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

Assume that you can borrow or lend at a risk-free interest rate of 2.5% per year. Assume also that the bid and ask prices for a risk-free bond that matures one year from today for $9000 are as follows: Bid = $8799 , Ask = $8801. 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.**

$$PV = \frac{9000}{1.025} = 8780.49$$

| Trans(t=0) | CF0 | CF1 | Trans(t=1) |
|---|---|---|---|
| +6 Short bond | +6 +8799 | +6 -9000 | +6 Buy back bond |
| +6 Loan PV of $9000 | +6 -8780.49 | +6 +9000 | +6 Loan pays off |
| Total | +6 +18.51 | +6 0 | Total |