

Exercise 2

1. Dum is considering investing in a 3-year government coupon bond initially offered to the public today. Face value of the bond is 1,000 baht and its coupon rate is at 10 percent, while the price is at 1,000 baht. The current market interest rate is 10 percent.

However, Dum plans to hold this bond for just 1 year, and after getting the first coupon payment, he will immediately sell the bond. It is widely expected that there is a probability of 20 percent that the market interest rate will rise to 20 percent next year, 40 percent that the rate stays at the current level, and 40 percent that the rate will fall to 5 percent.

Calculate the expected return and standard deviation of return from Dum's investment plan.