

SIMON FRASER UNIVERSITY

Sample Final Exam

BUS 418 97-3
International Financial Management

Rules for Submitting Exams: Answers to questions are to be typed, single spaced, of length no more than 2 pages for the required question and 1 page **each** for all other questions, 8"x11" standard paper, with 1" margin and type point not less than 12. (This assignment is typed in 12 point.) Violations will be subject to deductions.

Section I: Required Question (50 pts.)

"Mean-variance analysis has serious shortcomings that are too often ignored. Perhaps the most serious defect is the poor out-of-sample performance of the optimal portfolios. Another problem is the instability in the optimal portfolio: the proportions allocated to each asset are extremely sensitive to variations in expected returns, and adding a few observations may change the portfolio distribution completely. Also, optimal portfolios are not necessarily well diversified." (Jorion, 1985)

Assuming that the investor does not engage in hedging currency risk using forward or futures contracts, comment on the implications of this statement for the management of internationally diversified portfolios. In particular, be sure to 1) state what is meant by mean-variance analysis. In addition, be sure to address the implications of: 2) different possible specifications of the optimization problem; 3) whether the selection of a reference currency is important; and, 4) using different techniques for estimating the relevant parameters.

Section II: Answer all parts of any TWO of the THREE questions (25 points each):

1.a) "At recent levels of exchange rate volatility, hedging currency exposure greatly enhances the diversification potential of foreign investments. By following a hedged policy, US investors gain as much in risk reduction as they do by investing abroad, unhedged...." Explain whether you agree or disagree with the 'free lunch' statement.

b) What are the relative contributions of local and global factors to the risk of an unhedged foreign bond?

2.a) What is the optimal currency hedge ratio for a portfolio which contains only one foreign asset?
b) Is complete hedging optimal for internationally diversified portfolios?

3.a) Under what conditions will American put and call currency options be exercised early?
b) When is hedging foreign assets effective?