

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

Your Name: _____

1. As of April 1, 2005, the Bond Markets Association reported that pools of 6.5% mortgages originated in 2003 had a CPR of 26.8%.

a) (5 pts) What does this mean, exactly?

b) (5 pts) Suppose the CPR of 8.0% mortgages originated in 1996 was also 26.8%. Would this be plausible? What considerations are important?

2. A press release (slightly edited) from December:

(Marne-la-Vallee, 12/2/04) Euro Disney S.C.A., operator of Disneyland Resorts Paris, reported today that the company and other entities ... have finalized and signed the legal documentation called for by the previously announced memorandum of agreement (MOA). Most of the terms of the MOA ... remain subject to certain conditions including the condition that Euro Disney, subject to shareholders' approval, complete a capital increase for at least €250MM in the form of a rights offering. The Company has until March 31, 2005 to complete such a capital increase.

In January, Euro Disney, which had 1.1BB shares outstanding at the time, trading at €0.26 each, announced an underwritten rights offering: for every five shares now held, you get 13 transferable rights, and with each right you can buy one new share for €0.09.

a) (4 pts) Determine whether this offering is sufficient, by itself, to raise the €250MM.

b) (3 pts) Characterize the offering's underwriter's exposure to Euro Disney.

c) (3 pts). Bearing in mind that this offering is underwritten, how much should Euro Disney's share price *drop* on the day the shares go ex-rights – that is, from the day when ownership determines who gets the rights (when the share price is €0.26), to the following day?

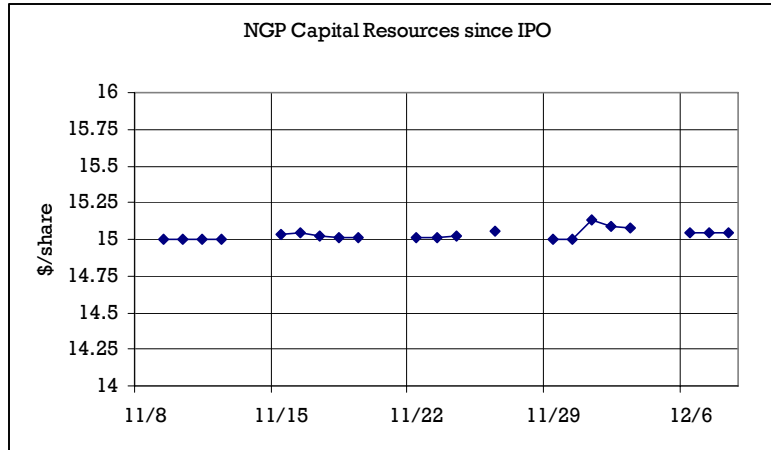
3. (10 pts) What rationale (if any) is there for the following policies intended to reduce stale-price trading of a mutual fund's shares?

a. (3 pts) Don't let investors know which stocks the fund holds

b. (4 pts) Just before the close of each trading day, place an order to buy or sell (randomly) one share of each stock the fund holds

c. (3 pts) Don't take any orders from fund investors after the market closes

4. Late last year, NGP Capital Resources went public, selling 16MM shares at \$15 each. The underwriter, Raymond James, had an overallotment option (i.e. Green Shoe) of 2.4MM shares. Here's the shares' market performance over the following weeks:



- a) (5 pts) Judging from the market price, is this IPO's offering price likely to have been a discount from the price range announced in August, when NGP announced their intention to go public? Why or why not?
- b) (5 pts) On November 29, NGP announced that Raymond James had exercised only a fraction of its overallotment option, 500,000 of the 2.4 million shares available. Is this consistent with what we see in the graph?
5. From a meeting of the Financial Institutions and Consumer Credit Subcommittee, Rep. Bachus (chairman), speaking:

I remain hopeful that we can work with the Senate and the administration to resolve the coverage issue and get deposit insurance reform passed this year. All of us have heard from community bankers in our districts about the challenges they face daily in competing for deposits with large money-center banks that are perceived by the market rightly or wrongly as being too big to fail.

- a) (5 pts) What is the difficulty facing a small bank whose competitor is "too big to fail?"
- b) (5 pts) Suppose Congress passes a new law: if a run starts, the Fed can provide liquidity only for a week, while it figures out whether the bank is solvent. If it is insolvent, the Fed must close the bank and bail out only the insured deposits. How would this affect the incentives of large depositors to monitor banks? What considerations are important?

6. You are a market maker for GE, so you post a bid and an ask at which you will honor the next order to sell or buy 1 share. GE will announce its earnings tomorrow, and everybody knows that GE will be worth 40 if earnings are good, and 38 if earnings are bad. The next order has a 25% chance of coming from an Insider, and 75% chance of coming from a Day Trader. Insiders know for sure what the stock will be worth tomorrow, and Day Traders think they know for sure but *you* know that they are right only 70% of the time.
- (3 pts) If a buy order comes in and you know it came from a Day Trader, what is the expected value of a share?
 - (4 pts) At what Ask price do you break even, given that the chance that a buy order came from a Day Trader is 75%?
 - (3 pts) Is the overconfidence of Day Traders good or bad for Insiders? Explain.

7. In a March 18, 2005 press release, we read

Sunstone Hotel Investors, Inc., (NYSE: SHO) announced that it has closed its public offering of 4,850,000 shares, including the underwriters' exercise of the over-allotment option, of 8.0% Series A and Series B Cumulative Redeemable Preferred Stock with a liquidation preference of \$25.00 per share for gross proceeds of \$121,250,000 ... Sunstone Hotel Investors, Inc. is a Southern California-based lodging real estate company that expects to qualify as a real estate investment trust for federal income tax purposes. The Company owns 54 hotels primarily in the upper-upscale and upscale segments primarily operated under nationally-recognized franchises, such as Marriott, Hilton, InterContinental and Hyatt.

- (5 pts) What kind of bond is this like? How is it unlike a bond?
 - (5 pts) 8% would be very high for a bond yield. Why not just sell a bond?
8. Your company has a bond outstanding that matures Aug 15, 2011, and that pays an 8% coupon. Currently this bond is trading at 100.
- (5 pts) Using the 4/11/05 prices from the WSJ (last page), how much would it cost to defease your bond? (Assume here that all the Treasury bonds mature on the 15th of the month, don't worry about accrued interest on either your company's bond or the Treasury bonds, and if you have a choice, don't use a "ci" STRIP).
 - (5 pts) Would your bond investors be sad, happy or indifferent about the defeasance? Explain.

Treasury Bonds, Notes and Bills

April 11, 2005

Explanatory Notes

Representative Over-the-Counter quotation based on transactions of \$1 million or more. Treasury bond, note and bill quotes are as of mid-afternoon. Colons in bid-and-asked quotes represent 32nds; 101:01 means 101 1/32. Net changes in 32nds; n-Treasury note, i-Inflation-Indexed issue. Treasury bill quotes in hundredths, quoted on terms of a rate of discount. Days to maturity calculated from settlement date. All yields are to maturity and based on the asked quote. Latest 13-week and 26-week bills are boldfaced. For bonds callable prior to maturity, yields are computed to the earliest call date for issues quoted above par and to the maturity date for issues below par. *When issued.

Source: eSpeed/Cantor Fitzgerald

U.S. Treasury strips as of 3 p.m. Eastern time, also based on transactions of \$1 million or more. Colons in bid and asked quotes represent 32nds; 99:01 means 99 1/32. Net changes in 32nds. Yields calculated on the asked quotation. ci-stripped coupon interest, bp-Treasury bond, stripped principal, np-Treasury note, stripped principal. For bonds callable prior to maturity, yields are computed to the earliest call date for issues quoted above par and to the maturity date for issues below par.

Source: Bear, Stearns & Co. via Street Software Technology Inc.

RATE	MATURITY	BID	ASKED	CHG	YLD	RATE	MATURITY	BID	ASKED	CHG	YLD
Government Bonds & Notes											
1.625	Apr 05n	99:31	99:31	1	2.24	3.625	May 13n	95:10	95:11	9	4.31
6.500	May 05n	100:10	100:11	-	2.48	1.875	Jul 13i	101:21	101:22	8	1.66
6.750	May 05n	100:11	100:12	-	2.29	4.250	Aug 13n	98:30	98:31	8	4.40
12.000	May 05	100:27	100:28	-1	2.27	4.250	Nov 13n	98:26	98:27	9	4.41
1.250	May 05n	99:25	99:26	-	2.52	2.000	Jan 14i	102:08	102:09	8	1.72
1.125	Jun 05n	99:21	99:22	1	2.56	4.750	Feb 14n	96:28	96:29	9	4.03
1.500	Jul 05n	99:18	99:19	-	2.79	4.750	May 14n	102:08	102:09	10	4.44
6.500	Aug 05n	101:06	101:07	-	2.91	2.000	May 14i	134:11	134:12	1	4.04
10.750	Aug 05	102:21	102:22	-1	2.80	2.000	Jul 14i	102:01	102:02	7	1.76
2.000	Aug 05n	99:19	99:20	-	2.95	4.250	Aug 14n	98:15	98:16	10	4.45
1.625	Sep 05n	99:20	99:21	-	3.04	4.250	Aug 14	133:10	133:11	3	4.05
1.625	Oct 05n	99:05	99:06	1	3.13	11.750	Nov 14	131:27	131:28	7	4.07
5.750	Nov 05n	101:14	101:15	-	3.22	4.250	Nov 14n	98:10	98:11	10	4.46
5.875	Nov 05n	101:16	101:17	-1	3.21	4.000	Feb 15n	96:15	96:16	10	4.44
1.875	Nov 05n	99:04	99:05	-	3.23	11.250	Feb 15	153:19	153:20	15	4.46
1.875	Dec 05n	99:00	99:00	-	3.27	10.625	Nov 15	150:06	150:07	11	4.50
1.875	Jan 06n	98:26	98:27	-	3.52	9.875	Nov 15	144:18	144:19	9	4.53
5.625	Feb 06n	101:27	101:28	-	3.56	9.250	Feb 16	139:29	139:30	11	4.54
9.375	Feb 06	105:02	105:03	-	3.39	7.250	May 16	123:00	123:01	12	4.58
1.625	Feb 06n	98:14	98:15	1	3.18	7.500	Nov 16	125:25	125:26	11	4.60
1.500	Mar 06n	98:04	98:05	-	3.45	8.750	May 17	137:24	137:25	13	4.63
2.250	Apr 06n	98:23	98:24	-	3.46	8.875	Aug 17	139:13	139:14	13	4.64
2.000	May 06n	98:13	98:14	1	3.46	9.125	May 18	143:09	143:10	15	4.66
4.625	May 06n	101:06	101:07	1	3.47	9.000	Nov 18	142:28	142:29	17	4.69
1.875	May 06n	98:18	98:19	1	3.47	8.875	Feb 19	141:30	141:31	17	4.71
2.500	Mar 06n	98:28	98:29	1	3.49	8.250	Aug 19	134:30	134:31	15	4.74
2.750	Jun 06n	99:02	99:03	1	3.51	8.500	Nov 19	139:19	139:20	17	4.75
7.000	Jul 06n	104:05	104:06	-	3.55	8.750	May 20	142:22	142:23	17	4.75
2.750	Jul 06n	98:30	98:31	1	3.55	8.750	Aug 20	143:03	143:04	17	4.76
2.375	Aug 06n	98:13	98:14	1	3.57	7.875	Feb 21	134:01	134:02	17	4.78
-2.375	Aug 06n	98:10	98:11	-	3.60	8.125	May 21	137:03	137:04	17	4.79
2.500	Sep 06n	98:12	98:13	-	3.62	8.125	Aug 21	137:14	137:15	17	4.79
6.500	Oct 06n	104:05	104:06	1	3.62	8.000	Nov 21	136:09	136:10	16	4.80
2.500	Oct 06n	98:08	98:09	1	3.64	2.500	Aug 22	128:10	128:11	14	4.82
2.625	Nov 06n	98:12	98:13	1	3.65	7.625	Nov 22	132:29	132:30	16	4.82
3.500	Nov 06n	99:24	99:25	1	3.64	7.125	Feb 23	127:06	127:07	17	4.83
2.875	Nov 06n	98:23	98:24	1	3.66	6.250	Aug 23	116:29	116:30	15	4.84
3.000	Dec 06n	98:27	98:28	1	3.68	7.500	Nov 24	133:12	133:13	18	4.84
3.000	Dec 06n	105:00	105:01	1	3.72	2.375	Jan 25i	107:02	107:03	9	1.94
3.125	Jan 07n	99:00	99:00	1	3.70	2.375	Feb 25	135:08	135:09	19	4.84
2.250	Feb 07n	97:12	97:13	1	3.71	7.875	Aug 25	126:00	126:01	19	4.85
6.250	Feb 07n	104:17	104:18	1	3.66	6.000	Feb 26	114:28	114:29	18	4.85
3.375	Feb 07n	99:12	99:13	1	3.70	6.750	Aug 26	125:01	125:02	19	4.85
3.750	Mar 07n	100:00	100:01	1	3.73	6.500	Nov 26	121:28	121:29	18	4.85
6.625	May 07n	105:23	105:24	1	3.74	6.625	Feb 27	123:22	123:23	17	4.85
4.375	May 07n	101:07	101:08	1	3.74	6.375	Aug 27	120:20	120:21	18	4.85
3.125	May 07n	98:23	98:24	1	3.75	6.375	Nov 27	117:11	117:12	18	4.85
2.750	Aug 07n	97:21	97:22	2	3.79	6.125	Apr 28i	130:27	130:28	16	4.85
3.250	Aug 07n	98:25	98:26	2	3.78	5.500	Aug 28	105:02	105:03	16	4.84
6.125	Aug 07n	105:06	105:07	2	3.78	5.250	Nov 28	105:20	105:21	17	4.84
3.000	Nov 07n	98:00	98:00	3	3.82	5.250	Feb 29	105:24	105:25	16	4.84
3.625	Jan 08n	107:16	107:17	7	3.88	3.875	Apr 29i	136:26	136:27	17	1.95
3.000	Feb 08n	97:20	97:20	1	3.82	6.125	Aug 29	118:08	118:09	18	4.84
5.500	Feb 08n	104:11	104:12	2	3.86	6.250	May 30	120:21	120:22	21	4.82
3.375	Feb 08n	98:20	98:20	2	3.88	5.375	Feb 31	109:16	109:17	20	4.73
2.625	May 08n	96:07	96:08	2	3.92	3.375	Apr 32i	131:30	131:31	22	1.86
5.625	May 08n	104:29	104:30	3	3.91	U.S. Treasury Strips					
3.250	Aug 08n	97:24	97:25	2	3.96	MATURITY TYPE BID ASKED CHG YLD					
3.125	Sep 08n	97:09	97:10	3	3.98	Apr 05	ci	99:31	99:31	-	2.53
3.125	Oct 08n	97:06	97:07	3	3.98	May 05	ci	99:25	99:25	-	2.56
3.375	Nov 08n	97:30	97:31	3	3.98	May 05	bp	99:25	99:25	-	2.42
4.750	Nov 08n	102:17	102:18	3	3.97	May 05	np	99:24	99:24	-	2.75
3.375	Dec 08n	97:27	97:28	3	4.00	Jul 05	ci	99:11	99:11	-	2.59
3.250	Jan 09n	97:12	97:13	3	3.99	Aug 05	ci	99:01	99:01	-	2.86
3.875	Jan 09n	110:06	110:07	2	4.09	Aug 05	bp	99:01	99:01	-	2.86
3.000	Feb 09n	96:12	96:13	4	4.02	Aug 05	np	99:00	99:00	-	2.93
2.625	Mar 09n	94:30	94:31	4	4.02	Oct 05	ci	98:14	98:14	-	3.10
3.125	Apr 09n	96:20	96:21	4	4.03	Nov 05	ci	98:06	98:06	-	3.13
3.875	Apr 09n	99:11	99:12	4	4.04	Nov 05	np	98:04	98:04	-	3.22
5.500	May 09n	105:17	105:18	5	4.01	Nov 05	np	98:04	98:04	-	3.24
4.000	Jun 09n	99:25	99:26	4	4.04	Jan 06	ci	97:23	97:23	1	3.05
3.625	Jul 09n	98:09	98:10	5	4.06	Feb 06	ci	97:08	97:08	1	3.33
3.500	Aug 09n	97:25	97:26	5	4.05	Feb 06	bp	97:09	97:09	1	3.28
6.000	Aug 09n	107:20	107:21	4	4.05	Mar 06	np	97:09	97:09	1	3.30
3.375	Sep 09n	97:05	97:06	5	4.08	Apr 06	ci	96:21	96:21	1	3.40
3.375	Oct 09n	97:01	97:02	4	4.09	Apr 06	bp	96:11	96:11	1	3.43
3.500	Nov 09n	97:17	97:18	5	4.09	May 06	ci	96:11	96:11	1	3.44
3.500	Dec 09n	97:12	97:13	5	4.11	May 06	bp	96:11	96:11	1	3.44
3.625	Jan 10n	97:27	97:28	5	4.12	May 06	np	96:11	96:11	1	3.43
4.250	Jan 10n	113:22	113:23	5	4.12	Jun 06	ci	95:15	95:15	1	3.48
3.500	Feb 10n	97:10	97:11	5	4.11	Jun 06	bp	95:11	95:11	1	3.57
6.500	Feb 10n	110:11	110:12	5	4.11	Oct 06	ci	94:25	94:25	1	3.58
4.000	Mar 10n	99:14	99:15	5	4.12	Nov 06	ci	94:15	94:15	1	3.61
0.875	Apr 10i	97:23	97:24	4	1.34	Nov 06	bp	94:14	94:14	1	3.62
10.000	May 10	100:20	100:21	-1	2.51	Nov 06	np	94:14	94:14	1	3.63
5.750	Aug 10n	107:17	107:18	5	4.16	Dec 06	ci	93:16	93:16	1	3.68
12.750	Nov 10	105:17	105:18	1	3.17	Dec 06	bp	92:15	92:15	1	3.77
3.000	Jan 11	110:00	110:00	7	1.54	Jan 07	ci	92:16	92:16	1	3.83
5.000	Feb 11n	104:04	104:05	6	4.19	Jan 07	bp	91:17	91:17	1	3.81
13.875	May 11	110:30	110:31	2	3.53	Feb 07	ci	91:17	91:17	1	3.81
5.000	Aug 11n	104:05	104:06	6	4.24	Feb 07	bp	91:17			