Session 6: Post Class tests

1. The equity risk premium is the premium that investors charge over and above the risk free rate to invest in equities. A key source of information about equities is earnings reports from companies. In the last two decades, companies have used both accounting discretion and operating choices to "manage" their earnings, making them smoother (less variability over time). What consequence would you expect for equity risk premiums from managed earnings?
    a. Equity risk premiums should go down. (Earnings are smoother)
    b. Equity risk premiums should go up. (Earnings are less informative)
    c. Equity risk premiums should not change.
2. Many analysts use past data on stock and government security returns to estimate a historical risk premium. Assume that the arithmetic (geometric) average of annual stock returns is 10% (9%) and that the arithmetic (geometric) average of annual treasury bond returns is 5% (4.5%) over a hundred year period. If the annualized standard deviation in stock returns over this period was 20%, which of the following is your fairest characterization of the historical risk premium (which you plan to use in your long term hurdle rate)?
    a. Historical risk premium is 5%, standard error is 20%
    b. Historical risk premium is 4.5%, standard error is 2%
    c. Historical risk premium is 5.5%, standard error is 2%
    d. Historical risk premium is 4%, standard error is 2%
    e. None of the above
3. The sovereign rating for Vietnam is B2 (with a default spread of 5%), the standard deviation in the Vietnamese equity index is 30% and the standard deviation in the Vietnamese government bond is 24%. If the premium for a mature market (say, the US) is 5.5%, estimate the <u>total equity risk premium</u> for Vietnam.
    a. 11.75%
    b. 6.25%
    c. 5%
    d. 10.5%
    e. None of the above
4. The implied equity risk premium is an alternative approach to estimating the expected equity risk premium. It is computed based upon the current equity prices, expected cash flows from owning equities and the risk free rate. Assuming that the risk free rate and growth rate do not change, which of the following statements about the implied equity risk premium is true?
    a. The implied equity risk premium is always higher than the historical risk premium
    b. The implied equity risk premium will increase if stock prices increase
    c. The implied equity risk premium will increase if stock prices decrease
    d. The implied equity risk premium will increase if stock prices decrease and cash flows decrease as well
    e. The implied equity risk premium will increase if stock prices decrease while cash flows increase

f. The implied equity risk premium will increase if stock prices increase while cash flows decrease
(If you find yourself confused, think about the relationship between bond prices, coupons and interest rates)

5. Assume that you are trying to estimate the cost of equity for an average risk (beta =1) Mexican company in US dollars. The US treasury bond rate is 2% and the company gets 60% of its revenues in the United States and 40% from Mexico. The equity risk premium for Mexico is 7.5% and the equity risk premium for the US is 5.5%. What is the company's US $ cost of equity?
   a. 7.5%
   b. 9.5%
   c. 8.5%
   d. 8.3%
   e. 8.7%