NAME:____

BEM 103 QUIZ 2

Financial literacy

1. What is an Arbitrage opportunity

a trade that profits by exploiting price differences without taking any risk; there are no arbitrage opportunities in perfect markets

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An investor is asked to contribute a million dollars to a movie. The movie will be finished in a year and then sold to a distributor. If the film is a success (probability 0.2) it will make 11 million dollars over all other costs, if it is a failure it will make nothing (probability 0.8).

2. What is the expect value of the project?

*EV=0.2*11+0.8*0=2.2 million.* Also acceptable *2.2 million/(1+r)*
-1 million+2.2 million/(1+r) is the NPV of the project, not its expected value

3. If the investor has an alternative investment that yields 10% a year and is risk neutral what is the minimum equity stake that he will accept to participate in the project.?

*Alternative return 1*1.1=1.1 million Aggregate return 2.2million, Minimum equity state 2.2/1.1 =0.5 Investor has to be given ownership of half the movie.*

4. Suppose six month into the project, the United States in retaliation for France's preference for French content material on TV places a ban on film exports to France. Revenues will then fall by 5%. Should the investor sell his stake?

The only news is a decline in revenue. The investor and everyone else knows this. So the "price' will adjust downwards from P to 0.95P.

His expected payout was X(1.1 million) and it is now 0.95X (1.045 million). He did not want to sell X because U(P)< U(X) he is not going to want to sell U(0.95P)<U(0.95X). So he has has no reason to sell.