LO.a: Describe the reasons for a written investment policy statement (IPS).

1. Analyst 1: A written IPS is part of the best practices for a portfolio manager.
   Analyst 2: A written IPS ensures the client's risk and return objectives can be achieved.
   Which analyst's statement is most likely correct?
   A. Analyst 1.
   B. Analyst 2.
   C. Both.

2. Which of the following is the *most* appropriate reason for a written investment policy statement? A written IPS:
   A. provides investment managers with a ready protection against client lawsuits.
   B. communicates a plan for trying to accomplish investment success.
   C. allows investment managers to educate clients about the correct use and purpose of investments.

LO.b: Describe the major components of an IPS.

3. The section of the investment policy statement (IPS) that describes the client is:
   A. Investment objectives.
   B. Introduction.
   C. Statement of purpose.

4. Saleem Sheikh, CFA, manages the portfolio of several clients. While preparing the IPS of these clients, he is *most likely* to begin with:
   A. the risk and return objectives of the investors.
   B. the needs and constraints of the investors.
   C. the external circumstances affecting the investors' portfolios.

5. Which of the following is the *most* difficult to quantify, while preparing an investment policy statement?
   A. Time horizon.
   B. Willingness to expect risk.
   C. Ability to take risk.

6. Mr. Amjad Mirza, director of Acme &Co. (a publicly listed company) cannot trade his company's stock at certain points of the year when disclosure of financial results are pending. What step regarding this restriction is *most appropriate* for Salahuddin Shaukat, who is managing Mirza's fund, in preparing a written investment policy statement (IPS)?
   A. The restriction should be included in the IPS.
   B. The restriction is irrelevant to the IPS.
   C. The restriction makes it illegal for the portfolio manager to work with this client.

7. Joseph Jackson, a fund manager at Hermes Global Equities, is preparing an IPS for his client. Which of the following will he *least* likely place in the appendices of this IPS?
   A. Procedures to update IPS.

B. Rebalancing policy of the portfolio.
C. Strategic asset allocation.

LO.c: Describe risk and return objectives and how they may be developed for a client.

8. An investment policy statement that includes a return objective of "No greater than a 6% probability of a loss of more than $34,500 over any 12-month period" is *best* characterized as having a(n):
   A. arbitrage-based return objective.
   B. absolute return objective.
   C. relative return objective.

9. An investment policy statement that includes a risk objective of "Return should be within 4% of the S&P 500 index return" is *best* characterized as having a(n):
   A. arbitrage-based risk objective.
   B. absolute risk objective.
   C. relative risk objective.

LO.d: Distinguish between the willingness and the ability (capacity) to take risk in analyzing an investor's financial risk tolerance.

10. Dean Jones is 43 years old and has a secure job with an annual salary of AUD 300,000. The income is sufficient to cover his and his family's expenses. He owns the house his family lives in and has savings of AUD 1,000,000. Jones is reluctant to invest in the stock market because he believes that stock market returns are based on luck. Furthermore, the thought of losing money causes him to have sleepless nights. Based on this information which of the following statements is *most accurate*?
    A. Jones has a low ability to take risk but a high willingness to take risk.
    B. Jones has a high ability to take risk and a high willingness to take risk.
    C. Jones has a high ability to take risk but a low willingness to take risk.

11. Emily Rose is willing to take risk when investing. She is young and has a secure, well-paying job. Her risk tolerance will *most likely* be characterized as:
    A. high.
    B. medium.
    C. low.

12. Which of the following factors is *most likely* to affect an investor's willingness to take risk?
    A. Wealth.
    B. Attitudes about investment.
    C. Job security.

13. Which of the following factors is *least likely* to impact the risk-taking ability of a client?
    A. Expected income.
    B. Personality type.
    C. Time horizon.

14. A financial advisor gathers the following information about a new client:
    - The client is a famous physics professor at one of the biggest universities in New York.
    - The client owns a penthouse and two cars with currently zero outstanding debt.
    - The client is currently working full-time and plans to continue this way for another five years after which he will work part time for 4 years before retirement.
    - The client has accumulated retirement savings of approximately $ 1.75 million through their employer's retirement plan and anticipates retirement spending needs of $80,000 per year.
    - Despite the concern regarding the current condition of the global economy, the client maintains to remain a long-term investor.
    - The client follows numerous financial publications closely and is aware of the evolving markets.

    Based on the above information, which of the following *best* describes this client?
    A. High ability to take risk and a high willingness to take risk.
    B. Low ability to take risk, but a high willingness to take risk.
    C. High ability to take risk, but a low willingness to take risk.

15. After interviewing a client in order to prepare a written investment policy statement (IPS), you have established the following:
    - The client has earnings that have exceeded $150,000 (pre-tax) each year for the past four years and has no dependents.
    - The client's basic needs are approximately $49,500 per year.
    - The client states that he feels particularly uncomfortable with his limited understanding of securities markets.
    - All of the client's current savings are invested in short-term securities guaranteed by an agency of her national government.
    - The client responded to a standard risk assessment questionnaire suggesting that he has low risk tolerance.

    The client is *best* described as having a:
    A. high ability to take risk and a high willingness to take risk.
    B. low ability to take risk, but a high willingness to take risk.
    C. high ability to take risk, but a low willingness to take risk.

16. Which of the following factors is *most likely* to impact an individual's willingness to take risk?
    A. Time horizon.
    B. Personality type.
    C. Wealth.

LO.e: Describe the investment constraints of liquidity, time horizon, tax concerns, legal and regulatory factors, and unique circumstances and their implications for the choice of portfolio assets.

17. Which of the following is *least likely* to be discussed in the constraints section of an investor's IPS?
    A. Liquidity.
    B. Time horizon.
    C. Level of risk aversion.

18. Which of the following is *least likely* an example of a portfolio constraint?
    A. Significant spending requirements in the long run.
    B. Higher tax rate on capital gains than on dividend income.
    C. Minimum total return requirement of 10%.

19. Which of the following types of institutions is *most likely* to have a higher level of risk tolerance and high income needs?
    A. Defined benefit pension plans.
    B. Banks.
    C. Life insurance companies.

20. In general, which of the following institutions will *most likely* have a high need for liquidity and a long time horizon?
    A. Life insurance companies.
    B. Endowments.
    C. Defined benefit pension plans.

21. Which of the following *best* describes the time horizon, liquidity needs and level of risk tolerance for an endowment?

	Time Horizon	**Liquidity Needs**	**Level of Risk Tolerance**
A.	Short	Low	High
B.	Long	Low	High
C.	Long	High	Low

LO.f: Explain the specification of asset classes in relation to asset allocation.

22. In a strategic asset allocation, assets within a specific asset class are *most likely* to have:
    A. high paired correlations.
    B. low paired correlations.
    C. high correlations with other asset classes.

23. Returns on asset classes are a function of:
    A. exposure to the failure of arbitrage.
    B. exposure to sets of systematic factors relevant to those asset classes.
    C. exposure to the idiosyncratic risks of those asset classes.

24. An investment manager in an asset management company is in the process of defining asset classes. Which of the following activities would be *most appropriate* considering the paired correlations of assets?

A. Assets with low correlations placed in the same asset class.
B. Assets with low correlations placed in different asset classes.
C. Assets with high correlations placed in different asset classes.

LO.g: Describe the principles of portfolio construction and the role of asset allocation in relation to the IPS.

25. A portfolio manager decides to allot a certain percentage of portfolio, each to different asset classes in order to achieve the client' long term goals. This decision is *most likely* an example of:
    A. rebalancing.
    B. strategic asset allocation.
    C. tactical asset allocation.

26. Patrick Dempsey, a portfolio manager, decides to temporarily invest more of a portfolio in equities than stated in the investment policy statement because he believes that equities are currently underpriced. This decision is *most likely* an example of:
    A. rebalancing.
    B. strategic asset allocation.
    C. tactical asset allocation.

27. Tactical asset allocation is *best* described as:
    A. selecting asset classes with the desired exposures to sources of systematic risk in an investment portfolio.
    B. attempts to exploit arbitrage possibilities among specific securities.
    C. the decision to deliberately deviate from the policy portfolio.

28. Sirajuddin Sheikh invests the majority of his portfolio on a passive risk strategy while managing a minority of the assets aggressively in smaller portfolios. This approach is *best* described as:
    A. a top-down investment policy.
    B. the core–satellite approach.
    C. a delta-neutral hedge approach.

Solutions

1. A is correct. The mere fact that a written IPS is prepared for a client, does not ensure that risk and return objectives will in fact be achieved.

2. B is correct. A written IPS is best seen as a communication instrument allowing clients and portfolio managers to mutually establish investment objectives and constraints.

3. B is correct. The introduction describes the client and outlines what is covered in the document. Often, the purpose and scope of the IPS is included as part of introduction.

4. A is correct. A written investment policy statement will typically begin with the investor's risk and return objectives.

5. B is correct. Measuring willingness to take risk (risk tolerance, risk aversion) is an exercise in applied psychology. Instruments attempting to measure risk attitudes exist, but they are clearly less objective than measurements of the ability to take risk. Ability to take risk is based on relatively objective traits such as expected income, time horizon, and existing wealth relative to liabilities.

6. A is correct. When a client has a restriction on trading, such as this obligation to refrain from trading, the IPS "should note this constraint so that the portfolio manager does not inadvertently trade the stock on the client's behalf."

7. A is correct. Appendices contain information on strategic (baseline) asset allocation and permitted deviations from policy portfolio allocations, as well as how and when the portfolio allocations should be rebalanced. Procedures to update IPS are a major component of the IPS that is not a part of the appendices.

8. B is correct. Absolute return objectives can also be stated in terms of the probability of specific portfolio results, percentage losses or dollar losses, rather than strict limits on portfolio results.

9. C is correct. The risk objective is expressed relative to a benchmark.

10. C is correct. Give the high income and savings, his ability to take risk is high. However, his attitude towards the stock market and the possibility of losing money indicates that his willingness to take risk is low.

11. A is correct. Given that she is young and has a secure, well-paying job, her ability to take risk is high. We are told that she is also willing to take risk. Consequently, her risk tolerance will most likely be characterized as 'high'.

12. B is correct. It is important to distinguish between the willingness to take risk and the ability to do so. An investor's willingness to take risk is based primarily on the investor's beliefs

and attitudes towards the investment. The other two factors affect the person's ability to take the risk and not the willingness.

13. B is correct. An individual's ability to take risk is impacted by such factors as time horizon and expected income. Personality type is most likely to impact an individual's willingness to take risk.

14. A is correct. The client is in a strong financial situation (stable job, no debt), has a reasonably long time horizon before needing any liquidity (10 years), and reasonable retirement spending needs relative to total assets. These factors indicate a high ability to take risk. In addition, the client's knowledge of financial markets, experience, and focus on the long term also indicates a high willingness to take risk.

15. C is correct. On one hand, the client has a stable, high income and no dependents. On the other hand, he exhibits above average risk aversion. His ability to take risk is high, but his willingness to take risk is low.

16. B is correct. An individual's willingness to take risk is impacted by factors as personality type. Wealth and time horizon are most likely to impact an individual's ability to take risk.

17. C is correct. Remember the five constraints using: LLTTU. Liquidity, Legal and regulatory, Time horizon, Tax, Unique circumstances.

18. C is correct. Return objectives are part of a policy statement's objectives, not constraints.

19. A is correct. Defined benefit pension plans have high income needs and a high level of risk tolerance.

20. A is correct. Life insurance companies have a long investment time horizon but high liquidity needs.

21. B is correct. Endowments are meant to provide financial support for specific purposes on an ongoing basis. Thus they have a long time horizon, low liquidity needs and the level of risk tolerance is high.

22. A is correct. In a strategic asset allocation, assets within a specific asset class will have high paired correlations and low correlations with assets in other asset classes.

23. B is correct. Strategic asset allocation depends on several principles. As stated in the reading, "One principle is that a portfolio's systematic risk accounts for most of its change in value over the long run." A second principle is that, "the returns to groups of like assets predictably reflect exposures to certain sets of systematic factors." This latter principle establishes that returns on asset classes primarily reflect the systematic risks of the classes.

24. B is correct. When defining asset classes, paired correlations of assets should be relatively high within an asset class. However, paired correlations of assets between different asset classes should be low in order to provide diversification relative to other asset classes.

25. B is correct. After having determined the investor objectives and constraints, a strategic asset allocation is developed which specifies the percentage allocations to the included asset classes.

26. C is correct. Tactical asset allocation is the decision to deliberately deviate from the policy exposures to systematic risk factors with the intent to add value based on forecasts of the near-term returns of those asset classes.

27. C is correct. Tactical asset allocation allows actual asset allocation to deviate from that of the strategic asset allocation (policy portfolio) based on short-term market expectations.

28. B is correct. The core–satellite approach to constructing portfolios is defined as “investing the majority of the portfolio on a passive or low active risk basis while a minority of the assets is managed aggressively in smaller portfolios.”