Part III Equities

THE CAPITAL ASSET PRICING MODEL

1. Answer is (c)

2. If the stock has an alpha of 1%, it is expected to outperform its CAPM return of 6% + (expected return on market – 6%) x 2.0. So, 20% = 1% + 6% +2(E(Rm) – 6%). Solving, gives E(Rm) = 12.5%.

   Answer is (c)

3. Using the CAPM, gives E (R) = 8% + 2(15% - 8%) = 22%. Using the Gordon Growth Model with g = 5% and D1/P0 = 5%, gives an expected return of 10%. Comparing with 22% gives an overvaluation using the CAPM of 12%.

   Answer = (a)

4. Answer is (d)

5. An increased use of equity versus debt will decrease the leverage of the Company. Hence it will do better in bad markets but not so well in good markets.

   Answer is (d)