ICCE
INSTITUTE OF CERTIFIED CHARTERED ECONOMISTS

FE1

FINANCIAL ECONOMICS I

PROFESSIONAL LEVEL

SYLLABUS & EXAMS GUIDE

PROFESSIONAL LEVEL

FE1 – FINANCIAL ECONOMICS I

SYLLABUS & EXAMS GUIDE

OVERVIEW

Globally, the financial sectors have, in recent years, been expanding at phenomenal rates and witnessing dramatic changes in their range and sophistication of operations.

Hence, there is increasing demand for financial practitioners who are not only equipped with a good foundation in economics, mathematics and statistics but who are also well trained in the emerging theoretical and empirical tools for a better understanding of the sector

The demand for highly skilled experts in financial economics continues to increase rapidly in the modern economy. This demand exists in the public sector (central banks, international organisations, academic institutions) and especially, in the private sector (commercial banks and insurance companies).

This course is designed to meet this demand, by combining a solid training in financial economics and macroeconomic principles, as well as the quantitative methods needed for the analysis of financial markets.

Financial economics is a fascinating area, having a history marked by outstanding achievements. A remarkable feature of this discipline is that its theoretical highlights (such as the Black-Scholes formula) turned out to be extremely important in practice.

Fundamental ideas and tools of financial economics that were developed at the interface between mathematical economics and finance created new markets essentially based on concepts suggested by academics.

A central goal of the course is to demonstrate the use of these ideas and tools in contexts where they are indispensable and widely exploited. The course will expose you to quantitative techniques and theory that will be useful in the financial industry - a portfolio manager, risk management consultant, or financial analyst.

LEARNING OBJECTIVES

The Financial system is sometimes viewed solely as a vehicle for making or losing money with no other purpose, while at other times it is viewed as a vital part of our economic system and an important component of economic growth. No matter the view, our financial system, with its institutions, structures, and instruments, is a dominant factor in our monetary economy.

From an economist's perspective, we are concerned with how the system aids resource allocation and economic growth.

At the end of this Paper, learner is expected to amongst other things know the following:

- Make capital budget decisions, analyze leverage structure and financing costs
- Understand and apply corporate finance theories for practice and research
- Describe the main functions of the financial system
- Solve present value problems
- Derive key financial formulas
- Explain how the stock and bond markets operate;
- Explain the major features of stocks and bonds;
- Articulate the major trends and patterns in the financial markets
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- Forms of Business Organization
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- The Goal of Management
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- The Role of Finance Specialist in a Corporation

Financial Markets & Institutions

- What is the Financial System?
- The Flow of Funds
- The Functional Perspective
- Financial Innovations and the "Invisible Hand"
- Financial Markets
- Financial Market Rates
- Financial Intermediaries
- Financial Infrastructure and Regulations

Managing Financial Health and Performance

- Functions of Financial Statements
- Review of Financial Statements
- Market Values versus Book Values
- Accounting versus Economic Measures of Income
- Returns to Shareholders versus Return on Book Equity
- Analysis Using Financial Ratios
- The Financial Planning Process
- Constructing a Financial Planning Model

- Growth and the Need for External Financing
- Working Capital Management
- Liquidity and Cash Budgeting

Allocating Resources Over Time

- Compounding
- The Frequency of Compounding
- Present Value and Discounting
- Alternative Discounted Cash Flow Decisions Rules
- Multiple Cash Flows
- Annuities
- Perpetual Annuities
- Loan Amortization
- Exchange Rates and Time Value of Money
- Inflation and Discounted Cash Flow Analysis
- Taxes and Investment Decisions

Household Saving and Investment Decisions

- A life-cycle Model of Saving
- Taking Account of Social Security
- Deferring Taxes Through Voluntary Retirement Plans
- Should You Invest in a Professional Degree?
- Should you Buy or Rent?

The Analysis of Investment Projects

- The Nature of Project Analysis
- Where do Investment Ideas come from?
- The Net Present Value of Investment Rule
- Estimating a Project's Cash Flows
- Cost of Capital
- Sensitivity Analysis Using Spreadsheets
- Analyzing Cost-Reducing Projects
- Ranking Mutually Exclusive Projects
- Inflation and Capital Budgeting

Principles of Market Valuation

- The Relation between an Asset’s Value and Its Price
- Value Maximization and Financial Decisions
- The Law of One Price and Arbitrage
- Arbitrage and the Prices of Financial Assets
- Interest Rates and the Law of One Price
- Exchange Rates and Triangular Arbitrage
- Valuation Using Comparables
- Valuation Models
- Accounting Measures of Value
- How Information is Reflected in Security Prices
- The Efficient Markets Hypothesis

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EXAM STRUCTURE

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- The Economic Journal
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SAMPLE QUESTIONS

1. The primary goal of corporate management is to _________ shareholder wealth.
    A. minimize
    B. maximize
    C. leverage
    D. mitigate

2. The day-to-day financial affairs of the firm are usually referred to as _________.
    A. working capital management
    B. capital structure
    C. capital budgeting
    D. strategic planning

3. Billy owns a house worth $350,000 and has a $55,000 bank account. Billy owes $270,000 to the bank on a home mortgage loan and has a $12,000 credit card debt outstanding. Calculate Billy's net worth.
    A. $135,000
    B. $123,000
    C. $497,000
    D. $37,000

4. Marlowe owns a house worth $150,000, a car worth $25,000 and has an $18,000 bank account. Marlowe owes $135,000 to the bank on a home mortgage loan, $18,000 on the car loan and has an $18,000 credit card debt outstanding. Calculate Marlowe's net worth.
    A. $58,000
    B. $123,000
    C. $22,000
    D. $37,000

5. All of the following are reasons for having a separation of management and ownership of the firm except:
    A. the "going concern" effect favors the separated structure
    B. professional managers may be found who possess a superior ability to run the business
    C. it prevents the possibility of a conflict of interest between the owners and management
    D. it allows for savings in the cost of information gathering

6. _________ involves the evaluation of costs and benefits spread out over time, and it is largely a financial decision-making process.

    A. Stock valuation
    B. Bond valuation
    C. Inventory costing
    D. Strategic planning

7. If a raider is interested in making a profit through the takeover of a prospective firm, the only expenses that need be incurred are _________.

A. the cost of identifying a mismanaged firm
B. the cost of acquiring the firm's shares
C. physical capital
D. both (a) and (b)

8. Which one of the following correctly orders the steps involved in capital structure decisions?
    A. determining a feasible financing plan; identifying new ideas for investment projects
    B. determining the optimal financing mix; determining a feasible financing plan
    C. identifying ideas for investment projects; determining the optimal financing mix
    D. determining a feasible financing plan; determining the optimal financing mix

9. Any U.S. or non-U.S. company that wishes to list its shares on a U.S. exchange must regularly report its activities by filing financial statements with the _________.
    A. SEC
    B. NYSE
    C. GAAP
    D. AMEX

10. Although it differs from the income statement, the statement of cash flows is a useful supplement to the income statement because:
    A. it focuses attention on what is happening to the firm's cash position over time
    B. it avoids the judgments about revenue and expense recognition that go into the income statement
    C. it is influenced by accrual accounting decisions
    D. (a) and (b)

11. Success Galore had a market price of $178 per share at the beginning of 19X7 and at the end of the year the price per share was $205.50. Cash dividends for the year were $7 per share. Calculate the total shareholder returns.
    A. 19.38%
    B. –19.38%
    C. 16.79%
    D. –16.79%

12. A firm has EBIT of $3 million, sales of $15 million, and average total assets of $30 million. Calculate its ROA.
    A. 6.67%
    B. 10%
    C. (c) 20%
    D. (d) 50%

13. If the average total assets for the Heartland Corporation are $660 million and EAT are $100 million, calculate its ROA. Assume a tax rate of 40% and interest of $3 million.
    A. 15.15%
    B. 15.6%
    C. 25.15%
    D. 25.71%

14. _________ refers to the interest rate at which money received before the end of the planning horizon can be reinvested.
    A. Internal rate
    B. Reinvestment rate
    C. Cost of equity
    D. Compound interest

15. Consider the situation where you have won a $10 million lottery to be received in 25 annual equal payments of $400,000. What will happen to the present value of these winnings if the interest rate increases during the next 25 years?
    A. it will not change
    B. it will be worth more
    C. it will be worth less
    D. it cannot be determined

16. You have determined the present value of an expected cash inflow stream. Which of the following would cause the stream to have a higher present value?
    A. The discount rate increases.
    B. The cash flows are paid over a shorter period of time.
    C. The discount rate decreases.
    D. Statements (b) and (c) are both correct.

17. The objective of a firm's management is to only undertake the projects that _________ the market value of shareholders' equity.
    A. decrease
    B. do not decrease
    C. change
    D. do not change

18. The decision rule that management uses with the net present value is to undertake only those projects with _________ NPV.
    A. a discounted
    B. a contingent
    C. a positive
    D. negative

19. If a firm decides to invest in automated machines that will allow the firm to reduce labor costs, this is an example of a _________ capital expenditures project.
    A. new products
    B. replacement of existing assets

C. cost reduction
D. advertising

20. The NPV of a project represents the amount by which it is expected to increase _________.
A. the break-even point
B. capital budgeting
C. capital expenditures
D. shareholder wealth

ANSWERS

1. B	11. A
2. A	12. B
3. B	13. D
4. C	14. B
5. C	15. C
6. D	16. D
7. D	17. B
8. D	18. C
9. A	19. C
10. D	20. D

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FE2

FINANCIAL ECONOMICS II

PROFESSIONAL LEVEL

SYLLABUS & EXAMS GUIDE

PROFESSIONAL LEVEL

FE2 – FINANCIAL ECONOMICS II

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Valuation of Known Cash Flows: Bonds

- Using Present Value Factors to Value Known Cash Flows
- The Basic Building Blocks: Pure Discount Bonds
- Coupon Bonds, Current Yields and the Yield to Maturity
- Reading Bond Listings
- Why Yields for the Same Maturity May Differ
- The Behavior of Bond Prices over time

Valuation of Common Stocks

- Reading Stock Listings
- The Discounted Dividend Model
- Earnings and Investment Opportunities
- A Reconsideration of the Price/Earnings Multiple Approach
- Does Dividend Policy Affect Shareholder Wealth?

Principles of Risk Management

- What is Risk?
- Risk and Economic Decisions
- The Risk-Management Process
- The Three Dimensions of Risk Transfer
- Risk Transfer and Economic Efficiency

- Institutions for Risk Management
- Portfolio Theory: Quantitative Analysis for Optimal Risk Management
- Probability Distributions of Returns
- Standard Deviation as a Measure of Risk

Hedging, Insuring and Diversifying

- Using Forward and Futures Contract to Hedge Risk
- Hedging Foreign-Exchange Risk with Swap Contracts
- Hedging Shortfall Risk by Matching Assets to Liabilities
- Minimizing the Cost of Hedging
- Insuring versus Hedging
- Basic Features of Insurance Contracts
- Financial Guarantees
- Caps and Floors on Interest Rates
- Options as Insurance
- The Diversification Principle

Portfolio Opportunities and Choice

- The Process of Personal Portfolio Selection
- The Trade-Off between Expected Return and Risk
- Efficient Diversification with Many Risky Assets

Capital Market Equilibrium

- The Capital Asset Pricing Model
- Determinants of the Risk Premium on the Market Portfolio
- Beta and Risk Premiums on Individual Securities
- Using CAPM in Portfolio Selection
- Valuation and Regulating Rates of Return
- Modifications and Alternatives to the CAPM

Forward and Futures Markets

- Distinctions between Forward and Futures Contracts
- The Economic Functions of Futures Markets
- The Role of Speculators
- Relations between Commodity Spot and Futures Prices
- Extracting Information from Commodity Futures Prices
- Forward-Spot Price Parity for Gold
- Financial Futures

- The Implied Riskless Rate
- The Foreign-Exchange Parity Relation
- The Role of Expectations in Determining Exchange Rates

Markets for Options and Contingent Claims

- How Options Work
- Investing with Options
- The Put-Call Parity Relations
- Volatility and Option Prices
- Two-State (Binomial) Option Pricing
- Dynamic Replication and the Binomial Model
- The Black-Scholes Model
- Implied Volatility
- Contingent Claims Analysis of Corporate Debt and Equity
- Credit Guarantees

Financial Structure of the Firm

- Internal versus External Financing
- Equity Financing
- Debt Financing
- The Irrelevance of Capital Structure in a Frictionless Environment
- Creating Value through Financing Decisions
- Reducing Costs
- Dealing with Conflicts of Interest
- Creating new Opportunities for Stakeholders

Real Options

- Investing in Real Options
- A Deferral Option: The Case of Uncertainty and Irreversibility
- Applying the Black-Scholes Formula to Value Real Options

EXAMINATION GUIDE

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SAMPLE QUESTIONS

1. A _________ is a quantitative method used to infer an asset's value from market information about the prices of other assets and market interest rates.
    A. fixed model
    B. perpetual valuation model
    C. valuation model
    D. variable model

2. Consider a fixed-income security that promises to pay $150 each year for the next five years. How much is this five-year annuity worth if the appropriate discount rate is 7% per year?
    A. $534.74
    B. $615.03
    C. $802.50
    D. $867.96

3. The price of any existing fixed-income security _________ when market interest rates rise because investors will only be willing to _________ them if they offer a competitive yield.

    A. rises; buy
    B. rises; sell
    C. falls; buy
    D. falls; sell

4. A fall in interest rates causes a _________ in the market value of a fixed-income security.
    A. a rise
    B. a fall
    C. no change
    D. it cannot be determined from the information given

5. A change in market interest rates causes _________ in the market values of all existing contracts promising fixed payments in the future.

    A. a change in the same direction
    B. a change in the opposite direction
    C. no change
    D. an unpredictable variation

6. Consider a four-year pure discount bond with a face value of $1,000. If its current price is $850, compute its annualized yield.
    A. 1.17%
    B. 4.15%
    C. 5.57%
    D. 17.60%

7. A _________ obligates the issuer to make periodic payments of interest to the bondholder for the life of the bond and then to pay the face value of the bond when the bond matures.

A. pure discount
B. zero-coupon
C. perpetual bond
D. coupon bond

8. The _________ of the bond is interest rate applied to the _________ of the bond to compute the periodic payment.
    A. coupon rate; face value
    B. maturity rate; face value
    C. coupon rate; price
    D. maturity rate; price

9. If the bond's market price is lower than its face value, it is termed a _________.
    A. par bond
    B. premium bond
    C. discount bond
    D. zero-par bond

10. Bonds offering the same future stream of promised payments can differ in a number of ways, but the two most important are _________ and _________.
    A. taxability, issue origin
    B. type of issuer, default risk
    C. type of issuer, taxability
    D. taxability, default risk

11. A _________ is one that gives the holder of a bond issued by a corporation the right to convert the bond into a pre-specified number of shares of common stock.
    A. callable bond
    B. convertible bond
    C. stock bond
    D. preferred bond

12. Five years ago, English and Co. issued 25-year coupon bonds with par value $1,000. At the time of issuance, the yield to maturity was 6 percent and the bonds sold at par. The bonds are currently selling at 110 percent of their par value. Assuming that the coupon is paid annually, what is the current yield to maturity?
    A. 3.77%
    B. 5.18%
    C. 5.27%
    D. 5.46%

13. Suppose you buy a 25-year pure discount bond with a face value of $1,000 and a yield of 6% per year. A day later market interest rates drop to 5% and so does the yield on your bond. What is the proportional change in the price of your bond?
    A. a decrease of 26.74%

B. a decrease of 21.10%
C. an increase of 26.74
D. an increase of 21.20

14. _________ that "matters" because if affects people's welfare. _________ exists whenever one does not know for sure what will occur in the future.
    A. Uncertainty is risk; Uncertainty
    B. Risk is uncertainty; Uncertainty
    C. Risk is uncertainty; Risk
    D. Uncertainty is risk; Risk

15. When choosing among investment alternatives with the same expected rate of return, a risk averse individual chooses the one with the _________ risk.
    A. surest
    B. most uncertain
    C. lowest
    D. highest

16. By definition, _________ are investors who take positions to reduce their exposures.
    A. operations insurers
    B. foreign exporters
    C. hedgers
    D. speculators

17. The risk arising from holding different kinds of financial assets such as equities or fixed income securities denominated in one or more currencies is an example of _________.
    A. unemployment risk
    B. liability risk
    C. financial-asset risk
    D. consumer-durable asset risk

18. Which of the following is most likely to need a lot of life insurance?
    A. a single person with no dependents
    B. a divorced person with no dependents
    C. a double-income couple with no kids
    D. married person with children

19. _________ is the quantification of the costs associated with the risks that have been identified in the first step of risk management.
    A. Risk assessment
    B. Selection of risk management techniques
    C. Implementation
    D. Review

20. An asset portfolio's expected return is identified with the _________ of the distribution, and its risk with the _________.
    A. variance; average

B. mean; standard deviation
C. standard deviation; average
D. median; normal distribution

ANSWERS

1. C	11. B
2. B	12. B
3. C	13. C
4. A	14. B
5. B	15. C
6. B	16. C
7. D	17. C
8. A	18. D
9. C	19. A
10. D	20. B

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