

STA371G Homework Assignment 4

(40 Points. Due in class. Group homework.) Please write down the NAME and EID of each group member. Each group consists of up to three members.

Problem 1 (5 points)

A company sets different prices for a particular stereo system in eight different regions of the country. The table below shows the numbers of units sold (in 1000s of units) and the corresponding prices (in hundreds of dollars).

Sales	420	380	350	400	440	380	450	420
Price	5.5	6.0	6.5	6.0	5.0	6.5	4.5	5.0

- (a) Let X denote Price and Y denote Sales. Using Excel or R: calculate the sample means of X and Y , sample standard deviations of X and Y , sample covariance between X and Y , and sample correlation between X and Y .
- (b) In Excel or R, regress sales on price and obtain the estimates of the intercept b_0 , slope b_1 and coefficient of determination R^2 .
- (c) Using the results obtained in (a) to calculate the intercept b_0 , slope b_1 and the coefficient of determination R^2 . Are the results the same as those obtained in (b)?
- (d) Present a plot with the data and the regression line.
- (e) Based on this analysis, briefly describe your understanding of the relationship between sales and prices.

Problem 2 (5 points)

Suppose we are modeling house price as depending on house size. Price is measured in thousands of dollars and size is measured in thousands of square feet.

Suppose our model is:

$$P = 20 + 50s + \epsilon, \quad \epsilon \sim N(0, 15^2).$$

- (a) Given you know that a house has size $s = 1.6$, give a 95% predictive interval for the price of the house.
- (b) Given you know that a house has size $s = 2.2$, give a 95% predictive interval for the price.
- (c) In our model the slope is 50. What are the units of this number?

- (d) What are the units of the intercept 20?
- (e) What are the units of the the error standard deviation 15?
- (f) Suppose we change the units of price to dollars and size to square feet
What would the values and units of the intercept, slope, and error standard deviation?
- (g) If we plug $s = 1.6$ into our model equation, P is a constant plus the normal random variables ϵ . Given $s = 1.6$, what is the distribution of P ?

Problem 3 (10 points)

Read the case “Waite First Securities” in the course packet. The data file is available on the course website. Consider the regression model

$$TI_t = \alpha + \beta SP500_t + \epsilon_t \quad \epsilon_t \sim N(0, \sigma^2)$$

where TI_t represents the return on Texas Instruments in month t and $SP500_t$ represents the return on the S&P 500 in month t .

- (a) What is the interpretation of β in terms of a measure of risk of the stock?
- (b) Plot TI against $SP500$. What graphical evidence is there of a relationship between TI and $SP500$? Does the relationship appear to be linear? Why or why not?
- (c) Estimate β . What is the interpretation of this estimate in terms of the risk of the stock? Why is Mr. Gagnon interested in this estimate?
- (d) Is the estimate of β obtained in part (c) the actual value of β ? Why or why not?
- (e) Now consider the regression models

$$Hilton_t = \alpha + \beta SP500_t + \epsilon_t \quad \epsilon_t \sim N(0, \sigma^2)$$

where $Hilton_t$ represents the return on Hilton in month t , and

$$Giant_t = \alpha + \beta SP500_t + \epsilon_t \quad \epsilon_t \sim N(0, \sigma^2)$$

where $Giant_t$ represents the return on Giant in month t . How does the beta risk of the three companies compare? If Mr. Gagnon wants to lower the overall market risk of his portfolio should he buy Giant, Hilton or Texas Instruments?

Problem 4 (20 points)

Read the “Milk and Money” case in the course packet. The data file is available on the course website.

Important information:

1. The Federal government, through the Agricultural Marketing Service (AMS), sets the price that dairy farmers receive for different “classes” of milk (these classes are called Class I, Class II, etc.). The prices set by the AMS depend on, among other things, the wholesale price of milk and can vary significantly over a two or three year period. In this problem, we will be concerned only with Class III milk prices.
2. A farmer can purchase a put option that gives him the right but not the obligation to sell a futures contract on Class III milk at the “strike” price on or before the expiration date of the option. This puts a “floor” under the price that the farmer will receive for his Class III milk. He removes the downside risk but still has the upside potential.

For example, suppose the strike price on a December 15 Class III milk put option is \$12/cwt (cwt is a unit of measurement that is roughly 100 pounds of milk). If the AMS price on December 15 is below \$12/cwt, the put option allows the farmer to sell his milk for \$12/cwt. If the AMS price is greater than \$12/cwt then he will sell his milk at the AMS price.

The cost of the put option is the price a farmer must pay someone to take on the downside risk. For example, the cost of a \$12/cwt December 15 put option purchased in June might be \$0.45/cwt.

The farmer must also pay trading costs for purchasing the option (e.g. brokers commission, etc.). For example, the trading cost on a \$12/cwt December 15 option might be \$0.05/cwt.

Strike prices on put options for Class III milk are available every \$0.25. For example, \$11.50/cwt, \$11.75/cwt, \$12/cwt, \$12.25/cwt, etc.

3. For historical and legal reasons, California dairy farmers participate in a California pricing system rather than the federal AMS pricing system. The price a California dairy farmer receives for his milk, called the “mailbox” price, is determined by a complex formula that depends on the value of various dairy products on the wholesale market. The California mailbox price varies a great deal over time just as the federal AMS price does. For example, between 2005 and 2007 the mailbox price varied between \$10.16/cwt and \$19.98/cwt with an average price in 2006 of \$11.28/cwt. The dairy farmer in the case, Gerard, estimates his costs are \$12/cwt so a price of \$11.28/cwt creates a significant financial problem for him.
4. Gerard is interested in hedging his revenue six months in advance and guaranteeing a price of at least \$12/cwt for his milk. For example, in June he wants to hedge his December 15 revenue.
5. Put options on the California mailbox price are not available. The federal Class III milk price is closely related, although not the same as, the California mailbox price

that Gerard will receive. For this reason, Gerard will use put options on the federal Class III milk price to hedge his revenue.

6. Gerard wants the probability to be at least 95% that his revenue will be \$12/cwt or more no matter what the California mailbox price is.

Parts (a) and (b) below provide an example of how to determine the value of a put option on Class III milk on its expiration date. The same idea is used in a slightly more complicated context in parts (c) – (j).

The discussion of put options on pages 6-8 of the case, and in particular the example at the bottom of page 7 and top of page 8 will be helpful in answering parts (a) and (b).

- (a) Suppose Gerard buys a December 15 put option on Class III milk in June with a strike price of \$12/cwt. If the Class III milk price on December 15 is \$11.50/cwt, how much is the put option worth when it expires on this day?
- (b) Suppose the price for the put option in part (a) is \$0.30/cwt and that the trading costs for purchasing the option are \$0.05/cwt. Combining the value of the option obtained in part (a) with the cost information, what is Gerards net gain on the option (i.e. what is the value of the put option minus the option cost and trading cost)?

For parts (c)–(j), suppose Gerard in June decides to hedge his December 15 revenue by purchasing a put option on Class III milk with a strike price of \$14.25/cwt and an expiration date of December 15.

You should do the calculations for parts (c)–(h) assuming the costs of the option are zero. A way to incorporate the additional costs into the hedging process is discussed in parts (i) and (j).

- (c) Plot the Class III milk price against the California mailbox price and add the estimated regression line to the plot. To add the estimated regression line right click on any data point, click on Add Trendline, click on the box above Linear, click on the Options tab, check the box next to Display equation on chart and click OK. What is the equation of the estimated regression line? How much do you expect the Class III milk price to change on average for a \$1/cwt change in the California mailbox price?

For the remainder of the problem use 0.60 as the value of σ (the standard deviation of the error term) and the estimated regression line as if it were the true regression line to answer the following questions.

- (d) What is the probability that Gerards December 15 put option on Class III milk with a strike price of \$14.25 is in the money (i.e. worth something) on December 15 if the California mailbox price on December 15 is \$12.50/cwt?
- (e) Suppose the California mailbox price on December 15 is \$12.00/cwt. What is the probability that the value of the put option will be greater than \$0.50?

- (f) Using your answer to part (e), what is the probability that Gerards net revenue (mailbox price plus payoff from the option) will exceed \$12.50/cwt if the California mailbox price is \$12.00/cwt?
- (g) Now suppose the mailbox price on December 15 is \$11.50/cwt. What is the probability that the value of the put option will be greater than \$1? Using your answer to this question, what is the probability that Gerards net revenue (mailbox price plus payoff from the option) will exceed \$12.50/cwt?
- (h) Is the probability at least 95% that his net revenue (mailbox price plus payoff from the option) will equal or exceed \$12.50/cwt for any mailbox price below \$12.50/cwt? Why or why not?

For parts (i) and (j), suppose the price in June for a December 15 put option on Class III milk with a strike price of \$14.25/cwt is \$0.45/cwt and the trading cost is \$0.05/cwt.

- (i) Is the probability at least 95% that Gerards net revenue (mailbox price plus payoff from the option minus option cost and trading cost) will equal or exceed his production costs of \$12.00/cwt no matter what the California mailbox price is?
- (j) Has Gerard effectively hedged his net revenue (mailbox price plus payoff from the option minus option cost and trading cost) if \$12/cwt is the amount he needs to receive for his milk to cover his production costs?