

Session 6: Post class test solutions

- 1. b. Equity risk premiums should rise.** If companies try to manage and manipulate earnings, investors trust those earnings numbers less. If they trust the earnings numbers less, equities will become riskier. Thus, earnings management, in general, even if it makes earnings smoother will make them less reliable and equity risk premiums should rise.
- 2. b. Risk premium is 4.5%, Standard error is 2%.** A risk premium in a hurdle rate will get compounded over time and is therefore better computed using the geometric averages. The standard error is computed by dividing the standard deviation of 20% by the square root of 100.
- 3. a. 11.75% or d. 10.5%.** There are two solutions. My preferred one is to take the default spread and scale it up to reflect the higher risk in equities ($5\% \times 30/24 = 6.25\%$) and to add this to the mature market premium (5.5%). My second best solution is to just add the default spread to the mature market premium ($5.5\% + 5\% = 10.5\%$)
- 4. e. The implied equity risk premium will increase if stock prices decrease while cash flows increase.** Just as lower bond prices translate into higher interest rates, lower stock prices usually translate into higher equity risk premiums. However, if cash flows decrease by more than stock prices drop, the equity risk premium will actually go down.
- 5. d. 8.3%.** The risk free rate is 2%. The equity risk premium is a weighted average of the Mexico and US equity risk premiums: $0.6 (5.5\%) + 0.4 (7.5\%) = 6.3\%$. The overall cost of equity = $2\% + 6.3\% = 8.3\%$.