

Session 5: Post Class tests

1. The implied equity risk premium is a forward-looking premium, estimated from the level of stock prices (the index) today and expected earnings/cash flows in the future. Assume that you compute the implied ERP at the start of a year and the market goes up 20% during the course of the year and that you compute the implied ERP again at the end of the year. Assuming that the risk free rate and growth rate do not change over the course of the year, which of the following would you expect to happen to the implied ERP?
 - a. The ERP will go down
 - b. The ERP will go down, if the earnings/ cash flows went up by less than 20% during the year
 - c. The ERP will go down, if the earnings/ cash flows went up by more than 20% during the year
 - d. The ERP will not change
 - e. The ERP will go up
2. To compute the implied ERP, one input that you need is the expected growth rate in earnings/cash flows in future years. That input can be estimated by looking at analyst estimates of growth in earnings for individual companies, but there are studies that indicate that these estimates are biased upwards. Assuming that these growth rates are biased upwards, what effect will it have on your computed ERP?
 - a. You will over estimate the implied ERP
 - b. You will under estimate the implied ERP
 - c. You could under or over estimate the implied ERP
3. One argument made by those who use a historical ERP is that using it is defensible, even if it is wrong, as long as you use the same ERP in all your valuations. Assume that the implied ERP is greater than the historical ERP and that you use the historical ERP to value all stocks. Which of the following will you find?
 - a. You will under value all stocks equally
 - b. You will over value all stocks equally
 - c. You will under value all stocks, but you will undervalue riskier stocks more than safe stocks
 - d. You will over value all stocks, but you will over value riskier stocks more than safe stocks
 - e. You will over value all stocks, but you will over value safe stocks more than riskier stocks
4. Historically, the implied equity risk premium in the United States have been about twice the default spread on Baa corporate bonds. Assume that the equity risk premium has dropped to 4% and that the Baa default spread is now 3%. Which of the following would you do as an investor, assuming that you expect normalcy to return?
 - a. Buy stocks and buy bonds
 - b. Buy stocks and sell bonds
 - c. Sell stocks and buy bonds

- d. Sell stocks and sell bonds
 - e. Do nothing
5. One measure of expected return from real estate is the capitalization rate, the rate used to convert the earnings on a property into its estimated value. Assuming that you were interested in investing in real estate, which of the following scenarios would be your best opportunity to do so?
- a. High capitalization rates, High PE ratios, High bond default spreads
 - b. High capitalization rates, Low PE ratios, Low bond default spreads
 - c. High capitalization rates, High PE ratios, Low bond default spreads
 - d. High capitalization rates, Low PE ratios, High bond default spreads
 - e. None of the above