RISK TESTS

HISTORICAL PREMIUMS

- The historical risk premium is the difference between the realized annual return from investing in stocks and the realized annual return from investing in a riskless security (T. Bill, T. Bond) over a past time period.
- To estimate this risk premium, how long a time period should you use?
  a. Just one year (last year)
  b. Last 5 years (to reflect current conditions)
  c. As long a time period as you can get the historical data for
  d. Should match the time period on your riskfree rate
  e. Should match the time period used to estimate your beta
- Assume that 2011 turns out to be a terrible year for stocks. If that occurs, you should expect to see the historical risk premium next year (including 2011):
  a. Go up
  b. Go down

FORWARD LOOKING PREMIUMS

- Assume that you were looking at an investment, where you were guaranteed a cash flow of $ 1 (with certainty) every year in perpetuity. How much would you pay for this investment right now?

- Now assume that you were looking at an investment, where you expect to generate a cash flow of $ 1, with about the same uncertainty as you would face on an average risk stock, in perpetuity. How much would you pay for this investment?