Financial Industry Regulatory Authority

Investor Knowledge Quiz

A helpful guide to learning more about investing.

An overwhelming 97 percent of investors realize they need to be better informed about investing. And nearly half said they could have avoided a negative experience had they known more about investing.*

*2003 Investor Survey

FINRA

Investor Knowledge Quiz

How much do you really know about investing? Take this short quiz and test your knowledge. Answers are on page 7.

1. If you buy a company's stock...

a) You own a part of the company
b You have lent money to the company
c) You are liable for the company's debts
d) The company will return your original investment to you with interest
e) Don't know/Not sure

2. If you buy a company's bond...

a) You own a part of the company
b) You have lent money to the company
c) You are liable for the company's debts
d) You can vote on shareholder resolutions
e) Don't know/Not sure

3. Which type of bond is the safest?

a) U.S. Treasury bond
b) Municipal bond
c) Corporate bond
d) Don't know/Not sure

4. In general, if interest rates go down, then bond prices...

a) Go down
b) Go up
c) Are not affected
d) Don't know/Not sure

5. Which of the following is the best definition for a "junk bond?"

a) A bond that is rated as "below investment-grade" by rating agencies
b) A bond that has declined dramatically in value
c) A bond that has defaulted
d) A bond that is not regulated
e) Don't know/Not sure

6. A "no-load" mutual fund is one that...

a) Carries no fees
b) Carries no sales charge
c) Does not contain high-risk securities
d) Has no limits on the period of time in which it can be bought or sold
e) Don't know/Not sure

7. In general, investments that are riskier tend to provide higher returns over time than investments with less risk.

a) True
b) False
c) Don't know/Not sure

8. What is a reasonable average annual return that can be expected from a broadly diversified U.S. stock mutual fund over the long run?

a) 5%
b) 10%
c) 15%
d) 20%
e) 25%
f) Don't know/Not sure

9. Over the last 20 years in the U.S., the best average returns have been generated by:

a) Stocks
b) Bonds
c) CDs
d) Money market accounts
e) Precious metals
f) Don't know/Not sure

10. Which of the following organizations insures you against your losses in the stock market?

a) FDIC (Federal Deposit Insurance Corporation)
b) FINRA (Financial Industry Regulatory Authority)
c) SEC (Securities and Exchange Commission)
d) SIPC (Securities Investor Protection Corporation)
e) None of the above
f) Don't know/Not sure

11. If a company files for bankruptcy, which of the following securities is most at risk of becoming virtually worthless?

a) The company's preferred stock
b) The company's common stock
c) The company's bonds
d) Don't know/Not sure

12. Which of the following best explains why many municipal bonds pay lower yields than other government bonds?

a) Municipal bonds are lower risk
b) There is a greater demand for municipal bonds
c) Municipal bonds can be tax-free
d) Don't know/Not sure

13. You invest $500 to buy $1,000 worth of stock on margin. The value of the stock drops by 50 percent. You sell it. Approximately how much of your original $500 investment are you left with in the end?

a) $500
b) $250
c) 0
d) Don't know/Not sure

14. Which is the best definition of "selling short?"

a) Selling shares of a stock shortly after buying it
b) Selling shares of a stock before it has reached its peak
c) Selling shares of a stock at a loss
d) Selling borrowed shares of a stock
e) Don't know/Not sure

15. If you receive a margin call that gives you 15 days to deposit additional cash or securities in your account, your broker cannot sell any of the securities in your account until after the 15 days.

a) True
b) False
c) Don't know/Not sure

16. Hedge funds are always subject to the same rules and regulations as mutual funds.

a) True
b) False
c) Don't know/Not sure

17. The principal difference between mutual fund share classes (Class A, Class B, Class C, etc.) is:

a) The different investments each class makes
b) The different fees and expenses each class charges
c) The different investment advisers in charge of managing each class
d) Don't know/Not sure

18. A Section 529 Plan is a tax-advantaged way to save for:

a) College
b) Retirement
c) Long-term health care
d) Don't know/Not sure

Answers

1. If you buy a company's stock…

- a) **You own a part of the company**
- b) You have lent money to the company
- c) You are liable for the company's debts
- d) The company will return your original investment to you with interest
- e) Don't know/Not sure

The correct answer is a:

Stocks are known as "equities" because each stock share represents a small percentage of ownership in the company, entitling the shareholder to vote in the election of directors and on other matters taken up at shareholder meetings or by proxy.

2. If you buy a company's bond…

- a) You own a part of the company
- b) **You have lent money to the company**
- c) You are liable for the company's debts
- d) You can vote on shareholder resolutions
- e) Don't know/Not sure

The correct answer is b:

Bonds are loans that investors make to a corporation or a government body in exchange for regular interest payments and the return of principal at a future date.

Companies issue corporate bonds to raise money for capital expenditures, operations and acquisitions. But unlike stockholders, bondholders don't receive ownership rights in the corporation.

3. **Which type of bond is the safest?**
   a) **U.S. Treasury bond**
   b) Municipal bond
   c) Corporate bond
   d) Don’t know/Not sure

   The correct answer is a:

   “Treasuries” are issued by the federal government. Unlike corporate or municipal bonds, they are backed by the “full faith and credit” of the U.S. government, which guarantees that interest payments will always be made and the bonds redeemed at maturity.

4. **In general, if interest rates go down, then bond prices...**
   a) Go down
   b) **Go up**
   c) Are not affected
   d) Don’t know/Not sure

   The correct answer is b:

   The cardinal rule of bonds: When interest rates fall, bond prices rise, and when interest rates rise, bond prices fall. This is because as interest rates go up, newer bonds come to market paying higher interest yields than older bonds already in the hands of investors, making the older bonds worth less.

5. **Which of the following is the best definition for a “junk bond?”**
   a) **A bond that is rated as “below investment-grade” by rating agencies**
   b) A bond that has declined dramatically in value
   c) A bond that has defaulted
   d) A bond that is not regulated
   e) Don’t know/Not sure

The correct answer is a:

"Junk" or "high-yield" bonds are issued by companies with poor credit ratings, meaning that compared with better-rated "investment-grade" bonds, the risk is greater that these companies will default on their interest payments or even go bankrupt and be unable to redeem their bonds when they mature. To attract investors, "junk" bonds pay higher yields than higher-graded corporate bonds.

6. A "no-load" mutual fund is one that...

a) Carries no fees
b) Carries no sales charge
c) Does not contain high-risk securities
d) Has no limits on the period of time in which it can be bought or sold
e) Don't know/Not sure

The correct answer is b:

Not all mutual funds charge sales loads. Called no-load funds, these funds do not charge a front-end sales charge or a deferred sales charge, such as a Contingent Deferred Sales Charge (CDSC). In addition, the fund's 12b-1 fees must not exceed 0.25 percent of the fund's average annual net assets in order to call itself a no-load fund.

No-load funds can be purchased directly from a mutual fund company or brokerage firm fund supermarket, but you won't receive the assistance of a broker or investment professional. For those wanting professional advice, no-load funds also may be purchased through an investment adviser or broker, but you'll typically pay a fee for this advice. This means you will be paying a fee on top of the underlying mutual fund expenses.

7. **In general, investments that are riskier tend to provide higher returns over time than investments with less risk.**

   a) **True**
   b) False
   c) Don't know/Not sure

   The correct answer is a:

   The stock and bond markets tend to reward risk-taking over the long term. This is called the risk-reward tradeoff. Over the short term, however, high-risk investments such as small-company stocks can be extremely volatile. The less willing you are to take that risk, the more you may want to emphasize investments that provide a regular return with less volatility, such as short-term bonds.

8. **What is a reasonable average annual return that can be expected from a broadly diversified U.S. stock mutual fund over the long run?**

   a) 5%
   b) **10%**
   c) 15%
   d) 20%
   e) 25%
   f) Don't know/Not sure

   The correct answer is b:

   Over a long period – such as 20 years or more – the U.S. stock market has historically returned average annualized returns of about 10 percent. However, over a shorter period, the stock market may experience a severe decline in value, including for several years at a time during a "bear" market.

9. **Over the last 20 years in the U.S., the best average returns have been generated by:**

   a) Stocks
   b) Bonds
   c) CDs
   d) Money market accounts
   e) Precious metals
   f) Don’t know/Not sure

   The correct answer is a:

   The average annualized returns for the U.S. stock market over the last 20 years have outpaced the return on bonds or other “safer” investments. The stock market has historically been the best-performing long-term investment vehicle, although equities can be extremely volatile and the stock market will experience sharp declines over a period of several years at a time.

10. **Which of the following organizations insures you against your losses in the stock market?**

    a) FDIC (Federal Deposit Insurance Corporation)
    b) FINRA (Financial Industry Regulatory Authority)
    c) SEC (Securities and Exchange Commission)
    d) SIPC (Securities Investor Protection Corporation)
    e) None of the above
    f) Don’t know/Not sure

    The correct answer is e:

    When you invest in stocks, you accept the risk that your investment may decline as well as rise in value. A primary role of securities regulators such as FINRA and the SEC is to ensure that securities laws and regulations are followed and to punish violators.

    The FDIC generally insures checking, savings and other deposit accounts when an FDIC-regulated bank fails.

The mission of the Securities Investor Protection Corporation (SIPC) is to return funds and securities to investors if the brokerage firm holding these assets becomes insolvent.

11. If a company files for bankruptcy, which of the following securities is most at risk of becoming virtually worthless?

a) The company's preferred stock
b) The company's common stock
c) The company's bonds
d) Don't know/Not sure

The correct answer is b:

Among those with claims to a bankrupt company's assets, shareholders of common stock have the last claim on any assets, falling in line behind secured creditors, bondholders and owners of preferred shares. Common shareholders may not receive anything if the secured and unsecured creditors' claims are not fully repaid.

12. Which of the following best explains why many municipal bonds pay lower yields than other government bonds?

a) Municipal bonds are lower risk
b) There is a greater demand for municipal bonds
c) Municipal bonds can be tax-free
d) Don't know/Not sure

The correct answer is c:

Because dividend payments from municipal bonds are usually exempt from federal income tax, even with lower yields than other government bonds, their after-tax rates of return are attractive to investors in higher tax brackets.

13. You invest $500 to buy $1,000 worth of stock on margin. The value of the stock drops by 50 percent. You sell it. Approximately how much of your original $500 investment are you left with in the end?

a) $500
b) $250
c) 0
d) Don't know/Not sure

The correct answer is c:

When you buy stock on margin, you risk losing your entire investment—or much more. In this example, an investor used $500 to buy $1,000 worth of stock, borrowing the additional $500 from a brokerage firm to make the purchase. When the stock was sold after dropping 50 percent in value, its remaining worth was only $500—the same amount the investor still owed to the brokerage firm for the margin loan.

14. Which is the best definition of "selling short?"

a) Selling shares of a stock shortly after buying it
b) Selling shares of a stock before it has reached its peak
c) Selling shares of a stock at a loss
d) Selling borrowed shares of a stock
e) Don't know/Not sure

The correct answer is d:

Short selling involves borrowing stock from a broker through a margin account and selling it, with the understanding that it must later be bought back and returned to the broker.

If the stock declines in value, as the short seller hopes, the investor will profit since the value of the stock borrowed and sold would be higher than the stock subsequently purchased and returned to the broker. However, if the stock rises in value, the investor must pay the difference to make good on the stock owed to the broker. NASD Rule 3350, the Short Sale Rule, sets forth restrictions for short sales of NASDAQ National Market® securities.*

15. If you receive a margin call that gives you 15 days to deposit additional cash or securities in your account, your broker cannot sell any of the securities in your account until after the 15 days.

a) True
b) False
c) Don't know/Not sure

The correct answer is b:

Some investors mistakenly believe that a firm must contact them first for a margin call to be valid. This is not the case. Most firms will attempt to notify their customers of margin calls, but they are not required to do so.

Even if you're contacted and provided with a specific date to meet a margin call, your firm may decide to sell some or all of your securities before that date without any further notice to you. For example, your firm may take this action because the market value of your securities has continued to decline in value.

16. Hedge funds are always subject to the same rules and regulations as mutual funds.

a) True
b) False
c) Don't know/Not sure

*You can find this rule at *www.finra.org*. Please note that FINRA is currently working toward a single, consolidated rulebook following the consolidation of NASD and NYSE Member Regulation.

The correct answer is b:

Hedge funds are basically private investment pools. Because they are usually only open to limited numbers of wealthy, financially sophisticated investors and do not advertise or publicly offer their securities, private hedge funds are usually not required to register with the SEC. As a result, unregistered private hedge funds do not provide many of the investor protections that apply to registered investment products, such as mutual funds.

For example, hedge funds generally are not subject to numerous mutual fund rules, such as regulations requiring a certain degree of liquidity, limiting how much can be invested in any one investment and protecting against conflicts of interests.

17. The principal difference between mutual fund share classes (Class A, Class B, Class C, etc.) is:

a) The different investments each class makes
b) The different fees and expenses each class charges
c) The different investment advisers in charge of managing each class
d) Don't know/Not sure

The correct answer is b:

A single mutual fund, with one portfolio and one investment adviser, may offer more than one "class" of its shares to investors. Each class represents a similar interest in the mutual fund's portfolio.

The principal difference between the classes is that the mutual fund will charge you different fees and expenses, depending on the class that you choose. If you are thinking about choosing a mutual fund with more than one class, it is important for you to understand the differences between them.

18. A Section 529 Plan is a tax-advantaged way to save for:

a) **College**
b) Retirement
c) Long-term health care
d) Don't know/Not sure

The correct answer is a:

Named after the section of the federal tax code that governs them, Section 529 plans are tax-advantaged programs that help families save for college.

FINRA
Investor Resources

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