

**Use the following information to answer Questions 1–4.**


Eva Williams is an investment manager for Straughn Capital Management (SCM). Williams believes that it would be beneficial to add some alternative investments to SCM's existing portfolio. She has asked Steven Riley, an analyst with the firm, to present some investment ideas to her. Riley is not certain which type of alternative investment might be most suitable for SCM, so he has prepared information regarding three different types of investments. The first investment is a hedge fund. The second investment is an office building in the downtown district of a major city. The third investment is a venture capital fund.

Riley makes the following observations:

- Observation 1:* Commodity investments, such as an investment in precious metals, are a good inflation hedge. Commodities as an asset class are receiving a lot of attention from hedge funds.
- Observation 2:* Demand for warehouse properties has been significantly influenced by the move to internet-based retail. The COVID-19 pandemic led to decreased demand for warehouse properties, forcing warehouse owners to consider alternative uses. However, warehouse properties are often designed for a specific application, making it relatively difficult to convert warehouses to substitute uses.

Williams is considering a trade in \$1,000 par convertible bonds and stock of KYT Inc. KYT stock pays dividends of \$2 per year and currently trades at a price of \$32. The 5% convertible has a conversion ratio of 40 and trades at 120% of par. The conversion option can be exercised at any time.

Compared to an investment in REOCs, one disadvantage of investing in REITs is:

- A) limited potential for income growth.** 
- B) greater taxation.
- C) lack of control.

#### Explanation


Due to high dividend payout (and low retention rates), REITs have limited potential for income growth. Exemption from taxation is an advantage that REITs enjoy compared to REOCs. Investors in both REITs and REOCs suffer from lack of control. (Module 32.1, LOS 32.a)

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#### Question #2 of 4

Question ID: 1685222

Hedge fund managers who believe in the Insurance Theory are *most likely* to take what kind of positions in commodity futures contracts?

- A) Long only.** 
- B) Short only.
- C) Long or short positions.

#### Explanation

The Insurance Theory holds that commodity producers will hedge their commodity price risk. Under the Insurance Theory, the cost of this risk reduction is a premium paid to speculators to entice them to take the long position in futures contracts. Consequently, futures prices should be less than expected spot prices, and a long-only position should result in positive excess returns. (Module 30.1, LOS 30.f)

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#### Question #3 of 4

Question ID: 1685223

With respect to observation 2, Riley's assertions regarding warehouse properties, which statement would be *least accurate*? The statement about:

- A)** The nature of warehouse properties making it relatively difficult to convert them to alternative uses.
- B)** The advent of internet-based retail having a significant impact on the demand for warehouse properties.

- C) Demand for warehouse properties decreasing with the onset of the COVID-19 epidemic. 

**Explanation**


Riley's statement about demand for warehouse properties decreasing with the onset of the COVID-19 epidemic is the least accurate statement: Demand for warehouse properties actually increased with the onset of the COVID-19 epidemic. It is accurate to say that warehouse properties have been significantly affected by the move to internet-based retail: specifically this shift has increased demand for warehouse properties. It is true that industrial and warehouse properties are often designed for a specific application, making them less viable for conversion to alternative uses.(Module 31.2, LOS 31.c)

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**Question #4 of 4**

Question ID: 1685224

Ignoring short costs, the convertible arbitrage profit per bond is closest to:

- A) \$80.   
B) \$40.  
C) \$60.

**Explanation**

Conversion price per share =  $\$1,200 / 40 = \$30$ .

Market price per share =  $\$32$ .

Long convertible, short stock arbitrage yields a profit of  $\$2$  per share x 40 shares per bond =  $\$80$ .

(Module 33.2, LOS 33.d)

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