Common Sense Economics
Part IV. Twelve Key Elements of Practical Personal Finance
Practice Test
Multiple Choice Questions

1. Your comparative advantage in a specific area is determined by
   a. the market value of the skill relative to your opportunity cost of supplying it.
   b. the absolute value of the skill in the performance of a specific job.
   c. minimum wage laws, health and safety standards and marginal tax rates.
   d. the comparative positions of the wealthy, the middle income individuals
      and low income individuals.

    Answer: a

2. Financial insecurity in America is primarily the result of
   a. the low incomes of Americans.
   b. the huge amount of time and complex knowledge required for basic
      financial planning.
   c. a low rate of personal saving and poor financial planning.
   d. a shortage of financial planners and portfolio managers.

    Answer: c

3. Economic analysis indicates that
   a. single-minded pursuit of money and wealth is the key to happiness.
   b. wealthy people are happier than those with lots of friends, satisfying
      marriages, and strong religious convictions.
   c. the desire for more wealth is limited to those who are interested only in
      their personal welfare.
   d. no matter what our objectives in life, they are easier to achieve if we have
      more wealth.

    Answer: d

4. Compared to graduates, high school drop outs are
   a. more valuable to employers.
   b. more likely to be highly productive.
   c. more likely to earn high incomes.
   d. more likely to be poor.

    Answer: d

5. Which of the following is true?
   a. Most entrepreneurs work very few hours.
   b. Entrepreneurs generally save less of their income than other Americans.

    Answer: b
c. Additional years of schooling will substantially increase your earnings even if it fails to increase your productivity and ability to provide others with things that they value.
d. If you want to make a lot of money, you had better figure out how to provide others with substantial value and find ways to discover and act on valuable opportunities.

Answer: d

6. Which of the following is the best example of an item that a "real world" savings account is designed to cover?
a. the monthly payment for the lease of your apartment  
b. the purchase of the gasoline you use driving back and forth to work  
c. an unexpected expenditure to repair the transmission of your car  
d. funds you are setting aside for your retirement years

Answer: c

7. Deferred tax saving plans such as a Roth Individual Retirement Account (IRA) or 401k plan will
a. reduce your current tax liability because funds paid into these plans are tax deductible.  
b. make it more difficult for a young person to save and accumulate wealth.  
c. increase your tax liability now, but you will pay lower taxes when you withdraw the funds.  
d. help those with the lowest incomes, but will be of little value to those with higher incomes who want to save for retirement.

Answer: a

8. Which of the following is an advantage of an indexed equity mutual fund relative to a managed equity fund?
a. Indexed funds generally have better stock pickers.  
b. Indexed funds engage in more detailed research.  
c. Indexed funds have lower operating costs because they engage in less stock trading.  
d. Indexed funds earn a significantly higher rate of return than a broad portfolio that represents the entire stock market.

Answer: c

9. The random walk theory indicates that
a. investors can make money by purchasing stocks that are widely expected to earn substantial profits in the future.
b. while changes in the prices of specific stocks are difficult to predict, experts are able to forecast the future direction of broad stock market indexes with a high degree of accuracy.

c. changes in stock prices are driven by surprise occurrences that are difficult to predict.

d. managed mutual funds will persistently out-perform indexed funds.

Answer: c

10. The variation in the rate of return one can expect from ownership of stocks will generally be smaller
    a. if all of the funds are invested in a specific sector of the economy such as health care.
    b. if a diverse set of stocks is held over a lengthy period of time such as 30 or 40 years.
    c. if all of the funds are invested in a single stock.
    d. if the funds are invested for a relatively short period of time.

Answer: b

11. Buying shares of corporate stock tends to be risky when
    a. the stock of a single corporation is purchased.
    b. the stock may have to be sold within a few months.
    c. all stocks bought are in the same industry.
    d. all of the above are true.

Answer: d

12. If an investor’s primary stock holding is currently Exxon Mobil, the purchase of which of the following stocks would provide the investor with the largest reduction in risk?
    a. BP / Amoco.
    b. Shell Oil Corporation.
    c. Wal-Mart.
    d. Texaco.

Answer: c
13. Which of the following has enhanced the ability of investors, without any special business skills, to benefit from the ownership of corporate America?
   a. the increased availability of mutual funds, that make it possible for even small investors to purchase a diverse stock portfolio at a low cost
   b. an increased tendency of small investors to buy and sell stock frequently
   c. the virtual disappearance of business failures among corporations with publicly traded stock shares
   d. all of the above

Answer: a

14. Which of the following is true?
   a. Managed equity funds that have yielded attractive returns during the last 5 or 10 years can generally be counted on to yield similar returns in the future.
   b. Managed funds generally outperform indexed equity mutual funds.
   c. An investment strategy that yielded a high rate of return in the past will often be disastrous in the future.
   d. Indexed equity mutual funds are usually tied directly to either the Consumer Price Index or Producer Price Index.

Answer: c

15. Which of the following is the best analogy to describe the power of compound interest?
   a. throwing a baseball into a strong wind that slows the speed of the pitch
   b. watering your lawn while it is raining because it doubles the volume of your output
   c. a snowball rolling down a snow-covered mountain, growing in size as it descends
   d. a penny dropped from the top of a very tall building, gathering speed as it falls

Answer: c

16. Which of the following is a risk associated with investing in bonds?
   a. Increases in interest rates can reduce the market value of a bond.
   b. Unanticipated inflation lessens the value of both principal and fixed-interest income.
   c. If the firm issuing the bond goes bankrupt, bondholders may lose all or most of their investment.
   d. All of the above are risks associated with bond investments.

Answer: d
17. It is often substantially cheaper to own and operate a used car rather than a new one because
   a. the interest rate on a used car loan is generally lower.
   b. the maintenance cost of a new car is generally higher.
   c. the depreciation cost for a new car will almost always be substantially higher.
   d. This is a trick question. All things considered, the cost per mile traveled is generally cheapest if you buy a new car every year.

Answer: c

18. Which of the following items would be most dangerous to purchase on credit
   a. an automobile
   b. a house
   c. a vacation
   d. a college education

Answer: c

19. Which of the following financial strategies will help you increase your wealth and future level of income?
   a. regularly saving and investing a portion of your income
   b. paying off the outstanding balance every month, if you use a credit card
   c. getting by with a used economy car rather than buying a new one every couple of years
   d. All of the above will help you build wealth.

Answer: d

20. Many Americans feel financially insecure primarily because
   a. the taxes of Americans are just about the highest in the world.
   b. it is difficult for Americans to borrow funds to deal with emergencies.
   c. the personal saving rate of Americans is low and many spend more than they earn.
   d. the incomes of Americans are low and, therefore, it would be virtually impossible for them to spend less and save more.

Answer: c