Foundations of Financial Markets and Institutions, 4e **(Fabozzi/Modigliani/Jones)**
Chapter 7 Investment Companies and Exchange-Traded Funds

Multiple Choice Questions

1 Types of Investment Companies

1) There are three types of investment companies: ________.
A) open-end funds, closed-end funds, unit funds
B) open-end trusts, closed-end trusts, unit trusts
C) open-end funds, closed-end funds, unit trusts
D) unit-end funds, closed-end funds, open-end trusts
Answer: C
Diff: 2
Topic: 7.1 Types of Investment Companies
Objective: 7.1 the different types of investment companies: mutual funds, closed-end investment companies, and unit trusts

2) ________, commonly referred to simply as mutual funds, are portfolios of securities, mainly stocks, bonds, and money market instruments.
A) Open-end funds
B) Closed-end funds
C) Unit trusts
D) Unit-end funds
Answer: A
Diff: 1
Topic: 7.1 Types of Investment Companies
Objective: 7.1 the different types of investment companies: mutual funds, closed-end investment companies, and unit trusts

3) Suppose that a mutual fund with 10 million shares outstanding has a portfolio with a market value of $430 million and liabilities of $30 million.
A) $20
B) $40
C) $60
D) $80
Answer: B
Comment: NAV = $\frac{\text{Market value of portfolio - Liabilities}}{\text{Number of shares outstanding}} = \frac{\$430{,}000{,}000 - \$30{,}000{,}000}{10{,}000{,}000} =$ **$40**.
Diff: 2
Topic: 7.1 Types of Investment Companies
Objective: 7.2 how the share prices of mutual funds and closed-end funds are determined

4) The shares of a ________ are very similar to the shares of common stock of a corporation in that the new shares are initially issued by an underwriter for the fund and after the new issue, the number of shares remains constant.
A) closed-end funds
B) unit-end funds
C) open-end trusts
D) opened-end fund
Answer: A
Diff: 2
Topic: 7.1 Types of Investment Companies
Objective: 7.1 the different types of investment companies: mutual funds, closed-end investment companies, and unit trusts

5) A ________ is not active in trading of the bonds in the portfolio, have a fixed termination date, and are common in Europe.
A) closed-end fund
B) opened-end fund
C) whole fund
D) unit trust
Answer: D
Diff: 2
Topic: 7.1 Types of Investment Companies
Objective: 7.1 the different types of investment companies: mutual funds, closed-end investment companies, and unit trusts

2 Fund Sales Charges and Annual Operating Expenses

1) There are two types of costs borne by investors in mutual funds: the first cost is the shareholder fee and the second cost is the annual fund operating expense. Which of the below descriptions relate to the second cost?
A) the expense ratio, which covers the fund's expenses and occurs on all funds
B) the "one-time" charge debited to the investor for a specific transaction
C) the charge based on the way the fund is sold or distributed
D) the charge that covers the purchase, redemption, or exchange
Answer: A
Comment: There are two types of costs borne by investors in mutual funds. The first is the shareholder fee, usually called the sales charge. This cost is a “one-time” charge debited to the investor for a specific transaction, such as a purchase, redemption, or exchange. The type of charge is related to the way the fund is sold or distributed. The second cost is the annual fund operating expense, usually called the expense ratio, which covers the fund’s expenses, the largest of which is for investment management. This charge is imposed annually. This cost occurs on all funds and for all types of distribution.
Diff: 2
Topic: 7.2 Fund Sales Charges and Annual Operating Expenses
Objective: 7.3 the structure of funds and the costs that they incur

2) Two decades ago, sales charges on mutual funds were related to the manner of distribution. Which of the below types characterize the two types of distribution?
A) sales force and direct
B) sales force and wholesale
C) sales force and indirect
D) wholesale and indirect
Answer: A
Comment: The two types of distribution were **sales force** (or **wholesale**) and **direct**. Sales-force (wholesale) distribution occurred via an intermediary, that is, via an agent, a stockbroker, insurance agent, or other entity, who provided investment advice and incentive to the client, actively "made the sale," and provided subsequent service. The other approach is direct (from the fund company to the investor), whereby there is no intermediary or salesperson to actively approach the client, provide investment advice and service, or make the sale.
Diff: 2
Topic: 7.2 Fund Sales Charges and Annual Operating Expenses
Objective: 7.3 the structure of funds and the costs that they incur

3) A decade ago, many observers speculated that load funds would become obsolete. But, the actual trend has been quite different. Which of the below is offered as a reason for load funds maintaining a costly fee?
A) Many investors have remained dependent on the investment counsel and service
B) Investors do not pay attention to fees and so do not care
C) Many investors have remained dependent on the initiative of the sales agent
D) Sales-force distributed funds have shown considerable ingenuity and flexibility in imposing sales charges
Answer: B
Comment: A decade ago, many observers speculated that load funds would become obsolete and no-load funds would dominate because of the investor's aversion to a sales charge. Increasingly financially sophisticated individuals, the reasoning went, would make their own investment decisions and not need to compensate agents for their advice and service. But, as discussed below, the actual trend has been quite different. Why has there not been a trend away from the more costly agent-distributed funds as many expected? There are two reasons. **First**, many investors have remained dependent on the investment counsel and service, and, perhaps more importantly, the initiative of the sales agent. **Second**, sales-force distributed funds have shown considerable ingenuity and flexibility in imposing sales charges, which both compensate the distributors and appear attractive to the clients.
Diff: 2
Topic: 7.2 Fund Sales Charges and Annual Operating Expenses
Objective: 7.3 the structure of funds and the costs that they incur

4) Many mutual fund families often offer their funds with three share classes: A, B, and C. Which of the below correctly describes these three classes?
A) A shares: closed-end loads; B shares: opened-end loads; C shares: level-end loads
B) A shares: front-end loads; B shares: back-end loads; C shares: level loads
C) A shares: back-end loads; B shares: front-end loads; C shares: level loads
D) A shares: front-end loads; B shares: middle-end loads; C shares: back-loads
Answer: B
Comment: Many mutual fund families often offer their funds with all three types of loads (called "classes"): front-end loads (usually called "A shares"); back-end loads (often called "B shares"); and level loads (often called "C shares"). This variety allows the distributor and its client to select the type of load they prefer.
Diff: 2
Topic: 7.2 Fund Sales Charges and Annual Operating Expenses
Objective: 7.3 the structure of funds and the costs that they incur

5) Which of the below statements is FALSE?
A) The operating expense, also called the expense ratio, is debited annually from the investor's fund balance by the fund sponsor.
B) The management fee, also called the investment advisory fee, is the fee charged by the investment advisor for managing a fund's portfolio.
C) While covering the annual operating expenses, the fund prospectus does not provide the fees, which are imposed only at the time of a transaction.
D) In 1980, the SEC approved the imposition of a fixed annual fee, called the 12b-1 fee, which is, in general, intended to cover distribution costs, including continuing agent compensation and manufacturer marketing and advertising expenses.
Answer: C
Comment: In addition to the annual operating expenses, the fund prospectus **provides** the fees, which are imposed only at the time of a transaction.
Diff: 2
Topic: 7.2 Fund Sales Charges and Annual Operating Expenses
Objective: 7.2 how the share prices of mutual funds and closed-end funds are determined

3 Economic Motivation for Funds

1) An investment company is a financial intermediary in that it pools the funds of ________ and uses these funds to buy ________.
A) institutional investors; portfolios of securities
B) individual investors; individual securities
C) institutional investors; individual securities
D) individual investors; portfolios of securities
Answer: D
Diff: 2
Topic: 7.3 Economic Motivation for Funds
Objective: 7.3 the structure of funds and the costs that they incur

2) Financial intermediaries can provide six economic functions. Which of the below is NOT one of these?
A) risk reduction via diversification
B) lower costs of contracting and processing information
C) a payments mechanism
D) illiquidity
Answer: D
Comment: Financial intermediaries provide some or all of the following six economic functions: (1) risk reduction via diversification, (2) lower costs of contracting and processing information, (3) professional portfolio management, (4) liquidity, (5) variety, and (6) a payments mechanism.
Diff: 2
Topic: 7.3 Economic Motivation for Funds
Objective: 7.5 the economic benefits that investment companies provide, including diversification and reduced costs of investing

4 Types of Funds by Investment Objective

1) Stock funds differ by ________.
A) the minimum market capitalization, style, and sector
B) the average market capitalization, style, and sector
C) the maximum market capitalization, style, and sector
D) None of these
Answer: B
Comment: Stock funds differ by:
• the **average** market capitalization (large, mid, and small) of the stocks in the portfolio
• style (growth, value, and blend)
• sector – "sector funds" specialize in one sector or industry (technology, health care, or utilities)
• other ways
Diff: 2
Topic: 7.4 Types of Funds by Investment Objective
Objective: 7.4 how investment companies can differ depending on their investment objectives

2) In order to meet investor needs, mutual funds offered in the market differ by a variety of measures. Which of the below is not ONE of these?
A) asset category
B) management style
C) management segment
D) market segment
Answer: C
Comment: In order to meet investor needs, mutual funds offered in the market differ by a variety of measures such as asset category (stock vs. bond, etc.); management style (active vs. passive); market segment (small cap vs. large cap in stock funds, investment grade vs. speculative grade in bond funds); and other such measures.
Diff: 2

Topic: 7.4 Types of Funds by Investment Objective
Objective: 7.4 how investment companies can differ depending on their investment objectives

5 The Concept of a Family of Funds

1) A concept that revolutionized the fund industry and benefitted many investors is what the mutual fund industry calls a ________, a group of funds or a complex of funds provided by the same fund company.
A) group of funds
B) benefit funds
C) family of funds
D) complex funds
Answer: C
Diff: 1
Topic: 7.5 The Concept of a Family of Funds
Objective: 7.5 the economic benefits that investment companies provide, including diversification and reduced costs of investing

6 Investment Vehicles for Mutual Funds

1) Mutual funds may be included in several different investment vehicles. One vehicle is often referred to as a nonqualified vehicle because it ________.
A) does not qualify for auto taxes.
B) does not qualify for reduced management fees.
C) does not qualify for investment fees.
D) does not qualify for tax advantages.
Answer: D
Comment: Mutual funds may be included in several different investment vehicles. For example, the Vanguard S&P500 Index Fund or the FidelityContra Fund can be sold as a standard taxable investment instrument (as a no-load fund or a class A, B, C, F, or other load fund, whichever it is). This vehicle is often referred to as a nonqualified vehicle because it **does not quality** for tax advantages.
Diff: 2
Topic: 7.6 Investment Vehicles for Mutual Funds
Objective: 7.8 the taxation of mutual funds

7 Mutual Funds Cost

1) The Investment Company Institute (ICI) has developed a measure that combines a fund's annual expense ratio and the annualized sales charge investors pay for one-time sales loads. From 1980 to 2006, this measure declined. There were three reasons for this decline. Which of the below is NOT one of these?
A) Loads in general declined and investors have shifted to lower load funds.
B) The growth in no-load mutual funds have contributed to this decline.
C) Mutual fund expenses have declined due to economies of scale and intense competition in the mutual fund industry.
D) Investors have gotten wiser and avoided companies by understanding all costs even those hidden.
Answer: D
Comment: Investors are very cost-sensitive. The competition among funds is very tough and costs are an important element of the competition. The Investment Company Institute (ICI) has developed a measure that combines a fund’s annual expense ratio and the annualized sales charge investors pay for one-time sales loads (front and back). This measure is weighted by the assets in the funds. From 1980 to 2006, this measure declined from 2.32% to 1.07% for stock funds and from 2.05% to 0.84% for stock funds and from 2.05% to 0.84% for bond funds. There were three reasons for this decline. First, loads in general declined and investors have shifted, in general, to lower load funds. In addition, the use of funds in retirement plans has grown significantly and loads are usually waived on these funds. Second, the growth in no-load mutual funds, both the traditional direct sales and sales through fund supermarkets and discount brokers, also contributed to this decline. Finally, mutual fund expenses have also declined due to economies of scale and intense competition in the mutual fund industry.
Diff: 2
Topic: 7.7 Mutual Funds Cost
Objective: 7.3 the structure of funds and the costs that they incur

8 Taxation of Mutual Funds

1) Mutual funds must distribute at least ________ of their investment income in order to avoid taxation at the fund level.
A) 60%
B) 70%
C) 80%
D) 90%
Answer: D
Diff: 2
Topic: 7.8 Taxation of Mutual Funds
Objective: 7.8 the taxation of mutual funds