**Quiz A for 9:45 Class: 7/11/12**          Name _____

Assume that you can buy or sell the following securities:

|          |             | Payoff one year from today if the economy is: | | Payoff two years from today if the economy is: | |
| -------- | ----------- | ------ | ----- | ------- | ----- |
| Security | Price Today | Strong | Weak  | Strong  | Weak  |
| TaxCut   | $65         | $15    | $5    | $100    | $0    |
| Market   | $100        | $10    | $0    | $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.