

Integrated case solutions risk and return assignment



**ASSIGN
BUSTER**

Twelfth Edition, by Eugene F. Brigham and Joel F. Houston, South-Western
Coinage Learning Risk and Return Case. Assume that you recently graduated
with a major in finance. You just landed a job as a financial planner with
Merrill Finch Inc., a large financial services corporation. Your first assignment
is to invest \$100,000 for a client. Because the funds are to be invested in a
business at the end of 1 year, you have been instructed to plan for an 1-year
holding period.

Further, your boss has restricted you to the investment alternatives in the
following table, shown with their probabilities and associated outcomes. (For
now, disregard the items at the bottom of the data; you will fill in the blanks
later.) Note that the estimated returns of U. S. Rubber do not always move
in the same direction as the overall economy. For example, when the
economy is below average, consumers purchase fewer tires than they would
if the economy were stronger.

However, if the economy is in a flat-out recession, a large number of
consumers who were planning to purchase a new car may choose to wait
and instead purchase new tires for the car they currently own. Under these
circumstances, we would expect U. S. Rubber's stock price to be higher if
there was a recession than if the economy was just below average. Merrill
Finch's economic forecasting staff has developed probability estimates for
the state of the economy; and its security analysts have developed a
sophisticated computer program, which was used to estimate the rate of
return on each alternative under each state of the economy.

High Tech Inc. is an electronics firm, Collections Inc. collects past-due debts, and U. S. Rubber manufactures tires and various other rubber and plastics products. Merrill Lynch also maintains a “market portfolio” that owns a market-weighted fraction of all publicly traded stocks; you can invest in that portfolio and thus obtain average stock market results. Given the situation described, answer the following questions and provide your recommendations to your boss. A. (1) Why is the T-bill’s return independent of the state of the economy?

Do T-bills promise a completely risk-free return? Explain. (2) Why are High Tech’s returns expected to move with the economy, whereas Collections’ are expected to move counter to the economy? . Calculate the expected rate of return on each alternative and fill in the blanks on the row for each alternative in the table. You should recognize that basing a decision solely on expected returns is appropriate only for risk-neutral individuals. Because your client, like most people, is risk-averse, the riskiness of each alternative is an important aspect of the decision.

One possible measure of risk is the standard deviation of returns. (1) Calculate this value for each alternative and fill in the blank on the row for each alternative in the table. (2) What type of risk is measured by the standard deviation? (3) Draw a graph that shows roughly the shape of the probability distributions for High Tech, U. S. Rubber, and T- bills. D. Suppose you suddenly remembered that the coefficient of variation (C. V.) is generally regarded as being a better measure of stand-alone risk than the standard deviation when the alternatives being considered have widely differing expected returns.

Calculate the missing C. v. and fill in the blanks on the row for C. V. in the table. Does the C. V. produce the same risk rankings as the standard deviation? Explain. E. Suppose you created a two-stock portfolio by investing \$50, 000 in High Tech and 50, 000 in Collections. (1) Calculate the expected return (Arp), the standard deviation (pop), and the coefficient of variation (Cap) for this portfolio and fill in the appropriate blanks in the table. (2) How does the rockiness of this two-stock portfolio compare with the rockiness of the individual stocks if they were held in isolation? . (1) Should the effects off portfolio impact the way investors think about the rockiness of individual stocks? (2)elf you decided to hold a l-stock portfolio (and consequently were exposed to more risk than diversified investors), could you expect o be compensated for all of your risk; that is, could you earn a risk premium on the part of your risk that you could have eliminated by diversifying? G. The expected rates of return and the beta coefficients of the alternatives supplied by Merrill Finch's computer program are as follows: (1) How are betas used in risk analysis? 2) Do the expected returns appear to be related to each alternative's market risk? (3) Is it possible to choose among the alternatives on the basis of the information developed thus far? Use the data given at the start of the problem to construct a ARPA that shows how the T-bill's, High Tech's, and the market's beta coefficients are calculated. Then discuss what betas measure and how they are used in risk analysis. H. The yield curve is currently flat; that is, long-term Treasury bonds also have a 5. 5% yield. Consequently, Merrill Finch assumes that the risk-free rate is 5. %.

(1) Write out the Security Market Line (SMS) equation, use it to calculate the required rate of return on each alternative, and graph the relationship between the expected and required rates AT return. (2) How AAA ten

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expected rates AT return compare Walt ten required attest of return? (3)

Does the fact that Collections has an expected return that is less than the T-bill rate make any sense? Explain. (4) What would be the market risk and the

required return of a 50-50 portfolio of High Tech and Collections? Of High

Tech and U. S. Rubber? I. 1) Suppose investors raised their inflation

expectations by 3 percentage points over current estimates as reflected in the 5.5% risk-free rate. What effect would higher inflation have on the SMS

and on the returns required on high- and low-risk securities? (2) Suppose

instead that investors' risk aversion increased enough to cause the market risk premium to increase by 3 percentage points. (Inflation remains constant.

) What effect would this have on the SMS and on returns of high- and low-

risk securities? INSTRUCTIONS: 1. This is a group business case consisting of a maximum of 5 members in a group. 2.

From the information gathered in the case, the group must then submit a written report forming analysis, conclusions and recommendations on the case. Incorporate the answers to the following guide questions on the case.

3. Outline: I. INTRODUCTION II. DISCUSSION: (This is the bulk of the paper.

Be sure to include answers to guide questions and support your answers with computations and logical ANALYSIS.) III. CONCLUSION/RECOMMENDATION '

V. REFERENCES: (if any) 4. Format of Written Report: a) Paper size: 8.5" x

11" b) Margin: 1" on all sides c) Font and Font size: Ottoman 11 d) Paragraph

alignment: Justified e) Paragraph spacing: 1. f) Length of written report: 5 to

10 pages, EXCLUDING cover page and attachments g) Attachments: Include

the copy of the business case and other attachments at the end of your

report. h) Insert the entire report in a short sliding folder. i) The cover page

should be as follows: MERRILL FINCH A Group Business case Presented to the Accountancy Department College De San Juan De Lateran In partial fulfillment Of the course requirements In FINANCE SUBMITTED To: (Name of Faculty) SUBMITTED BY: Surname, Given Name, M. I. * Surname, Given Name, M. I.

Date *NOTE: The names should be arranged alphabetically. 5. Deadline of Written Report: HTH class - September 19, 2013 (Thursday) 6. Presentation guidelines Use Powering for your case presentation. Submit printed Powering copy also during the presentation. Each group has a total of 20 minutes: 15 minutes to present and 5 minutes for the question and answer oration. Ensure your Powering file is compatible with the classroom computer. This is to avoid delay and technical problem. Each member of the group should present. Use smart casual attire.

Your team is graded according to the criteria below. 7. Grading for Group Business Case Presentation Criteria Exemplary (100%) Satisfactory (90%) Developing (80%) Beginning (75%) Oral presentation skills- 35% (Includes part, Dustless tattle) The group communicates clearly the content of the report, answers all questions properly and confidently, and generates interest among the audience. The group masticates clearly the content of the report and answers all questions. The group communicates somewhat clearly the content of the report, and fails to answer some of the questions.

The group communicates vaguely the content of the report and fails to answer the questions. Content- 35% (Application of theories and skills learned in FINANCE to the business case The student applies at least 2

FINANCE related theories and skills appropriately and includes only realistic assumptions in the paper. The student applies 2 FINANCE related theories and skills appropriately and includes a few unrealistic assumptions in the paper. The student applies only 1 FINANCE related theories and skills appropriately and includes some unrealistic assumptions in the paper.

The student fails to apply at least 1 FINANCE related theories and skills appropriately and includes many unrealistic assumptions in the paper.

Presentation format- 20% The group follows the presentation format, maximizes the allotted time, and makes use of appropriate presentation tools and techniques. The group follows the presentation format but fails to either maximize the allotted time, or make use of appropriate presentation tools and techniques. The group follows the presentation format but fails to maximize the allotted time, and make use of appropriate presentation tools and techniques.

The group fails to follow the presentation format, maximize the allotted time, and make use of appropriate presentation tools and techniques. Teamwork- 10% The group is organized and shows strong teamwork and camaraderie as evidenced in the presentation The group is organized and shows strong teamwork as evidenced in the presentation The group is somewhat organized and shows a hint of teamwork as evidenced in the presentation The group is disorganized and shows lack of teamwork as evidenced in the presentation 8.

Peer evaluation Grading Each member shall evaluate the group members in accordance with his contribution to team's final output and his attendance

during your meetings. Use the following criteria and format. The rater must sign the form. Contribution to team's final output - (100%) The student contributes to the team's final output more than expected. The student contributes to the team's final output as expected. The student contributes somewhat to the team's final output. The student did not contribute to the team's final output. Name Rating 2. 3. 4. Rated by: Name and signature