17 COST OF CAPITAL ADVANCED TOPICS

1. When attempting to build a risk premium into the required returns of stocks in a developing country, an analyst should use the:
   (A) country spread model.
   (B) modified Gordon Growth model.
   (C) country's weighted average cost of capital.

2. Equity analyst Yasmine Cordova of Substantial Securities is trying to determine the investment appeal of shares of Maxwell Mincemeat, a small food company. Cordova has assembled the following data about the company:
   - Internal rate of return: 9.4%.
   - Maxwell's 20-year bond yield to maturity: 7.9%.
   - Maxwell's two-year bond yield to maturity: 6.1%.
   - Treasury bill yield: 3.4%.
   - Maxwell's estimated beta: 2.1.
   - Maxwell's 20-year bonds are priced at $102.65.
   - Maxwell's two-year bonds are priced at $101.47.
   - Estimated return of Russell 2000 Index: 12.3%.
   - Substantial's credit analyst estimates that Maxwell's equity warrants a premium of 4.9% over its bonds.

   Cordova wants to make sure her estimates are accurate, so she decides to calculate the estimated required return in two ways. She opts for the bond-yield plus risk premium method and the capital asset pricing model. To check her work, she wants to compare the estimates derived under each method. The difference between the required returns is closest to:
   (A) 5.30%.
   (B) 5.89%.
   (C) 9.29%.

3. Currently the market index stands at 1,190.45. Firms in the index are expected to pay cumulative dividends of 35.71 over the coming year. The consensus 5-year earnings growth forecast for these firms is expected to increase to 6.2% up from last year's forecast of 4.5%. The long-term government bond is yielding 5.0%. According to the Gordon growth model, what is the equity risk premium?
   (A) 4.2%.
   (B) 1.2%.
   (C) 2.5%.

4. Types of estimates of the equity risk premium are least likely to include:
   (A) macroeconomic model estimates.
   (B) ex-ante estimates.
   (C) extemporized estimates.

5. In the process of estimating beta for a private company, unlevering the beta calculated for the publicly traded comparable company accomplishes what goal?
   (A) Establishing a baseline level of leverage.
   (B) Improving the accuracy of the estimate in the event that the private company's debt is of low quality.
   (C) Isolating market risk.

6. Ben Jacobs, CFA, is attempting to calculate a historical equity risk premium. His first estimate uses geometric mean equity returns and long-term bond yields. His second estimate uses arithmetic mean returns and short-term bond yields. The effect of the changes in methodology in the second estimate, relative to the first, will:
   (A) have offsetting effects.
   (B) both decrease the size of the risk premium.
   (C) both increase the size of the risk premium.

7. Junior analyst Quentin Haggard is struggling with a required return calculation. His main concern is compensating for exchange rate fluctuations between the country where his company is based and the home country of a portfolio of stocks he is analyzing. Haggard should calculate the return in his home country's currency, then adjust:
   (A) for expected changes in the foreign country's inflation rate.
   (B) the beta to account for exchange-rate fluctuations.
   (C) for expected changes in the foreign country's currency value.

8. Candace Elwince is attempting to calculate the required return of Skeun Inc., a machine-tool manufacturer in a small Eastern European country. Elwince has solid data from the German market but is not sure how to account for the exchange-rate risk Skeun investors would face.

   Her best choice for creating a risk premium is the:
   (A) difference between the bond yields of both markets.
   (B) Gordon Growth model.
   (C) difference between the inflation rates of both markets.

9. The country risk rating model:
   (A) determines a risk premium for any foreign market.
   (B) determines a risk premium for an emerging market.
   (C) depends on forecasts of exchange rates.

10. The equity risk premium is the difference between:
   (A) the required equity return and the risk-free return.
   (B) estimated equity returns and estimated bond returns.
   (C) the estimated equity return and the risk-free return.

11. An analyst attempting to derive the equity risk premium for a stock starting from the required return for that stock would find which of the following statistics least useful?
   (A) Historical 10-year Treasury bond rates.
   (B) The stock's estimated return.
   (C) The stock's beta.