

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

Name Key

Assume that you can borrow or lend at a risk-free interest rate of 5.5% per year. Assume also that the bid and ask prices for a risk-free bond that matures one year from today for \$6000 are as follows: Bid = \$5699, Ask = \$5701. 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.

$$PV = \frac{6000}{1.055} = 5687.20$$

<u>Trans (t=0)</u>	<u>CF₀</u>	<u>CF₁</u>	<u>Trans (t=1)</u>
+6 Short bond	+6 5699	+6 -6000	+6 buy back bond
+6 Lend PV of \$6000	+6 -5687.20	+6 +6000	+6 loan pays off
<u>Total</u>	+6 11.80	+6 ∅	<u>Total</u>