Quiz A for 1:15 Class: 7/11/12   Name ___Key___

Assume that you can buy or sell the following securities:

Security	Price Today	Payoff one year from today if the economy is: Strong	Weak	Payoff two years from today if the economy is: Strong	Weak
TaxCut	$160	$20	$10	$250	$50
Market	$100	$10	$5	$150	$50

Assume also that you can buy or short-sell risk-free bonds that mature either a year from today or two years from today for whatever amount you chose. The return on these bonds is 2.5% per year.

a. What investment in the market and risk-free bonds will generate cash flows identical to those generated by TaxCut?

b. Calculate the no-arbitrage price for TaxCut?

Note: Feel free to answer parts "c" and "d" with a table

c. What set of transactions today will generate an arbitrage profit today?

d. What cash flows (each trade and total) will your transactions produce today, a year from today, and two years from today? Note: Use a "+" for inflows and a "-" for outflows.

(10) a. Buy 2 market, short bond that matures in 2 yrs for $50

(8) b. $200 - \dfrac{50}{(1.025)^2} = 200 - 47.591 = 152.409$

(4) c & d

	$0	$1		$2	
		S	W	S	W
Trans					
Short TaxCut	+160	-20	-10	-250	-50
Buy 2 mkt	-200	+20	+10	+300	+100
Short bond	+47.591	0	0	-50	-50
Total	+7.591	0	0	0	0