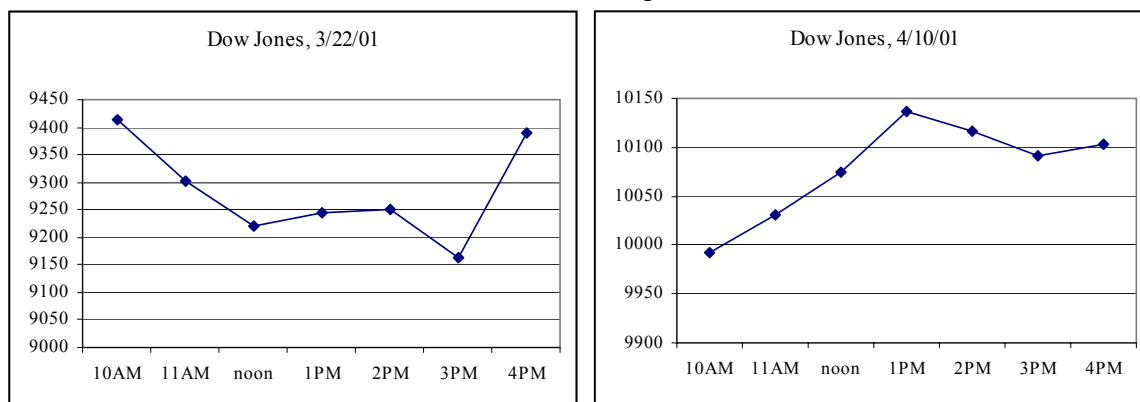


FUNDING INVESTMENTS
FINANCE 238/738, Spring 2001, Prof. Musto
Class 25 – SECOND TEST
80 minutes – 80 points



- Here are values of the Dow Jones Industrial Average, observed hourly on two recent days. Would there have been a profitable trade in mutual funds on one of these days? What trade, and what kind of fund? What makes it profitable?
- Suppose you purchased a piece of a PAC bond of a residential mortgage securitization. How do you expect the payments you receive over the life of the PAC bond would be affected if, over the life of the bond,
 - The Treasury-bond market did somewhat better than expected, i.e. long-term Treasury-bond prices moved up moderately, and stayed up.
 - The Treasury-bond market did far better than expected, i.e. long-term Treasury-bond prices moved way up, and stayed way up.
- How (*briefly*) is the Green Shoe important to price stabilization? Any evidence for this perspective on the Green Shoe?
- Suppose the chief executive of Acme Corp tells a stock trader, “I believe I’ll need to sell 200,000 shares of Acme to raise some money. I know you’d be nervous about taking the other side of this trade *today*, and therefore you’d give me a low bid, but how about *next week*? Let’s agree *now* that next week, I can choose, *if I want*, to sell 200,000 shares to you at the bid you’re quoting then, plus $\frac{1}{4}$.” Does the executive’s offer address the concerns that make the trader nervous? Explain.
- On 4/13/01, The general repo rate was 5% but the repo rate for the current 10-year note was $3\frac{1}{2}\%$. You wish to hedge your interest-rate exposure by shorting \$50MM worth of the current 10-year note for a week. How much more will this cost you, due to the specialness?

6. Here are prices from 4/10/01 for three Treasury securities maturing 2/15/06:

<u>Coupon</u>	<u>Bid</u>	<u>Asked</u>	<u>Ask Yld.</u>
0	79:18	79:22	4.74
5 5/8	104:00	104:02	4.68
9 3/8	119:28	120:02	4.70

Is it cheaper to buy the 9 3/8 directly, or to buy the same cash flows using the other two bonds? Show your work.

7. MBNA is going to securitize its credit-card receivables, and is deciding whether to add to the securitization contract a requirement that the securitization go into early amortization if the default rate on the receivables goes above 5%. Would this addition
- increase,
 - decrease, or
 - leave unchanged

MBNA's exposure to the default risk of its receivables? Explain.

8. Last Thursday (4/12/01), Bayview Capital Corp. announced a rights offering, where each shareholder gets one right for every 1.362 shares, and with a right you can buy one new share for \$4.59. Bayview Capital currently has 32.66M shares, and closed at \$5.20/share on Thursday.
- How much will the offering raise if all rights are taken up?
 - Disregarding market fluctuations, show that investors will exercise their rights no matter what they expect other investors will do.
9. There are two securities, *A* and *B*. Both cost \$100, and you can buy or sell any amount of either one. Their future payoffs depend on whether there is Depression *D* or prosperity *P*, which each have probability $\frac{1}{2}$:

<u>Security</u>	<u>Payoff in <i>D</i></u>	<u>Payoff in <i>P</i></u>
<i>A</i>	105	105
<i>B</i>	50	150

Suppose another security *C* that pays 0 in *D* and 50 in *P* sells for 25, and you can buy or sell any amount of *C*. Is there a profit opportunity here? Be precise.