Chapter 11 - Practice Questions

1. _____ a relationship between expected return and risk.
   A) APT stipulates
   B) CAPM stipulates
   C) Both CAPM and APT stipulate
   D) Neither CAPM nor APT stipulate
   E) No pricing model has found

2. The exploitation of security mispricing in such a way that risk-free economic profits may be earned is called _____.
   A) arbitrage
   B) capital asset pricing
   C) factoring
   D) fundamental analysis
   E) none of the above

3. An investor will take as large a position as possible when an equilibrium price relationship is violated. This is an example of _____.
   A) a dominance argument
   B) the mean-variance efficiency frontier
   C) a risk-free arbitrage
   D) the capital asset pricing model
   E) none of the above

4. The APT differs from the CAPM because the APT _____.
   A) places more emphasis on market risk
   B) minimizes the importance of diversification
   C) recognizes multiple unsystematic risk factors
   D) recognizes multiple systematic risk factors
   E) none of the above

5. Consider the multifactor model APT with two factors. Portfolio A has a beta of 0.75 on factor 1 and a beta of 1.25 on factor 2. The risk premiums on the factor 1 and factor 2 portfolios are 1% and 7%, respectively. The risk-free rate of return is 7%. The expected return on portfolio A is _____if no arbitrage opportunities exist.
   A) 13.5%
   B) 15.0%
   C) 16.5%
   D) 23.0%
   E) none of the above

Use the following to answer questions 6-7:

Consider the multifactor APT. There are two independent economic factors, F_1 and F_2. The risk-free rate of return is 6%. The following information is available about two well-diversified portfolios:

Portfolio	β on F_1	β on F_2	Expected Return
A	1.0	2.0	19%
B	2.0	0.0	12%

6. Assuming no arbitrage opportunities exist, the risk premium on the factor F_1 portfolio should be _____.
   A) 3%
   B) 4%
   C) 5%
   D) 6%
   E) none of the above

7. Assuming no arbitrage opportunities exist, the risk premium on the factor F_2 portfolio should be _____.
   A) 3%
   B) 4%
   C) 5%
   D) 6%
   E) none of the above

8. A well-diversified portfolio is defined as
   A) one that is diversified over a large enough number of securities that the nonsystematic variance is essentially zero.
   B) one that contains securities from at least three different industry sectors.
   C) a portfolio whose factor beta equals 1.0.
   D) a portfolio that is equally weighted.
   E) all of the above.

9. Which of the following is (are) true regarding the APT?

   I) The Security Market Line does not apply to the APT.
   II) More than one factor can be important in determining returns.
   III) Almost all individual securities satisfy the APT relationship.
   IV) It doesn't rely on the market portfolio that contains all assets.
   A) II, III, and IV
   B) II and IV
   C) II and III
   D) I, II, and IV
   E) I, II, III, and IV

10. Consider the one-factor APT. The standard deviation of returns on a well-diversified portfolio is 22%. The standard deviation on the factor portfolio is 14%. The beta of the well-diversified portfolio is approximately _____.
    A) 0.80
    B) 1.13
    C) 1.25
    D) 1.57
    E) none of the above

Answer Key

1. C
2. A
3. C
4. D
5. C
6. A
7. C
8. A
9. A
10. D