FIN 360: PRINCIPLES OF FINANCIAL MANAGEMENT
RISK, RETURN, THE SML, AND COST OF CAPITAL
CRITICAL THINKING & CONCEPTUAL QUESTIONS

1. What is the difference between a "realized" and "expected" return? How do past realized returns influence expected returns?
2. How might we determine appropriate probabilities of booms and busts?
3. Explain the interpretation of standard deviation and how we should think about the standard deviation relative to the expected return. Is a higher or lower standard deviation riskier? What causes a portfolio to have higher or lower standard deviation?
4. If you have a "3 standard deviation day", is that a good thing, a bad thing, or "it depends"?
5. Explain how unsystematic risk can be eliminated through diversification but systematic risk cannot be.
6. A friend tells you "Markets overall fell 3% yesterday, but my personal portfolio didn't fall at all. I have eliminated systematic risk!" Critique this claim.
7. Explain why the CAPM represents both an *expected* return and a *required* return.
8. Explain how the CAPM tells us about a stock's *systematic* risk, but not its *unsystematic* risk.
9. What are the axes of the SML? What does it show? What does it imply about a stock's return given its beta?
10. Why does the market have a beta of 1?
11. What does it mean if a stock is above or below the SML?
12. What do we expect traders and investors would do if they observed a stock that had a price such that it was *above* the SML? What would traders and investors do if they observed a stock that had a price such that it was *below* the SML?
13. Explain why a required return (or expected return) to an investor is a *cost* to the firm.
14. How do we obtain the cost of equity and the cost of debt?
15. How do we find a firm's capital structure weights?
16. Explain what the WACC is and how firms use the WACC once it is computed.
17. If a firm's tax rate increases, what does that mean for its after tax cost of debt?
18. Why doesn't tax matter for the cost of equity in the WACC equation?
19. Explain why the weighted average cost of capital as an appropriate discount rate depends on the "use of the funds, not the source".