PAPER # 3

Instructions: Answer all questions. Each question carries 10 marks.

Question 1

Define the following terms:

- Investment
- Portfolio
- Asset allocation
- Risk-return trade-off
- Capital market

Answers:

- Investment: An investment is anything that you buy in the hope of generating income or capital appreciation in the future.
- Portfolio: A portfolio is a collection of investments that an investor holds.
- Asset allocation: Asset allocation is the process of dividing your investment portfolio into different asset classes, such as stocks, bonds, and cash.
- Risk-return trade-off: The risk-return trade-off is the relationship between the risk and return of an investment. Higher-risk investments typically offer the potential for higher returns, while lower-risk investments typically offer the potential for lower returns.
- Capital market: The capital market is a financial market where investors can buy and sell long-term securities, such as stocks and bonds.

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Question 2

Explain the different types of investment analysis.

Answers:

There are two main types of investment analysis: fundamental analysis and technical analysis.

- Fundamental analysis: Fundamental analysis involves examining the financial and economic performance of a company to assess its intrinsic value.
- Technical analysis: Technical analysis involves examining the historical price and volume data of a security to identify patterns that may predict future price movements.

PAPER # 5

Section A - Multiple Choice (40 Marks)

Choose the best answer for each of the following questions:

1. Which of the following is not a primary financial market security?
   a. Common stock
   b. Treasury bills
   c. Corporate bonds
   d. Preferred stock

2. What is the primary goal of portfolio diversification?
   a. Maximizing returns
   b. Minimizing risk
   c. Reducing taxes
   d. Increasing leverage

3. Beta measures a stock's:
   a. Total risk
   b. Systematic risk
   c. Unsystematic risk
   d. Dividend yield

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4. The Capital Asset Pricing Model (CAPM) is used to:
   a. Calculate the standard deviation of a portfolio
   b. Determine the required rate of return for a security
   c. Estimate the earnings per share for a company
   d. Assess the liquidity of a stock

5. A limit order to buy is placed below the current market price. What is it called?
   a. Stop order

Section B: Short Answer Questions (20 points)

4. Explain the concept of "risk-return trade-off" in the context of investing. Provide an example.

Answer: The risk-return trade-off refers to the relationship between the level of risk and the potential return associated with an investment. Generally, higher-risk investments have the potential for higher returns, but they also come with a greater chance of loss. For example, investing in a startup company is riskier but may offer substantial returns, while investing in government bonds is less risky but offers lower returns. Investors must balance their risk tolerance with their return expectations when making investment decisions.

5. Describe the difference between systematic risk and unsystematic risk in a portfolio.

Answer: Systematic risk, also known as market risk, is the risk that cannot be eliminated through diversification. It is associated with factors that affect the entire market, such as economic conditions, interest rates, and political events. Unsystematic risk, on the other hand, is specific to individual assets or industries and can be reduced or eliminated through diversification. For example, if you hold a portfolio of technology stocks, a technology sector-specific issue is unsystematic risk, while general market fluctuations are systematic risk.

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Section C: Essay Question (15 points)

6. Discuss the Modern Portfolio Theory (MPT) and its key concepts. How does it guide investment decisions in portfolio management?

**Answer: Modern Portfolio Theory (MPT) is a framework developed by Harry Markowitz that emphasizes the importance of diversification in portfolio management. The key concepts of MPT include asset allocation and the efficient frontier. MPT suggests that by selecting a mix of assets with different risk and return profiles, investors can create portfolios that maximize returns for a given level of risk or minimize risk for a given level of return. It quantifies risk and return through the use of standard deviation and correlation coefficients. MPT guides investment decisions by encouraging diversification and the optimization of portfolios to achieve the best risk-return trade-off.

5. Which of the following types of risk can be mitigated through diversification?

a. Systematic risk

b. Unsystematic risk

c. Market risk

d. Inflation risk

Section B: Short Answer (4 points each)

6. Explain the concept of risk-return trade-off in the context of investments.

7. Describe two common methods for analyzing the risk associated with an investment or a portfolio.

Section C: Essay Questions (10 points each)

8. Discuss the Efficient Market Hypothesis (EMH). What are the three forms of EMH, and how does each form relate to the availability of information in the market?

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Answer:

The Efficient Market Hypothesis (EMH) is a theory that suggests that financial markets are highly efficient in reflecting available information in stock prices. There are three forms of EMH:

- Weak Form EMH: This form posits that all past trading information, such as historical stock prices and trading volume, is already reflected in stock prices. In other words, it assumes that technical analysis is not effective in predicting future price movements.

- Semi-Strong Form EMH: In this form, it is believed that all publicly available information, including not only historical trading data but also all public information, is already incorporated into stock prices. It implies that neither technical analysis nor fundamental analysis can consistently yield abnormal returns because the information is already reflected in the stock's price.