

**Reading 70****Derivative Benefits, Risks, and Issuer and Investor Uses****1. (C) Liquidity.****Explanation**

An advantage of derivatives is that they allow for greater liquidity as the low cash requirements for derivative transactions makes it more cost effective to enter into very large transactions. A disadvantage of derivatives is that the implicit leverage using derivatives contracts creates significantly more risk than their cash market equivalents.

The ease of short sales with derivatives (e.g., selling a forward or futures contract) is an advantage compared to cash market transactions. With cash markets, difficulty in borrowing an asset and restrictions on short sales may make short positions in underlying assets problematic or more expensive.

Low transaction costs, greater liquidity and leverage, and ease of short sales all make it less costly to exploit securities mispricing through derivatives transactions and improve the efficiency of market prices.

**(Module 70.1, LOS 70.a)**

**2. (C) fair value hedge.****Explanation**

Using an interest rate swap to hedge changes in the value of a balance sheet liability is considered a fair value hedge. If the interest rate swap is used to convert the floating-rate payments on a bond liability to fixed-rate payments, it would be considered a cash flow hedge.

**(Module 70.1, LOS 70.b)**

**3. (A) Volatility of the underlying.****Explanation**

We can use the values of the observable variables (e.g., interest rates, price of the underlying, time to expiration, and exercise price) together with the current market prices of derivatives to estimate the future price volatility of the underlying that market participants expect.

**(Module 70.1, LOS 70.a)**

**4. (A) the value of a foreign subsidiary.**

**Explanation**

A hedge using foreign currency derivatives to hedge the reported value (in domestic currency) of the equity of a foreign subsidiary is termed a net investment hedge.

**(Module 70.1, LOS 70.b)**

**5. (B) fair value hedge.**

**Explanation**

Using derivatives to hedge the changes in value of inventory is considered a fair value hedge.

**(Module 70.1, LOS 70.b)**

**6. (C) buy puts.**

**Explanation**

Buying puts will protect the owner of common stock from downside risk as well as allow the owner to retain the upside potential. Selling calls will remove the upside potential beyond the strike price set for the calls because the investor will need to sell the stock to the option owner at the strike price. Buying calls does not make sense if the investor already owns the underlying asset because the owner would automatically benefit from any price increases of the underlying. By buying the call, the investor would double the exposure to the upside. Buying calls would only make sense if the investor does not already own the underlying asset; the buyer would aim to acquire the asset at a "low" strike price and then benefit from subsequent price appreciation.

**(Module 70.1, LOS 70.a)**

**7. (C) A manufacturer can hedge the exchange risk of anticipated receipts or payments.**

**Explanation**

A portfolio manager can decrease or increase exposure to the risk and return of a market index.

The issuer of a fixed-rate obligation can change risk exposure by converting to a floating rate obligation. Converting from a fixed-rate to a floating-rate obligation does not necessarily mean increasing risk, especially if market interest rates are falling, for example.

**(Module 70.1, LOS 70.a)**

**8. (B) a call option on the asset.**

**Explanation**

Buying a call option allows an investor to participate in the upside potential of an asset while protecting against downside risk because the investor can walk away from the option at low asset prices (it is a right, not an obligation). It is not necessary to also buy a put option to protect against downside risk because the call option is a right, not an obligation, to the option buyer. A put option is beneficial if the investor already holds a long position in the underlying asset.

**(Module 70.1, LOS 70.a)**

