Chapter 9 - Practice Questions

1. According to the Capital Asset Pricing Model (CAPM) a well diversified portfolio's rate of return is a function of
   A) market risk
   B) unsystematic risk
   C) unique risk.
   D) reinvestment risk.
   E) none of the above.

2. Which statement is **not** true regarding the Capital Market Line (CML)?
   A) The CML is the line from the risk-free rate through the market portfolio.
   B) The CML is the best attainable capital allocation line.
   C) The CML is also called the security market line.
   D) The CML always has a positive slope.
   E) All of the above statements are true.

3. The Security Market Line (SML) is
   A) the line that describes the expected return-beta relationship for well-diversified portfolios only.
   B) also called the Capital Allocation Line.
   C) the line that is tangent to the efficient frontier of all risky assets.
   D) the line that represents the expected return-beta relationship.
   E) the line that represents the relationship between an individual security's return and the market's return.

4. Your personal opinion is that security X has an expected rate of return of 0.11. It has a beta of 1.5. The risk-free rate is 0.05 and the market expected rate of return is 0.09. According to the Capital Asset Pricing Model, this security is
   A) underpriced.
   B) overpriced.
   C) fairly priced.
   D) cannot be determined from data provided.
   E) none of the above.

5. You invest $600 in security A with a beta of 1.2 and $400 in security B with a beta of 0.90. The beta of the resulting portfolio is
   A) 1.40
   B) 1.00
   C) 0.36
   D) 1.08
   E) 0.80

6. The risk-free rate is 5 percent. The expected market rate of return is 11 percent. If you expect stock X with a beta of 2.1 to offer a rate of return of 15 percent, you should
   A) buy stock X because it is overpriced.
   B) sell short stock X because it is overpriced.
   C) sell stock short X because it is underpriced.
   D) buy stock X because it is underpriced.
   E) none of the above, as the stock is fairly priced.

7. The expected return – beta relationship of the CAPM is graphically represented by
   A) the security market line.
   B) the capital market line.
   C) the capital allocation line.
   D) the efficient frontier with a risk-free asset.
   E) the efficient frontier without a risk-free asset.

8. Your opinion is that security C has an expected rate of return of 0.106. It has a beta of 1.1. The risk-free rate is 0.04 and the market expected rate of return is 0.10. According to the Capital Asset Pricing Model, this security is
   A) underpriced.
   B) overpriced.
   C) fairly priced.
   D) cannot be determined from data provided.
   E) none of the above.

9. You invest 50% of your money in security A with a beta of 1.6 and the rest of your money in security B with a beta of 0.7. The beta of the resulting portfolio is
   A) 1.40
   B) 1.15
   C) 0.36
   D) 1.08
   E) 0.80

10. Security A has an expected rate of return of 0.10 and a beta of 1.3. The market expected rate of return is 0.10 and the risk-free rate is 0.04. The alpha of the stock is
    A) 1.7%.
    B) -1.8%.
    C) 8.3%.
    D) 5.5%.
    E) none of the above.

Answer Key

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