

Question #1 of 14

Question ID: 1574390

The risk of receiving less than market value when selling a bond is referred to as:

- A) recovery rate risk. 
- B) loss severity risk. 
- C) market liquidity risk. 

Explanation

Market liquidity risk is the risk of receiving less than market value when selling a bond and is reflected in the size of the bid-ask spreads. Market liquidity risk is greater for the bonds of less creditworthy issuers and for the bonds of smaller issuers with relatively little publicly traded debt. Loss severity and recovery rate refer to defaults.

(Module 62.1, LOS 62.a)

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Question ID: 1576501

Which component of traditional credit analysis includes evaluation of industry structure, industry fundamentals, and company fundamentals?

- A) Capacity. 
- B) Covenants. 
- C) Collateral. 

Explanation

Analyzing a corporate borrower's capacity to repay its debt obligations is similar to the top-down process used in equity analysis. Collateral analysis is evaluating the issuer's assets. Analyzing covenants involves reviewing the terms and conditions of lending agreements.

(Module 62.1, LOS 62.a)

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Question ID: 1576504

The "four Cs" of credit analysis include:

- A) capacity and character.
- B) circumstances and covenants.
- C) collateral and capital.

Explanation

The "four Cs" of credit analysis are capacity, collateral, covenants, and character.

(Module 62.1, LOS 62.a)

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Question ID: 1576503

Fraud and malfeasance, soundness of strategy, and prior treatment of bondholders are criteria to evaluate a borrower's:

- A) covenants.
- B) character.
- C) capacity.

Explanation

Character refers to the quality of management. Character analysis includes soundness of strategy, management's track record, accounting policies and tax strategies, fraud and malfeasance record, and prior treatment of bondholders.

Capacity refers to the ability of the borrower to make its debt payments on time.

Covenants are the terms and conditions of lending agreements with which the issuer must comply.

(Module 62.1, LOS 62.a)

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Which of the following is the most appropriate strategy for a fixed income portfolio manager under the anticipation of an economic expansion?

- A) Purchase corporate bonds and sell Treasury bonds.
- B) Sell lower-rated corporate bonds and buy higher-rated corporate bonds.
- C) Sell corporate bonds and purchase Treasury bonds.

Explanation

During periods of economic expansion corporate yield spreads generally narrow, reflecting decreased credit risk. If yield spreads narrow, the prices of corporate bonds increase relative to the prices of Treasuries. Selling lower-rated bonds and buying higher-rated bonds is an appropriate strategy if an economic contraction is anticipated.

(Module 62.1, LOS 62.c)

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If a U.S. investor is forecasting that the yield spread between U.S. Treasury bonds and U.S. corporate bonds is going to widen, then which of the following is most likely to be CORRECT?

- A) The economy is going to contract. 
- B) The economy is going to expand. 
- C) The U.S. dollar will weaken. 

Explanation

If economic conditions are expected to get worse, then the probability that corporations may default increases and causes credit spreads to widen.

(Module 62.1, LOS 62.c)

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Question ID: 1576502

Analysis of a firm's intellectual capital, equity market capitalization, depreciation, and intangible assets is associated with which aspect of credit analysis?

- A) Capacity. 
- B) Collateral. 
- C) Covenants. 

Explanation

These items are part of analyzing a borrower's collateral. Analyzing depreciation expense and equity market capitalization can provide insight into the quality of a firm's fixed assets. Intellectual capital and intangible assets can potentially be used as collateral if they can be separated from the firm and sold. Capacity refers to a borrower's ability to repay its obligations. Analysis of capacity focuses on industry structure and company fundamentals. Covenants are terms and conditions of a bond issue.

(Module 62.1, LOS 62.a)

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Loss severity is *most accurately* defined as the:

- A) amount a bondholder will lose if the issuer defaults. 
- B) percentage of a bond's value a bondholder will receive if the issuer defaults. 
- C) probability that a bond issuer will default. 

Explanation

Loss severity is the money amount or percentage of a bond's value a bondholder will lose if the issuer defaults. The percentage of a bond's value a bondholder will receive if the issuer defaults is the recovery rate.

(Module 62.1, LOS 62.a)

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The yield spreads between corporate bonds and government bonds are *most likely* to decrease if:

- A) investors increase their estimates of the recovery rate on the corporate bonds. 
- B) a credit rating downgrade on the corporate bonds becomes more likely. 
- C) liquidity decreases in the market for the corporate bonds. 

Explanation

Yield spreads reflect the credit quality of bond issuers and the liquidity of the market for their bonds. Narrowing (decreasing) yield spreads reflect improving credit quality or more liquidity. Widening (increasing) yield spreads reflect deteriorating credit quality or less liquidity. Increased estimates of the recovery rate in the event of default represent an improvement in investors' assessment of the issuer's credit quality and are likely to narrow yield spreads on the issuer's bonds.

(Module 62.1, LOS 62.a)

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What is the *most likely* effect on yield spreads when demand for bonds is high and supply of bonds is low?

- A) The effect on yield spreads will depend on whether supply or demand is the stronger influence. 
- B) Yield spreads are likely to narrow. 
- C) Yield spreads are likely to widen. 

Explanation

Credit spreads tend to narrow in times of high demand for bonds and widen in times of low demand for bonds. Credit spreads tend to widen under excess supply conditions, such as large issuance in a short period of time, and narrow when supply is low.

(Module 62.1, LOS 62.c)

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Yield spreads tend to widen when equity market performance is:

- A) weak. 
- B) strong. 
- C) stable. 

Explanation

Conditions that cause equity markets to weaken, such as poor economic growth, also tend to widen yield spreads in the bond market. Likewise, strong equity market performance tends to coincide with narrowing yield spreads. Yield spreads tend to narrow when equity markets are stable because investors "reaching for yield" increase their demand for bonds.

(Module 62.1, LOS 62.c)

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The factors that must be considered when estimating the credit risk of a bond include:

- A) only the bond rating and the recovery rate. 
- B) only the bond rating. 
- C) the bond rating, the recovery rate, and the yield volatility. 

Explanation

Credit risk is calculated with the probability of default (estimated from the bond rating) and the estimated recovery value should the bond default. Yield volatility is combined with duration to estimate the *price risk* of a bond.

(Module 62.1, LOS 62.a)

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Question ID: 1577974

An 8% annual coupon, 5-year corporate bond has a yield spread of 275 basis points to its benchmark bond. The bond's bid and offer prices are 98.25 and 98.75. The yield spread is *best* described as being composed of:

- A) 8% liquidity risk and 92% credit risk. 
- B) 12% liquidity risk and 88% credit risk. 
- C) 5% liquidity risk and 95% credit risk. 

Explanation

Yield at the bid price: $N = 5$; $PMT = 8$; $FV = 100$; $PV = -98.25$; $CPT I/Y = 8.4434$

Yield at the offer price: $PV = -98.75$; $CPT I/Y = 8.3157$

Liquidity spread = $8.4434 - 8.3157 = 0.1277 = 12.77$ basis points

The proportion of the yield spread attributable to liquidity risk is $12.77 / 275 = 4.64\%$. The remaining 95.36% of the spread is attributable to credit risk.

(Module 62.1, LOS 62.c)

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Question ID: 1574395

If investors expect greater uncertainty in the bond markets, yield spreads between AAA and B rated bonds are *most likely* to:

- A) narrow. 
- B) widen. 
- C) slope downward. 

Explanation

With greater uncertainty, investors require a higher return for taking on more risk. Therefore credit spreads will widen.

(Module 62.1, LOS 62.c)