MAASAI MARA UNIVERSITY

REGULAR UNIVERSITY EXAMINATIONS 2020/2021 ACADEMIC YEAR FIRST YEAR SECOND SEMESTER

SCHOOL OF BUSINESS AND ECONOMICS BSC. IN FINANCIAL ECONOMICS

COURSE CODE: ECF 1203-1
COURSE TITLE: THEORY OF FINANCE

DATE: 14TH OCTOBER, 2021   TIME: 1100 – 1300HRS

INSTRUCTIONS TO CANDIDATES

- Question **ONE** is compulsory

- Answer any other **TWO** Questions

QUESTION ONE

a. Working capital management is the way in which a firm manages both its current assets and current liabilities. Discuss characteristics of good working capital management.

(6 Marks)

b. Suppose you save sh. 200 on the first day of each month for 6 months at 12% per month, compounded monthly, and then put sh. 500 on the last day of each month starting from 7th month for another 6 months at the same interest rate. How much money will you have at the end of the 12th month?

(5 Marks)

c. Identifying assumptions of CAPM, discuss respective criticisms to each assumption.

(6 Marks)

d. Preferential rights are enjoyed by preference shareholders. Discuss.

(3 Marks)

QUESTION TWO

a. Suppose that short-term securities yield 5% per year and it costs the organization sh. 50 each time it buys or sells securities. The daily variance of cash flows is sh. 1000 and your bank requires sh. 1,000 minimum checking account balance. Determine the target cash balance.

(3 Marks)

b. Write short notes on the following business finance concepts
   i. Nominal returns vs real returns
   ii. Systematic risk vs unsystematic risk
   iii. Secured debentures vs unsecured debentures
   iv. Presents value factor sum vs Future value factor sum

(8 Marks)

c. Assuming the expected market return is 14% and T-bill rate is 5%. What should be the expected return on a portfolio made up of 50% T-bills and 50% market portfolio?

(4 Marks)

QUESTION THREE

   a. To help manage cash on a day-to-day basis in actual dollars and cents, there are a number of cash management models. Discuss.

(8 Marks)

   b. Systematic risk is only a part of return volatility. Consider an asset with annual volatility (σ) of 40%, market beta of 1.2. Suppose that the annual volatility of the market is 25%. What percentage of the total variance of the asset is attributable to non-systematic risk?

(4 Marks)

   c. Discuss any three factors expected to have impact on asset prices.

(3 Marks)

QUESTION FOUR

   a. Suppose that CAPM holds. The expected market return is 14% and T-bill rate is 5%. What should be the expected return on a stock when:

     i. $\beta = 0$

(2 Marks)

     ii. $\beta = 1$

(2 Marks)

   b. Nyaboke, a financial economics' first year student at the University of Maasai Mara University is concerned about the practical applicability of the knowledge of finance. Advice Nyaboke on relevance of finance with respect to personal, corporate and government perspectives.

(3 Marks)

   c. Discuss the various factors determining the choice of business finance. **(4 Marks)**

   d. A project requires an initial investment of sh. 100,000 and produces one of two cash flows in one year: sh. 130, 000 or sh.90000. the probability of sh. 130, 000 cash flow is 40%. Using a 10% discount rate, what is the NPV of the project? **(3 Marks)**

   e. State any two stylized facts about risk and return

(1 Mark)

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