



KENYATTA UNIVERSITY
UNIVERSITY EXAMINATIONS 2016/2017
SECOND SEMESTER EXAMINATION FOR THE DEGREE OF DOCTOR OF
PHILOSOPHY IN BUSINESS ADMINISTRATION
BAC 905: FINANCE THEORY

DATE: Monday, 8th May 2017

TIME: 5.30p.m-8.30p.m

INSTRUCTIONS

Answer ALL questions

QUESTION ONE (20 marks)

Competition in financial sector is an important variable that has influence on profitability of financial institutions. measurement of competition , therefore Structural and non-structural indicators are the two types of competition measurement that have gained prominence or widely used in the financial literature, especially banking to evaluate the competitive behaviour of the banking industry.

Required: Discuss TWO theories that explain competition, within the financial industry , and provide FOUR measures that are used to estimate competition in financial sector . (12 Marks)

Measurement of financial efficiency of financial institutions is important in determining the performance of the firms. Financial literature has established methods of measuring financial efficiency. Discuss Data envelopment analysis (DEA) and Stochastic frontier analysis SFA (8 Marks)

QUESTION TWO (16marks)

Explaining dividend policy has been a challenge for finance scholars . Even after decades of study, we cannot say that there complex factors have been identified and understood. In this

context, however, research has brought into attention a phenomenon, the disappearance phenomenon of dividends. Explain the phenomenal in relation to the dividend clientele effect theory and the signaling theory.

(6 Marks)

Dividend behavior among emerging financial markets is assumed to be quite different from developed markets. Lintner (1956) provides two explanations as to why firms tend to stabilize their dividend policy. These explanations are mainly stemmed from the fact that smoothing dividend policy tend to reduce asymmetric information and agency problems. Therefore, it is expected that firms with more severe agency and asymmetric information problems to smooth their dividend policy. Dividend policies in firms may adopt Partial adjustment dividend Behavioral models in emerging markets.

In order to find out the behaviour of firms regarding dividend policy, the well known dividend models such as Lintner's model; the Britain's model; the Darling's model; fama and babiak's (1968) partial adjustment model:and the Dobrovolsky's model have been tested. Provide the testable model for each of the model .

(10 Marks)

QUESTION THREE (10marks)

Asset pricing models expression is key to finance theory, discuss clearly the models below :

THE TRADITIONAL CAPM

$$E(R_i) = R_f + \beta_i^M [E(R_m) - R_f] \quad [1]$$

$$R_{it} - R_{ft} = \alpha_i + \beta_i^M [R_{mt} - R_{ft}] + \varepsilon_{it} \quad i = 1, \dots, n \text{ and } t = 1, \dots, T \quad [2]$$

THE THREE MOMENT CAPM

$$E(R_i) - R_f = \beta_1^M [E(R_m) - R_f] + \beta_2^M [E(R_m) - R_f]^2 \quad [3]$$

Where β_1^M and β_2^M are the slopes in the following regression:

$$R_{it} - R_{ft} = \alpha_i + \beta_1^M [R_{mt} - R_{ft}] + \beta_2^M [R_{mt} - R_{ft}]^2 + \varepsilon_{it} \quad i = 1, \dots, n \text{ and } t = 1, \dots, T \quad [4]$$

THE FOUR MOMENT CAPM

$$E(R_i) - R_f = \beta_1^M [E(R_m) - R_f] + \beta_2^M [E(R_m) - R_f]^2 + \beta_3^M [E(R_m) - R_f]^3 \quad [5]$$

Where β_1^M , β_2^M and β_3^M are the slopes in the following regression:

$$R_{it} - R_{ft} = \alpha_i + \beta_1^M [R_{mt} - R_{ft}] + \beta_2^M [R_{mt} - R_{ft}]^2 + \beta_3^M [R_{mt} - R_{ft}]^3 + \varepsilon_{it} \quad [6]$$

$i = 1, \dots, n$ and $t = 1, \dots, T$

THE CAHART FOUR FACTOR MODEL (1997)

$$R_{i,t} - R_{F,t} = \beta_{i,1} RMRF_t + \beta_{i,2} SMB_t + \beta_{i,3} HML_t + \beta_{i,4} MOM_t + e_{i,t} \quad [7]$$

THE CHAN AND FAFF MODEL (2005):

$$R_{i,t} - R_{F,t} = \beta_{i,1} RMRF_t + \beta_{i,2} SMB_t + \beta_{i,3} HML_t + \beta_{i,4} LIQ_t + e_{i,t} \quad [8]$$

[10 Marks]

QUESTION FOUR (14marks)

The diagrams below represent various market anomalies that negate the efficient market hypothesis, critically evaluate each.

[6 Marks]

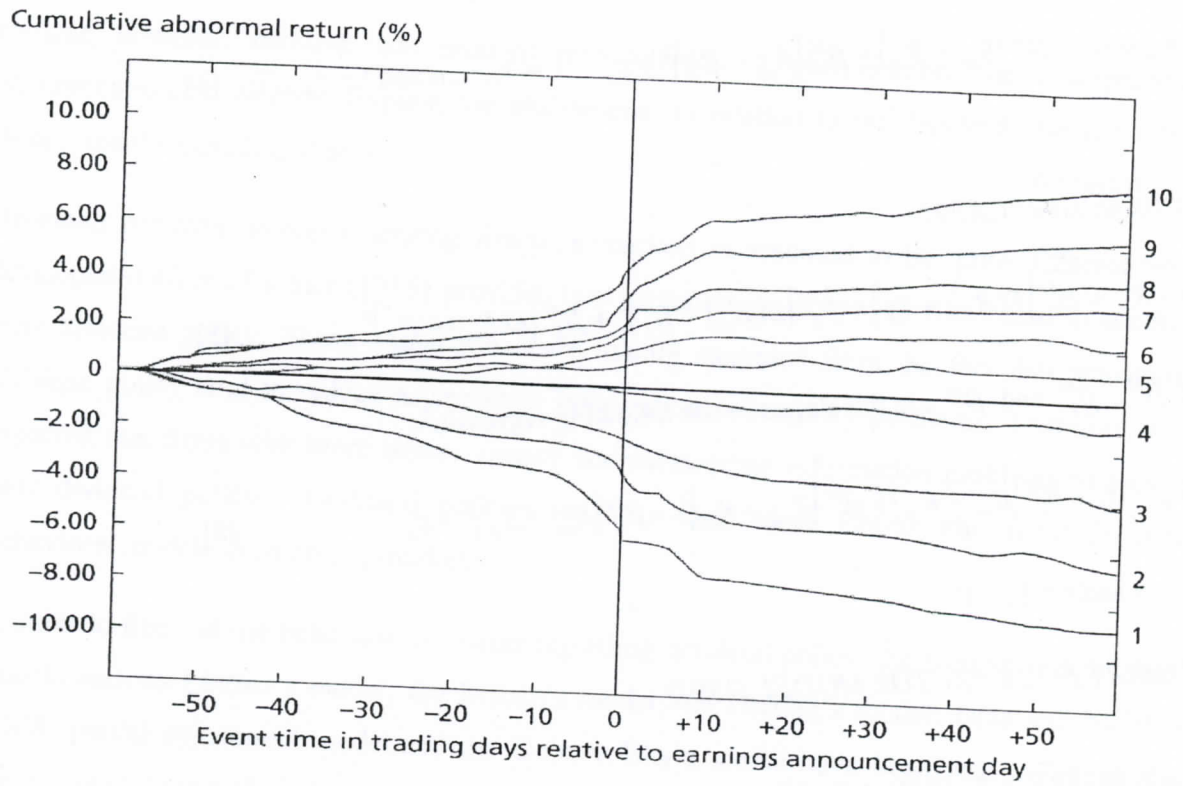


Diagram 1.1

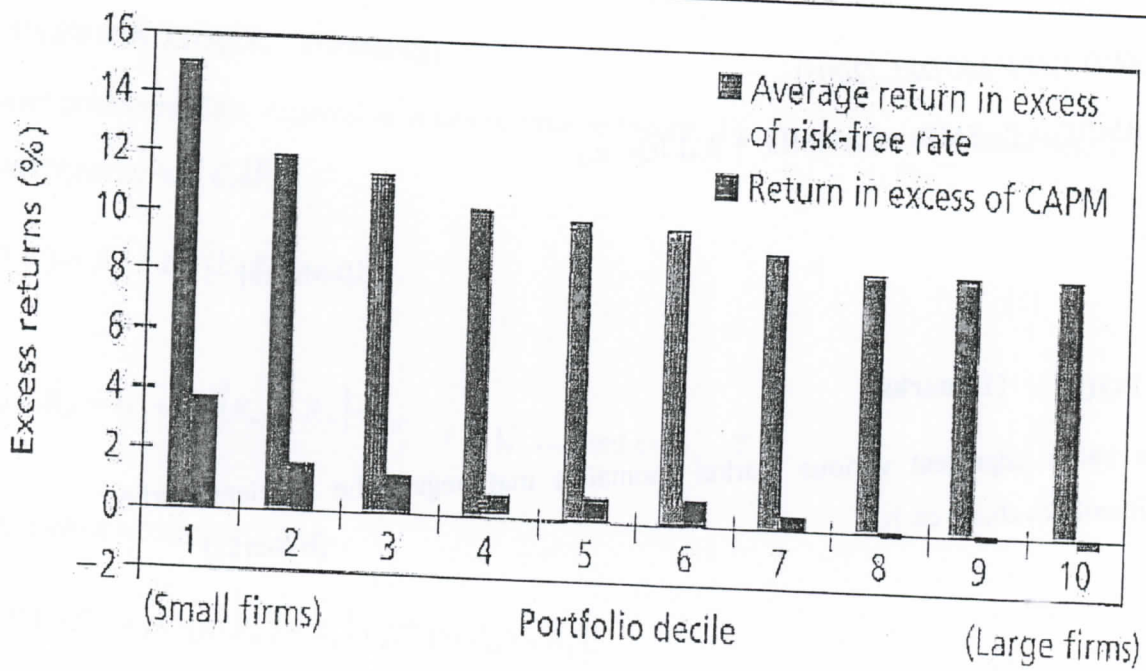


Diagram 1.2

Figure 7.3: Returns by Month of the year - 1927 - 2001

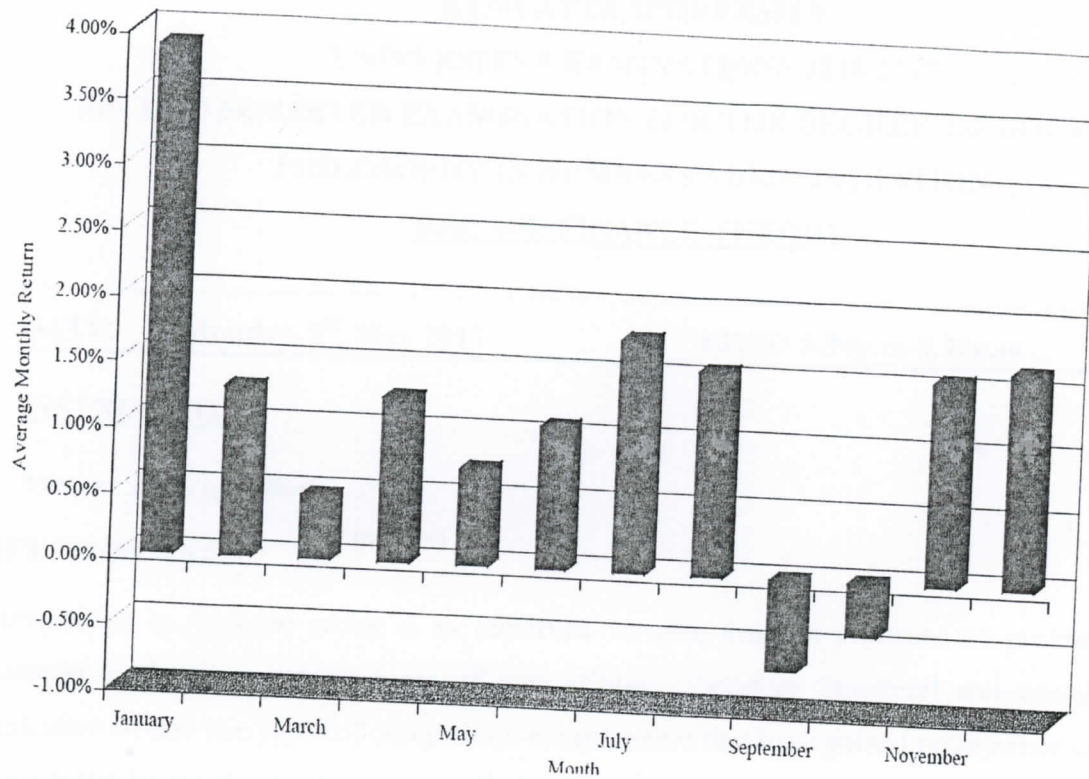


Diagram 1.3

Behavioural Models form the basis of behavioural finance, critically analysis Four models applicable to finance.

[8 Marks]