Economics 322 - Fall 2014
Exercise Sheet 4 (Assignment 1 – 10% of your final grade)
Instructor: Robert J. McKeown

You are expected to have read Elton & Gruber chapter 10 and 12.
We have skipped EG Ch. 11 – it is not examinable.

The following questions are due on October 10th by 1:00pm. A dropbox will be setup on the second floor of Dunning Hall.

EG 9th Edition:
1. EG Chapter 12 Question 2. (30 marks)
2. EG Chapter 12 Question 3. (30 marks)

EG 8th Edition:
1. EG Chapter 12 Question 3. (30 marks)
2. EG Chapter 12 Question 4. (30 marks)

The questions from the 8th edition and 9th edition are the same: only the numbering is different.

Please read the article "Long-Term Investing" by Andrew Smithers. A direct link is also available on the course website.

http://blogs.ft.com/andrew-smithers/2014/08/long-term-investing/

Students are entitled to a free subscription to the Financial Times through Queen's University. Visit the website using a campus server and register using your Queens email account (##initials##@queensu.ca). If you find this beyond your abilities, Staufer library has a help desk to assist you. Furthermore, office hours are offered Monday-Thursday. A thoughtful economist should be succinct; please notice the maximum number of words allowed. Each part is worth 10 marks.

A) Why did the author limit his asset classes to equity, long-term bonds and short-term deposits (cash)? In practice, why were only two of the above included in the most efficient portfolio? (50 words)

B) By what criteria is the portfolio weighting 80% equity and 20% short-term deposits the most efficient? Does this weighting produce the highest expected return? Explain. (50 words)

C) The author considers reducing the portfolio weight on equities when the market is "overvalued" (according to certain metrics such as equity q). What problems does he identify with this investment strategy? (100 words)

D) Suppose you have a particularly risk-averse friend who is saving for his retirement in 40 years. Which of the three strategies (80%-20%, 100% equity, the q-method) would you recommend and why? (100 words)

Note: equity q = (m.v. of equity) / (m.v. of assets – m.v. of liabilities)
m.v. = market value
A high q implies the equity market is overvalued.