call feature.
D) extraordinary return similar to an IPO.
Answer: C
Diff: 2
Question Status: Previous edition

23) A ________ feature on a bond allows the issuer to buy back the bond from the investor before maturity.
A) convertible
B) dividend
C) call
D) recall
Answer: C
Diff: 1
Question Status: Previous edition

24) Which of the following features of a bond **could** result in the company never paying out cash to redeem the bonds?
A) Par value
B) Call feature
C) Convertibility
D) Yield to maturity
Answer: C
Diff: 2
Question Status: Previous edition

25) If a company anticipates a substantial decline in interest rates in the future, which of the following is it likely to include in a bond?
A) Par value
B) Call feature
C) Convertibility
D) Reverse dividend
Answer: B
Diff: 1
Question Status: Revised

26) Callable bonds are issued when interest rates are expected to
A) stay the same.
B) decline.
C) rise.
D) None of the above.
Answer: B
Diff: 1
Question Status: Previous edition

27) Bonds that may be exchanged for common stock when the stock reaches a specified price are called
A) options.
B) convertible bonds.
C) callable bonds.
D) stock bonds.
Answer: B
Diff: 1
Question Status: Revised

28) Convertible bonds tend to offer a(n) ________ return than nonconvertible bonds.
A) higher
B) lower
C) similar
D) indexed
Answer: B
Diff: 1
Question Status: Revised

29) If a company's stock price is expected to increase substantially over the next few years, which of the following may entice potential bondholders to accept a lower coupon rate on the company's bonds?
A) Par value
B) Call feature
C) Convertibility
D) Reserve feature
Answer: C
Diff: 1
Question Status: Revised

30) If a bond's price is lower than the principal amount, its yield to maturity will be ________ the coupon rate.
A) less than
B) more than
C) equal to
D) no relation to
Answer: B
Diff: 2
Question Status: Revised

31) The return on bonds currently held will be more favorable if interest rates ________ over the period you hold the bonds.
A) increase
B) decrease
C) fluctuate
D) remain the same
Answer: B
Diff: 1
Question Status: Revised

32) The coupon rate of interest on a bond is always stated as a(n)
A) daily rate.
B) monthly rate.
C) semiannual rate.
D) annual rate.
Answer: D
Diff: 2
Question Status: Revised

33) On the secondary bond market,
A) only new bonds can be sold.
B) bonds are guaranteed to bring at least par value.
C) bond prices vary with interest rate movement and other factors.
D) bonds usually take several days to sell.
Answer: C
Diff: 1
Question Status: Previous edition

34) The ________ is the stated interest rate of the bond at the time it was issued.
A) effective rate
B) yield
C) coupon rate
D) IRR
Answer: C
Diff: 1
Question Status: Previous edition

35) If a bond's value rises above its face value during its life, interest rates have
A) increased.
B) decreased.
C) stayed the same.
D) there is no relationship between bond prices and interest rates.
Answer: B
Diff: 1
Question Status: Previous edition

36) The current yield on a $1,000 par value bond worth $900 and a coupon rate of 10% is
A) 12.05%.
B) 9%.
C) 10%.
D) 11.11%.
Answer: D
Explanation: D) $100/$900 = 11.11%
Diff: 1
Question Status: Previous edition

37) What is the semiannual interest payment on a $1,000 bond with a 7% coupon rate?
A) $70
B) $35
C) $350
D) $700
Answer: B
Explanation: B) $1,000 × 0.07 × 0.5 = $35
Diff: 2
Question Status: Revised

38) If a bond pays $50 interest semiannually with a par value of $1,000, its coupon rate is
A) 5%.
B) 10%.
C) 15%.
D) 20%.
Answer: B
Explanation: B) ($50 × 2)/$1,000 = 10 percent
Diff: 2
Question Status: Revised

39) Another name for the par value of a bond is its ________.
Answer: face value
Diff: 1
Question Status: Previous edition

40) If a bond can be exchanged for common stock if the stock reaches a specified price, the bond is a(n) ________.
Answer: convertible bond
Diff: 1
Question Status: Revised

Use the following two columns of items to answer the matching questions below:

A) long-term securities issued by government agencies or corporations
B) par value or the amount returned to the investor at maturity
C) bonds that can be converted into stock
D) annualized return on a bond if held to maturity

41) bonds
Diff: 1
Question Status: New

42) yield to maturity
Diff: 1
Question Status: New

43) face value
Diff: 1
Question Status: New

44) convertible
Diff: 1
Question Status: New

Answers: 41) A 42) D 43) B 44) C

45) If a par value $1,000 bond is convertible into 20 shares of the company's stock at the discretion of the investor, what must the market price of the stock be in order for the investor to make the conversion?
A) $1,000
B) $49.50
C) $50.01
D) $50
Answer: C
Diff: 1
Question Status: New

46) The advantage of a convertible bond to the investor is
A) higher coupon interest rates.
B) ability to "own the upside" if the company performs well.
C) convertibility protects the investor if the stock decreases in value.
D) none of these are advantages.
Answer: B
Diff: 2
Question Status: New

47) You own a $1,000 par value convertible bond with a 6% coupon rate. The bond is convertible into 20 shares of stock at the investor's discretion. The stock price has reached $51 per share with a $1 per share annual dividend, but you do not forecast any further price appreciation in the stock. Should you make the conversion?
A) No, 20 shares of stock are not worth $1,000.
B) Yes, since the stock is worth $51 per share it is worth more than the bond.
C) No, the total stock is only worth $20 more than the bond, and you would lose $40 in annual cash flow based on the coupon rate versus the dividend.
D) Yes, while the stock is only worth $20 more in total than the bond, you will receive an annual $1 per share dividend.
Answer: C
Diff: 3
Question Status: New

16.2 Types of Bonds

1) The interest received from U.S. Treasury bonds is exempt from federal, state, and local income taxes.
Answer: FALSE
Diff: 2
Question Status: Previous edition

2) Since municipal bond interest is exempt from federal income tax, it is especially beneficial to high-income investors.
Answer: TRUE
Diff: 1
Question Status: Previous edition

3) Municipal bonds are those issued by the U.S. Treasury Department for the benefit of cities and states.
Answer: FALSE
Diff: 1
Question Status: Previous edition

4) Junk bonds offer a relatively high rate of return, but they are more likely to default than other bonds.
Answer: TRUE
Diff: 1
Question Status: Previous edition

5) Some ________ bonds are called junk bonds, which have a high level of risk.
A) Treasury
B) Municipal
C) Federal Agency
D) Corporate
Answer: D
Diff: 1
Question Status: New

6) Which of the following is not a characteristic of Treasury bonds?
A) Long-term debt securities
B) Issued by the U.S. Treasury
C) Exempt from federal tax
D) Highly liquid
Answer: C
Diff: 2
Question Status: Revised

7) ________ bonds are the least risky of all bonds and, therefore, pay a lower rate of interest.
A) Treasury
B) Municipal
C) Federal agency
D) Corporate
Answer: A
Diff: 1
Question Status: Previous edition

8) ________ bonds are issued by state and local government agencies.
A) Treasury
B) Municipal
C) Federal agency
D) Corporate
Answer: B
Diff: 1
Question Status: Previous edition

9) Municipal bonds tend to have a ________ coupon rate than Treasury bonds issued at the same time; however, municipal bonds usually offer a(n) ________ after-tax return to investors.
A) higher; lower
B) lower; higher
C) higher; higher
D) lower; equal
Answer: B
Diff: 2
Question Status: Previous edition

10) Municipal bonds are most beneficial for investors who
A) reside in a different state from the municipality that issued the bonds.
B) are in a low tax bracket.
C) are in a high tax bracket.
D) qualify for the earned income credit.
Answer: C
Diff: 1
Question Status: Revised

11) Which of the following statements is **not** true regarding municipal bonds?
A) They are issued by state and local governments.
B) They are free from the risk of default.
C) The interest is exempt from federal income taxes.
D) The interest is exempt from state taxes if the investor resides in the state where the bond was issued.
Answer: B
Diff: 2
Question Status: Revised

12) Federal agency bonds are all of the following **except**
A) issued by government agencies or government-sponsored entities.
B) have a very low degree of default risk.
C) issued by Ginnie Mae, Freddie Mac, and Fannie Mae.
D) exempt from all taxation.
Answer: D
Diff: 1
Question Status: Revised

13) A bond from Ginnie Mae is an example of a bond issued by
A) a corporation.
B) the U.S. Treasury.
C) a municipality.
D) an agency of the federal government.
Answer: D
Diff: 2
Question Status: Revised

14) Which of the following is **not** a characteristic of corporate bonds?
A) Have different ratings
B) Are long-term equity securities
C) Subject to default risk
D) Not backed by the federal government
Answer: B
Diff: 1
Question Status: Previous edition

15) Which of the following is a characteristic of corporate bonds?
A) Rated on a scale from AAAA to FFFF
B) Used to finance debt over a short period such as six months
C) Issued as long-term debt securities
D) Exempt from state tax in the state where the issuing company has its headquarters
Answer: C
Diff: 2
Question Status: New

16) A(n) ________ corporate bond will pay a ________ return.
A) lower-rated; higher
B) higher-rated; higher
C) lower-rated; lower
D) unrated; lower
Answer: A
Diff: 1
Question Status: Previous edition

17) Which of the following issuers' bonds would be subject to both federal and state income taxes?
A) City of Chicago
B) Saline, Michigan School District
C) Apple, Inc.
D) U.S. Treasury
Answer: C
Diff: 2
Question Status: Revised

18) Which of the following statements is **not** true of corporate bonds?
A) They are debt securities issued by large companies.
B) They have long-term maturity dates.
C) They are very secure and almost never default.
D) They can offer a predictable source of income.
Answer: C
Diff: 1
Question Status: Revised

19) Another name for high-yield bonds is
A) corporate bonds.
B) federal agency bonds.
C) T-bills.
D) junk bonds.
Answer: D
Diff: 1
Question Status: Previous edition

20) Corporate bond quotations in the daily financial newspapers include all of the following, **except**
A) coupon rate and volume.
B) maturity and closing price.
C) current yield and net change from the previous day.
D) original face value of the bond.
Answer: D
Diff: 2
Question Status: Revised

21) A $1,000 bond with a coupon rate of 6.5% has a market price of $950. What is the current yield?
A) 6.5%
B) 6.8%
C) 7.0%
D) 6.2%
Answer: B
Explanation: B) $\$1,000 \times 0.065 = \$65/\$950 = 6.8\%$ (rounded)
Diff: 2
Question Status: Revised

22) A $1,000 face value bond with a quoted price of 98 is selling for
A) $1,000.
B) $98.
C) $980.
D) $988.
Answer: C
Explanation: C) $\$1,000 \times 0.98 = \$980$
Diff: 2
Question Status: Previous edition

23) The City of Chicago would issue ________ if it wished to borrow money.
Answer: municipal bonds
Diff: 1
Question Status: Revised

Use the following two columns of items to answer the matching questions below:

A) subject to a higher degree of default risk
B) issued by the U.S. Treasury

24) junk bonds
Diff: 1
Question Status: New

25) Treasury bonds
Diff: 1
Question Status: New

Answers: 24) A 25) B

26) A corporate bond with a rating below ________ is considered to be a junk bond?
A) AAA
B) A
C) BBB
D) B
Answer: C
Diff: 1
Question Status: New

27) A bond's yield to maturity is above its coupon rate when
A) the bond's market price is above par value.
B) the bond's market price is below par value.
C) the bond is convertible and the stock has appreciated.
D) interest rates are lower than the prime rate.
Answer: B
Diff: 2
Question Status: New

28) When a bond has a call feature, the investor should consider the ________ when deciding whether to invest in the bond if it is not selling at par value?
A) convertibility provision
B) interest rate
C) yield to call
D) yield to maturity
Answer: C
Diff: 3
Question Status: New

16.3 Return from Investing in Bonds

1) As interest rates rise, the market price of your bond is also likely to rise.
Answer: FALSE
Diff: 2
Question Status: Previous edition

2) If you buy a corporate bond for $970 and sell it six months later for $1,050, you will have
A) interest income of $80.
B) a short-term capital gain of $80.
C) a long-term capital gain of $80.
D) nontaxable income of $80.
Answer: B
Diff: 1
Question Status: Revised

3) Which of the following tax effects could **not** occur with the purchase and sale of a corporate bond?
A) Capital gain
B) Capital loss
C) Interest is taxed at ordinary rates.
D) Interest is not taxable.
Answer: D
Diff: 2
Question Status: Previous edition

4) The relationship between a bond's price and the yield to maturity
A) changes at a rate equal to the change in yield.
B) is linear.
C) is inverse.
D) is relative.
Answer: C
Diff: 2
Question Status: Previous edition

5) Which of the following tax implications will result from selling your bonds at a lower price than what you paid for them eight months ago?
A) You have a short-term capital gain taxed at your ordinary income tax rate.
B) You have a long-term capital gain subject to capital gains tax.
C) You have a long-term capital loss.
D) You have a short-term capital loss.
Answer: D
Diff: 2
Question Status: Previous edition

6) If you purchased a 6% bond at par value and sold it 12 months plus 1 day later for $1100, the taxable income you would have realized over the two year period is
A) $100 long term capital gain.
B) $160 ordinary income gain.
C) $60 ordinary income and $100 short term capital gain.
D) $60 ordinary income and $100 long term capital gain.
Answer: D
Diff: 2
Question Status: New

16.4 Valuing a Bond

1) Figuring the present value of future coupon payments, along with the present value of the principal payment, is a good way to determine the value of a bond.
Answer: TRUE
Diff: 2
Question Status: Previous edition

2) The present value of a bond can be computed by discounting the ________ to be received from the bond.
A) capital gains
B) required rate of return
C) tax benefits
D) future cash flows (coupon and principal payments)
Answer: D
Diff: 2
Question Status: New

3) The two future cash flows used to determine a bond value are the periodic coupon payments and the ________ at maturity.
Answer: principal payment
Explanation: *Appendix
Diff: 1
Question Status: Previous edition

4) The secondary market price of a bond is based on
A) the bond's coupon payments.
B) the number of years the bond has until maturity.
C) the market interest rate required for bonds of a similar risk and term.
D) All of the above are factors in determining the bond's market price.
Answer: D
Diff: 2
Question Status: New

16.5 Risk from Investing in Bonds

1) The risk premium of bonds is the amount by which their annualized yield exceeds the Treasury bond yield.
Answer: TRUE
Diff: 1
Question Status: Previous edition

2) To completely avoid the risk of default, investors can invest in Treasury bonds or A-rated corporate bonds.
Answer: FALSE
Diff: 2
Question Status: Previous edition

3) Bonds with longer maturities are more sensitive to interest rate movements than bonds that have shorter maturities.
Answer: TRUE
Diff: 2
Question Status: Previous edition

4) If you expect interest rates to rise over time, you should consider investing in bonds with longer maturities.
Answer: FALSE
Diff: 1
Question Status: Previous edition

5) All bonds are subject to the following risks **except**
A) default risk.
B) call risk.
C) interest rate risk.
D) impact of economic conditions.
Answer: B
Diff: 2
Question Status: Previous edition

6) As interest rates go up, bond prices
A) also go up.
B) go down.
C) remain the same.
D) may go up or down.
Answer: B
Diff: 2
Question Status: Previous edition

7) Bonds with a ________ degree of default risk are most susceptible to default when economic conditions are ________.
A) low; strong
B) high; weak
C) high; strong
D) low; weak
Answer: B
Diff: 2
Question Status: Previous edition

8) ________ bonds do not contain a risk premium because they are free from default risk.
A) Treasury
B) Municipal
C) Corporate
D) City
Answer: A
Diff: 1
Question Status: Previous edition

9) The risk that you will be forced to sell your bond back to the issuer prior to maturity is the
A) call (prepayment) risk.
B) default risk.
C) interest rate risk.
D) political risk.
Answer: A
Diff: 2
Question Status: Previous edition

10) The ________ is an additional return beyond the risk-free rate that investors require to compensate them for the additional risk.
A) additional premium
B) risk premium
C) specific return
D) nominal return
Answer: B
Diff: 2
Question Status: Revised

11) Bonds with ________ terms to maturity are ________ sensitive to interest rate movements than bonds that have short terms remaining until maturity.
A) middle; less
B) longer; less
C) longer; more
D) longer; equally
Answer: C
Diff: 2
Question Status: Previous edition

12) Which of the following does **not** influence a bond's yield to maturity?
A) Call risk
B) Interest rate risk
C) Firm's risk
D) Historic yields to maturity
Answer: D
Diff: 2
Question Status: Previous edition

13) Which of the following bond ratings represents a high-quality risk class?
A) Baa
B) Aa
C) Ba
D) C
Answer: B
Diff: 2
Question Status: Revised

14) The possibility that a bond will be called by the corporation prior to its maturity is an example of ________ risk.
Answer: call; prepayment
Diff: 1
Question Status: Revised

Use the following two columns of items to answer the matching questions below:

A) risk that a bond's price will decline in response to an increase in interest rates
B) compensation required for default risk
C) risk that the face value may not be repaid

15) risk premium
Diff: 1
Question Status: New

16) default risk
Diff: 1
Question Status: New

17) interest rate risk
Diff: 1
Question Status: New

Answers: 15) B 16) C 17) A

18) Name and explain two risks involved with bonds.
Answer: Default risk is the risk that the issuer will not repay the principal.
Interest rate risk is the risk of a decline in price in response to rising interest rates.
Call risk is the risk that the bond will be called before maturity.
Diff: 1
Question Status: Previous edition

19) One important aspect of bond research includes finding the bond rating. Bond ratings are related to what type of risk?
Answer: Default risk
Diff: 1
Question Status: Previous edition

16.6   Bond Investment Strategies

1) A passive strategy of bond investing consists of buying bonds for the long term and not selling them until maturity.
Answer: TRUE
Diff: 2
Question Status: Previous edition

2) The maturity matching strategy involves selecting bonds that will generate payments to match future expenses.
Answer: TRUE
Diff: 1
Question Status: Previous edition

3) When you select bonds based on the expectation that interest rates will decline, you are using a(n) ________ strategy.
A) interest rate
B) maturity matching
C) passive rate
D) active rate
Answer: A
Diff: 1
Question Status: Revised

4) The ________ strategy is intended to generate periodic and stable interest income.
A) interest rate
B) maturity matching
C) passive
D) active
Answer: C
Diff: 1
Question Status: Previous edition

5) Your son will be ready for college in 10 years and your daughter in 15. Which of the following bond strategies would be best suited to your goal of financing your children's education?
A) Interest rate
B) Passive
C) Maturity matching
D) Active
Answer: C
Diff: 1
Question Status: Previous edition

6) If an investor purchases a diversified portfolio of bonds and holds them until maturity, the investor is employing the ________ strategy of bond investing.
Answer: passive
Diff: 1
Question Status: Previous edition

7) List and describe three strategies for investing in bonds.
Answer: Interest rate strategy is selecting bonds for investment based on interest rate expectations. Passive is investing in a diversified portfolio of bonds that are held for a long period of time. Maturity matching is investing in bonds that will generate payments to match future expenses.
Diff: 2
Question Status: Revised

8) If you are concerned that market interest rates may risk in the near and intermediate term, your bond investment strategy should be to
A) buy only junk bonds.
B) buy bonds with shorter term maturities to minimize interest rate risk.
C) buy bonds with long maturities to limit interest rate risk.
D) exit bond investments and buy equities.
Answer: B
Diff: 3
Question Status: New

16.7 How Bond Decisions Fit Within Your Financial Plan

1) As an investor, why should you consider investing in bonds?
Answer: Bonds can provide a higher return than bank deposits and can be a better choice than stocks for investors looking for periodic income. Treasury bonds have no default risk, and high-quality corporate bonds can offer a higher yield with only slightly higher risk. Some bonds also offer tax benefits.
Diff: 1
Question Status: Revised

2) If you build your financial and investment plan with a focus on safety and security you should probably avoid
A) small cap equities.
B) junk bonds.
C) BB rated municipal bonds.
D) all of the above should be avoided.
Answer: D
Diff: 2
Question Status: New