

CFA-LEVEL-1^{Q&As}

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QUESTION 1

A firm has issued a perpetuity with a total face value of 100 million dollars and a coupon rate of 5.8%. If the risk free rate equals 5.8% and investors require a rate of return of 10.6% from the perpetuity, what\\'s the amount the firm raised through the issue?

- A. \$55.28 million
- B. none of these answers
- C. \$100 million
- D. \$54.72 million

Correct Answer: D

The price of a perpetuity that pays C per year, at a discount rate of R, equals C/R. Hence, the price of the perpetuity issue = (100*5.8%/10.6%) million = \$54.72 million.

QUESTION 2

Which of the following is not one of the three main determinants of the required rate of return on an asset?

- A. The risk premium on the asset
- B. The expected rate of inflation during the holding period
- C. The economy\\'s real risk-free rate of return
- D. The Markowitz efficient frontier

Correct Answer: D

Although the Markowitz efficient frontier may be used in the process of deriving the risk premium on the asset, it is not in itself one of the three main determinants of the required rate of return on an asset. All investments are affected by the real risk-free rate of return and the expected rate of inflation, because those two factors determine the nominal risk-free rate of return. The nominal risk-free rate of return plus the risk premium on the asset is equal to the asset\\'s required rate of return.

QUESTION 3

A project requires an initial outlay of 650. It also needs capital spending of 700 at the end of year 1 and 900 at the end of year 2. It has no revenues for the first 2 years but receives 1,200 in year 3, 1,600 in year 4 and 2,300 in year 5. The project\\'s cost of capital is 10%. The discounted payback period equals _____.

A. 2.26 years

B. 4.02 years

C. 3.19 years



D. 3.46 years

Correct Answer: B

The cash flows of the project starting at the end of year 1 are: -700, -900, +1,200, +1,600, +2,300 The discounted payback period is defined as the expected number of years that would be required to recover the original investment using discounted cash flows. The discounted cash flow at the end of year N

is obtained by dividing that year\\'s cash flow by 1.1N, since the project\\'s cost of capital is 10%. Using this,

the discounted cash flows are:

-636, -744, +902, +1,093, +1,428.

Recovery occurs in the 5th year. At the beginning of the 5th year, the outstanding balance equals 650 +

636 + 744 - 902 - 1093 = 35. Therefore, the discounted payback period = 4 + 35/1428 = 4.02 years.

QUESTION 4

If the ratio of specialists// short sales to total short sales is 25%, then technicians would view this as

- A. neither particularly bullish nor bearish.
- B. a bearish sign.
- C. a sign of an approaching flat market trend.
- D. a sign of a approaching market peak.

E. a bullish sign.

Correct Answer: E

Technical analysts trying to follow the "smart money" sometimes use the proportion of specialists\\' short sales to total short sales as a market indicator. A decline of the ratio below 30% is viewed as a bullish sign, indicating that specialists are trying to minimize participation in short sales in expectation of a rising market. A increase in the ratio above 50%, conversely, is viewed as a bearish sign.

QUESTION 5

Consider the following information for Company XYZ:

30 day T-Bill rate (Risk free rate) 5.2%

Common Stock Beta 1.1

Expected Rate of return for the market 12.0%

Debt Credit Rating BBB

Calculate this firm\\'s cost of retained earnings using the CAPM approach.



- A. 5.72%
- B. 17.2%
- C. 10.2%
- D. 12.0%
- E. 12.68%
- F. 5.2%

Correct Answer: E

To calculate the cost of retained earnings for a firm using CAPM, one may use the following formula: Cost of retained earnings = risk free rate + ((expected rate of return on the market - risk free rate) x Beta). In this case the cost of retained earnings = $5.2\% + ((12.0\% - 5.2\%) \times 1.1 = 12.68\%)$.

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