



FIN 366: INVESTMENTS
FIXED INCOME
CRITICAL THINKING & CONCEPTUAL QUESTIONS

1. How are shorter term debt securities less risky than longer term debt securities?
2. Why are a firm's debt instruments less risky than a firm's equity instruments?
3. In what way are T-bills "risk-free"? Which T-bill security is the commonly used benchmark for the risk-free rate of return?
4. When you look up T-bill quotes online, are these dealers or the federal government posting bid and asks? Would this be a secondary or primary market transaction?
5. What does it mean when a debt instrument is "issued at a discount"?
6. How can you determine from the WSJ quotes pages what a T-bill, T-Note, or T-bond's average annualized rate of return is?
7. Explain what the statement "T-bills are quoted at yields not at prices" means.
8. Dealers profit on the bid-ask spread. Why, then, is the value in the bid column greater than the value in the ask column for T-bill quotes?
9. Explain why an investor may be willing to purchase a T-bond at a price greater than the principal or face value of the bond.
10. Describe how TIPS adjust for inflation. Given they offer this inflation protection benefit, why wouldn't everyone buy TIPS instead of regular treasuries?
11. How does the federal funds rate affect us as individuals and investors if it is the rate that banks borrow to and lend from each other?
12. What is the distinction between a *general obligation* muni bond and a *revenue* muni bond?
13. What is an advantage of muni bonds, particularly as it pertains to investors in high tax brackets?
14. What is a disadvantage or risk associated with muni bonds relative to treasury securities?
15. Define the *equivalent taxable yield*.
16. All else equal, if a muni bond's equivalent taxable yield is greater than a similar but taxable bond's yield, which bond is preferred?
17. What are the differences between corporate bonds and commercial paper?
18. What might prevent small investors from investing in commercial paper?
19. Describe the process of securitization. What does collateralized mean?
20. Identify each of the following fixed income securities/transactions/rates. Which are *money market* securities/transactions/rates?
 - a. A securities dealer acquires additional T-bonds for their inventory by paying \$1.0 million to another party, agreeing to sell back the bonds to the same party for \$1.01 million.
 - b. You open an interest-bearing account at Iberia Bank, but the money cannot be withdrawn from your account until the end of the year.
 - c. To borrow cash, a dealer sells some of their T-bonds to another party, agreeing to buy them back at a higher price in the near future.

- d. FLFB Corp., a large chemical company, issues a promissory note to borrow \$300,000 for an upcoming expense. They will pay back the holder \$310,000 in 250 days.
 - e. To meet its reserve requirements, B&T bank borrows \$15,000,000 from American Bank Corp., and will pay back \$15,001,234 within 24 hours.
 - f. A large institutional investor holds a security that earns interest and principal payments from auto loans.
21. **CHALLENGE** A very young and risky company wants to borrow money from you, promising to pay you back \$1,000 in exactly one year. A much safer and older firm with steady cash flows similarly want to borrow money from you, promising to pay you back exactly \$1,000 in one year. Which company would you require sell you a bond at a “deeper discount”, and why? How does this relate to the yield that each must offer you?
22. **CHALLENGE** A **yield spread** is the difference between yields on debt instruments. For example, if corporate bonds are yielding 5% and 10-year Treasury Notes are yielding 2%, the spread is $5\% - 2\% = 3\%$. Given corporate bonds are riskier than Treasury securities, what do we think will happen to the yield spread between corporate bonds and Treasuries if we enter a steep recession? (Hint: think about what a recession entails about the riskiness of corporate bonds. Consider your answer to the question above.)
23. **CHALLENGE** **Open market operations** are when the Fed enters into short term buying and selling of Treasury securities with banks to implicitly establish the federal funds rate. Suppose you run a bank with an account at the Federal Reserve. You enter into an agreement to buy Treasury securities from the Fed, with an agreement to sell the securities back to the Fed at a higher price later, with the higher price received later representing an implicit interest rate received. What type of money market transaction (that we discussed in class) is this transaction called, from the perspective of the bank?
24. **CHALLENGE** If the Fed offers to pay high implicit rates of interest in the example in the previous question, what are banks likely to do with their money? What does this mean for the amount of money banks have to lend consumers? What does that mean for the rates of interest that they charge for mortgages and loans? Is the Fed following an **expansionary** or **contractionary** policy by paying a high rate of interest? (Hint: read up in the WSJ or other business news sources what the Fed is currently doing.)

