Assume that you can buy or sell (or short-sell) any of the following securities:

Risk-free bonds: bonds that mature one year from today earn 2.5% per year and bonds that mature two years from today earn 3.5% per year.

Risky securities:

Security	Price Today	Payoff one year from today if the economy is:		Payoff two years from today if the economy is:	
		Strong	Weak	Strong	Weak
Private Buy	$300	$70	$20	$500	$0
Market	$500	$50	$0	$750	$250

What set of transactions today will generate an arbitrage profit for you today. In your answer list all transactions required today and all individual and total cash flows today, a year from today, and two years 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.

Equivalent to Private: Buy market + buy bond that matures for $20 in one year + short-sell a bond that matures for $250 in two years.

No arbitrage price $= 500 + \dfrac{\overbrace{19.512}^{\tfrac{20}{1.025}}}{} - \dfrac{\overbrace{233.378}^{\tfrac{250}{(1.035)^2}}}{} = 286.13$

$$CF_1 \qquad\qquad CF_2$$

Trans(t=0)	CF_0	S	W	S	W
Short Private	+300	-70	-20	-500	$\emptyset$
Buy Market	-500	+50	$\emptyset$	+750	+250
Buy bond that matures for $20 in one year	-19.512	+20	+20	$\emptyset$	$\emptyset$
Short bond that matures for $250 in 2 years	+233.378	$\emptyset$	$\emptyset$	-250	-250
Total	+13.866	$\emptyset$	$\emptyset$	$\emptyset$	$\emptyset$