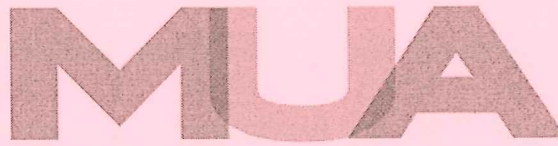


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**UNDERGRADUATE UNIVERSITY EXAMINATIONS**

**SCHOOL OF MANAGEMENT AND LEADERSHIP**

**DEGREE OF BACHELOR OF COMMERCE**

**FIN 421: SECURITY ANALYSIS AND SECURITIZATION**

**DATE: 3<sup>rd</sup> AUGUST 2023**

**DURATION: 2 HOURS**

**MAXIMUM MARKS: 70**

**INSTRUCTIONS:**

1. Write your registration number on the answer booklet.
2. **DO NOT** write on this question paper.
3. This paper contains **SIX (6)** questions.
4. Question **ONE** is compulsory.
5. Answer any other **THREE** questions.
6. Question **ONE** carries **25 MARKS** and the rest carry **15 MARKS** each.
7. Write all your answers in the Examination answer booklet provided.

**QUESTION ONE**

**Read the Case Study below carefully and answer the questions that follow:**

An efficient market is one in which prices always fully reflect all available relevant information. Adjustment to new information is virtually automatic and instantaneous, while a random walk implies that there is no discernible pattern of travel or movement of stock price. The size and direction of the next movement of stock price cannot be predicted from the size and direction of the previous movements. Random walk is a term used in mathematics and statistics to describe a process in which successive changes and movements are statistically independent.

Combined, in the words of another authority, "first, the theory (random walk and efficient markets) says that new information about a company, its industry, or anything that affects the prospects of the company is disseminated very quickly, once it becomes public. Second, the price of a stock at any particular time represents the judgment of all investors, based on all the information that is public and third, new information about a company is disseminated randomly over time.

The efficient markets hypothesis (EMH), popularly known as the Random Walk Theory, is the proposition that current stock prices fully reflect available information about the value of the firm, and there is no way to earn excess profits, (more than the market overcall), by using this information. It deals with one of the most fundamental and exciting issues in finance – why prices change in security markets and how those changes take place.

The key reason for the existence of an efficient market is the intense competition among investors to profit from any new information. The ability to identify over and underpriced stocks is very valuable (it would allow investors to buy some stocks for less than their "true" value and sell others for more than they were worth). Consequently, many people spend a significant amount of time and resources in an effort to detect "mispriced" stocks.

**Required:**

- a) Discuss any four characteristics of an efficient Capital market. (8marks)
- b) Explain three advantages of market efficiency (6marks)
- c) Describe Two types of market efficiency (8marks)
- d) Evaluate how one would know the capital market is efficient in its weak form (3marks)

**QUESTION TWO**

- a) Karim plc and Roshan plc are quoted companies. The following figures are from their current balance sheets:

	KARIM PLC	ROSHAN PLC
	Sh.'000	Sh.'000
Ordinary Share Capital		
Authorized: 2,000,000 shares @ 50	<u>1,000</u>	<u>1,000</u>
Issued: 1,000,000 shares @50	500	500
Reserves	<u>1,750</u>	<u>150</u>
Shareholders' funds	2,250	650
6% Irredeemable debentures	-	2,500

Both companies earn an annual profit, before charging debenture interest of Sh.500,000 which is expected to remain constant for the indefinite future. The profits of both companies, before charging debenture interest, are generally regarded as being subject to identical levels of risk. It is the policy of both companies to distribute all available profits as dividends at the end of each year.

The current market value of Karim Ltd.'s ordinary shares is Sh.3.00 per share cum div. An annual dividend is due to be paid in the very near future.

Roshan Ltd. has just made annual dividend and interest payments both on its ordinary shares and on its debentures. The current market value of the ordinary shares is Sh.1.40 per share and of the debentures, Sh.50.00 percent.

Mr. Hashim owns 50,000 ordinary shares in Roshan Ltd. He is wondering whether he could increase his annual income, without incurring any extra risk, by selling his shares in Roshan Ltd and buying some of the ordinary shares of Karim Ltd. Mr. Hashim is able to borrow money at an annual compound rate of interest of 12%.

**You are required:**

- i. Analyze the cost of ordinary share capital and the weighted average cost of capital of Karim Ltd and Roshan Ltd. ( 4 marks)
  - ii. Examine briefly why both the cost of ordinary share capital and weighted average cost of capital of Karim Ltd differ from those of Roshan Ltd. ( 5 marks)
- b) Explain the following types of common stock
- i. blue chip stock (3marks)
  - ii. Defensive stock (3marks)

### QUESTION THREE

Derrick an employee at Ubora schools wants to invest in financial markets. He has approached you for advice.

- a) Propose to him two classifications of financial markets (2 marks)
- b) Discuss three major theories that explain the behaviour of the yield curve and examine the implication of yield curve analysis in financial management. (13 marks)

**QUESTION FOUR**

- a) Kasuku Limited has set aside Sh. 40 million for investments as on 1 January 2022. Five proposals are presented to the company's board of directors by the finance manager as shown below:

Project project	Initial cost	Annual revenue	Annual fixed costs	Life of
Sh. '000'	Sh. '000'	Sh. '000'	Sh. '000'	Years
A	10,000	20,000	5,000	3
B	30,000	30,000	10,000	5
C	15,000	18,000	6,000	4
D	12,000	17,000	8,000	10
E	18,000	8,000	2,000	15

**Additional information:**

1. Projects D and E are mutually exclusive.
2. Each project is divisible and can only be undertaken once.
3. Variable costs are 40% of annual revenue.
4. All cashflows will occur at the end of the year commencing 31 December 2004.
5. Cost of capital is 10% (ignore tax).

**Required**

- i) Determine the optimal allocation of the Sh.40million amongst the five projects. **(8marks)**
  - ii) Compute the net present value resulting from this allocation? **(2 marks)**
- b) Total Risk Management (TRM) will become a common term in finance just like Total Quality Management (TQM) has in production and marketing." (Professor Andrew W. Lo. 1999).

**Required:**

- i. Define risk management as used in finance. (2 marks)
- ii. Discuss reasons why risk management might increase shareholder's wealth. (3 marks)

**QUESTION FIVE**

The rise and fall characteristic of the stock market dictated by stock market condition gave rise to the concept of "Bull" and "Bear" situation in the stock market.

- a) Differentiate between a Bull market and a bear market. (5marks)
- b) Describe two types of costs incurred during investment of stock (8marks)
- c) Define the term "par value" (2marks)

**QUESTION SIX**

Mr. Oba and his wife have a plan to invest in a five-year bond. They are however aware that any investments involve some risks. They are not familiar with the types of risks involved and have approached you for advice.

- a) Describe four major sources of risk that might affect their potential investment instruments. (12marks)
- b) Highlight three important economic variables that can significantly affect the level of interest rates. (3marks)