UNIVERSITI KUALA LUMPUR
BUSINESS SCHOOL

# FINAL EXAMINATION

# MARCH 2026 SEMESTER

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| COURSE CODE | : | EGB30103 |
| COURSE TITLE | : | FINANCIAL ECONOMICS 2 |
| PROGRAMME NAME | : | BACHELOR OF SCIENCE (HONOURS) IN ANALYTICAL ECONOMICS |
| DATE | : | 22 JUNE 2026 |
| TIME | : | 2:00PM - 5:00PM |
| DURATION | : | 3 HOURS |

## INSTRUCTIONS TO CANDIDATES

1. Please read the instructions given in the question paper CAREFULLY.
2. This question paper is printed on both sides of the paper.
3. This question paper consist of ONE sections.
4. Section A consist of five questions. Answer FOUR (4) questions only.
5. Please write your answer on the answer booklet provided.
6. Please answer all questions in English only.
7. Refer to the attached Formula/ Appendies. ☐ *Tick if applicable*

THERE ARE 6 PAGES OF QUESTIONS INCLUDING THIS PAGE

SECTION A (Total: 100 marks)

**Answer FOUR (4) questions.**

**Please use the answer booklet provided.**

## Question 1

Under the assumption of certainty and perfect capital markets, the valuation of a firm is fundamentally tied to its capacity to generate investor returns and its future investment opportunities.

(a) State the two main components that determine the total value of a firm to its stockholders when management follows the market value rule.

(4 marks)

(b) Explain the concept of a "holding period yield." Briefly describe why using a geometric average yield to maturity can be misleading if the investor's actual holding period is shorter than their original planning horizon.

(4 marks)

(c) Analyze the theoretical implications of operating under "certainty in a perfect capital market." Discuss how this specific assumption simplifies the valuation of a firm's future growth opportunities compared to the complexities faced in real-world corporate finance.

(8 marks)

(d) A firm's management decides to undertake a new project that yields returns in excess of current market rates. Evaluate how this decision impacts the market value of the firm. In your evaluation, distinguish between assessing this value through the stream of earnings accruing to original stockholders versus assessing it via discounted current earnings plus the firm's period 1 equivalent market value.

(9 marks)

## Question 2

Firms must carefully choose their organizational forms and rely on various components of the financial system to minimize transaction costs and secure necessary funding.

(a) Identify four specific corporate governance mechanisms (internal or external) used to discipline management and reduce agency costs.

(4 marks)

(b) Explain the concept of "transaction costs" as it relates to financial intermediation.

(4 marks)

(c) Analyze why a growing mid-sized corporation might prefer to raise capital through a financial intermediary (like a commercial bank) rather than issuing securities directly to investors in the capital markets. Focus your analysis on economies of scale and expertise.

(8 marks)

(d) A publicly traded firm is considering a leveraged buyout (LBO) to transition back into a private organizational form. The management argues this will eliminate the pressures of quarterly earnings reports. Evaluate the trade-offs of this decision by comparing the governance efficiency and access to capital between public and private organizational forms.

(9 marks)

**Question 3**

Financial economics utilizes both prescriptive models of rational behavior and descriptive observations of actual human decisions to understand financial markets.

(a) Distinguish between the *prescriptive* approach and the *descriptive* approach as used in financial economics.

(4 marks)

(b) Explain the von Neumann-Morgenstern expected utility theory and how it resolves decision-making under uncertainty.

(4 marks)

(c) Discuss the St Petersburg paradox. Explain why calculating expected monetary value does not prescribe rational behaviour in this case. Explain how the notion of "utility" resolves this paradox.

(8 marks)

(d) While Expected Utility Theory is a prescriptive bedrock, descriptive research in behavioral finance often reveals anomalies. Evaluate why real-world investors might violate expected utility axioms by discussing the psychological concept of "loss aversion." Justify why standard classical models may fail during periods of extreme market distress.

(9 marks)

## Question 4

Risk management relies heavily on quantifying uncertainty, but traditional measures often carry underlying assumptions that may fail during extreme market conditions.

(a) Define a "two-moment decision model" and state the two statistical moments it utilizes to describe random variables.

(4 marks)

(b) Explain the concept of "Value at Risk" (VaR) as a percentile risk measure. Provide a brief interpretation of what a 95% VaR represents for a portfolio.

(4 marks)

(c) Analyze the limitations of using standard deviation (derived from the two-moment model) as a singular risk measure. Specifically, address how standard deviation treats upside and downside volatility and its assumptions regarding the normal distribution of returns.

(8 marks)

(d) A financial institution uses VaR exclusively to estimate potential market losses. Evaluate the severe shortcomings of relying solely on VaR, particularly focusing on its inability to assess the severity of "black swan" (extraordinary) events and tail risks beyond the confidence threshold.

(9 marks)

## Question 5

Due to the empirical limitations of the traditional CAPM, modern financial economics frequently turns to multifactor pricing models and behavioural adjustments to accurately assess asset risk.

(a) Based on behavioral finance metrics, define what the Book-to-Market (B/M) ratio compares.

(4 marks)

(b) Explain the core premise of the "multifactor asset pricing theory" and how it differs from the traditional CAPM.

(4 marks)

(c) The CAPM asserts that the expected return on any asset is determined by specific systemic variables. Analyze the structural components of the CAPM equation by explaining how expected return relates to both market risk and the market risk premium.

(8 marks)

(d) A portfolio manager notes that standard empirical tests routinely reject the single-factor CAPM and considers adopting the Intertemporal Capital Asset Pricing Model (ICAPM). Evaluate the argument that standard CAPM tests are fundamentally mis-specified, and justify how adopting a multifactor approach like ICAPM addresses extra-market sources of risk.

(9 marks)

**END OF EXAMINATION PAPER**