

Quiz: 1/23/2012 (Annotated)**Key**

Quiz: Assume that risk-free bonds earn a return of 3.5% and that an investment today of \$1,000 in the market index fund will pay off either \$1,200 (strong economy) or \$850 (weak economy) one year from today. Assume also that an investment of \$720 today in SNFY Inc. will pay off either \$925 (strong) or \$575 (weak) one year from today. List all transactions or events and the resulting cash flows both today and one year from today that would generate an arbitrage profit today. (*Note:* Feel free to create a table to answer this question.)

No arbitrage price

$$1,000 - (275 / 1.035) = 1,000 - 265.7 = 734.50$$



CF (t = 1)

Transaction	CF (t = 0)	Strong	Weak	Explanation of CF (t = 1)
Buy SNFY	-\$720	+925	+575	Payoff on SNFY
Short-Sell Market	+\$1,000	-\$1,200	-\$850	Buy back market index to return to lender
Buy risk-free bond	-\$265.70	+\$275	+\$275	Our investment in bonds pays off
Total	+\$14.30	\$0	\$0	