

Problem Set: Hand in 5. (complete)

Exercise 1.

[5]

What is an Exchange-traded fund? Give two examples of specific ETFs. What are some advantages they have over ordinary open-end mutual funds? What are some disadvantages?

Exercise 2.

[Easy]

Discuss why common stocks must earn a risk premium.

Exercise 3.

[3]

A fair game

- A) will not be undertaken by a risk-averse investor.
- B) is a risky investment with a zero risk premium.
- C) is a riskless investment.
- D) Both A and B are true.
- E) Both A and C are true.

Exercise 4.

[Moderate]

Discuss how the investor can use the separation theorem and utility theory to produce an efficient portfolio suitable for the investor's level of risk tolerance.

Exercise 5.

[3]

LJP Corporation has a beta of 1.0. The annualized market return yesterday was 11%, and the risk-free rate is currently 5%. You observe that LJP had an annualized return yesterday of 14%. Assuming that markets are efficient, this suggests that

- A) bad news about LJP was announced yesterday.
- B) good news about LJP was announced yesterday.
- C) no news about LJP was announced yesterday.
- D) interest rates rose yesterday.
- E) interest rates fell yesterday.

Exercise 6.

[1]

Debt securities are often called fixed-income securities because

- A) the government fixes the maximum rate that can be paid on bonds.
- B) they are held predominantly by older people who are living on fixed incomes.
- C) they pay a fixed amount at maturity.
- D) they promise either a fixed stream of income or a stream of income determined by a specific formula.
- E) they were the first type of investment offered to the public, which allowed them to "fix" their income at a higher level by investing in bonds.

Exercise 7.

[3]

Describe the protective put. What are the advantages of such a strategy?

Exercise 8.

[Moderate]

Discuss the relationship between option prices and time to expiration, volatility of the underlying stocks, and the exercise price.

Exercise 9.

[1]

_____ are analysts who use information concerning current and prospective profitability of a firm to assess the firm's fair market value.

- A) Credit analysts
- B) Fundamental analysts
- C) Systems analysts
- D) Technical analysts
- E) Specialists

Exercise 10.

[3]

You are considering acquiring a common stock that you would like to hold for one year. You expect to receive both \$0.75 in dividends and \$16 from the sale of the stock at the end of the year. The maximum price you would pay for the stock today is _____ if you wanted to earn a 12% return.

- A) \$23.91
- B) \$14.96
- C) \$26.52
- D) \$27.50
- E) none of the above

Exercise 11.

[3]

High Tech Chip Company paid a dividend last year of \$2.50. The expected ROE for next year is 12.5%. An appropriate required return on the stock is 11%. If the firm has a plowback ratio of 60%, the dividend in the coming year should be

- A) \$1.00
- B) \$2.50
- C) \$2.69
- D) \$2.81
- E) none of the above

Exercise 12.

[1]

Suppose that the average P/E multiple in the oil industry is 20. Dominion Oil is expected to have an EPS of \$3.00 in the coming year. The intrinsic value of Dominion Oil stock should be _____.

- A) \$28.12
- B) \$35.55
- C) \$60.00
- D) \$72.00
- E) none of the above

Exercise 13.

[1]

Investors want high plowback ratios

- A) for all firms.

- B) whenever $ROE > k$.
- C) whenever $k > ROE$.
- D) only when they are in low tax brackets.
- E) whenever bank interest rates are high.

Exercise 14.

[1]

Who popularized the dividend discount model, which is sometimes referred to by his name?

- A) Burton Malkiel
- B) Frederick Macaulay
- C) Harry Markowitz
- D) Marshall Blume
- E) Myron Gordon

Exercise 15.

[1]

_____ refers to the possibility of expropriation of assets, changes in tax policy, and the possibility of restrictions on foreign exchange transactions.

- A) Default risk
- B) Foreign exchange risk
- C) Market risk
- D) Political risk
- E) None of the above

Exercise 16.

[3]

Active portfolio managers try to construct a risky portfolio with _____.

- A) a higher Sharpe measure than a passive strategy
- B) a lower Sharpe measure than a passive strategy
- C) the same Sharpe measure as a passive strategy
- D) very few securities
- E) none of the above

Exercise 17.

[3]

Trading activity by mutual funds just prior to quarterly reporting dates is known as

- A) insider trading.
- B) program trading.
- C) passive security selection.
- D) window dressing.
- E) none of the above.

Exercise 18.

[3]

Consider the Sharpe and Treynor performance measures. When a pension fund is large and has many managers, the _____ measure is better for evaluating individual managers while the _____ measure is better for evaluating the manager of a small fund with only one manager responsible for all investments.

- A) Sharpe, Sharpe
- B) Sharpe, Treynor
- C) Treynor, Sharpe

- D) Treynor, Treynor
- E) Both measures are equally good in both cases.

Exercise 19.

[3]

Suppose you own two stocks, A and B. In year 1, stock A earns a 2% return and stock B earns a 9% return. In year 2, stock A earns an 18% return and stock B earns an 11% return. _____ has the higher arithmetic average return.

- A) stock A
- B) stock B
- C) the two stocks have the same arithmetic average return
- D) at least three periods are needed to calculate the arithmetic average return
- E) none of the above

Exercise 20.

[3]

Suppose you own two stocks, A and B. In year 1, stock A earns a 2% return and stock B earns a 9% return. In year 2, stock A earns an 18% return and stock B earns an 11% return. Which stock has the higher geometric average return?

- A) stock A
- B) stock B
- C) the two stocks have the same geometric average return
- D) at least three periods are needed to calculate the geometric average return.
- E) none of the above

Exercise 21.

[3]

The following data are available relating to the performance of Caribou Stock Fund and the market portfolio:

	Caribou	Market Portfolio
Average Return	18%	15%
Standard Deviation of Returns	25%	20%
Beta	1.25	1.00
Residual Standard Deviation	2%	0%

The risk-free return during the sample period was 7%.

1. What is the information ratio measure of performance evaluation for Caribou Stock Fund?
 - A) 1.00%
 - B) 8.80%
 - C) 44.00%
 - D) 50.00%
 - E) none of the above

2. Calculate Sharpe's measure of performance for Caribou Stock Fund.
 - A) 1.00%
 - B) 8.80%
 - C) 44.00%
 - D) 50.00%
 - E) none of the above

3. Calculate Treynor's measure of performance for Caribou Stock Fund.

- A) 1.00%
- B) 8.80%
- C) 44.00%
- D) 50.00%
- E) none of the above

4. Calculate Jensen's measure of performance for Caribou Stock Fund.

- A) 1.00%
- B) 8.80%
- C) 44.00%
- D) 50.00%
- E) none of the above

Exercise 22.

[1]

The geometric average rate of return is based on

- A) the market's volatility.
- B) the concept of expected return.
- C) the standard deviation of returns.
- D) the CAPM
- E) the principle of compounding.

Exercise 23.

[3]

To determine whether portfolio performance is statistically significant requires

- A) a very long observation period due to the high variance of stock returns.
- B) a short observation period due to the high variance of stock returns.
- C) a very long observation period due to the low variance of stock returns.
- D) a short observation period due to the low variance of stock returns.
- E) a low variance of returns over any observation period.