Investment

Finance



Investment A). The discount rate is the interest rate that is used in the determination of the present value of all the future cash flows. It can be taken as the interest rates that the banks obtain for their lending from the federal bank or the rate at which banks charge other banks for overnight borrowings. The discount rate is determined by several factors. First is the general economic conditions i. e. the discount rate will increase during periods in which the inflation rates are high or when the foreign exchange rates are volatile (Bierman & Smidt, 2004). The second factor that influences this rate is the marketability of a firm's security. Firms whose securities are on high demand will experience a decline in their discount rates.

b)Product 1 rate of return

The total dividend in a year = 1.5*4 = 6

Year 1 rate of return= 1+discount/nominal price*100

= 1+6/100*100% = 7%

Year 2-4 rater of return= 6/100*100%= 6%

Year 5 rate of return= 6+6. 4/100*100%= 12. 4%

Average rate of return=

= 7.48%

Product 2 rate of return= nominal interest rate

= 6%

Product 3 rate of return

Year 1 rate of return=*100%= 5%

Rear 2 and 3 return= nominal rate = 7%

Product rate of return = = 6.33%

Product 1 looks more attractive because it has the highest rate of return

compared to product 2 and 3.

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c)In making the decisions, it is important that an investor consider the duration of the investment as this will determine the net present value. The longer the investment period, the less attractive the worth of the investment because of the time value of cash flows (Bierman & Smidt, 2004).

d) (I)The real value of the investment is the present value of future cash flows. In this case the inflation rate is used and the discounting rate and since there is nonpayment of a coupon ion the investment, the value of the investment will be the present value of the 100 after 10 years

Real value=-100

=£ (32.44)

The present value of the coupons to be paid for the 10 years= 32. 44 (ii)The coupon payment = = = ± 4

The coupon rate should be 4% per annum i. e. the coupon rate should be equal inflation annual inflation rate.

In conclusion, before determining which investment to pursue, factors like inflation, time and the general economic conditions are important.

Reference

Bierman, H & Smidt, S 2004, The capital budgeting decision: economic analysis of investment projects (6th ed.), Macmillan: New York.