

**Cooleconomics.com**  
**Financial Markets and Institutions**

**Study Questions: Capital Markets (Answers on next page)**

1. Folks can buy either of two bonds. These bonds are identical, except that the returns from bond A are taxable and the returns from bond B are not taxable. Bond A has an annualized return of 9% (pretax) and bond B has an annualized return of 6%.

a) Which bond should Ross buy? Ross is in the 39.6% tax bracket. Support your answer with a calculation.

b) Which bond should you buy? You are in the 28% tax bracket

2. Pretend that ABC stock pays an annual dividend of \$5 per share; this dividend is expected to grow at 3% annual rate.

According to the Gordon growth model, what is a fair price for a share of ABC stock? Use a discount rate of 5%

1. a) The 9% bond has an after tax yield of  
 $(1-.396) \times .09 = .05436$  for Ross  
This is worse than the tax-free bond yield of 6%. Ross should buy bond B.
  - b) The 9% bond has an after tax yield of  
 $(1-.28) \times .09 = .0648$  for you  
This is better than the tax-free bond yield of 6%. You should buy bond A.
- 
2. fair price =  $\$5 / (.05 - .03) = \$250$  per share