

# AFRICAN ECONOMIC RESEARCH CONSORTIUM

Collaborative MA Programme in Economics for Anglophone Africa  
(Except Nigeria)

## JOINT FACILITY FOR ELECTIVES JUNE – OCTOBER 2005

### CORPORATE FINANCE & INVESTMENT

#### Second Semester: Final Examination

Time: 09.00 AM – 12.00 Noon

Thursday September 29, 2005

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**INSTRUCTION:** Answer Any **FOUR** questions.

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#### Question 1

- a) Distinguish between the following:
- i) Excess volatility and fundamental volatility (*5 marks*)
  - ii) Market volatility and conditional volatility (*5 marks*)
- b) Why is it important to analyse stock return volatility? (*3 marks*)
- c) A student did a study on volatility of a stock returns. The following model was fitted:

$$R_t = \alpha_0 + \alpha_1 R_{t-1} + \alpha_2 h_t + \varepsilon_t$$

$$h_t = w + \delta \varepsilon_{t-1}^2 + \beta h_{t-1}$$

The results were as follows:

$$\alpha_1 = 0.597(0.221)$$

$$\alpha_2 = 1.356(0.078)$$

$$\delta = 0.685(0.212)$$

$$\beta = 0.220(0.102)$$

The standard errors of the parameter estimates are given in parentheses.

- i) Interpret each of these results (*5 marks*)

- ii) Do you think the conditional volatility is stable? Explain *(5 marks)*
- iii) If the student found that with this estimation there was no more heteroskedasticity problem, how would you explain the data generating process of stock returns? *(2 marks)*

### Question 2

- a) Discuss the four market microstructure elements used in evaluating the performance of a stock market *(13 marks)*
- b) How would the following changes made in a stock market impact the market microstructure elements?:
  - i) Tightening of disclosure rules;
  - ii) Heightening investors' protection; and
  - iii) Automation of the trading system. *(4 marks each)*

### Question 3

All stock markets strive to become efficient.

- a) What do you understand by the concept of efficiency in the context of Efficient Market Hypothesis (EMH)? *(6 marks)*
- b) A researcher carried out a study testing for weak-form efficiency using various methods. The study used stock returns and found evidence of the following:
  - Negative serial correlation
  - A significant lagged stock return variable
  - Monday dummy variable was negative and significant
  - Stock returns were stationary at levels
- i) Interpret each of these results *(8 marks)*
- ii) Is weak-form efficiency rejected considering these results? Explain your answer. *(5 marks)*
- c) How does efficiency help the stock market to play an effective role in the development process? *(6 marks)*

#### **Question 4**

- a) A call auction is an order-driven trading system but not all order-driven trading systems are call auctions. Discuss *(10 marks)*
- b) What factors distinguish a continuous order-driven market system from a competitive quote-driven market system? *(15 marks)*

#### **Question 5**

In the reform process, emerging markets have seen changes in the regulatory framework.

- a) Distinguish between self-regulation and statutory regulation *(5 marks)*
- b) Discuss the regulatory and development roles of a statutory body *(20 marks)*

#### **Question 6**

- a) What are the similarities and differences, if any, between the valuation models defining stock prices and bond prices? *(10 marks)*
- b) How would you explain an upward sloping yield curve based on term structure theories? *(15 marks)*

#### **Question 7**

- a) Discuss the agency problem in the context of capital structure and dividend policy. *(12.5 marks)*
- b) Explain the signalling role of dividend payments and under-pricing of initial public offers. *(12.5 marks)*

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