Session 6A: Post class test solutions

1. **b. The ERP will go down, if the earnings/ cash flows went up by less than 20% during the year.** If the growth rate and risk free rate don't change, the effect will depend upon how much stocks go up, relative to earnings/cashflows. If the stock market goes up by more than earnings go up, the ERP will go down.
2. **a. You will over estimate the implied ERP.** When you use an upwardly biased expected growth in earnings, you will get a higher IRR (expected return on stocks) for investing in stocks. That, in turn, will lead to too high an estimate for the ERP.
3. **d. You will over value all stocks, but you will over value riskier stocks more than safe stocks.** By using too low an ERP, you will end up with too low a cost of equity/capital, and over estimate the value, but the effect will be a function of your relative risk measure. If you use beta as your measure of relative risk, you will under estimate the cost of equity more for high beta stocks than for low beta stocks, and consequently over value them by more.
4. **c. Sell stocks and buy bonds.** You would expect equity risk premiums to go up to 6% or default spreads to go down to 2% or both to move (but in opposite directions).
5. **c. High capitalization rates, High PE ratios, Low bond default spread.** High PE ratios, other things remaining equal, translate into low equity risk premiums. You want to get into real estate when you get high risk premiums on real estate when you are getting low risk premiums on equity and bonds.