The answer to the question is highlighted in red. Explanations are highlighted in green.

15. Many experts forecast that interest rates will increase during the next few years. If you invest in a corporate bond today and interest rates do increase, what will happen to the value of your bond?

a. The bond’s value should increase also, because the return (yield) on the bond has to increase so the bond earns a higher rate of return.

b. The bond’s value should decrease, because the price must be adjusted downward so as to equate the return on the bond to the higher market rates generated by other similar risk bonds.

c. The value of the bond should not change, because, assuming the company does not default, the value of the bond at maturity must equal its face, or par, value.

d. The value of the bond will change, but the direction of the change cannot be determined until the magnitude of the interest rate increase is known.

e. None of the above is a correct answer.

The value of any investment moves opposite changes in market rates of return (interest rates). When rates increase, values decrease, and vice versa. All else equal, the only way an investment can be sold to yield a higher (lower) return is if the price at which it is sold is lowered (increased). Also, see the equation used to compute the value of a financial asset. The required rate of return is in the denominator, which means the mathematical relationship is negative.

RETURN TO THE SAMPLE QUESTIONS