Possible Answers for Exercise I - MAN 322

1. You should not join the ranks of A-Fund immediately because if A-Fund is very risky (yield is 10% percent more than the safe one), the current yield could reflect an earlier capital loss.

2. a. Value=$10000; current yield=600/10000=6%.
b. Value=$600/\frac{1}{1.05} + \frac{600}{1.05^2} + \frac{600}{1.05^3} = $10354.6; current yield=600/10354.6=5.79%.
c. Value=$\frac{600}{1.05} + \frac{600}{1.05^2} + \frac{600}{1.05^3} = $10272.33; (600+272.33)/10000=8.72%; total rate of return a year ago=[600+(10272.33-10354.6)]/10354.6=5%.

3. The news of the settlement reduces the default risk on any Hitechco debt. The default risk premium on Hitechco bonds should then fall, reducing the yield and increasing the bond’s price.

4. a. The supply curve for bonds shifts to the right due to new bonds issued by government and firms to cover expenses or investments, hence the real interest rate raises.
b. The supply curve for bonds shifts to the left since this policy expectation discourages firms to invest as they are taxed further, thus the real interest rate reduces.
c. The demand curve for bonds shifts to the left since households don’t want to be taxed for their savings and decrease their bond demands and this cause the real interest rate to raise.