

Question #1 of 8

Question ID: 1574463

The calculation of derivatives values is based on an assumption that:

- A) investors are risk neutral. 
- B) arbitrage opportunities are exploited rapidly. 
- C) arbitrage opportunities do not arise in real markets. 

Explanation

Derivatives valuation is based on the assumption that any arbitrage opportunities in financial markets are exploited rapidly so that assets with identical cash flows are forced toward the same price. It does not assume arbitrage opportunities do not arise or that investors are risk neutral.

(Module 71.1, LOS 71.a)

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Question ID: 1574467

A net benefit from holding the underlying asset of a forward contract will:

- A) increase the value of the forward contract during its life. 
- B) decrease the no-arbitrage forward price at initiation. 
- C) decrease the value of the forward contract at expiration. 

Explanation

Compared to an underlying asset with no net holding cost or benefit, a net benefit from holding the underlying asset will decrease the no-arbitrage forward price at initiation and the value of a forward contract during its life. Holding costs and benefits have no effect on the value of a forward contract at expiration.

(Module 71.1, LOS 71.b)

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Costs of holding the underlying that are greater than benefits from holding the underlying will:

- A) decrease the no-arbitrage forward price. ✘
- B) increase the no-arbitrage forward price. ✔
- C) have no effect on the no-arbitrage forward price. ✘

Explanation

When costs of holding the underlying are greater than benefits from holding the underlying, the no-arbitrage forward price is higher than it would be in the absence of costs or benefits of holding the underlying.

(Module 71.1, LOS 71.b)

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Question ID: 1574470

Other things equal, an increase in storage costs of the underlying asset will:

- A) not affect the no-arbitrage forward price. ✘
- B) decrease the no-arbitrage forward price. ✘
- C) increase the no-arbitrage forward price. ✔

Explanation

An increase in holding costs of the underlying asset increases the no-arbitrage forward price, other things equal.

(Module 71.1, LOS 71.b)

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Question ID: 1574469

Which of the following is *most likely* to increase the no-arbitrage forward price of an asset?

- A) Lower storage costs for a commodity. ✘
- B) Higher dividends from a stock. ✘
- C) Lower convenience yield for a commodity. ✔

Explanation

Either a decrease in benefits or an increase in costs of holding the underlying asset would increase the no-arbitrage price of a forward contract.

(Module 71.1, LOS 71.b)

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Question ID: 1574464

It is possible to profit from arbitrage when there are no costs or benefits to holding the underlying asset and the forward contract price is:

- A) equal to the future value of the spot price. 
- B) greater than the present value of the spot price. 
- C) less than the future value of the spot price. 

Explanation

An opportunity for arbitrage exists if the forward price is not equal to the future value of the spot price, compounded at the risk-free rate over the period of the forward contract.

(Module 71.1, LOS 71.a)

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Question ID: 1574468

Other things equal, the no-arbitrage forward price of an asset will be higher if the asset has:

- A) storage costs. 
- B) dividend payments. 
- C) convenience yield. 

Explanation

Costs of holding an asset increase its no-arbitrage forward price. Benefits from holding the asset, such as dividends or convenience yield, decrease its no-arbitrage forward price.

(Module 71.1, LOS 71.b)

Question #8 of 8

Question ID: 1574466

For an underlying asset that has no holding costs or benefits, the no-arbitrage forward price at initiation of a forward contract is:

- A) zero. 
- B) the future value of the spot price. 
- C) equal to the spot price. 

Explanation

At initiation of a forward contract on an underlying asset with no holding costs or benefits, the no-arbitrage forward price is the future value of the spot price, compounded at the risk-free rate to the expiration date of the forward contract: $F_0(T) = S_0(1 + R_f)^T$. The forward contract has a *value* of zero at initiation if the forward price in the contract is equal to the no-arbitrage forward price.

(Module 71.1, LOS 71.b)