KIBABII UNIVERSITY COLLEGE (KIBUCO)

MAIN CAMPUS

UNIVERSITY REGULAR EXAMINATIONS

2014/2015 ACADEMIC YEAR

3RD YEAR 1ST SEMESTER EXAMINATION

MAIN EXAMINATION

2 Hours

FOR THE DEGREE

OF

BACHELOR OF COMMERCE

COURSE CODE: BCF 336

COURSE TITLE: FINANCIAL RISK MANAGEMENT

DATE: January 2015 **TIME:**

INSTRUCTIONS

Answer question ONE and any other Two

1. (a) Explain the meaning of the following

    i) Beta (2mks)
    ii) Risk Premium (2mks)
    iii) Futures contract (2mks)
    iv) Expected Return (2mks)
    v) Co-variance(In Risk) (2mks)

(b) The probability distribution of the rate of return of two assets under for possible states of nature are given below: -

State of Nature	**Probability**	**Return on asset 1**	**Return on asset 2**
1	0.30	-6%	12%
2	0.20	18%	15%
3	0.30	21%	18%
4	0.20	27%	22%

Required:-

(a) What is the standard deviation of the return on asset 1 and on asset 2? (8mks)
(b) What is the covariance between the returns on assets 1 and 2. (8mks)
(c) What is the co-efficient of correlation between the returns on assets 1 and 2 (4mks)

(Please show your workings)

SECTION B

2. Write short notes on the following:-

(a) Security Market line (5mks)
(b) Unsystematic Risk (5mks)
(c) Interest Swap contract (5mks)
(d) Efficient Portfolio (5mks)

3. (a) Consider the data regarding portfolios below:-

Portfolio	Expected Return(%)	Standard deviation (%)
1	15	18
2	18	22
3	10	9
4	12	15
5	15	20
6	13	16
7	22	22
8	14	17

Required:-

Establish which of the above portfolios constitute the efficient set. (10mks)

(b) Explain the meaning of Portfolio Theory and also outline the basic steps involved in Portfolio construction. (10mks)

4. ABC Ltd is a company incorporated and trading in Kenya with its main interest being agribusiness. It sources its major raw material in the form of fruits from local farmers where the crop is available on seasonal basis and prices fluctuate from time to time. 2 years ago, it borrowed a loan in foreign currency from a lending institution in the United States of America for which it is repaying principal as well as interest in foreign currency (US Dollars). Its products are sold locally and for export.

Required:-

Please outline some of the possible risks that the business is exposed to in the course of its operation and suggest ways or options the company can employ to minimize the risks.

Also state with explanation whether the lending institution back in the United States of America is in any way exposed to risk for the period the loan remains outstanding. (20mks)

5. (a) The following information is available regarding two stocks(A and B)

	Stock A	Stock B
Expected Return	12%	26%
Standard deviation	15%	21%
Coefficient of Correlation	0.30	

Required:-

(i) What is the covariance between stocks A and B? (5mks)

(ii) What is the expected return and risk of a portfolio in which A and B are weighted 3:7? (5mks)

(b) Define Capital Asset Pricing Model (CAPM) and outline the assumptions upon which it is anchored. (10mks)

(Please show your workings)