

The Little Case

AN INVESTMENT SITUATION MINI-CASE

Lucas Little has been asked by his client to review the financial statements of Stuff Stores Company. Mr. Little's client is considering making a substantial purchase of Stuff Stores stock. Before doing so, the client would like to know a bit more about the financial stability of the company. The information in Table VI.6 should be used to conduct a basic analysis of Stuff Stores' financial situation.

Table VI.6 Annual Financial Data for Stuff Stores Company (\$ millions)

Financial Attribute	Year 1	Year 2	Current
Market capitalization	200,000.5	212,234.0	249,926.5
Total sales	139,208.0	166,809.0	193,295.0
Net income (earnings)	4,430.0	5,377.0	6,295.0
Dividends per share	.16	.20	.24
Shares outstanding	4,474.8	4,443.8	4,464.5
Total assets	64,654.0	70,349.0	78,130.0
Debt	16,891.0	18,712.0	18,824.0
Shareholder's equity	19,136.0	24,216.0	31,343.0
Cash flow	7,580.0	8,194.0	9,604.0

Other relevant data include:

- Beta for Stuff Stores stock: .85
- Standard deviation for Stuff Stores stock: 14.5%
- Average return for Stuff Stores stock: 10.5%

782 Case Approach to Financial Planning

- Risk-free rate of return: 4.0%
- Return on the market: 9.0%

Information on similar stocks is shown in Table VI.7.

Table VI.7 Data for Similar Stocks

Company	Stock Beta	Stock Standard Deviation	Average Stock Return
Wigwam Stores, Inc.	.90	15.5%	8.0%
Maryland Markets	.80	12.0%	9.0%
Pacific Mercantile, Inc.	.89	15.0%	11.0%

Please use this information to answer the following questions:

Case Questions

1. Based on current information, what is the net profit margin for Stuff Stores?
 - a. 1.98%
 - b. 2.97%
 - c. 3.26%
 - d. 3.56%
 - e. 3.88%
2. Based on current information, the price to earnings ratio (P/E) for one share of Stuff Stores stock is:
 - a. 1.29
 - b. 7.97
 - c. 20.08
 - d. 26.02
 - e. 39.70
3. When comparing Stuff Stores stock to similar stocks in the market, which has the highest required rate of return?
 - a. Stuff Stores Company.
 - b. Wigwam Stores, Inc.

- c. Marryland Markets.
 - d. Pacific Mercantile, Inc.
 - e. Stuff Stores Company and Pacific Mercantile, Inc. are the same.
4. Based solely on past performance compared to the required rate of return, which stock should Mr. Little's client avoid?
- a. Stuff Stores Company.
 - b. Wigwam Stores, Inc.
 - c. Marryland Markets.
 - d. Pacific Mercantile, Inc.
 - e. Both Marryland Markets and Pacific Mercantile, Inc.
5. Mr. Little would like to rank the four stocks in a standardized way before making a recommendation to his client. Using the average stock return data provided, rank the four stocks from highest to lowest using the Sharpe ratio.
- I. Stuff Stores Company. .448
 - II. Wigwam Stores, Inc. .258
 - III. Maryland Markets. .147
 - IV. Pacific Mercantile, Inc. .467
- a. II, III, I, and IV
 - b. IV, III, II, and I
 - c. III, I, IV, and II
 - d. IV, I, III, and II
 - e. I, IV, III, and II
6. Mr. Little's client has noticed that the price of Stuff Stores Company stock has remained steady during the past six months. He is convinced that the stock will continue to trade in a narrow range. He would like to make money on the stock, however. Which of the following strategies will cause Mr. Little's client to experience the greatest potential loss if Stuff Stores' stock price begins to fluctuate more widely?
- a. Selling a naked put option.
 - b. Selling a naked call option.
 - c. Selling a covered call option.

- d. Buying a call option.
 - e. Buying shares in Stuff Stores Company directly.
7. Assume that Mr. Little's client decides to purchase shares in Stuff Stores stock to add to his sizable portfolio. The client tells Mr. Little that he does not want to incur the cost of selling the stock or the entire portfolio. The client also does not want to risk mistiming the market should stock prices start to fall. One strategy for the client to protect against a possible decline in both Stuff Stores stock price and the value of the portfolio would be to
- a. buy an index call option.
 - b. sell an index call option.
 - c. buy an index put option.
 - d. sell an index put option.
 - e. avoid all options strategies because the client cannot protect against the decline with these options.
8. If the market risk premium were to increase, the value of common stock, including Stuff Stores Company stock, (holding all other factors constant) would¹
- a. not change because this does not affect stock values.
 - b. increase to compensate the investor for increased risk.
 - c. increase because of higher risk-free rates.
 - d. decrease to compensate the investor for increased risk.
 - e. decrease because of lower risk-free rates.
9. Mr. Little thinks that he has found an interesting bond investment for his client's portfolio. Mr. Little, when searching for investment ideas, focused on his client's goal of return maximization. The bond has a face value of \$1,000 with a maturity date in seven years. The bond's coupon rate is 6.25% compounded annually. Today, the bond sells for \$1,185.00. The indenture agreement states that the bond can be called for \$1,100 after five years. Which of the following statements is (are) true?
- a. The current yield is greater than both the yield to maturity and yield to call.
 - b. Given the client's investment objective, this bond should do particularly well if interest rates start to increase.

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- c. Mr. Little can lock in a yield to maturity that is higher than the current yield by purchasing the bond today.
 - d. The value of the bond today in comparison to the spread in the yield to maturity and the current yield indicates tht this bond will not be called early.
10. According to the dividend growth model method of stock valuation, which of the following statements is true, assuming that Mr. Little's client has a required rate of return of 16% and that the dividend has grown from .16 to .24 in three years?
- I. The current Stuff Stores stock price exceeds the calculated value.
 - II. The current Stuff Stores stock price is less than the calculated value.
 - III. Using the dividend growth model as the only measure, the Stuff Stores stock is undervalued.
 - IV. The market price and the calculated value for Stuff Stores match closely, as expected given the high degree of efficiency in the markets.
- a. I only
 - b. III only
 - c. II and III only
 - d. III and IV only