ANSWER OUTLINE

ECONOMICS 353 **L. Tesfatsion/Fall 07**
EXERCISE 8: 8 Questions (8 Points Total) **DUE: Tues, Oct 30, 2007, 2:10pm**

****IMPORTANT REMINDER: LATE ASSIGNMENTS WILL NOT BE ACCEPTED – NO EXCEPTIONS****

EXERCISE INSTRUCTIONS:

- (1) Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **353 Exercise 8** in the top margin of Side 1.
- (2) Use a number 2 pencil to **mark your answers on Side 1 of the bubble sheet to all eiqht questions Q1 through Q8, below**, which are in multiple choice format. There is no Web Exercise question for Exercise 8.
- (3) Each question Q1 through Q8 is worth 1 point.

Q1. As discussed in class, the ONE-PERIOD VALUATION MODEL FOR COMMON STOCKS presented in Mishkin, Chapter 7, EQUATION (1), implies that the current price of a stock share equals

A. the average expected dividend payment per period.

B. the average expected dividend payment plus capital gains (or losses) per period.

C. the value of next period's expected dividend payment plus next period's expected share sale price discounted by the yield to maturity.

D D. the value of next period's expected dividend payment plus next period's expected share sale price discounted by the required return on investments in equity.

Q2. As discussed in class, the GENERALIZED DIVIDEND VALUATION MODEL presented in Mishkin Chapter 7, EQUATION (2), implies that the price P_n of a stock share in a distant time period n will NOT have any significant effect on the current share price P_0

A. under any circumstances.

B. if investors have rational expectations.

C C. if the price P_n increases more slowly than the discount factor $(1 + k_e)^n$ as n increases.

D. if the stock share pays a positive dividend in each period.

Q3 (1 Point). As discussed in class, if the GENERALIZED DIVIDEND VALUATION MODEL presented in Mishkin Chapter 7, EQUATION (3), is valid for a particular stock S, this implies

A. stock S will definitely pay positive dividends to its shareholders in future time periods.

B **B.** there is no price bubble on stock S.

C. investors in stock S have strong-form rational expectations.

D. all of the above.

E. only B and C.

Q4. The GORDON GROWTH MODEL discussed by Mishkin on pages 153-154 is derived from the generalized dividend valuation model, Mishkin Chapter 7, Equation (3), under the special assumption that

A. the expected dividend growth rate g increases.

B. the required return on equity investment k_e increases at a constant rate.

C **C.** dividends are expected to grow at a constant rate g.

D. dividends are constant over time.

E. none of the above.

Q5. The view that expectations are formed from past experience as some kind of weighted average of past observations, known as ______, implies that _________.

A. optimal statistical forecasting; information is used optimally.

B **B.** adaptive expectations; expectations tend to change slowly over time.

C. rational expectations; all relevant information is taken into account.

D. perfect foresight expectations; forecast errors have small standard deviations.

E. extrapolative expectations; forecast errors are sequentially independent.

Q6. The key assumption characterizing RATIONAL EXPECTATIONS is that

A. people do not make use of past observations because these observations are out-of-date.

B B. people make optimal use of their information when forming their expectations.

C. people do not make sudden changes in their expectations.

D. people are able to forecast future events without error.

E. only B anc D.

Q7. As discussed in class, an important implication of the stronger version of the EFFICIENT MARKET HYPOTHESIS presented in Mishkin Chapter 7 (page 162) is that stock market investors

A. should act quickly to take advantage of "hot tips" in published reports by investment advisors.

B. should pay close attention to trends and patterns in past stock price data.

C C. should not expect to be able to earn returns in the stock market that are persistently higher than the general market average.

D. should not follow a "buy and hold" strategy since such an overly cautious approach will leave unexploited profit opportunities.

E. should never buy into a mutual fund, because such funds cannot consistently outperform the market.

Q8 (1 Point). As discussed in Mishkin Chapter 7, the Efficient Market Hypothesis remains controversial because of the persistence of stock market ANOMALIES that appear to contradict the predictions of the EMH. Examples of these anomalies include:

A. Stock prices tend to fluctuate more than their associated dividend payment streams.

B. Stock prices sometimes fall after receipt of good news.

C. Stock prices do not always instantaneously adjust to profit announcements.

D. All of the above.

E E. Only A and C.