

Session 6

Trading Costs and Taxes

Tests

1. The bid-ask spread measures the difference between the bid price and the ask price on an asset or security at a point in time. In which of the following stocks, are you likely to see the highest bid-ask spread, as a percent of the price?
 - a. A large market-cap stock, with a high stock price and lots of analysts tracking it.
 - b. A small market-cap stock, with a high stock price and lots of analysts tracking it.
 - c. A large market-cap stock, with a low stock price and lots of analysts tracking it.
 - d. A small market-cap stock, with a low stock price and lots of analysts tracking it.
 - e. A large market-cap stock, with a low stock price and few analysts tracking it.
 - f. A small market-cap stock, with a low stock price and lots of analysts tracking it.
2. Assume that you have a two-year time horizon and have an investment strategy heavily focused on investing in illiquid companies, with high bid-ask spreads. If the average bid-ask spread is 4% of the stock price and the annual return that you need to make (given risk in your strategy) is 10%, what annual return would you need to generate on your stock picks over the next 2 years to beat the market?
 - a. 10%
 - b. 10.4%
 - c. 12.0%
 - d. 12.22%
 - e. 14%
3. The price impact measures the effect you have on stock prices when you trade on a stock, pushing the price up as you buy and pushing it down as you sell. For which of the following types of investors is the cost of the price impact going to be greatest?
 - a. Small investors investing in large cap stocks
 - b. Small investors investing in small cap stocks
 - c. Large investors investing in large cap stocks
 - d. Large investors investing in small cap stocks
4. You can reduce your trading costs by waiting for the right time to trade or by breaking up your trades into smaller trades but there can be a cost to waiting to trade. For which of the following investment strategies is the cost of waiting likely to be highest?
 - a. Momentum trading, based upon new information reaching the market
 - b. Contrarian trading, based upon new information reaching the market

- c. Momentum trading, based upon your judgment of value
 - d. Contrarian trading, based upon your judgment of value
5. As investors, we care about after-tax returns. As you look across investment options, which of the following is likely to minimize the tax bite (reduce the gap between pre-tax and after-tax returns) on your returns?
- a. Invest with a 10-year holding period, in index funds
 - b. Invest with a 1-year holding period, in index funds
 - c. Invest with a 10-year holding period, in an actively managed fund
 - d. Invest with a 1-year holding period, in an actively managed fund