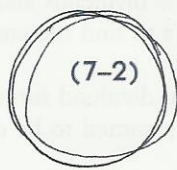


Questions

- (7-1) Define each of the following terms:
- Proxy; proxy fight; takeover; preemptive right; classified stock; founders' shares
 - Closely held stock; publicly owned stock
 - Intrinsic value (\hat{P}_0); market price (P_0)
 - Required rate of return, r_s ; expected rate of return, \hat{r}_s ; actual, or realized, rate of return, \bar{r}_s
 - Capital gains yield; dividend yield; expected total return
 - Normal, or constant, growth; supernormal, or nonconstant, growth; zero growth stock
 - Preferred stock
 - Equilibrium; Efficient Markets Hypothesis (EMH); three forms of EMH
 - Purely rational behavior; animal spirits; herding instincts; anchoring; behavioral finance



- (7-2) Two investors are evaluating General Electric's stock for possible purchase. They agree on the expected value of D_1 and also on the expected future dividend growth rate. Further, they agree on the risk of the stock. However, one investor normally holds stocks for 2 years and the other normally holds stocks for 10 years. On the basis of the type of analysis done in this chapter, they should both be willing to pay the same price for General Electric's stock. True or false? Explain.

- (7-3) A bond that pays interest forever and has no maturity date is a perpetual bond, also called a perpetuity or a consol. In what respect is a perpetual bond similar to (1) a no-growth common stock and (2) a share of preferred stock?

- (7-4) In this chapter and elsewhere we have argued that a stock's market price can deviate from its intrinsic value. Discuss the following question: If all investors attempt to behave in an entirely rational manner, could these differences still exist? In answering this question, think about information that's available to insiders versus outsiders, the fact that historical probabilities of financial events are "fuzzier" than probabilities related to physical items, and the validity of the concepts of animal spirits, herding, and anchoring.

Self-Test Problems

Solutions Appear in Appendix A

- (ST-1) **Constant Growth Stock Valuation**
Ewald Company's current stock price is \$36, and its last dividend was \$2.40. In view of Ewald's strong financial position and its consequent low risk, its required rate of return is only 12%. If dividends are expected to grow at a constant rate g in the future, and if r_s is expected to remain at 12%, then what is Ewald's expected stock price 5 years from now?
- (ST-2) **Supernormal Growth Stock Valuation**
Snyder Computer Chips Inc. is experiencing a period of rapid growth. Earnings and dividends are expected to grow at a rate of 15% during the next 2 years, at 13% in the third year, and at a constant rate of 6% thereafter. Snyder's last dividend was \$1.15, and the required rate of return on the stock is 12%.
- Calculate the value of the stock today.
 - Calculate \hat{P}_1 and \hat{P}_2 .
 - Calculate the dividend yield and capital gains yield for Years 1, 2, and 3.