Question #1 of 37

Question ID: 1209605

To determine which rate of return to use as a discount rate, an analyst should consider the:

A) nature of the cash flows being discounted.

B) likely return of the stock market over the next year.

C) length of the holding period.

Explanation

The discount rate should correspond to the type of cash flow being discounted. The holding period determines how we calculate the present value, but not the discount rate. Expected stock-market returns are a suitable discount rate for some investments, but not all.

(Study Session 9, Module 25.1, LOS 25.h)

Related Material

SchweserNotes - Book 3

Question #2 of 37

Question ID: 1209575

An analyst attempting to derive the equity risk premium for a stock starting from the required return for that stock would find which of the following statistics *least* useful?

A) The stock's estimated return.

B) The stock's beta.

C) Historical 10-year Treasury bond rates.

Explanation

The required return for a stock is equal to the risk-free return plus beta times the equity risk premium. An analyst starting from the required return would need beta and a risk-free rate. Historical 10-year T-bond rates can be used as an estimate of the risk-free rate. Since the analyst is starting with the required return, estimated returns are not needed.

(Study Session 9, Module 25.1, LOS 25.b)

Related Material

SchweserNotes - Book 3

Question #3 of 37

Question ID: 1209573

One year ago, Makato Omura purchased a 6.50% fixed coupon bond for 98.50. Recently, she sold the bond for 99.25 and calculated her return at 7.4%. Her friend, Takanino Takemiya, CFA, reminds Omura that this is the nominal return and that to calculate the real return, she needs to factor in the inflation rate over the holding period. If the price index for the current year is 118.5 and the price index one year ago was 115.9, Omura's real return is *closest* to:

A) 9.6%.

B) 6.3%.

C) 5.2%.

Explanation

Omura's real return is approximated by subtracting the inflation rate from the calculated (nominal) return. The inflation rate is calculated using the formula:

Inflation = (Price Index$_{\text{this year}}$ – Price Index$_{\text{last year}}$) / Price Index$_{\text{last year}}$

Here, inflation = (118.5 – 115.9) / 115.9 = 0.0224, or approximately 2.2%.

Thus, the real return = 7.4% - 2.2% = 5.2%.

(Study Session 9, Module 25.1, LOS 25.a)

Related Material

SchweserNotes - Book 3

Question #4 of 37

Question ID: 1209570

Laura's Chocolates, is a maker of nut-based toffees. The company holds shares in one of its suppliers, and wants to know what the holding period return was last year.

January 1 (purchase date)	$40
December 31	$45
Dividend paid (December 31)	$5
Cost of equity	11%
Cost of debt	8%
Debt : equity	1:3

What is the holding period return (ignore taxes)?

A) 12.50%.

B) 22.50%.

C) 25.00%.

Explanation

$$\frac{[(45 - 40) + 5]}{40} = 25\%$$

(Study Session 9, Module 25.1, LOS 25.a)

Related Material

SchweserNotes - Book 3

Question #5 of 37

Question ID: 1209595

Equity analyst Mason Kramer wants to calculate the return on equity for a number of stocks. Kramer values predictive power over all other factors and is in no hurry to finish the work. Which model is Kramer's *best* option?

A) Capital asset pricing.

B) Multifactor.

C) Build-up.

Explanation

Multifactor models are more robust than the other alternatives. They are also more complex, but given Kramer's goals, a multifactor model makes the most sense.

(Study Session 9, Module 25.1, LOS 25.e)

Related Material

SchweserNotes - Book 3

Question #6 of 37

Question ID: 1209572

In an efficient market, a mutual fund's required return is the same as the:

A) holding period return.

B) internal rate of return.

C) net asset value return.

Explanation

The internal rate of return (IRR) is the rate that equates the value of the discounted cash flows to the current price of the security. In an efficient market, where securities are properly priced, the IRR and required return are the same.

(Study Session 9, Module 25.1, LOS 25.a)

Related Material

SchweserNotes - Book 3

Question #7 of 37

Question ID: 1209569

If an investor had determined that an asset's market price was too high, (implying that it will soon fall) the expected holding period return (HPR) would be:

A) equal to the required return.

B) lower than the required return.

C) higher than the required return.

Explanation

If the investor determined that the asset's price was too high, then the expected HPR would be less than the required return, and the asset would have a negative alpha.

(Study Session 9, Module 25.1, LOS 25.a)

Related Material

SchweserNotes - Book 3

Question #8 of 37

Question ID: 1209583

Equity analyst Yasmine Cordova of Substantial Securities is trying to determine the investment appeal of shares of Maxwell Mincemeat, a small food company. Cordova has assembled the following data about the company:

- Internal rate of return: 9.4%.
- Maxwell's 20-year bond yield to maturity: 7.9%.
- Maxwell's two-year bond yield to maturity: 6.1%.
- Treasury bill yield: 3.4%.
- Maxwell's estimated beta: 2.1.
- Maxwell's 20-year bonds are priced at $102.65.
- Maxwell's two-year bonds are priced at $101.47.
- Estimated return of Russell 2000 Index: 12.3%.
- Substantial's credit analyst estimates that Maxwell's equity warrants a premium of 4.9% over its bonds.

Cordova wants to make sure her estimates are accurate, so she decides to calculate the estimated required return in two ways. She opts for the bond-yield plus risk premium method and the capital asset pricing model. To check her work, she wants to compare the estimates derived under each method. The difference between the required returns is *closest* to:

A) 5.30%.

B) 5.89%.

C) 9.29%.

Explanation

The capital asset pricing model uses the following equation:

Required return = risk-free rate + beta × equity risk premium

To calculate the required return under CAPM, use the Russell 2000 index return, the beta, and the risk-free rate.

Required return = 3.4% + 2.1 × (12.3% − 3.4%) = 22.09%.

The bond-yield model uses the following equation:

Required return = yield to maturity on long-term bonds + risk premium.

Required return = 7.9% + 4.9% = 12.8%.

The difference between the two estimated required returns is 9.29%.

(Study Session 9, Module 25.1, LOS 25.c)

Related Material

SchweserNotes - Book 3

Question #9 of 37

Question ID: 1209602

For an analyst seeking to value an entire company, the *best* tool is the:

A) Pastor-Stambaugh model.

B) weighted average cost of capital.

C) capital asset pricing model.

Explanation

The capital asset pricing model and Pastor-Stambaugh models are used to calculate the required return on equity. The weighted average cost of capital is used to value an entire company.

(Study Session 9, Module 25.1, LOS 25.g)

Related Material

SchweserNotes - Book 3

Question #10 of 37

Question ID: 1209580

Analyst Charlie Howell, CFA, has constructed two models for determining the required return on equity for Yazz Jazz, a saxophone maker. One takes the company's size into account, the other takes the shares' liquidity into account. Which of the following pairs of equity-return models require the use of:

	Size	Liquidity
A)	Build-up	Fama-French
B)	Build-up	Pastor-Stambaugh
C)	Capital asset pricing model	Fama-French

Explanation

The build-up method takes into account a company's size and is usually applied to closely held companies for which beta is not available. The Pastor-Stambaugh method is a modified version of the Fama-French factor model that considers liquidity.

(Study Session 9, Module 25.1, LOS 25.c)

Related Material

SchweserNotes - Book 3

Question #11 of 37

Question ID: 1209601

Marina Syltus, chief financial officer of Worcester Water Treatment, wants to know the cost of the company's capital so it can make wiser budgeting decisions. Syltus has assembled the following data:

- Worcester's long-term debt has a market value of $230 million.
- Worcester's shares have a total market value of $782 million.
- The marginal tax rate is 37%.
- The required return on equity is 14.6%.
- Worcester's long-term debt has a weighted average interest rate of 9.4%.

To calculate the weighted average cost of capital, Syltus needs:

A) the required return on debt. ✗

B) both the required return on debt and the target debt/equity ratio. ✓

C) the target debt/equity ratio. ✗

Explanation

The equation for the weighted average cost of capital is as follows:

Market value of debt / market value of debt and equity × required return on debt × (1 − tax rate) + market value of equity / market value of debt and equity × required return on equity.

As such, we need the required return on debt to determine the WACC. However, analysts normally assume debt and equity are at their target ratio to calculate the cost of capital. If the current capital allocation does not match the target weighting, we use the target weighting. Thus, we also need the target weights for debt and equity, which we can derive from a target debt/equity ratio.

(Study Session 9, Module 25.1, LOS 25.g)

Related Material

SchweserNotes - Book 3

Question #12 of 37

Question ID: 1209577

Currently the market index stands at 1,190.45. Firms in the index are expected to pay cumulative dividends of 35.71 over the coming year. The consensus 5-year earnings growth forecast for these firms is expected to increase to 6.2% up from last year's forecast of 4.5%. The long-term government bond is yielding 5.0%. According to the Gordon growth model, what is the equity risk premium?

A) 1.2%.

B) 4.2%.

C) 2.5%.

Explanation

Equity risk premium = (35.71 / 1,190.45) + (6.2%) – 5.0% = 4.2%

(Study Session 9, Module 25.1, LOS 25.b)

Related Material

SchweserNotes - Book 3

Question #13 of 37

Question ID: 1209606

In order to calculate the value of a firm's equity, the firm's FCFE should be discounted at the firm's:

A) cost of capital as determined by the capital asset pricing model.

B) required return on equity.

C) weighted average cost of capital (WACC).

Explanation

Discounting a firm's FCFE at the required return on equity gives the value of the firm's equity. Discounting a firm's FCFF at the WACC gives the total value of all of the firm's capital. The weighted average cost of capital reflects the cost of both debt and equity.

(Study Session 9, Module 25.1, LOS 25.h)

Related Material

SchweserNotes - Book 3

Question #14 of 37

Question ID: 1209593

In the process of estimating beta for a private company, unlevering the beta calculated for the publicly traded comparable company accomplishes what goal?

A) Establishing a baseline level of leverage. ✗

B) Isolating market risk. ✓

C) Improving the accuracy of the estimate in the event that the private company's debt is of low quality. ✗

Explanation

Market risk, also known as systematic risk, is the risk common to all assets within a certain class. Deleveraging the beta strips out the company-specific risk related to the target company's leverage, thereby isolating market risk. Beta calculations do not require a baseline level of leverage. The equation for calculating beta for private companies assumes the company in question has high-grade debt. The deleveraging process will not help if the assumption is incorrect.

(Study Session 9, Module 25.1, LOS 25.d)

Related Material

SchweserNotes - Book 3

Question #15 of 37

Question ID: 1209597

When attempting to build a risk premium into the required returns of stocks in a developing country, an analyst should use the:

A) country's weighted average cost of capital. ✗

B) country spread model. ✓

C) modified Gordon Growth model. ✗

Explanation

The country spread model uses data from a developed market, then adjusts it using the difference between the bond yields for the emerging and developed markets. Neither a modified Gordon Growth model nor a weighted average cost of capital will do this job.

(Study Session 9, Module 25.1, LOS 25.f)

Related Material

SchweserNotes - Book 3

Question #16 of 37

Question ID: 1209571

To determine the present value of an investment based on a future estimate of the investment's value, an analyst should use the:

A) internal rate of return.

B) discount rate.

C) required return.

Explanation

The discount rate is the rate used to find the present value of an investment.

(Study Session 9, Module 25.1, LOS 25.a)

Related Material

SchweserNotes - Book 3

Question #17 of 37

Question ID: 1209603

Jaime Moreno, a new hire at the venture-capital fund Burkhart Partners, has been tasked with assessing the appeal of various potential equity investments. Moreno has been given the weighted average cost of capital (WACC) for each company. To determine the value of each company's equity, Moreno should:

A) strip the effects of debt out of the WACC, then calculate the value of equity.

B) calculate the firm value using the WACC, then strip out the value of debt.

C) calculate the equity value using the WACC, then incorporate the value of debt.

Explanation

WACC is used to value an entire firm. To value the equity, use the WACC to calculate the firm's value, then subtract the market value of its long-term debt.

(Study Session 9, Module 25.1, LOS 25.g)

Related Material

SchweserNotes - Book 3

Question #18 of 37

Question ID: 1209582

Morgan Bondillo, CFA, is attempting to calculate the value of Smith Sprockets. She is using a supply-side model to estimate the equity risk premium and a build-up model to estimate returns.

Based on the strategies Bondillo is using, Smith Sprockets is *least likely* to:

A) be located in a developed market.

B) be closely held.

C) need its beta adjusted for drift.

Explanation

Supply-side models work best in developed countries, where public equities represent a significant share of the economy, suggesting that there is a relationship between macroeconomic variables and asset prices. The use of a supply-side model suggests Smith Sprockets is in a developed market. Build-up models are generally used for closely held companies for which betas are not easy to obtain. Bondillo's use of a build-up model suggests Smith Sprockets is probably closely held. Betas of public companies must be adjusted for drift. However, since the use of the build-up method suggests the company is closely held and has no beta available, beta drift is probably not relevant for Smith Sprockets.

(Study Session 9, Module 25.1, LOS 25.c)

Related Material

SchweserNotes - Book 3

Question #19 of 37

Question ID: 1209592

There is a multistep process used to estimate the beta of nonpublic companies. What extra step must be taken to use the process on thinly traded public companies?

A) Beta must be adjusted to reflect debt and equity levels.

B) Beta must be reduced using a liquidity factor.

C) No extra step must be taken.

Explanation

The same procedure is used for both nonpublic and thinly traded public companies. Beta is adjusted to reflect debt and equity levels for both types of companies. The procedure for estimating beta for private or thinly traded public companies does not involve a liquidity factor.

(Study Session 9, Module 25.1, LOS 25.d)

Related Material

SchweserNotes - Book 3

Question #20 of 37

Question ID: 1209579

Analyst Charlie Howell, CFA, is trying to calculate the required return on equity for Yazz Jazz, a maker of saxophones. However, Yazz Jazz operates in a country with rapidly changing inflation rates. Which method should Howell use?

A) Build-up.

B) A multifactor model.

C) Bond-yield plus risk premium.

Explanation

The build-up method assigns premiums based on company size and other company-specific factors. It is designed for use on closely held companies and does not take inflation changes into account. The bond-yield method adds a risk premium to the yield on the company's publicly traded debt. The bond yields will reflect inflation indirectly, but the model does not easily adjust for inflation changes. For taking rapid inflation changes into account, a multifactor model works the best.

(Study Session 9, Module 25.1, LOS 25.c)

Related Material

SchweserNotes - Book 3

Question #21 of 37

Question ID: 1209598

Candace Elwince is attempting to calculate the required return of Skeun Inc., a machine-tool manufacturer in a small Eastern European country. Elwince has solid data from the German market but is not sure how to account for the exchange-rate risk Skeun investors would face. Her *best* choice for creating a risk premium is the:

A) Gordon Growth model.

B) difference between the bond yields of both markets.

C) difference between the inflation rates of both markets.

Explanation

The country spread model suggests an analyst can approximate the risk premium between a developed market and an emerging market by subtracting the bond yields in the developed market from yields in the emerging market.

(Study Session 9, Module 25.1, LOS 25.f)

Related Material

SchweserNotes - Book 3

Question #22 of 37

Question ID: 1209574

The equity risk premium is the difference between:

A) the required equity return and the risk-free return. ✓

B) the estimated equity return and the risk-free return. ✗

C) estimated equity returns and estimated bond returns. ✗

Explanation

The equity risk premium reflects the return in excess of the risk-free rate that investors require for holding stocks. It is derived by subtracting the risk-free return from the required return.

(Study Session 9, Module 25.1, LOS 25.b)

Related Material

SchweserNotes - Book 3

Question #23 of 37

Question ID: 1209599

The country risk rating model:

A) depends on forecasts of exchange rates. ✗

B) determines a risk premium for an emerging market. ✓

C) determines a risk premium for any foreign market. ✗

Explanation

The country risk rating model begins with a model from a developed country, then modifies that model with inputs from an emerging market to derive a risk premium for the emerging market. Forecasts of exchange rates may well be part of the model, but they are not a requirement.

(Study Session 9, Module 25.1, LOS 25.f)

Related Material

SchweserNotes - Book 3

Question #24 of 37

Question ID: 1209594

If an analyst uses a build-up model to estimate a stock's return rather than using a multifactor model or the capital asset pricing model, the analyst is probably *least* concerned about:

A) accuracy.

B) timeliness.

C) simplicity.

Explanation

The build-up model typically uses historical values as estimates. Historical data may no longer be relevant, so a user of the build-up model is probably not concerned with timeliness.

(Study Session 9, Module 25.1, LOS 25.e)

Related Material

SchweserNotes - Book 3

Jaden Hoyle is evaluating the MegaFood Market chain of grocery stores and Strinson Carburetors, a maker of automobile and industrial engine parts. MegaFood is publicly traded, while Strinson is a private company. Hoyle's firm, Janssen and Associates, is considering the purchase of a 50% equity stake in one or both of the companies, and may be willing to purchase the companies outright. Janssen only invests in companies with a weighted average cost of capital of less than 11%.

Hoyle has assembled the following data on the two companies:

	MegaFood Market	Strinson Carburetors
Beta	0.87	
Market value of equity	$173 million	$993 million
Market value of debt	$38 million	$567 million
Marginal tax rate	42.8%	31%
Target debt/equity ratio	35%	78%
Equity risk premium		4.6%
Required return on debt	9%	6.5%

The risk-free rate of return is 5.2%. Hoyle must make recommendations regarding both MegaFood Market and Strinson Carburetors.

Hoyle does not have all of the data she needs and knows she will have to estimate some values using the data she does possess. To help estimate the required return on equity for Strinson Carburetors, Hoyle takes three actions:

Action A:	She selects a benchmark company, unlevers the beta of that company, then levers up the adjusted beta using Strinson's debt and equity allocation.
Action B:	She calculates a risk premium, then adds that premium to the yield to maturity of the company's long-term debt.
Action C:	She prepares a supply-side multifactor model considering expected inflation, expected GDP growth, and expected changes in P/E ratio.

Before she finishes her analysis of MegaFood Market and Strinson Carburetors, Hoyle must construct valuation models for two other companies, Halberd Hardware, a maker of hand tools, and the Jones Group, one of the world's largest consultants. She has assembled the following information about each company.

Halberd Hardware

- Gary Halberd, the founder, still owns 85% of the company, and all the rest is in the hands of company directors and friends of Halberd who bought stakes 20 years ago.
- Halberd Hardware has publicly traded debt.
- Historical data on equity returns is sparse, as there have been very few trades over the last two decades.
- Halberd Hardware is headquartered in New York City.
- The company plans to go public in the next six months, with Gary Halberd selling 30% of his ownership interest.

Jones Group

- Jones Group, one of the world's largest consulting companies, has been publicly traded for four years on the South Pittson Island stock market. Its ADR trades on the U.S. market.
- South Pittson Island is a small island nation in the Mediterranean known for its business-friendly tax code.

For her analysis of Halberd Hardware, Hoyle is considering three models to calculate the estimated return. But she has already decided to use the Gordon Growth model to calculate the equity risk premium.

As soon as Hoyle finishes determining which models are best suited to her purposes, her boss comes into the office and tells her to use the capital asset pricing model (CAPM) for all four of the companies she is reviewing. Hoyle is concerned about the effectiveness of the CAPM. With regards to Jones Group, her three main worries are:

Worry A:	The need to use the country spread model to revise the equity risk premium.
Worry B:	The CAPM's effectiveness because of Jones Group's ADR.
Worry C:	The need to create a beta estimate using an unlevered beta.

Question #25 - 30 of 37

Question ID: 1209585

Assuming MegaFood Market has a required return on equity of 13.6% and Strinson Carburetors has a required return on equity of 15.3%, what recommendation should Hoyle give her superiors at Janssen regarding each company?

	MegaFood Market	Strinson Carburetors	
A)	Don't buy the company	Don't buy the company	✗
B)	Don't buy the company	Buy the company	✓
C)	Buy the company	Buy the company	✗

Explanation

To determine whether the investments fit Janssen's requirements, we must calculate the weighted average cost of capital. We have the target debt/equity ratio, from which we can derive the debt/capital ratio needed to calculate WACC. Debt/capital = (debt / equity) / (1+ debt / equity)

For MegaFood, the target debt/capital ratio is 25.93%. For Strinson, the target debt/capital ratio is 43.82%.

> WACC = [debt / capital × required return on debt × (1 − tax rate)] + (equity / capital) × required return on equity.
>
> MegaFood WACC = [(25.93% × 9% × (1 − 42.8%)] + (1 − 25.93%) × 13.6% = 11.41%.
>
> Strinson WACC = [(43.82% × 6.5% × (1 − 31%)] + (1 − 43.82%) × 15.3% = 10.56%.

For MegaFood, WACC is 11.41%, higher than the Janssen's 11% target. For Strinson, WACC is 10.56%, below the target. Thus, Janssen should buy Strinson, but not MegaFood.

(Study Session 9, Module 25.1, LOS 25.c)

Related Material

SchweserNotes - Book 3

Question #26 - 30 of 37

Question ID: 1209586

Which of Hoyle's actions is *least* helpful in the calculation of required return on equity for Strinson Carburetors?

A) Action B.

B) Action C.

C) Action A.

Explanation

Action A is a useful method for calculating beta for private or thinly traded companies. With that estimated beta, Hoyle has all the pieces needed to calculate required return using the capital asset pricing model. Action B reflects the bond-yield plus risk premium method for calculating required return on equity for companies with publicly traded debt. This strategy would provide Hoyle with a target return. The model created in Action C is useful for estimating an equity risk premium. But Hoyle already has an equity risk premium.

(Study Session 9, Module 25.1, LOS 25.c)

Related Material

SchweserNotes - Book 3

Question #27 - 30 of 37

Question ID: 1209587

Which of the following is the *best* model for calculating Strinson Carburetors' required return?

A) Fama-French model.

B) Pastor-Stambaugh model.

C) Capital asset pricing model.

Explanation

Strinson is not publicly held, and its shares have little liquidity. The Fama-French model is useful for estimating returns, but the Pastor-Stambaugh model adds a liquidity factor to the Fama-French model. As such, the Pastor-Stambaugh model is probably better for a company like Stinson because it takes liquidity into account. The CAPM requires the estimation of beta and is likely to be less accurate than the other models.

(Study Session 9, Module 25.1, LOS 25.c)

Related Material

SchweserNotes - Book 3

Question #28 - 30 of 37

Question ID: 1209588

Hoyle wants to calculate an expected return for Halberd Hardware and Jones Group. She has access to a variety of models, but her *best* option is:

	for Halberd	for Jones	
A)	bond-yield plus risk premium	capital asset pricing	✓
B)	build-up method	capital asset pricing model	✗
C)	build-up method	country spread model	✗

Explanation

Both the build-up method and the bond-yield plus risk premium method work for thinly traded companies. But the build-up method relies on historical estimates, so it wouldn't work well for Halberd, which has minimal historical data. Thus, the bond-yield plus risk premium method is the best option. The country spread model is not designed to calculate an expected return, but instead to adjust data from emerging markets for comparison with data from developed markets. The question only provides two options, and the CAPM is the only model that would actually do the required job for Jones.

(Study Session 9, Module 25.1, LOS 25.c)

Related Material

SchweserNotes - Book 3

Question #29 - 30 of 37

Question ID: 1209589

Hoyle wants to use a macroeconomic model to derive equity risk premiums for both Halberd Hardware and Jones Group. Such a model is appropriate for:

A) Halberd Hardware, but not Jones Group, because macroeconomic models don't work for nations like South Pittson Island.

B) both Halberd Hardware and Jones Group.

C) Jones Group, but not Halberd Hardware, because macroeconomic models don't work for closely held companies.

Explanation

Macroeconomic models work for any market in which public equities represent a large enough share of the economy that analysts can reasonably infer a relationship between economic factors and asset prices. Since South Pittson Island is known as a tax haven, it is likely that many other companies are domiciled there for the same reason Jones Group is, and the financial industry is a large part of the economy. However, even if we don't want to assume that South Pittson Island's economy is suitable for such models, we have another argument. Jones Group is one of the world's largest consulting companies. Therefore, it is highly likely that it has significant operations in large, developed markets. Macroeconomic models can be constructed to reflect data from those markets – and in fact, any such model should reflect that data.

While Halberd is closely held, that status should not affect a macroeconomic model, which looks at broad factors that affect both public and private companies. We need not have a beta or historical trading data to use such a model.

(Study Session 9, Module 25.1, LOS 25.c)

Related Material

SchweserNotes - Book 3

Question #30 - 30 of 37

Question ID: 1209590

Which of Hoyle's worries about using the CAPM for Jones Group is *most* justified?

A) Worry C.

B) Worry B.

C) Worry A.

Explanation

Currency-translation issues are a concern for any company with operations in foreign countries. But the country spread model is designed to adjust results from emerging markets using data from developed markets, assigning the proper amount of extra risk for the emerging market. Most tax havens would not need to be treated as emerging markets. In addition, as one of the world's largest consultancies, Jones Group must do a lot of business in the U.S. and other developed markets. It is unlikely that results from a company like Jones Group would require the adjustments from the country spread model. Regarding beta: Since Jones is publicly traded, there is no need to extrapolate a beta using data from another company. Thus, there is no reason to unlever beta from a benchmark company, then relever it to reflect Jones' financial condition. The biggest concern is the overall effectiveness of the CAPM. The model should work for Jones Group, but it has weaknesses, most importantly its dependence on just one factor. Jones trades on at least two exchanges, and any model depending on just one market index is not going to reflect the whole picture.

(Study Session 9, Module 25.1, LOS 25.c)

Related Material

SchweserNotes - Book 3

Question #31 of 37

Question ID: 1209581

Senior analyst James Matin is instructing a room full of new hires in the finer points of equity valuation. He makes two statements:

Statement 1:	"When the return you expect for a stock doesn't match the required return, make sure you calculate a convergence yield and build that into your valuation model."
Statement 2:	"When you estimate the equity return of a thinly traded company, the Pastor-Stambaugh model is a better option than the Fama-French model."

Do the statements represent good advice?

	Statement 1	Statement 2	
A)	Yes	Yes	✗
B)	No	Yes	✓
C)	Yes	No	✗

Explanation

Statement 1 is not good advice because in some cases market inefficiencies will prevent the price from converging with intrinsic value. As such, Matin's advice is not sound. Statement 2 is good advice, as the Pastor-Stambaugh model adds a liquidity factor to the traditional Fama-French model. Such a liquidity factor would be useful in the analysis of a thinly traded stock.

(Study Session 9, Module 25.1, LOS 25.c)

Related Material

SchweserNotes - Book 3

Question #32 of 37

Question ID: 1209578

Types of estimates of the equity risk premium are *least likely* to include:

A) extemporized estimates.

B) macroeconomic model estimates.

C) ex-ante estimates.

Explanation

There are four types of estimates of the equity risk premium: historical estimates, forward-looking (ex-ante) estimates, macroeconomic model estimates, and survey estimates.

(Study Session 9, Module 25.1, LOS 25.c)

Related Material

SchweserNotes - Book 3

Question #33 of 37

Question ID: 1209591

Adjusted beta for public companies compensates for:

A) drift.

B) leverage.

C) changes in the market's growth rate.

Explanation

An adjusted beta is a weighted average of the estimated beta and either 1.0 (the average for all stocks) or a peer mean (the beta of similar firms). The objective of an adjusted beta measure is to compensate for beta drift, or the tendency of beta to revert to 1.0 (or the industry average).

(Study Session 9, Module 25.1, LOS 25.d)

Related Material

SchweserNotes - Book 3

Question #34 of 37

Question ID: 1209600

Junior analyst Quentin Haggard is struggling with a required return calculation. His main concern is compensating for exchange rate fluctuations between the country where his company is based and the home country of a portfolio of stocks he is analyzing. Haggard should calculate the return in his home country's currency, then adjust:

A) for expected changes in the foreign country's currency value. ✓

B) the beta to account for exchange-rate fluctuations. ✗

C) for expected changes in the foreign country's inflation rate. ✗

Explanation

The proper method of compensating for changes in exchange rates is to calculate the required return in the home currency, then adjust the return using forecasts for changes in the exchange rate.

(Study Session 9, Module 25.1, LOS 25.f)

Related Material

SchweserNotes - Book 3

Question #35 of 37

Question ID: 1209604

Joe Bates, CFA, has prepared a schedule of real cash flows for his company's plant expansion. Bates generally uses the weighted average cost of capital to discount such cash flows, but in order to accurately determine the present value of those real cash flows, he should adjust the discount rate to reflect:

A) expected inflation. ✓

B) expected changes in the market growth rate. ✗

C) the company's cost of both debt and equity.

Explanation

In the context of cash flows, "real" refers to inflation-adjusted cash flows. The weighted average cost of capital already takes the cost of both debt and equity into account, but this is a nominal, not a real, discount rate. The market's growth rate is rarely relevant to cash flows to the firm and is not part of the WACC calculation.

(Study Session 9, Module 25.1, LOS 25.h)

Related Material

SchweserNotes - Book 3

Question #36 of 37

Question ID: 1209576

Ben Jacobs, CFA, is attempting to calculate a historical equity risk premium. His first estimate uses geometric mean equity returns and long-term bond yields. His second estimate uses arithmetic mean returns and short-term bond yields. The effect of the changes in methodology in the second estimate, relative to the first, will:

A) both increase the size of the risk premium.

B) have offsetting effects.

C) both decrease the size of the risk premium.

Explanation

Switching from a geometric mean to an arithmetic mean will increase the mean equity return. All else being equal, that will increase the estimated risk premium. When the yield curve slopes upward, short-term bonds yield less than long-term bonds. Thus, the equity risk premium estimate will be larger when short-term bond rates are used.

(Study Session 9, Module 25.1, LOS 25.b)

Related Material

SchweserNotes - Book 3

Question #37 of 37

Question ID: 1209596

Juliann Kellmann, CFA, wants to quickly and simply calculate the expected return of equity in a company with few shares outstanding. She should use:

A) the capital asset pricing model.

B) a multifactor model.

C) a build-up model.

Explanation

Build-up models are very simple and apply to closely held companies. CAPM does not work well with such companies. A carefully assembled multifactor model can take liquidity issues into account, but the procedure is far more complex than that of a build-up model.

(Study Session 9, Module 25.1, LOS 25.e)

Related Material

SchweserNotes - Book 3