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	$700	$50	$0	$1200	$200
Market	$500	$70	$20	$1000	$0

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 + short-sell a bond that matures for $20 in one year + buy a bond that matures for $200 in two years.

$$\text{No arbitrage price} = 500 - \underbrace{\frac{20}{1.025}}_{19.512} + \underbrace{\frac{200}{(1.025)^2}}_{186.702} = 667.19$$

Trans (t=0)	CF0	CF₁ S	CF₁ W	CF₂ S	CF₂ W
Short Private	+700	-50	0	-1200	-200
Buy Market	-500	+70	+20	+1000	0
Short-sell bond that matures for $20 in one year.	+19.512	-20	-20	0	0
Buy bond that matures for $200 in two years	-186.702	0	0	+200	+200
Total	+32.81	0	0	0	0