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Chapter 12: Bonds and Mutual Funds

Check Your Answers: Section Assessment

Section 1

Review Key Concepts
1. Debentures—bonds that are backed by the corporation's reputation; mortgage bonds—bonds that are backed by the corporation's assets; subordinated debentures—unsecured bonds that give bondholders a claim to interest payments and assets; convertible bonds—bonds that an investor can trade for shares of the corporation's common stock.

2. A company might issue corporate bonds in order to finance regular business activities; raise money when it is difficult to sell stock; reduce the taxes it pays.

3. Investors buy corporate bonds because many are safeinvestments; bonds may help diversify an investment portfolio; most bonds provide interest income; and bonds may increase in value.

4. The government sells bonds and other securities to help finance regular services and the national debt.

5. A general obligation bond is a bond that is backed by the full faith and credit of the government. A revenue bond is a bond that is repaid from the income generated by the project it finances.

Higher Order Thinking
6. The investor must be compensated for taking the risk that the bond issuer will call the bond if interest rates decline, which would force the investor to reinvest the proceeds at lower yields.

English Language Arts
7. Personal Goals and the Community Answers will vary. Students may suggest that Saundra buy the bonds because they are virtually risk-free and have a chance to increase the financial stability of her community. Others may say that she should invest her money in other ways to increase her personal return. Some students may say that she compromise and invest her money in bonds as well as other securities.

Mathematics
8. Bond Market Value Total interest earned each year = $2,000 × 7.5% = $150.00 per bond or $150.00 × 2 = $300.00 total; Julian's bonds increased in value. Since the interest rate on comparable bonds decreased, Julian's bonds earn more interest than these new bonds, therefore their value increases; Approximate market value = $150.00/6.75% = $2,222.22 per bond or $2,222.22 × 2 = $4,444.44 total

Section 2

Review Key Concepts
1. Annual reports, the Internet, business magazines, and government reports and research.

2. To find the current yield of a bond, divide the dollar amount of annual interest income by its current market value. This calculation lets you compare the yield on a bond investment with the yields of other investment alternatives.

3. In a bond price quotation, the price of a bond is given as a percentage of its face value. To find the current market value for a bond, multiply the face value ($1,000) by the price quotation given in the newspaper. For government bonds, most financial publications include two price quotations: the bid price and the asked price. The bid price is the amount a seller could receive for the bond. The asked price represents the amount a buyer could pay to purchase the bond.

4. Bond ratings are generally categorized from AAA (the highest—the best) to D (the lowest—the worst). Independent rating companies assign to each bond a rating based on the financial stability of its issuer. Bond ratings help investors determine the quality and risk associated with bonds.

Higher Order Thinking
5. Bonds are rated by independent companies. The ratings tell investors how secure their investments are and how likely they are to receive interest and principal repayment. Depending on your risk tolerance and the level of return you want, you will choose bonds ranging from "junk" to "high-grade investment quality."

21st Century Skills
6. Solve Problems Andrew should multiply $1,000 by 98% to find the current market value of $980.

Mathematics
7. Bond Price and Yield Selling price =$1,000 × (86/100) = $860; Interest earned = $1,000 × 6.75% = $67.50; Current yield = $67.50/$860 = 7.85%

Section 3

Review Key Concepts
1. A mutual fund is an investment alternative in which investors pool their money to buy stocks, bonds, and other securities based on the selections of professional managers who work for an investment company.

2. Mutual funds are professionally managed, and they are diversified, which reduces the shareholders' risk.

3. Stock mutual funds, bond mutual funds, and mixed mutual funds.

4. Closed-end funds have a fixed number of shares that are issued by an investment company when the fund is first organized. Open-end funds have an unlimited number of shares that are issued and redeemed by an investment company at the investors' request. Load funds require a commission every time shares are bought or sold. No-load funds do not require commissions.

Higher Order Thinking
5. Opinions should be supported by logic and reason. For example: fees are charged and justified because the manager is providing a service to the investor. It is not reasonable to expect such service for free.

English Language Arts
6. Fund Objectives Ana's advice best addresses Kaylee's concerns. Utility funds and money-market funds are considered safe and secure investments. The aggressive-growth funds and high-yield (junk) bond funds are too risky for Kaylee's risk tolerance.

Mathematics
7. Load Fund Load charged = $2,250 × 5.5% = $123.75; Remaining amount invested = $2,250 - $123.75 = $2,126.25; Shares purchased = $2,126.25/$23.00 = 92.45 shares

Section 4

Review Key Concepts
1. Newspapers, quotations, prospectuses, annual reports, financial publications, professional advice, the Internet.

2. When you buy shares in an open-end mutual fund from an investment company, you have several purchase options: a regular account transaction, a voluntary savings plan, a payroll deduction plan, a contractual savings plan, or a reinvestment plan. You can also sell shares of closed-end funds to another investor any time you want on the stock exchange or in the over-the-counter market. Shares in an open-end fund can be sold to the investment company that sponsors the fund.

3. Income dividends are reported along with all other dividend amounts you have received; they are taxed as regular income. Capital gain distributions are reported on your federal income tax return. Capital gains or losses that result from your selling shares in a mutual fund are reported on your federal income tax return. Almost all investment companies allow you to reinvest the capital gains distributions and income dividends you earn instead of receiving cash. These distributions are taxable and must be reported on your income tax return. Since you get to decide when to sell your stocks or bonds, you can pick the tax year when you pay tax or deduct losses on these investments. Mutual funds buy and sell securities on a regular basis during any 12-month period, so you have no control over when the mutual fund sells securities.

4. Capital gain distributions are payments made to shareholders that result from the sale of securities in the fund's portfolio. A capital gain distribution occurs when the fund sells securities within the fund's portfolio and distributes profits to shareholders. A capital gain occurs when the shareholder sells some of his or her shares in the mutual fund.

Higher Order Thinking

5. Mutual funds can be used to invest money that is contributed to tax-deferred 401(k) and 403(b) plans or individual retirement accounts (IRAs). These investments will grow larger over time, so the earlier you start, the longer it is allowed to grow.

21st Century Skills

6. Make Judgments and Decisions A voluntary savings plan would allow Erik to make smaller purchases than the minimum required by the regular account transaction, but he must commit to making regular minimum purchases of the fund's shares. A contractual savings requires that Erik make regular purchases of shares over a specific period of time, and pay penalty fees if he does not make the required purchases. With a reinvestment plan, Erik's distributions would be automatically reinvested to buy additional shares of the fund without paying additional sales charges or commissions. Students' suggestions will vary, but most will likely suggest that Erik choose the voluntary or reinvestment plan because the contractual plan is too risky.

Mathematics

7. Capital Gain and Percentage of Asset Growth Withdrawal Total capital gain after one year = (\$46.25 - \$43.50) × 125 shares = \$343.75; Withdrawal amount after one year = \$343.75 × 45% = \$154.69; Capital gain per share after two years = \$52.90 - \$43.50 = \$9.40