Solution

1. In paired arbitrage, you pair stocks based upon their history and you buy the stock that is cheap based upon the past, while selling the stock that looks expensive. How would you go about finding paired stocks in the market?
    a. Look for stocks with similar market capitalizations
    b. Look for stocks that have similar growth potential
    c. Look for stocks in the same sector
    d. Look for stocks that have had no correlation with each other in the past.
    e. Look for stocks that have had high positive correlation with each other in the past.

Explanation: For a paired stock strategy to work, you need two stocks whose prices move together. While two stocks within the same sector may move together, it is safer to look at price correlations and try to find stocks with high positive correlation with each other.

2. Which of the following statements best describes what studies have found about paired arbitrage?
    a. It has never earned excess returns
    b. It has earned positive excess returns, before adjusting for transactions costs, but not after adjusting for the costs.
    c. It has earned positive excess returns after adjusting for transactions costs, and its profitability has remained stable over time.
    d. It has earned positive excess returns after adjusting for transactions costs, but its profitability has decreased over time.
    e. It has earned positive excess returns after adjusting for transactions costs and its profitability has increased over time.

Explanation: Studies find that paired arbitrage has earned higher risk-adjusted returns than investing in the market and that the profitability has declined over time, because of imitation and attempts to scale up.

3. In merger arbitrage, you buy shares in the target company after the acquisition is announced and hope to make excess returns. Which of the following assumptions would you need to make for this strategy to work?
    a. Acquisition bids usually fail and the acquiring company stock price will go up when the acquisition fails.
    b. Acquisition bids usually fail and the acquiring company stock price will go down when the acquisition fails.
    c. Acquisition bids seldom fail and the acquiring company will have to pay more than the initially announced acquisition price.
    d. Acquisition bids seldom fail and the acquiring company will have to pay the initially announced acquisition price.
    e. Acquisition bids seldom fail and the acquiring company will have to pay less than the initially announced acquisition price.

Explanation: You make money from the stock price rising from the initial offering price to the final transaction price. For that to happen, bids must succeed most of the time, with offering prices increasing from the initial level.

4. Studies of hedge funds have looked at the returns and risk characteristics of these funds over time. What have they found?
    a. Hedge funds generate higher returns and are more risky than the market.
    b. Hedge funds generate lower returns and are more risky than the market.
    c. Hedge funds generate higher returns and are less risky than the market.
    d. Hedge funds deliver a better return/risk tradeoff (Sharpe ratio) than the market.

Explanation: Hedge funds, on average, deliver lower returns than the market but with much less risk. They do better on a Sharpe ratio (average return/standard deviation) basis than the rest of the market.

5. Assume that you compute the average annual returns and risk characteristics, over the last five years, <u>of all hedge funds that are in business today</u>. Given the failure rate among hedge funds is high, which of the following are you likely to find?
    a. Your average return will be too low and your risk estimates too high, relative to actuals.
    b. Your average return will be too high and your risk estimates too high, relative to actuals.
    c. Your average return will be too low and your risk estimates too low, relative to actuals.
    d. Your average return will be too high and your risk estimates too low, relative to actuals.

    Explain why.

    Explanation: The hedge funds that fail tend to be the ones that have the worst returns and the highest risk. Thus, not including them will bias up your average return and bias down your risk measures.