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Moderated

KENYATTA UNIVERSITY

SCHOOL OF ECONOMICS

DEPARTMENT OF APPLIED ECONOMICS

EAE 202: FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

2019/2020 SEMESTER II

Externally moderated 3/02/2020

INSTRUCTIONS:

Answer question one (compulsory) and any other TWO questions. Question one carries 30 marks and the rest carry 20 marks each.

Question One

a) Distinguish between the following pair of terms as used in finance (10 marks)
   i) Systemic and systems risk
   ii) Contingent capital instruments and embedded derivatives
   iii) Ordinary and preferred stocks
   iv) Forwards and futures contract
   v) Perpetuities and Zero coupon bonds

b) Describe the factors that shift bonds demand curve (6 marks)

c) Suppose the price of a certain stock is KES80 on June 30th and the stock may go up in November.

The following plans are available to an investor:

I) The investor spends KES800,000 in cash to buy 10, 000 shares on June 30th or

II) The investor pays a premium of KES35, 000 to purchase a call option to buy 10,000 shares at strike price of KES82 on 15th November.

Examine the investors profits and returns in the two scenarios (ignore interests) if

i) The stock price goes up to KES90 on 15th November (6 marks)

ii) The stock goes down to KES66 on 15th November (6 marks)

iii) Which plan would you counsel the investor to adopt and why? (2 marks)

Question Two

a) Financial markets can be divided into three segments. Identify and clearly distinguish between these segments. (10 marks)

b) A 2 year 10% coupon bond with a face value of KES1, 000 is selling at KES1, 035.67 today. Find its yield to maturity. (6 marks)

c) Distinguish between real and nominal interest rate (4 marks)

Question Three

a) Financial assets are important vehicles for transferring present consumption to the future. Explain any four characteristics of financial assets that make this function possible. (10 marks)

b) Using well labeled diagrams distinguish between the payoffs of a short position forward contract and a long position European put option. (10 marks)

Question Four

a) A Covenant is a contractual clause that allows or prohibits a borrower from doing certain actions. Identify the two possible categories and enumerate the specific financial and operating constraints under each of them. (12 marks)

b) Consider a 4 year 13% coupon government bond with a face value of KES1, 000. If coupon payments are made semiannually and that and that the stated annual interest rate in the market is 10%. Find the value of this bond today. 6 marks)

c) Identify two scenarios when embedded derivatives separated from the host contract? (2 marks)

Question Five

a) Shares are put into the public through two main channels. Discuss each channel by clearly showing its participants and roles. (10 marks)

b) Explain how derivatives are used in speculation (10 marks)