

HW-413707009-Tom

2.1 Consider the following five observations. You are to do all the parts of this exercise using only a calculator.

x	y	$x - \bar{x}$	$(x - \bar{x})^2$	$y - \bar{y}$	$(x - \bar{x})(y - \bar{y})$
3	4				
2	2				
1	3				
-1	1				
0	0				
$\sum x_i =$	$\sum y_i =$	$\sum (x_i - \bar{x}) =$	$\sum (x_i - \bar{x})^2 =$	$\sum (y_i - \bar{y}) =$	$\sum (x_i - \bar{x})(y_i - \bar{y}) =$

- Complete the entries in the table. Put the sums in the last row. What are the sample means \bar{x} and \bar{y} ?
- Calculate b_1 and b_2 using (2.7) and (2.8) and state their interpretation.
- Compute $\sum_{i=1}^5 x_i^2$, $\sum_{i=1}^5 x_i y_i$. Using these numerical values, show that $\sum (x_i - \bar{x})^2 = \sum x_i^2 - N\bar{x}^2$ and $\sum (x_i - \bar{x})(y_i - \bar{y}) = \sum x_i y_i - N\bar{x}\bar{y}$.
- Use the least squares estimates from part (b) to compute the fitted values of y , and complete the remainder of the table below. Put the sums in the last row.
Calculate the sample variance of y , $s_y^2 = \sum_{i=1}^N (y_i - \bar{y})^2 / (N - 1)$, the sample variance of x , $s_x^2 = \sum_{i=1}^N (x_i - \bar{x})^2 / (N - 1)$, the sample covariance between x and y , $s_{xy} = \sum_{i=1}^N (y_i - \bar{y})(x_i - \bar{x}) / (N - 1)$, the sample correlation between x and y , $r_{xy} = s_{xy} / (s_x s_y)$ and the coefficient of variation of x , $CV_x = 100(s_x / \bar{x})$. What is the median, 50th percentile, of x ?

x_i	y_i	\hat{y}_i	\hat{e}_i	\hat{e}_i^2	$x_i \hat{e}_i$
3	4				
2	2				
1	3				
-1	1				
0	0				
$\sum x_i =$	$\sum y_i =$	$\sum \hat{y}_i =$	$\sum \hat{e}_i =$	$\sum \hat{e}_i^2 =$	$\sum x_i \hat{e}_i =$

- On graph paper, plot the data points and sketch the fitted regression line $\hat{y}_i = b_1 + b_2 x_i$.
- On the sketch in part (e), locate the point of the means (\bar{x}, \bar{y}) . Does your fitted line pass through that point? If not, go back to the drawing board, literally.
- Show that for these numerical values $\bar{y} = b_1 + b_2 \bar{x}$.
- Show that for these numerical values $\hat{\bar{y}} = \bar{y}$, where $\hat{\bar{y}} = \sum \hat{y}_i / N$.
- Compute $\hat{\sigma}^2$.
- Compute $\widehat{\text{var}}(b_2 | \mathbf{x})$ and $\text{se}(b_2)$.

2.1 Solution:

a.

	x	y	xm	xm2	ym	xym
1	3.00000	4.00000	2.00000	4.00000	2.00000	4.00000
2	2.00000	2.00000	1.00000	1.00000	0.00000	0.00000
3	1.00000	3.00000	0.00000	0.00000	1.00000	0.00000
4	-1.00000	1.00000	-2.000...	4.00000	-1.00000	2.00000
5	0.00000	0.00000	-1.00000	1.00000	-2.000...	2.00000
6	5.00000	10.0000	0.00000	10.0000	0.00000	8.00000

Mean of x = 1; mean of y = 2.

b.

b1 = 0.8; b2 = 1.2; therefore y = 0.8 + 1.2x

c.

$$\sum_{i=1}^5 x_i^2 = 15$$

$$\sum_{i=1}^5 x_i y_i = 18$$

$$\sum (x_i - \bar{x})^2 = 10$$

$$\sum x_i^2 - N\bar{x}^2 = 10; \text{ Therefore, } \sum (x_i - \bar{x})^2 = \sum x_i^2 - N\bar{x}^2$$

$$\sum (x_i - \bar{x})(y_i - \bar{y}) = \sum x_i y_i - N\bar{x}\bar{y} = 10$$

d.

	x	y	yhat	e	e2	xe
1	3.00000	4.00000	3.60000	0.4000...	0.1600...	1.20000
2	2.00000	2.00000	2.80000	-0.800...	0.6400...	-1.60000
3	1.00000	3.00000	2.00000	1.00000	1.00000	1.00000
4	-1.00000	1.00000	0.4000...	0.6000...	0.3600...	-0.600000
5	0.00000	0.00000	1.20000	-1.20000	1.44000	-0.00000
6	5.00000	10.0000	10.0000	-2.220...	3.60000	-1.33227e-15

Variance of $y = 2.5$

Variance of $x = 2.5$

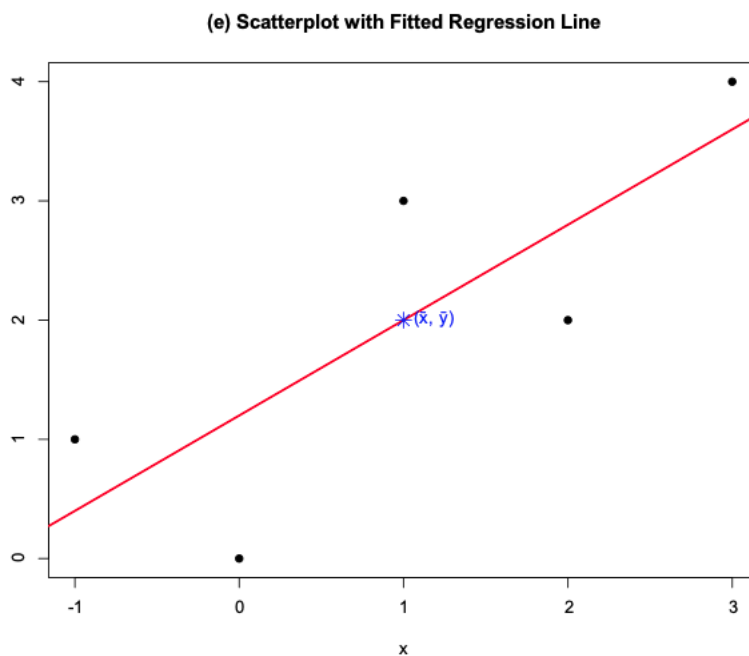
Variance between x and $y = 2$

Coefficient of variation of $x = 158.11$

Correlation between x and $y = 0.8$

Median of $x = 1$

e,f



The line pass through the point

g.

$$y_{\text{mean}} = b_1 + b_2 \cdot x_{\text{mean}} = 0.8 + 1.2 \cdot 1 = 2$$

h.

Apply the equation of mean of y hat, we get mean of y hat is equal of mean of y (2)

i.

$$\sigma^2 = 1.2$$

$$\text{var}(b_2|x) = 0.12$$

se $b_2 = 0.346$

- 2.14** Consider the regression model $WAGE = \beta_1 + \beta_2 EDUC + e$, where $WAGE$ is hourly wage rate in U.S. 2013 dollars and $EDUC$ is years of education, or schooling. The regression model is estimated twice using the least squares estimator, once using individuals from an urban area, and again for individuals in a rural area.

$$\text{Urban} \quad \widehat{WAGE} = -10.76 + 2.46 EDUC, \quad N = 986$$

(se) (2.27) (0.16)

$$\text{Rural} \quad \widehat{WAGE} = -4.88 + 1.80 EDUC, \quad N = 214$$

(se) (3.29) (0.24)

- a. Using the estimated rural regression, compute the elasticity of wages with respect to education at the “point of the means.” The sample mean of $WAGE$ is \$19.74.
- b. The sample mean of $EDUC$ in the urban area is 13.68 years. Using the estimated urban regression, compute the standard error of the elasticity of wages with respect to education at the “point of the means.” Assume that the mean values are “givens” and not random.
- c. What is the predicted wage for an individual with 12 years of education in each area? With 16 years of education?

2.14 Solution:

a.

Elasticity of wage in rural area = 1.247

b.

standard error of elasticity in urban area = 0.11

c.

predicted wages of education:

12 years: Urban = 18.76; Rural = 16.72

16 years: Urban = 28.6; Rural = 23.92

2.16 The capital asset pricing model (CAPM) is an important model in the field of finance. It explains variations in the rate of return on a security as a function of the rate of return on a portfolio consisting of all publicly traded stocks, which is called the *market* portfolio. Generally, the rate of return on any investment is measured relative to its opportunity cost, which is the return on a risk-free asset. The resulting difference is called the *risk premium*, since it is the reward or punishment for making a risky investment. The CAPM says that the risk premium on security j is *proportional* to the risk premium on the market portfolio. That is,

$$r_j - r_f = \beta_j(r_m - r_f)$$

where r_j and r_f are the returns to security j and the risk-free rate, respectively, r_m is the return on the market portfolio, and β_j is the j th security's "*beta*" value. A stock's *beta* is important to investors since it reveals the stock's volatility. It measures the sensitivity of security j 's return to variation in the whole stock market. As such, values of *beta* less than one indicate that the stock is "defensive" since its variation is less than the market's. A *beta* greater than one indicates an "aggressive stock." Investors usually want an estimate of a stock's *beta* before purchasing it. The CAPM model shown above is the "economic model" in this case. The "econometric model" is obtained by including an intercept in the model (even though theory says it should be zero) and an error term

$$r_j - r_f = \alpha_j + \beta_j(r_m - r_f) + e_j$$

- a. Explain why the econometric model above is a simple regression model like those discussed in this chapter.
- b. In the data file *capm5* are data on the monthly returns of six firms (GE, IBM, Ford, Microsoft, Disney, and Exxon-Mobil), the rate of return on the market portfolio (*MKT*), and the rate of return on the risk-free asset (*RISKFREE*). The 180 observations cover January 1998 to December 2012. Estimate the CAPM model for each firm, and comment on their estimated *beta* values. Which firm appears most aggressive? Which firm appears most defensive?
- c. Finance theory says that the intercept parameter α_j should be zero. Does this seem correct given your estimates? For the Microsoft stock, plot the fitted regression line along with the data scatter.
- d. Estimate the model for each firm under the assumption that $\alpha_j = 0$. Do the estimates of the *beta* values change much?

2.16 Solution:

a.

The CAPM model can be viewed as a linear regression, in which the excess return on a security is modeled as a linear function of a single explanatory variable (the market risk premium), along with an intercept, a slope, and an error term. This setup aligns exactly with the basic simple regression framework discussed in the chapter and yields parameters with clear financial significance.

b.

Estimated beta

stock	term	estimate	std.error	statistic	p.value	type
<chr>	<chr>	<dbl>	<dbl>	<dbl>	<dbl>	<chr>
Ford	market_excess	1.66	0.207	8.03	1.27e-13	aggressive
Microsoft	market_excess	1.20	0.122	9.84	1.63e-18	aggressive
GE	market_excess	1.15	0.0895	12.8	4.47e-27	aggressive
Disney	market_excess	1.01	0.0946	10.7	6.50e-21	aggressive
IBM	market_excess	0.977	0.0978	9.98	6.37e-19	defensive
ExxonMobil	market_excess	0.457	0.0716	6.38	1.48e-9	defensive

Stock is the most aggressive is Ford

stock	term	estimate	std.error	statistic	p.value	type
<chr>	<chr>	<dbl>	<dbl>	<dbl>	<dbl>	<chr>
Ford	market_excess	1.66	0.207	8.03	1.27e-13	aggressive

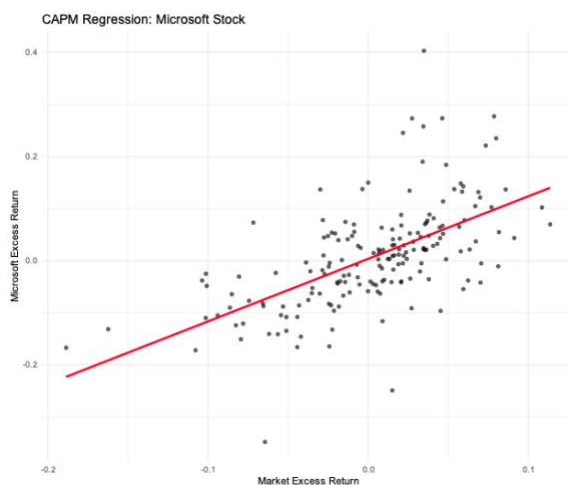
Stock is the most defensive is Exxon

stock	term	estimate	std.error	statistic	p.value	type
<chr>	<chr>	<dbl>	<dbl>	<dbl>	<dbl>	<chr>
ExxonMobil	market_excess	0.457	0.0716	6.38	0.00000000148	defensive

c.

stock	estimate	std.error	statistic	p.value
<chr>	<dbl>	<dbl>	<dbl>	<dbl>
GE	-0.000959	0.00442	-0.217	0.829
IBM	0.00605	0.00483	1.25	0.212
Ford	0.00378	0.0102	0.370	0.712
Microsoft	0.00325	0.00604	0.538	0.591
Disney	0.00105	0.00468	0.224	0.823
ExxonMobil	0.00528	0.00354	1.49	0.137

All values of alphas are insignificant different from 0; therefore, CAPM theory is supported.



d.

stock	beta_with_intercept	beta_without_intercept
<chr>	<dbl>	<dbl>
GE	1.15	1.15
IBM	0.977	0.984
Ford	1.66	1.67
Microsoft	1.20	1.21
Disney	1.01	1.01
ExxonMobil	0.457	0.463

Betas are quite similar between having intercept and no intercept.