

## Corporate Finance, Module 3: "The Value of Common Stocks"

### *Growth Stocks and Income Stocks*

(The attached PDF file has better formatting.)

The Brealey and Myers textbook compares growth stocks and income stocks. We discuss expected returns, risk adjusted expected returns, and abnormal returns in later modules, along with capital market efficiency. The following illustrative test question puts together these concepts. We have not yet covered most of these items; at the end of the course, come back and review these questions.

#### Question 1.1: Returns and Risk Adjusted Returns

Suppose the expected earnings for the *average* firm is 12%.

- ! Firm Y is a growth stock with expected earnings of 18%.
- ! Firm Z is an income stock with expected earnings of 8%.

Which of the following is true? Let  $R_j$  be the expected return for Firm  $j$  and  $R_j'$  be the risk adjusted expected return for Firm  $j$ .

- A.  $R_y > R_z$  and  $R_y' > R_z'$
- B.  $R_y > R_z$  and  $R_y' < R_z'$
- C.  $R_y < R_z$  and  $R_y' > R_z'$
- D.  $R_y < R_z$  and  $R_y' < R_z'$
- E.  $R_y > R_z$  and  $R_y' = R_z'$

Answer 1.1: E

The exercise tells us that  $R_y > R_z$ ; if capital markets are efficient,  $R_y' = R_z'$ .

#### Question 1.2: Returns and Risk Adjusted Returns

Suppose the expected earnings for the *average* firm is 12%.

- ! Firm Y is a growth stock with expected earnings of 18%. On December 1, it announces annual earnings of 15%.
- ! Firm Z is an income stock with expected earnings of 8%. On December 1, it announces annual earnings of 10%.

Which of the following is true? Let  $R_j$  be the actual return for Firm  $j$  and  $R_j'$  be the risk adjusted actual return for Firm  $j$ .

- A.  $R_y' > R_z'$  and  $R_y > R_z$
- B.  $R_y' > R_z'$ ; we don't know which firm has the higher actual return
- C.  $R_y' < R_z'$  and  $R_y > R_z$
- D.  $R_y' < R_z'$ ; we don't know which firm has the higher actual return
- E.  $R_y' = R_z'$  and  $R_y > R_z$

Answer 1.2: C

The exercise tells us that the expected return is higher for Firm Y than for Firm Z; the risk adjusted expected returns should be the same. Because Y did not achieve its earning expectations and Firm Z exceeded its earnings expectations, the actual return is lower for Firm Y and higher for Firm Z.