Which type of projects are good candidates for calculating the equivalent annual annuity?

YOU ANSWERED: **CONFIDENT**

**CORRECT ANSWER**

(C) mutually exclusive, repeatable projects with differing time lengths

**EXPLANATION**

If projects are mutually exclusive and repeatable, than the impact of the differing time lengths must be accounted for by comparing their EAA.

What is the internal rate of return (IRR)?

YOU ANSWERED: **CONFIDENT**

**CORRECT ANSWER**

(B) the return received over the life of our investment

**EXPLANATION**

Internal rate of return (IRR) is a widely used capital budgeting technique; essentially, it is the return we will receive over the life of our investment.

Which of the following is used for expected rate of return?

**CORRECT ANSWER**

(B) the weighted mean of the possible investment outcomes

**EXPLANATION**

When we talk of expected rate of return, we will use the weighted mean of the possible investment outcomes; that is, each possible outcome weighted by the probability of that outcome.

What does the semi-strong form of the efficient market hypothesis (EMH) argue?

**CORRECT ANSWER**

(A) All public information has been accounted for by the market.

**EXPLANATION**

The semi-strong form of the EMH argues that all public information has been accounted for by the market (including financial analysis of released statements and analysts' forecasts). If the semi-strong form is true, than investments based upon the fundamentals of a company shouldn't be able to earn excess profits. Most academics tend to embrace the semi-strong form, though many Wall Street traders reject it.

When calculating the expected rate of return, what is each possible outcome weighted by?

**CORRECT ANSWER**

(A) the probability of the outcome

**EXPLANATION**

When we talk of expected rate of return, we will use the weighted mean of the possible investment outcomes; that is, each possible outcome weighted by the probability of that outcome.

Which of the following is true if semi-strong form of the efficient market hypothesis (EMH) is true?

**CORRECT ANSWER**

(D) Investments based upon the fundamentals of a company shouldn't be able to earn excess profits.

**EXPLANATION**

The semi-strong form of the EMH argues that all public information has been accounted for by the market (including financial analysis of released statements and analysts' forecasts). If the semi-strong form is true, than investments based upon the fundamentals of a company shouldn't be able to earn excess profits. Most academics tend to embrace the semi-strong form, though many Wall Street traders reject it.

What is one major critique of the capital asset pricing model (CAPM)?

**CORRECT ANSWER**

(D) It ignores systematic risk factors outside of market risk.

**EXPLANATION**

One general critique of CAPM is that there are systematic risk factors beyond just market risk. For example, some multi-factor models (such as including a variable for company size) seem to be better predictors of expected returns.

What is the term for all costs incurred by the issuing and selling of a security?

**CORRECT ANSWER**

(D) flotation costs

**EXPLANATION**

Flotation costs are the costs of issuing and selling a security. Typical costs include both underwriting and administrative costs.

Which method for calculating the cost of equity makes an estimation based on historic data about cost of debt?

**CORRECT ANSWER**

(A) the debt plus risk premium model

**EXPLANATION**

The debt plus risk premium model makes an estimation based on historic data about cost of debt. If we know that, historically, our stock has traded at a particular premium to our cost of debt, we can use that relationship to estimate our cost of equity. If our stock isn't publically traded, we can estimate based upon competitors' data or industry averages.

What does the debt plus risk premium model use to make an estimation?

**CORRECT ANSWER**

(B) historic data about the cost of debt

**EXPLANATION**

The debt plus risk premium model makes an estimation based on historic data about cost of debt. If we know that, historically, our stock has traded at a particular premium to our cost of debt, we can use that relationship to estimate our cost of equity. If our stock isn't publically traded, we can estimate based upon competitors' data or industry averages.

What is used to estimate the cost of equity in the debt plus risk premium model if a stock isn't publicly traded?

**CORRECT ANSWER**

(D) industry averages

**EXPLANATION**

The debt plus risk premium model makes an estimation based on historic data about cost of debt. If we know that, historically, our stock has traded at a particular premium to our cost of debt, we can use that relationship to estimate our cost of equity. If our stock isn't publically traded, we can estimate based upon competitors' data or industry averages.

How does financial leverage increase risk?

**CORRECT ANSWER**

(D) Debt increases the variability of potential returns.

**EXPLANATION**

Financial leverage increases risk because borrowing funds increases the variability of returns.

Why is increased risk a result of financial leverage?

**CORRECT ANSWER**

(C) Because debt increases the variability of potential returns.

**EXPLANATION**

Financial leverage increases risk because borrowing funds increases the variability of returns.

What is a stock split?

**CORRECT ANSWER**

(B) a financial transaction that decreases the stock price

**EXPLANATION**

Stock splits are not a dividend but instead a financial transaction which decreases the stock price. When a company does a stock split, they increase the number of shares held by each stockholder.