RISK TESTS

Estimating a risk free rate

You have been asked to estimate the risk free rate for a Swiss multinational, which gets 10% of its revenues in Switzerland (in Swiss Francs), 30% of its revenues in the EU (in Euros), 40% of its revenues in the US (in US $) and 20% of its revenues in India (in Indian rupees). The risk free rates are 0.5% in Swiss Francs, 1% in Euros, 2.5% in US $ and 6% in Indian Rupees. What risk free rate will you use in your valuation?

a. The simple average of the risk free rates

b. The weighted average of the risk free rates

c. The Swiss franc rate, since it is a Swiss company

d. The lowest of the rates, since it has to be risk free

e. The highest of the rates, to be conservative

f. None of the above

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 next year turns out to be a terrible year for stocks. If that occurs, you should expect to see the historical risk premium next year :

   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?