

Solutions

1. Risk can be described as a combination of danger and opportunity. Which of the following actions are compatible with that definition?
 - a. You should never take risk, since it exposes you to danger
 - b. You should always seek more opportunity, even if it exposes you to danger
 - c. You should only take opportunities that don't expose you to danger.
 - d. You should seek out opportunity, but only if it outweighs the danger that it exposes you to.**
 - e. None of the above

Explanation: Investing requires trade off. Avoiding risk altogether will create a low return (=riskless rate portfolio and seeking out opportunities just because they exist will mean you are taking investments with bad risk/return tradeoff)

2. In conventional risk and return models, risk is often defined as standard deviation or variance in actual returns around an expected return. Using that definition, you are counting both positive outcomes (actual > expected) and negative outcomes (actual < expected) as risk. What is the underlying assumption that drives this choice?
 - a. Investors are equally troubled by both upside and downside outcomes
 - b. Risk is symmetric, i.e., investments with upside will inevitably have downside somewhere along the way.**
 - c. You cannot separate downside outcomes from upside outcomes
 - d. None of the above

Explanation: When returns are distributed normally, the risk is symmetric, and your rankings/measures based upon total risk will converge on just downside risk measures.

3. You can measure the risk (volatility) in an investment (company) by looking at earnings/cash flows or stock prices. In making the choice of which one you would use, what are the factors that come into play?
 - a. The liquidity of the market in which the stock trades
 - b. Your investment philosophy (do you believe in intrinsic value or are you trading)
 - c. The frequency with which accounting earnings are estimated
 - d. Accounting consistency and earnings smoothing
 - e. All of the above

Explanation: Using prices gives you more data than using accounting earnings, but the information in prices will be greater in liquid markets. With accounting earnings, you are better off if accountants are consistent and measure earnings more frequently. In addition, your investment philosophy will also have a role, with value investors preferring earnings over prices.

4. When a diversified investor invests in an individual stock, some of the risk is company risk (and thus diversifiable) and some is risk that cannot be diversified away (non-diversifiable or market). Which of the following is an example of market risk?

- f. That a company takes a project that does much worse than expected
- g. An unexpected change in sector regulations that hurts the sector in which the company operates
- h. A top manager leaves the firm and joins a competitor
- i. Interest rates increase unexpectedly**
- j. Movement in an exchange rate causes a hit to company earnings

Explanation: (a), (b) and (c) are diversifiable. Exchange rate movements often affect many companies, but in different directions, with some companies gaining and other losing.

5. The notion that diversification reduces risk is at the basis of much of conventional risk and return in finance. Which of the following reasons is the best one for explaining why a stock may be less risky to a diversified investor than to an investor who holds just that stock?

- k. The stock will be a much smaller percent of the diversified investor's portfolio
- l. Individual stocks in the portfolio do not move in lock step, and that absence in co-movement can make the portfolio less risky.**
- m. Diversified investors tend to have more money to invest than single stock investors
- n. Institutional investors are diversified, and individual investors are not, and the former are less exposed to risk
- o. None of the above

Explanation: While (a) is partial comfort, the basis for diversification is low correlation (or correlation less than one) across investments.