

Reading 56**YIELD & YIELD SPREAD MEASURES
FOR FLOATING-RATE INSTRUMENTS**

1. (A) **2.00%.**

Explanation

The add-on yield for the 73-day holding period is $\$1,004 / \$1,000 - 1 = 0.4\%$. The bond equivalent yield, which is an add-on yield based on a 365-day year, is $(365 / 73) \times 0.4\% = 2.0\%$.

(Module 56.1, LOS 56.b)

2. (B) **3.15%.**

Explanation

When the company that issues the FRN has less credit risk than the institution where the MRR was derived, the quoted margin (QM) will be a subtraction from the MRR. The only choice where the coupon rate is below the MRR is 3.15%—3.50% implies that the floor for the coupon rate is the MRR, and that is not the case.

(Module 56.1, LOS 56.a)

3. (B) **the note's credit quality has improved.**

Explanation

The quoted margin of a floating-rate note is the number of basis points added to or subtracted from the note's reference rate to determine its coupon payments. The required margin or discount margin is the number of basis points above or below the reference rate that would cause the note's price to return to par value at each reset date. The discount margin may be different from quoted margin if a note's credit quality has changed since issuance. If there is an improvement in credit quality, the discount margin will be less than quoted margin and the note will trade at a premium. Changes in the reference rate will not impact the relative difference between the discount and quoted margin.

(Module 56.1, LOS 56.a)

4. (B) **Below par.**

Explanation

If the QM is deemed to be deficient, this means it is lower than the discount margin (DM). The coupons are based on market reference rate (MRR) + QM, and so if the coupons being offered are less than the required return, the bond will trade below par value. If $QM = DM$, the bond would trade at par, and if QM was greater than DM, the bond would trade at a premium.

(Module 56.1, LOS 56.a)

5. (B) higher than 1.5%.

Explanation

The BEY is an add-on yield based on a 365-day year. The discount of 1.5% implies a discount of $\$1,000 \times 1.5\% \times 150/360 = \6.25 . The current price is therefore $\$1,000 - \$6.25 = \$993.75$.

This gives a HPR of $\$6.25 / \$993.75 = 0.629\%$.

$BEY = 0.629\% \times 365/150 = 1.53\%$.

(Module 56.1, LOS 56.b)

6. (B) greater than the quoted margin.

Explanation

The quoted margin (QM) on an FRN is the amount above (or below) the market reference rate (MRR) that determines the actual coupon payment itself. The discount (required) margin (DM) is the required return on the note for it to be priced at par. If the DM is greater than the QM, this means that investors are requiring a higher yield than currently being offered, causing the note to trade below par.

(Module 56.1, LOS 56.a)

7. (B) equal the discount margin.

Explanation

If there has been no change to the credit quality of the note since issuance, even as the note gets closer to maturity, the QM and the discount margin will remain the same.

(Module 56.1, LOS 56.a)

8. (C) 7.5%.

Explanation

The equivalent add-on return the investor earns for the 146-day holding period is $\$1,000 / \$971 - 1 = 0.0299 = 2.99\%$. The bond-equivalent yield is $(365 / 146) \times 2.99\% = 7.47\%$.

(Module 56.1, LOS 56.b)

9. (A) add-on yield based on a 365-day year.

Explanation

A bond-equivalent yield is an add-on yield based on a 365-day year.

(Module 56.1, LOS 56.b)

10. (B) \$1,008,325.

Explanation

The coupon payments will be based on a rate of 4.3% (3.5% + 0.80%), and the discount rate will be equal to 4.0% (3.5% + 0.5%). Using a financial calculator, $N = 3$, $I/Y = 4.0$, $FV = 1,000,000$, $PMT = 43,000$ (4.3% of 1,000,000), and the computed $PV = 1,008,325$.

(Module 56.1, LOS 56.a)

