

Quiz B for 9:45 Class: 7/11/12

Name _____

Assume that you can buy or sell the following securities:

<u>Security</u>	<u>Price Today</u>	Payoff one year from today if the economy is:		Payoff two years from today if the economy is:	
		<u>Strong</u>	<u>Weak</u>	<u>Strong</u>	<u>Weak</u>
TaxCut	\$120	\$10	\$0	\$130	\$30
Market	\$100	\$25	\$15	\$100	\$0

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 3.5% per year.

- What investment in the market and risk-free bonds will generate cash flows identical to those generated by TaxCut?
- Calculate the no-arbitrage price for TaxCut?

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

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