

Quiz A for 4:00 Class: 8/27/12

Name Key

Assume that you can borrow or lend at a risk-free interest rate of 4.5% per year. Assume also that the bid and ask prices for a risk-free bond that matures one year from today for \$8000 are as follows: Bid = \$7599, Ask = \$7601. 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.

$$PV = \frac{8000}{1.045} = 7655.50$$

<u>Trans (t=0)</u>	<u>CF₀</u>	<u>CF₁</u>	<u>Trans (t=1)</u>
+6 Buy bond	+6 -7601	+6 +8000	+6 Bond matures
+6 Borrow PV of \$8000	+6 +7655.50	+6 -8000	+6 Pay off on loan
<u>Total</u>	+6 +54.50	+6 0	<u>Total</u>