Quiz A for 2:30 Class: 8/27/12 Name Key

Assume that you can borrow or lend at a risk-free interest rate of 3.5% per year. Assume also that the bid and ask prices for a risk-free bond that matures one year from today for $7000 are as follows: Bid = $6699 , Ask = $6701. What set of transactions today will generate an arbitrage profit for you today. In your answer list all transactions required today and a year from today and all individual and total cash flows today and a year from today. Use a "+" for an inflow of cash and a "-"for an outflow of cash. Note: I recommend setting up a table like is in the notes, but this is not required.

Wall Street Journal Questions are on the back of this page.

$$PV = \frac{7000}{1.035} = 6763.29$$

Trans(t=0)	CF_0	CF_1	Trans(t=1)
+6 Buy bond	+6 −6701	+6 +7000	+6 Bond matures
+6 Borrow PV of $7000	+6 +6763.29	+6 −7000	+6 Pay off loan
Total	+6 +62.29	+6 0	Total