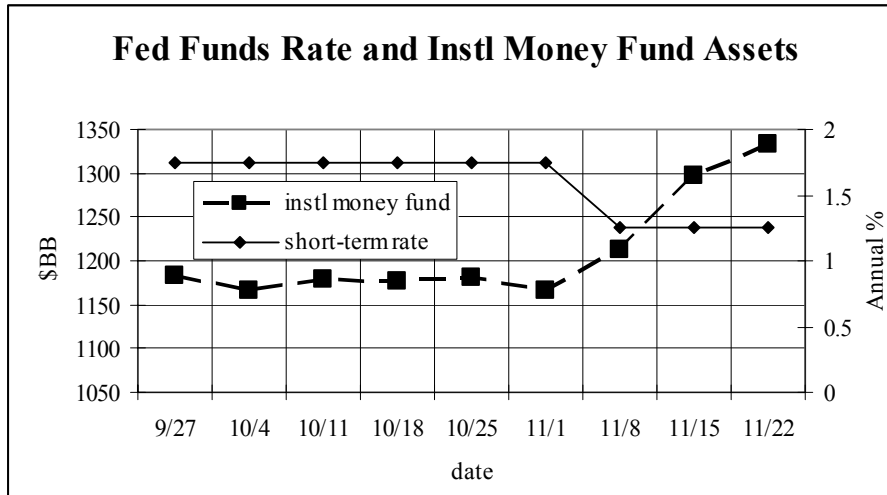


FUNDING INVESTMENTS
FINANCE 238/738, D. Musto
SECOND TEST
80 MINUTES / 80 POINTS

Your Name: _____

Section you are registered for: _____

- (10 pts) This graph tracks two statistics over the past two months: the short-term interest rate (i.e., the Fed Funds target set by Alan Greenspan, on the right axis), and the money invested in institutional money-market funds (i.e., money funds for large institutional investors, on the left axis):



What is a plausible causal connection between the movements of these lines?

- You are securitizing a pool of fixed-rate home mortgages which all have an 8% interest rate and which have a total principal amount of \$500MM.
 - (5 pts) How could you construct a \$75M tranche paying LIBOR+50bp, up to 20%? Be precise.
 - (5 pts) Suppose you sold interest-only and principal-only tranches. Which would do better if the current mortgage rate dropped substantially?
- (10 pts) You are making a market for the equity of GE, which announces earnings tomorrow. You and all other uninformed traders calculate a 90% probability that the earnings will be on target, in which case GE will trade for \$30/share, and a 10% probability that it will be below target, in which case GE will trade for \$22/share. You also know that informed traders already know today what GE will announce tomorrow. You have to post a Bid and an Ask for the next order to sell or buy one share. Assuming that there is a 5% probability that the next order comes from an informed trader (whether this order is a buy or a sell), and assuming that competition forces you to post prices at which you just break even, what prices do you post?
- (10 pts) Your bank is underwriting the IPO of Cosi, and after initially announcing a price range of \$8-\$10 you have learned on the road show that Cosi will trade for \$30. The CEO of Cosi, Fred Cosi, concludes you should price it at \$30. You say what?

5. (10 pts) Amazon currently sells for 23 and in a year it will be either 15 or 25, each with probability $\frac{1}{2}$, and you can borrow or lend for a year at 2%. Consider a European put on Amazon with strike price 20. An investor is willing to buy or sell this option for \$2.45 because the expected payoff in a year is 2.5, and $2.5/1.02 = \$2.45$. Is this an opportunity for you to make money? If so, how, and how much?
6. (10 pts) This is from a Thursday 11/21/02 press release:

Sweetheart Cup Company Inc. ("Sweetheart") announced today that it filed a registration statement on Form S-4 relating to a proposed offer to exchange new Senior Subordinated Notes due 2007 for all its outstanding 12% Senior Subordinated Notes due 2003 ("Sweetheart Notes") and a consent solicitation to eliminate and/or amend certain restrictive covenants and other provisions in the indenture governing the Sweetheart Notes. The proposed offer will be conditioned on, among other things, the receipt of tenders from holders of at least 90% of the principal amount outstanding of the Sweetheart Notes...

How do the elements of this Sweetheart deal affect its chances for success?

7. (10 pts) This is from the Monday 11/25/02 WSJ, describing a sale on 11/22/02:

Boeing Capital Corp - \$150 million of medium-term notes was priced through lead managers Credit Suisse First Boston Corp. and Barclays Capital, according to MCM CorporateWatch. Terms: maturity: Nov. 30, 2009; coupon: 5.4%; price: 99.780; yield: 5.438%; spread: 170 basis points above Treasurys; settlement: Nov 27, 2002 (flat); call: make-whole call at Treasurys plus 35 basis points; ratings: A3 (Moody's Investor Service Inc.), single-A-plus (Standard & Poor's Ratings Group).

And these are some closing prices from 11/22/02:

	MATURITY				ASK
RATE	MO/YR	BID	ASKED	CHG	YLD
10.375	Nov 09	115:18	115:19	-3	2.25
0	Nov 09	74:21	74:24	-4	4.22

(These bonds mature 11/15/09, and 11/22/02 is 7 days after 11/15/02 and 5/15/03 is 181 days after 11/15/02. For simplicity, assume the Boeing Capital bond also matures 11/15/09, not 11/30/09).

- (5 pts) How much would it have cost Boeing Capital to defease this bond on 11/22/02?
- (5 pts) How would you calculate the cost to Boeing Capital of calling back the bond on 11/22/02, rather than defeasing it? Be precise (but don't bother actually running the calculations).

8. This is from a press release early this month, announcing a credit-card securitization (analogous to those we have seen) by Bank One:

Bank One Issuance Trust's issuance of \$850 million ONEseries class A (2002-5) notes are rated 'AAA' by Fitch Ratings. The class A (2002-5) notes accrue interest at one-month LIBOR plus 0.12% payable monthly with an expected maturity date of Oct. 15, 2007.

- a. (5 pts) To a potential investor, how do the payments by this bond compare to those of a regular bond paying LIBOR+12bp monthly, maturing 10/15/07? Are they the same, and if not, what drives the differences?
- b. (5 pts) Adding in the subordinated pieces, the trust sold \$1B of bonds. Should regulators and rating agencies view this securitization as moving \$1B of debt off of Bank One's balance sheet until 10/15/07?