

Quiz A for 1:00 Class: 1/23/13

Name Key

Assume two risk-free bonds will pay \$2000 one year from today. However, the return on Bond A is 6.5% and the return on Bond B is 7.5%. 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.

$$P_A = 1877.93 = \frac{2000}{1.065}$$

$$P_B = 1860.47 = \frac{2000}{1.075}$$

	<u>CF<sub>0</sub></u>	<u>CF<sub>1</sub></u>	<u>TRANS</u>
<u>Trans</u>			
Buy B <sup>+5</sup>	-1860.47 <sup>+5</sup>	+2000 <sup>+5</sup>	Bond matures <sup>+5</sup>
Short A <sup>+5</sup>	+1877.93 <sup>+5</sup>	-2000 <sup>+5</sup>	Buy back bond or make <sup>+5</sup> up cash flow
<u>Total</u>	<u>+17.46<sup>+5</sup></u>	<u>∅<sup>+5</sup></u>	