Flashcards

Fold on the dotted line · cut on the dashed lines

How to use: cut along each dashed line, fold along the centre so the answer is on the back. Read the question, answer aloud, then flip.

Q1 Module 2.1 · RBei Classes

What are the two sources of return on any investment?

A1

Price return (capital appreciation): change in the investment's value.
Capital distribution return: income paid while you hold it.
Total return = price return + distribution return.

Q2 Module 2.1 · RBei Classes

Write the holding period return formula. Why divide by P_0?

A2

$r = (P_1 - P_0 + \text{Income}) / P_0$
Return answers "how much did each rupee I invested earn?" The amount invested is P_0.

Q3 Module 2.1 · RBei Classes

Fixed vs variable capital distribution — give two examples of each.

A3

Fixed: rate set at the start — bond coupon, fixed deposit.
Variable: uncertain amount — equity dividend, floating-rate note coupon.

Q4 Module 2.1 · RBei Classes

Where does most of an equity's return come from, and why?

A4

Price return. Shareholders are owners; value grows with expected earnings. Dividends are discretionary, so they are a **variable** distribution.

Q5 Module 2.1 · RBei Classes

Where does most of a bond's return come from?

A5

The **fixed coupon** (fixed capital distribution). But the bond's market price changes during its life, so bonds also earn price return.

Q6 Module 2.1 · RBei Classes

What is a derivative? Give an example.

A6

A contract that derives its value from a reference (underlying) asset. A contract to buy gold at a fixed future price gains if gold rises; the seller loses the same amount.

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Q7 Module 2.1 · RBei Classes

What return does cash give? Why hold it?

A7

No return (notes, coins, non-interest-bearing deposits). Held for **liquidity**. With inflation, its real return is negative.

Q8 Module 2.1 · RBei Classes

What is a hybrid financial asset?

A8

An asset blending equity and debt features, e.g. a **convertible bond**: pays coupons and can be converted into the issuer's shares.

Q9 Module 2.1 · RBei Classes

What is a financial indicator? Name three.

A9

A metric that **affects returns but generates no cash flows** itself: interest rates, foreign exchange rates, market indexes.

Q10 Module 2.1 · RBei Classes

Why are short-term government bills called risk-free?

A10

The government is assumed to make promised payments, so they are free of **credit risk**. They are not free of inflation risk.

Q11 Module 2.1 · RBei Classes

How is a T-bill priced, and where does its return come from?

A11

Issued at a **discount** to face value, pays face value at maturity. No coupon, so its whole return is **price return** (income = 0).

Q12 Module 2.1 · RBei Classes

How do you annualize a 90-day return? Why not multiply?

A12

$r_{annual} = (1 + r_{90})^{365/90} - 1$. Compounding captures return earned on reinvested return; multiplying ignores it.

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Q13 Module 2.1 · RBei Classes

Why do bond prices fall when interest rates rise?

A13

The cash flows are fixed. A buyer can only earn the new, higher required return by paying a **lower price** today. Rates ↑ → price ↓.

Q14 Module 2.1 · RBei Classes

Why do longer-dated bonds fall more when rates rise?

A14

More fixed cash flows over a longer time are discounted at the higher rate. A 0.5% rise: 90-day T-bill ≈ -0.12%, 10-year zero ≈ -4.7%.

Q15 Module 2.1 · RBei Classes

What happens to a bond when the issuer's default risk rises?

A15

Investors demand a higher return, so the **price falls**. Corporate bonds pay a **credit spread** over lower-risk government bonds.

Q16 Module 2.1 · RBei Classes

Local currency return vs domestic currency return?

A16

Local: return in the foreign currency, ignoring exchange rates.
Domestic: return in the investor's home currency, including exchange rate changes.

Q17 Module 2.1 · RBei Classes

Write the domestic return formula. Why multiply?

A17

$R_{DC} = (1 + R_{FC})(1 + R_{FX}) - 1$. The currency change applies to the gain too, not just the original investment.

Q18 Module 2.1 · RBei Classes

Foreign currency strengthens. What happens to the domestic return?

A18

It **rises** above the local return. A weakening foreign currency **reduces** the domestic return. Both price and income returns are affected.

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Q19 Module 2.1 · RBei Classes

Why do indexes usually have better compound returns than single stocks?

A19

They are **diversified**, so returns vary less. Lower volatility means less volatility drag, so multiperiod geometric returns are higher.

Q20 Module 2.1 · RBei Classes

Arithmetic vs geometric mean: which is higher, and which shows actual performance?

A20

Geometric ≤ arithmetic. **Geometric** reflects compounding and actual multiperiod performance. The gap grows with volatility.

Q21 Module 2.1 · RBei Classes

How do you measure relative outperformance of compound returns?

A21

$(1 + R_A) / (1 + R_B) - 1$.
Example: 1.1226 / 1.1123 - 1 = 0.93%, not 12.26% - 11.23% = 1.03%.

Q22 Module 2.2 · RBei Classes

State the risk-return tradeoff with two applications.

A22

Rational investors demand higher long-term returns for higher risk. Small-caps should beat large-caps; corporate bonds should beat government bonds.

Q23 Module 2.2 · RBei Classes

Name four observations from historical returns (1979–2023).

A23

Equities beat bonds · long-term bonds beat short-term · 30-day T-bill ≈ zero real return · dividend yields and bond income both fell over time.

Q24 Module 2.2 · RBei Classes

Why have dividend yields fallen over time?

A24

Companies increasingly use **share buybacks**. These support share prices and create capital gains, often taxed at lower rates than dividends.

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Q25 Module 2.2 · RBei Classes

Define risk. What are the two families?

A25

Chance of a return different from expected. **Systematic** (macro): affects all investments, not diversifiable. **Unsystematic** (micro): security-specific, diversifiable.

Q26 Module 2.2 · RBei Classes

Name three systematic risks. How do rising rates hurt equities?

A26

Inflation, interest rate, market risk. Higher rates raise companies' financing costs and lower the present value of future cash flows.

Q27 Module 2.2 · RBei Classes

What are the parts of issuer risk? Name one other unsystematic risk.

A27

Business risk (earnings volatility), **financial risk** (leverage), **credit risk** (meeting debt payments). Also: **sector / industry risk**.

Q28 Module 2.2 · RBei Classes

What is a risk premium? What is the simplest risk measure?

A28

Extra return demanded for extra risk; equities earn higher premiums than fixed income. Simplest measure: **range** = highest - lowest return.

Q29 Module 2.2 · RBei Classes

How should asset allocation match the client?

A29

Need high returns → more **equity**. Low risk tolerance + need income → more **fixed income**. Both → **balanced** portfolio.

Q30 Module 2.2 · RBei Classes

Retired investor, Allocation C (40/50/10). Compute the returns.

A30

Appreciation 3.45% + distribution 3.95% = **7.40%**. Portfolio return = weighted average of asset-class returns.

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