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Week 2 Quiz answers

1. Is inflation always good or bad? Explain your answer with one example.
   Inflation of less than 2% can be a good thing. In a recession, the inflation rate was close to 5%. However, incredibly high inflation means that the value of our money is worthless. An example of what would happen with a relatively stable currency in terms of inflation would be that capital investment would increase, and asset productivity would rise.

2. In your own words, define deflation.
   Deflation is a decrease in the general price level of goods and services.

3. List and describe three ways to measure risk.
   The Arithmetic Average Return is the sum of all the returns for the years divided by the number of years, R, over n periods.
   Standard Deviation is the square root of the variance. It is a statistic that looks at how far from the mean a group of numbers is.
   The Coefficient of Variation (CV) is a measure of risk per unit of return. It is the standard deviation of returns divided by average return.

4. What is a portfolio?
   A portfolio is any combination of financial assets or investments.

5. How does the correlation between assets affect portfolio variance?
   Lower portfolio variability arises from the benefits of diversification. It is the greatest when asset returns have negative correlations.
   A negative correlation exists when two-time series tend to move in opposite directions.
   A positive correlation exists when stocks move in the same direction.

6. Why should investors consider investing in a way that cuts across assets, industries, and country borders?

We can look beyond our national borders and include non-U.S. assets in the portfolio to gain some additional reduction in portfolio risk since the world's economies and financial markets do not move in unison.

7. What is the difference between systemic and unsystematic risk?
   Unsystematic risk is that which can be diversified away as assets are added to a portfolio; also known as firm-specific or industry-specific risk
   Systematic risk (market risk) is that which is inherent in the macroeconomy and cannot be eliminated through diversification

8. What is beta?
   Beta is the measure of an asset's systematic risk.

9. What is the relationship between systemic risk and a portfolio's variability relative to the market portfolio?
   In a well-diversified portfolio, the only risk that remains is the systematic risk (that is, the sensitivity of the asset's returns to macroeconomic events). This means the only risk that should matter to financial markets is a systematic risk.

10. What is the relationship between a project's cost of capital and its minimum required rate of return?
    Since a cash flow, or return, to an investor represents a cash outflow or a cost, to the firm, the minimum required rate of return is a weighted average of the firm's costs of various sources of capital. Thus, the required rate of return on a project is equivalent to the project's cost of capital.

11. What are three measurable influences on a company's growth?
    The measurable influences on a company's growth are dividend policy (as reflected in the retention rate), profitability (as measured by ROA), and the firm's capital structure (as measured by the equity multiplier).

12. How is EBIT/EPS analysis useful to managers?
    EBIT fluctuates over time, depending on sales growth, industry competitive conditions, and the firm's operating leverage. Variations in EBIT will produce changes in earnings per share. Should the firm's expected EBIT lie above the indifference EBIT level, the firm's managers will need to consider the potential variation of earnings in their EBIT forecast. Depending on its uncertainty, management may decide to use a more conservative financing strategy with less debt.