Securities Analysis  
Homework 3

Chapters 12, 13, & 14

Following are 30 questions, each worth 3.3 points.

**CHAPTER 12: Macroanalysis and Microvaluation of the Stock Market**

1. Why would you expect a relationship between economic activity and stock price movements?

2. At a lunch with some business associates, you discuss the reason for the relationship between the economy and the stock market. One of your associates contends that she has heard that stock prices typically turn before the economy does. How would you explain this phenomenon?

3. Explain the following statements:   
(a) There is a strong, consistent relationship between money supply changes and stock prices.   
  
(b) Money supply changes cannot be used to predict stock price movements.

4. The current rate of inflation is 3 percent, and long-term Treasury bonds are yielding 7 percent. You estimate that the rate of inflation will increase to 6 percent. What do you expect to happen to long-term bond yields? Compute the effect of this estimated change in inflation on the price of a 15-year, 10 percent coupon bond with a current yield to maturity of 8 percent.

5. Some observers contend that it is harder to estimate the effect of a change in interest rates on common stocks than on bonds. Discuss this contention.

6. An investor is convinced that the stock market will experience a substantial increase next year because corporate earnings are expected to rise by at least 12 percent. Do you agree or disagree? Why or why not?

7. Find at least three sources of historical information on nominal and real GDP. Find two sources of an annual estimate of nominal GDP.

8. To arrive at an estimate of the net profit margin, why would you spend time estimating the operating profit margin and work down?

9. You are convinced that capacity utilization next year will decline from 82 percent to about 79 percent. Explain what effect that only this change will have on the operating profit margin.

10. You see an estimate that hourly wage rates will increase by 6 percent next year. What other information do you need to determine the effect of this wage rate increase on the operating profit margin, and why do you need it?

**CHAPTER13: Industry Analysis**

3. Assume all the firms in a particular industry have consistently experienced similar rates of return. Discuss what this implies regarding the importance of industry and company analysis for this industry.

6. What were the results when industry risk was examined during successive time periods? Discuss the implication of these results for industry analysis.

7. Assume the industry you are analysing is in the fourth stage of the industrial life cycle. How would you react if your industry-economic analysis predicted that sales per share for this industry would increase by 20 percent? Discuss your reasoning.

8. Discuss at what stage in the industrial life cycle you would like to discover an industry. Justify your decision.

9. Give an example of an industry in Stage 2 of the industrial life cycle. Discuss your reasoning for putting the industry in Stage 2 and any evidence that caused you to select this stage for the industry.

10. Discuss the impact of substitute products on the steel industry’s profitability.

11. Discuss the two variables that must be considered whether you are using the present value of cash flow approach or the relative valuation ratio approach to valuation. Why are these variables relevant for either valuation approach?

12. List the three variables that are relevant when attempting to determine whether the earnings multiple (P/E ratio) for an industry should be higher, equal to, or lower than the market multiple.

13. Discuss when you would use the two-stage growth FCFE model rather than the constant growth model.

14. You are examining the P/CF ratio for an industry compared to the market and find that the industry ratio has always been at a discount to the market—for example, the industry market ratio of ratios is about 0.80. Discuss the variable(s) you would examine to explain this difference or to justify an increase in the industry-market ratio.

**CHAPTER14: Company Analysis and Stock Valuation**

3. A biotechnology firm is growing at a compound rate of more than 21 percent a year. (Its ROE is over 30 percent, and it retains about 70 percent of its earnings.) The stock of this company is priced at about 65 times next year’s earnings. Discuss whether you consider this a growth company and/or a growth stock.

4. Select a company outside the retail drugstore industry and indicate:

a.) what economic series you would use for a sales projection. Discuss why this is a relevant series.

b.) indicate what industry series you would use in an industry analysis. (Use one of the industry groups designated by Standard & Poor’s.) Discuss why this industry series is appropriate. Were there other possible alternatives?

7. Discuss a company that is known to be a low-cost producer in its industry and consider why it is a cost leader. Do the same for a firm known for differentiating.

8. Under what conditions would you use a two- or three-stage cash flow model rather than the constant-growth model?

9. What is the rationale for using the price/book value ratio as a measure of relative value?

10. What would you look for to justify a price/book value ratio of 3.0? What would you expect to be the characteristics of a firm with a P/BV ratio of 0.6?

11. Why has the price/cash flow ratio become a popular measure of relative value during the recent past? What factors would help explain a difference in this ratio for two firms?

12. Assume that you uncover two stocks with substantially different price/sales ratios (e.g., 0.5 versus 2.5). Discuss the factors that might explain the difference.

13. Specify the major components for the calculation of economic value added. Describe what a positive EVA signifies.

14. Discuss why you would want to use EVA return on capital rather than absolute EVA to compare two companies or to evaluate a firm’s performance over time.