

The Mock exam for the exam Level II 2012 Morning session

24. According to the CAPM, is Schilz's assessment of PSMG's valuation most likely correct?

- A. Yes.
- B. No, because PSMG is overvalued.
- C. No, because PSMG is fairly valued.

Answer = **B**

“Portfolio Concepts,” by Richard A. DeFusco, Dennis W. McLeavey, Jerald E. Pinto, and David E. Runkle

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Explain the security market line (SML), the beta coefficient, the market risk premium, and the Sharpe ratio, and calculate the value of one of these variables given values of the remaining variables.

B is correct. Exhibit 2 contains the inputs of the CAPM, and the expected return for PSMG is the same as indicated by the model:

$$E(R_i) = R_F + \beta_i[E(R_m) - R_F]$$

where

$E(R_i)$ = the expected return on asset i (PSMG)

R_F = the risk-free rate of return (2%)

$E(R_M)$ = the expected return on the market portfolio (global large cap equities, 12%)

β_i = beta of asset i , 1.1

According to the CAPM, the expected return (or investors' required rate of return) of PSMG = 2% + 1.2(12% – 2%), or 14%. Because the given expected return of PSMG IS 12% (less than 14%), the stock is overvalued.