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CFA Level III Item-set - **Question**
Study Session 7
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FinQuiz Item-set ID: 11919

Questions 1(*11920*) through 6(*11925*) relate to Reading 16

Earl Webber Case Scenario

Earl Webber, CFA is an equity analyst serving Quantime Inc., a research firm. Webber is currently studying several global equity markets would like to establish the valuation of U.S., Japanese, and German equity markets.

Webber has a particular interest in the Japanese equity markets and he finds these markets particularly attractive for investment. He collects the following data for valuation purposes (exhibit 1).

Exhibit 1
Japanese Market Index and Economic Data

Inflation adjusted growth in capital stock	2.5%
Total factor productivity projected growth rate	1.0%
Long-term labor projected growth rate	0.0%
Output elasticity of capital stock	0.7
Current Japanese index level	1,545
Forecasted dividend growth into perpetuity	3.4%
Forecasted 12-month dividend per share	¥115

Webber would also like to determine expected equity returns for Japanese corporate stocks. He is aware that there are two approaches, bottom-up and top-down, which may typically be used to estimate equity returns but is unsure of which approach is optimal. He contacts his long-time friend and senior economist, Carl Knight. Knight offers two recommendations.

Recommendation 1: The tendency of the analyst, using the bottom-up approach for forecasting purposes, to be influenced by overly-optimistic forecasts produced by corporate managers may result in a greater preference for the top-down forecasting approach which generates unbiased market forecasts.

Recommendation 2: In circumstances where forecasted changes in the Yen relative to foreign exchange rates places certain local exporting corporations at an advantage, a bottom-up or top-down approach may be utilized to estimate the expected returns to be generated on investments in the affected corporations' stocks.

For his valuation of the U.S. corporate securities, Webber would like to use a model which:

- accurately captures the riskiness of equity securities
- fully accounts for the effect of inflation on security price returns
- allows for changes in the input values over the evaluation horizon

For his valuation of German equity markets, Webber's colleague has suggested he should use the Yardeni model to determine how German index stocks are valued relative to their current index values. AA-rated corporate bonds currently yield 8.50% and the forecast for long-term earnings growth is 13.45%. The German equity index's current earnings yield stands at 4.00%. Webber uses a 0.40 weighting factor for the analysis.

Webber's colleague asks him how the inputs to the Yardeni model may affect fair value estimates of the P/E ratio.

Jacques Rose is a junior research analyst serving Quantime Inc. Rose believes the Tobin's q ratio is particularly useful for valuing corporate securities and for equity market valuation. She would like to determine how the conclusion for US equity market valuation would differ if she uses this measure. Rose obtains data from the Federal Reserve database to arrive at an appropriate conclusion (exhibit 2).

Exhibit 2
U.S. Market-Level Analysis using Federal Reserve Data

Market value or replacement cost of assets	$45,259
Liabilities	$30,234
Market value of equity outstanding	$25,837
Long-term average for Tobin's q and equity Q	1.00
Price-to-book ratio	2.45

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1. The real-GDP growth using the Cobb-Douglas model is *closest* to:

   A. 1.75%
   B. 2.75%
   C. 3.50%

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2. The required rate of return using the Gordon growth model is:

   A. 9.2%
   B. 10.8%
   C. 11.1%

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3. Which of the following recommendations, offered by Knight, accurately characterizes the use of the bottom up and top-down approaches?

   A. 1
   B. 2
   C. Both recommendations.

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4. Which of the following models will Webber *most likely* prefer for valuing U.S. corporate securities given the specified model characteristics?

   A. The Yardeni model.
   B. The Fed model.
   C. The P/10-year MA(E) model.

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5. Using the data on German index stocks, Webber will conclude that the stocks (using the Yardeni model) are:

   A. fairly valued
   B. overvalued
   C. undervalued

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6. Which of the conclusions will Rose *least likely* reach regarding the valuation of U.S. equity markets (using the Tobin's equity Q)?

   A. U.S. equity markets are undervalued.
   B. U.S. equity markets are overvalued.
   C. The replacement costs of assets are understated.