You are considering three investments. The first is a bond selling for $1,100: it has

$1,000 par value, coupon rate of 13%, and 15-year maturity. For bonds in this risk class,

it should offer 14% yield to maturity (rate of return). The second is a preferred stock with

$100 par value selling for $90 per share, with a $13 annual cash dividend – you require

a 15% rate of return on this preferred stock. The third is a common stock with $25 par

value that pays a cash dividend of $2; earnings per share for the company increased

from $3 to $6 over 10 years, and the growth in dividends will be the same as the growth

in earnings per share. The market price of the stock is $20 per share, and you think a

reasonable rate of return on it is 20%.

1. Explain how to calculate the value of each security based on the stated required

rate of return.

B. Which investment would you buy? Explain.

C. If your required rate of return changed to 12% for the bond, 14% for the preferred

stock, and 18% for the common stock, how would your answers to parts a and b

change? Don’t do the calculations – explain how to do them.

D. Repeat part c with required rates of return of 20% on the common stock, with

anticipated constant growth rate changes to 12%.