

CHAPTER 17
COST OF CAPITAL ADVANCED TOPICS

1. (A) **country spread model.**

Explanation

The country spread model uses data from a developed market, then adjusts it using the difference between the bond yields for the emerging and developed markets. Neither a modified Gordon Growth model nor a weighted average cost of capital will do this job.

(Module 17.2, LOS 17.d)

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2. (C) **9.29%.**

Explanation

The capital asset pricing model uses the following equation

Required return = risk-free rate + beta x equity risk premium

To calculate the required return under CAPM, use the Russell 2000 index return, the beta, and the risk-free rate.

Required return = 3.4% + 2.1 x (12.3% - 3.4%) = 22.09%.

The bond-yield model uses the following equation:

Required return = yield to maturity on long-term bonds + risk premium.

Required return = 7.9% + 4.9% = 12.8%.

The difference between the two estimated required returns is 9.29%.

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3. (A) **4.2%.**

Explanation

Equity risk premium = (35.71 / 1,190.45) + (6.2%) — 5.0% = 4.2%

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CFA[®]**4. (C) extemporized estimates.****Explanation**

There are four types of estimates of the equity risk premium: historical estimates, forward-looking (ex-ante) estimates, macroeconomic model estimates, and survey estimates.

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5. (C) Isolating market risk.**Explanation**

Market risk, also known as systematic risk, is the risk common to all assets within a certain class. Deleveraging the beta strips out the company-specific risk related to the target company's leverage, thereby isolating market risk. Beta calculations do not require a baseline level of leverage. The equation for calculating beta for private companies assumes the company in question has high-grade debt. The deleveraging process will not help if the assumption is incorrect.

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6. (C) both increase the size of the risk premium.**Explanation**

Switching from a geometric mean to an arithmetic mean will increase the mean equity return. All else being equal, that will increase the estimated risk premium. When the yield curve slopes upward, short-term bonds yield less than long-term bonds. Thus, the equity risk premium estimate will be larger when short-term bond rates are used.

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7. (C) for expected changes in the foreign country's currency value**Explanation**

The proper method of compensating for changes in exchange rates is to calculate the required return in the home currency, then adjust the return using forecasts for changes in the exchange rate.

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CFA[®]**8. (A) difference between the bond yields of both markets.****Explanation**

The country spread model suggests an analyst can approximate the risk premium between a developed market and an emerging market by subtracting the bond yields in the developed market from yields in the emerging market.

(Module 17.2, LOS 17.d)

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9. (B) determines a risk premium for an emerging market.**Explanation**

The country risk rating model begins with a model from a developed country, then modifies that model with inputs from an emerging market to derive a risk premium for the emerging market. Forecasts of exchange rates may well be part of the model, but they are not a requirement.

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10. (A) the required equity return and the risk-free return.**Explanation**

The equity risk premium reflects the return in excess of the risk-free rate that investors require for holding stocks. It is derived by subtracting the risk-free return from the required return.

(Module 17.1, LOS 17.a)

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11. (B) The stock's estimated return.**Explanation**

The required return for a stock is equal to the risk-free return plus beta times the equity risk premium. An analyst starting from the required return would need beta and a risk-free rate. Historical 10-year T-bond rates can be used as an estimate of the risk-free rate. Since the analyst is starting with the required return, estimated returns are not needed.

(Module 17.2, LOS 17.c)

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