Quiz B for 2:30 Class: 9/11/13   Name _____

Short Answer 1: What three things might cause the risk premium on a security to rise?

Short Answer 2: Assume the risk-free interest rate equals 1% and that $200 investment in the market might pay off $245 one year from today and might pay off $185 one year from today. These two outcomes are equally likely. Set up the calculations required to determine the market risk premium.

Problem: Given the following information show how you could generate the <u>highest possible</u> arbitrage profit today. Be sure to list all individual transactions, the resulting cash flows from each transaction, and all total cash flows. Use a "+" for inflows and a "-" for outflows. I will assume a "+" if you show neither. I recommend building a table.

Risk-free bonds: You can buy or short-sell any amount of risk-free bonds. The rate on risk-free bonds maturing in 1 year is 1.5% and on risk-free bonds maturing in two years is 1.75%.

Risky securities: The prices and number of shares available at each price are as shown below.

Security	Bid Price	Number	Ask Price	Number	Payments in one year if economy is Weak	Strong	Payments in two years if economy is Weak	Strong
Market	$929	500	$931	200	$100	$150	$900	$1000
van Gogh Inc.	$985	300	$987	400	$50	$100	$1000	$1100

Wall Street Journal Questions are on the back of this page.