

Solutions

1. Which of the following is the best measure of the payoff to “active” value investing?
 - a. The difference between the average returns earned by active value investors and an index fund of all stocks.
 - b. The difference between the average returns earned by active value investors and a growth index fund.
 - c. The difference between the average returns earned by active value investors and a value index fund**
 - d. The difference between the average returns earned by value index fund and a growth index fund.
 - e. The difference between the average returns earned by value index fund and an index fund of all stocks.

Explanation: If active value investing pays off, an active value fund has to beat a value index fund. Any of the other comparisons will be contaminated by other factors that have nothing to do with activity.

2. Which of the following best characterizes the findings in studies of active individual investors?
 - a. On average, active individual investors beat the market, with the most active among them doing the best.
 - b. On average, active individual investors break even with the market, with the most active among them doing the best.
 - c. On average, active individual investors do worse than the market, with the most active among them doing the best.
 - d. On average, active individual investors beat the market, with the most active among them doing the worst.
 - e. On average, active individual investors break even with the market, with the most active among them doing the worst.
 - f. On average, active individual investors do worse than the market, with the most active among them doing the worst.**

Explanation: Barber & Odean’s study of brokerage accounts concludes that the average individual investor lags the market and that more activity hurts, rather than helps.

3. Which of the following best characterizes the findings in studies of activist value investors?
 - a. The median or typical activist value investor beats the market, with activist mutual funds doing better than activist hedge funds or individuals.
 - b. The median or typical activist value investor beats the market, with activist mutual funds doing worse than activist hedge funds or individuals.
 - c. The average return across activist value investors is greater on a risk-adjusted basis than the return on the market, with activist mutual funds doing better than activist hedge funds or individuals.

- d. The average return across activist value investors is greater on a risk-adjusted basis than the return on the market, with activist mutual funds doing worse than activist hedge funds or individuals.**

Explanation: It does seem likely the average return across activist investors is greater on a risk-adjusted basis than the return on the market, but the outperformance also seems to be due to the biggest winners. Hence, it is not the median activist investor who beats the market.

4. If you do not believe that beta is a good measure of equity risk, you cannot do discounted cash flow valuation.
- a. True
 - b. False**

Explanation: You can use any approach that captures risk and brings it into a discount rate, to do discounted cash flow valuation. You don't need to use beta, if you don't like it as a measure of equity risk.

5. Which of the following will not change the intrinsic value of a company?
- a. A new earnings report from the company
 - b. An acquisition announcement from the company
 - c. An increase in interest rates
 - d. A stock dividend**
 - e. A change in management

Explanation: A stock dividend changes the number of units (shares outstanding) in a company without affecting cash flows, growth or risk. Hence, it is the only action that has no potential to change value (though it may affect the price).