# The Portfolio Management Process and the Investment Policy Statement

**Test ID: 7442187**

## Questions #1-6 of 47

Yoo Jin, CFA, is the Chief Investment Officer of Park, Kim & Lee Investment Management (PKL), which specializes in private wealth management for affluent families. Yoo has recently met with a potential new client, the Ahn family. PKL was highly recommended by a business associate of eldest member of the family, Ahn Kwan, and three generations of the family are considering investing with the firm to establish a new investment portfolio. The portfolio is intended solely to provide capital for the fourth and youngest generation of the family and their descendents, so the family can maintain its position in future generations. Portfolio income is not currently needed to support the three eldest generations of the Ahn family because the business ventures provide an income sufficient to maintain a luxurious lifestyle.

Since the elderly Ahn Kwan is not in sufficiently good health to attend the meeting in person, the family represented at this initial conference by Ahn Kwan's eldest son, Ahn Yong. He explains to Yoo that the family wants to take a cautious approach to its investments. The family takes substantial risk in its business ventures and does not want to risk its capital.

As the discussion proceeds, he informs Yoo that the family is also interested in exploring new investment opportunities for their existing portfolios as well. The three adult generations of the Ahn family have so far kept their money in various bank accounts because of concern about possible losses in the securities market. The accounts generally pay an interest rate between 4% and 5%. Ahn Kwan, however, has been persuaded by his business associate that the family is losing an important opportunity to increase its returns by not investing in the stock market. The Korean equity market soared more than 40% in the previous year, and Ahn Kwan realizes that keeping money in interest-bearing accounts is costing the family substantially in missed opportunities. He has agreed to consider moving a substantial portion of the family's assets over to PKL since he has been assured that PKL is a responsible, cautious firm.

In discussing the move into equities, Ahn Yong explains his father's position. "My father has devoted his entire life to establishing the success of his family. The financial position of his children, his grandchildren, and their descendants is of primary importance to him. He does not want to risk losing money that he has worked decades for."

Ahn Yong elaborates on his father's concerns by saying, "My father has seen what happened in Japan. The peak in the Nikkei index came in 1989, and the market has never recovered. Anyone who invested back then lost nearly two-thirds of his money. My father does not want that to happen to our family."

Yoo Jin asks, "We would of course only invest your family's money in markets that you want to participate in. Would your father want the family's money invested in the Japanese market?" Ahn Yong asserts emphatically, "My father is only interested in participating in the Korean markets. He does not want our money invested overseas."

The portfolio manager who would be responsible for the Ahn family portfolios is Shin Sun, CFA. In reviewing the meeting with Shin, Yoo explains that in her view, the family's goals are inconsistent and education is required to resolve the inconsistency. Yoo notes that the family is only interested in investing in the Korean equity market, but the Korean equity market is highly volatile. It would not be possible to create a portfolio consisting solely of Korean equities that would be consistent with Ahn Kwan's investment risk tolerance.

Shin makes the case that the family has a very high risk tolerance. Shin argues, "The time horizon of the Ahn family is virtually infinite, since the money is intended for future generations. In addition, the portfolio has no current income requirements. In this case, they can have a very high risk tolerance. Certainly the Ahn family is in an excellent position to invest in the Korean equity market."

Shin suggests, "Educating a new client can be a very delicate issue. That is especially true when the client is the elderly head of a very successful family. I would not want to tell Ahn Kwan that we cannot do what he wants. We should follow his instructions and invest the family's money in a portfolio of Korean equities. If that is what he says, then it is our duty to follow his wishes." Shin concludes that PKL should construct a portfolio consistent with the Ahn family's substantial ability to assume risk.

## Question #1 of 47

Question ID: 464632

The *best* description of the importance of portfolio perspective is that investors, analysts and portfolio managers should analyze the:

- ✗ **A)** **unsystematic risk of the individual investments in the portfolio.**
- ✓ **B)** risk-return tradeoff of the portfolio as a whole.
- ✗ **C)** risk-return tradeoff of the individual investments in the portfolio.

Explanation

Investors, analysts and portfolio managers should analyze the risk-return tradeoff of the portfolio as a whole, not the individual investments in the portfolio. (Study Session 18, LOS 60.a)

## Question #2 of 47

Question ID: 464633

Which of the following is *least likely* to determine an individual investor's ability to accept risk?

- ✗ **A)** **Long-term wealth target.**
- ✗ **B)** Liabilities.
- ✓ **C)** Market expectations.

Explanation

Liabilities and long-term wealth target are each direct determinants of an individual investor's ability to accept risk. Market expectations will affect return achieved but is not a direct determinant of an investor's ability to accept risk. (Study Session 18, LOS 60.e)

## Question #3 of 47

Question ID: 464634

The two principal risk objective measurements are *best* described as:

- ✗ **A)** **tracking risk and absolute risk.**
- ✓ **B)** absolute risk and relative risk.
- ✗ **C)** absolute risk and qualitative risk.

Explanation

The two risk objective measurements are absolute and relative risk. Tracking risk is an example of a relative risk objective. Qualitative risk is a form in which an absolute risk objective may be stated. (Study Session 18, LOS 60.e)

## Question #4 of 47

Question ID: 464635

Regarding Shin's and Yoo's assertions about the family's risk tolerance and the implications for the management of their portfolios:

- ✗ **A)** **Yoo's statement is incorrect; Shin's statement is correct.**

✓ **B)** Yoo's statement is correct; Shin's statement is incorrect.

✗ **C)** Yoo's statement is correct; Shin's statement is correct.

Explanation

Shin's statement that the family has a very substantial ability to assume risk is correct, but he is incorrect to claim that the portfolio should be constructed in accordance with their ability to assume risk without resolving the conflict with their low willingness to assume risk). When the investor's ability and willingness to assume risk are in conflict, the curriculum always recommends designing portfolios consistent with the willingness, not ability, to assume risk. Yoo is correct that there is an inconsistency in the stated risk tolerance - not increasing the risk of the portfolio above that of interest-bearing bank accounts - and the goal of investing in the stock market, and that educating the client is required. Since the willingness to assume risk is inherently in conflict with the stated objective of investing in equities (which cannot duplicate the low risk of interest-bearing bank accounts), there is no way around having to educate the family to resolve the conflict. (Study Session 18, LOS 60.e)

## Question #5 of 47

Question ID: 464636

A return objective should *best* be considered from the perspective of:

✓ **A)** **total return.**

✗ **B)** return from income relative to return from capital gains.

✗ **C)** required return.

Explanation

The return objective should be considered from a total return perspective, even if there is a specific income or capital gains target. Desired or required return may be unrealistic given available market conditions or risk tolerance. (Study Session 18, LOS 60.e)

## Question #6 of 47

Question ID: 464637

Which is *least likely* to be considered one of the three integrative steps in the portfolio management process?

✗ **A)** **Planning.**

✓ **B)** Developing an investment policy statement.

✗ **C)** Feedback.

Explanation

The three integrative steps in the portfolio management process are planning, execution and feedback. Developing an IPS is part of the planning phase. (Study Session 18, LOS 60.b)

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## Question #7 of 47

Question ID: 464613

The investment policy statement is important because it helps:

✗ **A)** **direct short-term investment portfolio decisions as a result of short-term responses to overreacting markets.**

✗ **B)** direct long-term investment portfolio decisions and promotes adjustments in response to panic and overreaction.

✓ **C)** direct long-term investment portfolio decisions that deter adjustments due to panic and overconfidence.

Explanation

The investment policy statement helps insure against short-term strategy changes due to panic or overconfidence.

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## Question #8 of 47

Question ID: 464625

Which of the following is not typically included in an investment policy statement?

✗ **A)** **Identification of duties.**

✓ **B)** Names of specific managers or mutual funds that should be used.

✗ **C)** A client description.

Explanation

General statements about how funds should be invested are included in the investment policy statements. It would not be wise to include specific manager/mutual funds, as the people involved in managing money change over time. Instead, asset allocation objectives should be used.

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## Question #9 of 47

Question ID: 464608

Which of the following is not considered to be an investment constraint?

✗ **A)** **Time horizon.**

✓ **B)** Risk tolerance.

✗ **C)** Tax concerns.

Explanation

An investor's risk tolerance is included under objectives. Constraints include liquidity needs, time horizon, tax concerns, legal and regulatory factors, and unique circumstances.

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## Question #10 of 47

Question ID: 464612

Which of the following is *least likely* to be an advantage of a valid investment policy statement?

✗ **A)** **Allows for a continual dynamic process in meeting investor objectives.**

✓ **B)** Provides for short-term strategy shifts in response to short-term dramatic value declines.

✗ **C)** Promotes long-term discipline in investment decisions.

Explanation

The investment policy statement does not provide for shifts in strategy due to value declines.

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## Question #11 of 47

Question ID: 464622

The objective of achieving a 10% annual rate of return is an example of a(n):

✗ **A) relative return objective.**

✗ **B)** absolute risk objective.

✓ **C)** required return objective.

Explanation

The objective of earning a 10% return is a required return objective because it represents some level of return that must be acheived by the portfolio.

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## Question #12 of 47

Question ID: 464624

Investor objectives relate to which of the following? Evaluating:

✗ **A) asset allocation and security factors.**

✓ **B)** risk and return factors.

✗ **C)** capital market and security factors.

Explanation

Investor objectives relate directly to the risk and return factors acceptable to the investor. Risk factors are associated with how much risk the investor can tolerate. Return factors relate to required and desired returns.

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## Question #13 of 47

Question ID: 464648

Max and Anna Klushefski have both turned 30 in the last year. The couple decides that 30 is the right age to start thinking more about their future, so they meet with a financial planner, Thelma Black. Both Max and Anna work. Their 401k plans have a combined value of $135,000 and this represents their only investment assets. Anna, a schoolteacher, is pregnant with their first child and plans to quit her job when the child is born. The couple hopes to have at least two more children. Max makes $95,000 per year as a junior executive at a clothing firm. The couple has been banking Anna's salary for the last two years, as they can live on what Max makes.

Max and Anna had not thought much about their future, but in response to Black's questions, they come up with two goals:

- Anna wants to stay out of the work force until all of their children are out of the house.
- Max wants to retire at 65 with at least $2 million in their portfolio.

Neither Max nor Anna knows much about investing, but Max's friends tell him that stocks are the best option because equities earn the best returns. Max and Anna want to invest most of their money in stocks.

Based only on the information presented above, the Klushefskis':

✗ **A) investment objectives are unrealistic.**

✓ **B)** time horizon should be multistage.

✗ **C)** ability to take risk conflicts with their willingness to take risk.

Explanation

A multistage horizon is a combination of shorter term and longer term horizons, such as when a couple must fund both their children's education in the near term and their retirement much later. A 30-year-old man is making $95,000 in an executive position can be excused for aiming fairly high: a $2 million portfolio is aggressive, but not necessarily out of reach, with 35 years to work on it. The Klushefskis are young enough that they can afford to take risks that meshes with their willingness to focus on stocks.

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## Question #14 of 47

Question ID: 464645

Which of the following statements regarding the effect of investors' time horizon on portfolio choice is *least* accurate?

✗ **A)** **Legal and regulatory factors usually do not affect the investment policies of individual investors.**

✓ **B)** Endowments and foundations typically invest with an average or below average tolerance for risk.

✗ **C)** Longer time horizons may indicate an investor's greater ability to take risk, even if willingness is not apparent.

Explanation

Endowments and foundations typically invest with an average or above average tolerance for risk, in part due to their relatively longer investment time horizons.

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## Question #15 of 47

Question ID: 464646

Which of the following factors are *least likely* to affect the formulation of an investment policy statement for a university's endowment fund?

✗ **A)** **Social considerations.**

✓ **B)** Tax considerations.

✗ **C)** Multi-stage time horizons.

Explanation

An endowment would receive tax-exempt status, and therefore would not have to include tax considerations when formulating an investment policy statement.

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## Question #16 of 47

Question ID: 464606

Which of the following is not a step in the portfolio management process?

✓ **A)** **Developing an IPS.**

✗ **B)** Execution.

✗ **C)** Feedback.

Explanation

Developing an IPS is a subset of the planning process.

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## Question #17 of 47

Question ID: 464629

Which of the following statements about investment policy statements (IPS) is *least* accurate? The IPS:

✗ **A)** **helps insure against short-term shifts in strategy when either market environments or portfolio performance cause panic or overconfidence.**

✗ **B)** can be readily implemented by current or future investment advisors.

✓ **C)** is an informal statement of objectives and constraints.

Explanation

Investment policy statements should always be *formally* written documents that take into account objectives and constraints and governs investment decision-making.

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## Question #18 of 47

Question ID: 464601

Equity pricing models assume which risk is priced?

✗ **A)** **Unsystematic.**

✗ **B)** Both systematic and unsystematic.

✓ **C)** Systematic.

Explanation

Unsystematic risk can be diversified away. Thus, equity-pricing models are designed to reflect only systematic risk. It is assumed that the portfolio manager will take steps to diversify and reduce risk.

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## Question #19 of 47

Question ID: 464604

Which of the following is not part of the general steps of the portfolio management process?

✗ **A)** **Feedback.**

✓ **B)** Performance evaluation.

✗ **C)** Planning.

Explanation

Performance evaluation is a substep under the feedback process. The three general steps are planning, execution, and feedback, in that order.

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## Question #20 of 47

Question ID: 464605

Which of the following *most accurately* identifies the three main steps in the portfolio management process?

✗ **A)** **Objectives, constraints, risk tolerance.**

✓ **B)** Planning, execution, feedback.

✗ **C)** Planning, asset allocation, security selection.

Explanation

The three main steps in the portfolio management process are planning, execution, and feedback. The other items listed are subcomponents of these steps.

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## Question #21 of 47

Question ID: 464627

Investment constraints are best defined as factors:

✓ **A)** **restricting investment choices.**

✗ **B)** encouraging investment choices.

✗ **C)** determining investment choices.

Explanation

Investment constraints are those factors limiting or restricting investment choices.

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## Question #22 of 47

Question ID: 464649

Which of the following statements regarding the ethical conduct necessary for managing portfolios is *least* accurate?

✓ **A)** **The portfolio manager should not presume that they have more knowledge than the client.**

✗ **B)** The standard of conduct is embodied by the CFA Institute Code and Standards.

✗ **C)** The portfolio manager should meet standards of competence.

Explanation

Because the portfolio manager is an expert in the field, he or she has presumably more knowledge than the client. The manager is thus in a position of trust and should adhere to the highest standards of ethical conduct.

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## Question #23 of 47

Question ID: 464614

The investment policy statement does not contain which of the following?

✓ **A)** **Portfolio position listing.**

✗ **B)** Asset allocation guidelines.

✗ **C)** Evaluation of investor risk preferences.

Explanation

The investment policy statement does not contain a listing of portfolio positions, only guidelines as to what positions are allowed.

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## Question #24 of 47

Question ID: 464623

Which of the following does not relate to return objectives? Specifying:

✓ **A)** **security-specific returns.**

✗ **B)** portfolio real after-tax returns.

✗ **C)** return requirements.

Explanation

Required and desired returns, specified in real after-tax levels, relate directly to the formulation of the investor's return objective. Security-specific returns are important in analyzing potential additions to the portfolio, but do not come into play when specifying the overall portfolio return objective.

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## Question #25 of 47

Question ID: 464628

Individual investors and institutional investors can be impacted differently by different constraints. Which constraints have a large impact on individual investors and a large impact on pension funds, respectively?

✗ **A)** **Legal and regulatory issues for individual investors and tax considerations for pensions.**

✓ **B)** Tax considerations for individual investors and legal and regulatory issues for pensions.

✗ **C)** Liquidity concerns for individual investors and tax considerations for pensions.

Explanation

Individual investors are taxable entities, whereas pensions are tax exempt. Institutional investors must operate under ERISA regulations, whereas individuals can invest as they see fit. Liquidity concerns and unique considerations do affect both individual investors and pensions.

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## Question #26 of 47

Question ID: 464630

Which of the following is not considered an investment constraint?

✓ **A)** **High-risk securities.**

✗ **B)** Liquidity requirements.

✗ **C)** Unique considerations.

Explanation

Although there may be reasons why high-risk securities are not included in an overall portfolio, they are only a consequence of constraining factors. Liquidity requirements and unique considerations are both constraining factors.

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## Question #27 of 47

Question ID: 464617

Horace Cline buys large-cap stocks and shorts S&P 500 Index futures. What investment strategy does Cline practice?

✓ **A)** **Active.**

✗ **B)** Semi-active.

✗ **C)** Growth.

Explanation

Cline uses index futures, but that does not make him an indexer. By purchasing stocks and shorting the index, Cline is trying to take the index's movements out of the equation, leveraging the alpha from his stock picks. He is an active manager. We do not have enough information to determine whether Cline is a growth or value investor.

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## Question #28 of 47

Question ID: 464647

A defined benefit pension plan would *most likely* have which of the following set of return objectives and risk tolerance?

| | Return Requirements | Risk Tolerance |
|---|---|---|
| ✓ **A)** | **Fund pension liablility + inflation** | **Plan features, funding status of plan, & age of workforce** |
| ✗ **B)** | Life cycle stage of beneficiaries | Risk tolerance of beneficiaries |
| ✗ **C)** | Pension liablility + inflation | Risk tolerance of beneficiaries |

Explanation

For a defined benefit pension plan, return requirements are based upon the minimum needed to fund the pension liability while accounting for inflation. The risk tolerance is dependent upon the plan's features, the age of the workforce, and the funding status of the plan.

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## Question #29 of 47

Question ID: 464650

Jack Weatherford is a portfolio manager and is providing advice for Maria Conn, an accountant. From his brief conversation with Conn, Weatherford has learned that Conn is 43 years old and her goal is to save for retirement. Weatherford has been extremely busy lately but would like to get Conn started with an asset allocation as soon as possible. He tells her that he might temporarily put her assets in domestic equities and then reallocate her assets when he has time. Which of the following statements is *most* accurate? Weatherford should:

✓ **A)** **not allocate her assets until he has developed an investment policy statement for her.**

✗ **B)** invest Conn's funds in the domestic equities immediately so Conn does not miss out on potential bull markets.

✗ **C)** let Conn make investment decisions so that he avoids liability for potential investment losses.

Explanation

Weatherford should not allocate her assets until he has determined her risk and return objectives as well as investment constraints. An entire allocation to equities may be unsuitable for her if, for example, she has high liquidity needs. Because the portfolio manager is an expert in the field, he or she has presumably more knowledge than the client. The manager should not rely on the client to make the investment decision. The manager should also not rely solely on the client's profile to make the investment decision. The manager is in a position of trust and should meet both standards of competence and conduct.

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## Question #30 of 47

Question ID: 464603

Diversification can reduce:

✓ **A)** **unsystematic risk.**

✗ **B)** systematic risk.

✗ **C)** macroeconomic risks.

Explanation

Systematic risk reflects factors that have a general effect on the security markets as a whole, and cannot be diversified away. Macroeconomic risk comes in many forms, and it is usually considered systematic risk. Unsystematic risk can be reduced through diversification.

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## Question #31 of 47

Question ID: 464620

Which of the following *best* represents the general steps of the planning phase of the portfolio management process? Determining:

✗ **A)** **the investor's tax situation and unique circumstances.**

✓ **B)** investor objectives and constraints.

✗ **C)** the investor's time horizon.

Explanation

The two major steps in the planning phase are determining investor objectives and constraints. The other choices are subsets of this choice. Objectives are concerned with what an investor wishes or requires to happen with the investment portfolio as well as being mainly concerned with risk and return considerations. Constraints pertain to limitations placed on how portfolio objectives are achieved. Primary constraints associated with liquidity include (1) time horizon, (2) legal and regulatory issues, (3) taxes, and (4) unique circumstance considerations.

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## Question #32 of 47

Question ID: 464602

Which one of the following alternatives correctly outlines the importance of the portfolio perspective?

- ✗ **A) Market participants should attempt to eliminate the unsystematic risk associated with each security by forming portfolios that will diversify away this risk.**
- ✗ **B)** Market participants should focus on the systematic risk of the components of a portfolio not the unsystematic risk of the components of a portfolio.
- ✓ **C)** Market participants should analyze the risk-return trade-off of a portfolio as a whole, not the risk-return trade-off of the individual investments in a portfolio.

Explanation

The key underlying principle of the portfolio perspective is that market participants should analyze the risk-return trade-off of the portfolio as a whole, not the risk-return trade-off of the individual investments in the portfolio.

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## Question #33 of 47

Question ID: 464609

The guidelines in the investment policy statement are important because they:

- ✗ **A) dictate how subsequent managers should change portfolio implementation.**
- ✓ **B)** allow continuity in implementation by current and subsequent managers.
- ✗ **C)** determine how to make portfolio shifts after dramatic short-term value declines.

Explanation

The investment policy statement creates implementation guidelines so that any competent manager can implement portfolio decisions.

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## Question #34 of 47

Question ID: 464621

William Parthley, age 69, has had bad luck with his investments in recent years and decides to consult Moira Wembley, CFA, for advice.

Parthley's portfolio is composed of 90% stocks and 10% bonds, with a total value of $2.6 million. Classifying himself as conservative, Parthley blamed the aggressive allocation on a previous money manager, and says he wants to substantially increase the fixed-income weighting of his portfolio.

From his portfolio, Parthley hopes to fund his retirement at a rate of $7,000 per month, adjusted for inflation. He has also promised his alma mater at least $2 million upon his death. Parthley is in good health, and most of the men in his family have lived into their late 80s.

Based solely on the information presented above, Wembley can conclude that there is *most likely* a conflict between Parthley's:

- ✗ **A) return requirements and asset allocation.**
- ✗ **B)** return requirements and asset allocation as well as his willingness to take risk and ability to take risk.
- ✓ **C)** willingness to take risk and ability to take risk.

Explanation

Parthley's portfolio is large enough to meet his needs, with some room to spare. His annual spending accounts for just 3.23% (\$7,000/month × 12 months / \$2.6 million) of the portfolio. Even accounting for inflation and taxes, a 7% return would probably be enough to support Parthley without dipping into the principal. Furthermore, with a \$600,000 cushion above the \$2 million needed for the bequest, Parthley can afford to dip into the principal if necessary. As such, his desire to move to a more conservative allocation is not in conflict with his return requirements.

Parthley's wealth and modest return requirement suggest he has a substantial ability to take risk. Yet Parthley considers himself conservative. There appears to be a conflict here.

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## Question #35 of 47

Question ID: 464651

Kelsey Opelt is a portfolio manager and is providing advice for Jay Steele, a retiree. Opelt has been working with Steele for many years. They have a good relationship and Opelt has taught Steele the basic of investments. Steele has fairly steady liquidity requirements. His house is paid for, he has good health insurance, and he has a steady pension. He only requires \$1,000 a month in spending money that allows him to enjoy retirement. His children are grown and financially independent. His wife Harriet passed away five years ago. Because of Steele's steady lifestyle, low liquidity requirements, and investment knowledge, Opelt has not adjusted Steele's portfolio for capital market expectations in many years. The portfolio has performed quite well recently, due to an average return in the stock market of 25% over the past three years. Opelt should:

✗ **A)** **not interfere with the portfolio because it is performing so well.**

✗ **B)** not perform any actions because Steele's circumstances have not changed, and are not expected to change, for many years.

✓ **C)** monitor the portfolio and capital market expectations more closely.

Explanation

Opelt should monitor the portfolio and capital market expectations more closely. Although it appears that Steele's circumstances have not changed, capital market conditions can change, which could call for a change in asset allocation. This may well be the case here because of the recent high stock market returns. Monitoring the portfolio and capital market expectations is an important part of portfolio management.

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## Question #36 of 47

Question ID: 464618

A money manager who crafts portfolios using all of Standard & Poor's sector index exchange traded funds (ETFs), aggressively overweighting and underweighting sectors, follows what investment strategy?

✗ **A)** **Active.**

✓ **B)** Semi-active.

✗ **C)** Passive.

Explanation

Semi-active strategies involve using indexes as the underlying investments, but trying to add value through some active management. In this case, the manager starts with index ETFs, but actively adjusts the allocation. He is a semi-active manager.

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## Question #37 of 47

Question ID: 464611

The investment policy statement is *least likely* to contain which of the following?

✓ **A)** **Investor contact phone numbers and addresses.**

✗ **B)** Portfolio adjustment guidelines.

✗ **C)** Identification of responsibilities of parties involved.

Explanation

The investment policy statement does not contain contact information, only information regarding responsible parties.

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## Question #38 of 47

Question ID: 464626

Ophelia McGillicutty, a retired airline executive, has been buying and selling stocks for more than 50 years. At 74, she controls a modest investment portfolio of $280,000. Over the last three decades, McGillicutty has given away millions of dollars to charities. She lives comfortably on her pension and her deceased husband's Social Security benefits. McGillicutty keeps the bulk of her investments in stocks, although her children and grandchildren say she is taking on too much risk at her age.

McGillicutty should be *most* concerned about:

✓ **A)** **tax considerations.**

✗ **B)** liquidity.

✗ **C)** diversification.

Explanation

Given McGillicutty's ability and willingness to live on her existing monthly income, liquidity is not a concern. We have no reason to believe that income will not support her for the rest of her life, and we know of no pressing needs for her investment funds. As such, while a high stock weighting may look odd on paper considering her age, it is not necessarily inappropriate, particularly if she is investing for growth to fund charitable donations or her children's inheritance. Taxes, however, concern most investors. Given McGillicutty's relative insensitivity to the other two options, tax considerations seem to be the biggest potential problem area.

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## Question #39 of 47

Question ID: 464607

In which step of the portfolio management process developing an IPS occur?

✗ **A)** **Strategic asset allocation.**

✗ **B)** Feedback

✓ **C)** Planning.

Explanation

Developing an IPS occurs in the planning steps of the process. The purpose of developing an IPS is to govern decision making.

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## Question #40 of 47

Question ID: 464619

Karen Mogdans is a money manager working on an account for Jim Howell. In order to channel Mogdans' knowledge of the risk and return characteristics of different asset classes into a strategic asset allocation for Howell, she needs:

- ✗ **A) a return target.**
- ✓ **B)** an investment policy statement (IPS).
- ✗ **C)** a rebalancing strategy.

Explanation

Mogdans has expertise on different asset classes, suggesting she is also knowledgeable about the market's risk characteristics. The rebalancing strategy will be developed at the same time as the asset allocation, or perhaps afterward. It won't help create the allocation. And while Howell's return target is important, it must be considered in the context of his risk tolerance, portfolio constraints, etc. The IPS contains data needed for a knowledgeable manager to structure a portfolio suitable for an individual investor.

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## Question #41 of 47

Question ID: 464616

The investment policy statement does not contain:

- ✓ **A) industry specifics for potential investment.**
- ✗ **B)** a client description.
- ✗ **C)** guidelines for adjusting portfolio composition.

Explanation

The investment policy statement may provide guidelines for which industry may or may not be included in the portfolio but will not provide specifics about industry characteristics.

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## Questions #42-47 of 47

Herbert von Soltanini, CFA, manages a variety of balanced portfolios for Great Performance Asset Management (GPAM). GPAM has a broad base of clients covering the entire spectrum of institutional investors. The firm manages money globally, but the bulk of its clients are located in Europe and the Americas.

Soltanini is scheduled to travel to the US in a few weeks for annual meetings with key clients in New York, Boston, and Chicago. Great Performance requires portfolio managers to review the investment policy statements (IPS) of each client before the annual meeting to ensure that the IPS still meets the current requirements of the client, and that the IPS is up to date before any revisions are made to it as a result of the annual meeting.

In preparation for the trip, Soltanini asked his assistant, Domenico Bachandel, to review the relevant United States-based clients and the status of their investment policy statements. Bachandel immediately finds a potential discrepancy in the IPS among the firm's pension fund clients, and asks Soltanini for a meeting to discuss the problem.

Soltanini manages portfolios for many large plans. Although the majority of the plans are defined benefit, there are also several defined contribution plans for which Soltanini manages investment funds. The status of the defined benefit plans varies considerably. Most try to maintain contributions in line with actuarial requirements, but Soltanini's defined benefit pension clients cover the full spectrum, from severely underfunded to significantly overfunded.

In addition, the range of beneficiaries varies widely as well. Some of Soltanini's oldest client relationships are with the defined benefit plans sponsored by long-established firms. These firms' employee bases often consist mostly of skilled manufacturing workers with high salaries and generous pension benefits. They generally have a very large proportion of retirees and extremely high requirements for current income to pay the benefits of the plan's retirees. Often, their plans are severely underfunded. A clear example is Riverbank Manufacturing, which covers all employees with a defined benefit plan. The plan is extremely generous and drastically underfunded because more plan participants are retired than are currently employed.

In contrast, Soltanini has more recently developed relationships with many firms in the service sector, especially financial services, communications, and technology. Most of these firms have defined contribution plans, but Soltanini also manages several defined benefit plans sponsored by service sector firms as well.

The defined benefit plans for the newer clients tend to be fully-funded. In fact, many of them are significantly overfunded because the firms make large pension contributions in good years to give themselves the flexibility to reduce required contributions in bad years. These plans tend to have a very small percentage of retirees - in many cases, less than 5% - and very high turnover among workers, so that only a small percentage become vested in the plan.

In addition, these plans tend to offer less generous pension benefits than the plans established earlier by the manufacturing firms. Consequently, many of Soltanini's service sector clients find that funding their defined benefit plans is relatively inexpensive for the plan sponsor. Sunrise Telecom is a perfect example of this. Only 3% of the plan participants at Sunrise are retired, and it experiences a very high turnover among workers. Previous contributions to the pension plan have provided sufficient portfolio assets to make the plan substantially overfunded.

Bachandel is concerned because his review showed a great divergence of investment objectives in the IPS for the various pension clients and several of the IPS for the plans appear to conflict. The IPS for the plan at Riverbank Manufacturing indicates a very low tolerance for risk, while that for Sunside Telecom indicates a very high risk tolerance. Given that these are both defined benefit plans, Bachandel wonders why the IPSs are so different.

At the meeting with Soltanini, Bachandel suggests one possible explanation for the discrepancies by saying, "The return requirements for defined benefit pension plans don't have to be similar since they are determined by the life cycle stage of the beneficiaries." Soltanini points out, "The risk tolerance of the plan will depend on the risk tolerance of the beneficiaries."

Bachandel also raises concern about the IPS statements in general, since the problems extend beyond the pension fund clients. He sees a striking difference in the IPS of the various insurance companies for which Great Performance manages portfolios, as well.

Bachandel clarifies for Soltanini, "The return requirements for life insurance companies depend primarily on policy pricing and financial strength." He hypothesizes to Soltanini that this fact could explain the discrepancies in their stated return requirements. Soltanini adds that all their insurance company clients will most likely have similar risk tolerances. "The risk tolerance at both life and casualty insurance companies is likely to be below average because of regulatory constraints."

Bachandel and Soltanini decide that there is no obvious problem with the client investment policy statements. They agree to wait and review the IPS with the clients at the upcoming annual meetings.

## Question #42 of 47

Question ID: 464639

The *most likely* event to be successfully diversified away in a portfolio would be:

- ✗ **A)** **business cycle risk.**
- ✓ **B)** unanticipated corporate loss.
- ✗ **C)** unanticipated inflation.

Explanation

Portfolios can diversify unsystematic risk but cannot diversify systematic risk. Corporate events are sources of unsystematic risk in a portfolio and thus can be diversified away. Inflation, consumer confidence and the business cycle are all sources of systematic risk. (Study Session 18, LOS 60.a)

## Question #43 of 47

Question ID: 464640

Regarding Bachandel's and Soltanini's assertions about the risk tolerance of defined benefit pension plans:

✗ **A)** **Soltanini's statement is incorrect; Bachandel's statement is correct.**

✓ **B)** Soltanini's statement is incorrect; Bachandel's statement is incorrect.

✗ **C)** Soltanini's statement is correct; Bachandel's statement is correct.

Explanation

Both statements are incorrect. Bachandel's statement is incorrect because return requirements depend on the life cycle stage of beneficiaries at defined contribution, not defined benefit, plans. Soltanini's statement is also incorrect because the risk tolerance of a defined contribution, not defined benefit, plan is determined by the risk tolerance of the beneficiaries. (Study Session 18, LOS 60.f)

## Question #44 of 47

Question ID: 464641

Which of the following is *least likely* to be considered part of the planning phase of the portfolio management process?

✓ **A)** **Selecting appropriate individual investments.**

✗ **B)** Determining the appropriate investment strategy.

✗ **C)** Developing an investment policy statement.

Explanation

The planning phase of the portfolio management process consists of analyzing objectives and constraints, developing an IPS, determining the appropriate investment strategy, and selecting an appropriate asset allocation. Selecting appropriate individual investments is part of the execution phase, not the planning phase. (Study Session 18, LOS 60.b)

## Question #45 of 47

Question ID: 464642

Regarding Bachandel's and Soltanini's assertions about the return requirements and risk tolerances for insurance companies:

✗ **A)** **Soltanini's statement is incorrect; Bachandel's statement is correct.**

✗ **B)** Soltanini's statement is correct; Bachandel's statement is correct.

✓ **C)** Soltanini's statement is correct; Bachandel's statement is incorrect.

Explanation

Soltanini's statement is correct since both life and non-life insurance companies tend to have below average risk tolerance because of significant regulatory constraints. Bachandel's statement is incorrect because the return requirements of *non*-life insurance companies depend primarily on policy pricing and financial strength. The return requirements of life insurance companies depend primarily on policy holder reserve rates. (Study Session 18, LOS 60.f)

## Question #46 of 47

Question ID: 464643

The *most* accurate characterization of the proper use of strategic asset allocation would be:

✗ **A)** **active investment strategies should be used instead of strategic asset allocation when the portfolio manager believes he can exceed market returns.**

✗ **B)** market expectations determine the objectives and constraints of the investor, which translate into strategic asset allocation.

✓ **C)** forecasts of risk-return characteristics of asset classes included in the portfolio connect market expectations to the objectives and constraints of the investor.

Explanation

Active and passive investment strategies are investment approaches, not replacements for strategic asset allocation. Passive approaches are less, not more, responsive to changes in expectations. Market expectations do not determine the objectives or constraints of the investor. (Study Session 18, LOS 64.c)

## Question #47 of 47

Question ID: 464644

Which of the following is *least likely* to be considered one of the five main classes of investment constraints?

✗ **A)** **Time horizon.**

✓ **B)** Willingness to assume risk.

✗ **C)** Tax considerations.

Explanation

The five main classes of investment constraints are liquidity, time horizon, legal and regulatory concerns, tax considerations, and unique circumstances. Willingness to assume risk is an aspect of risk tolerance, which is considered an investment objective, not an investment constraint. (Study Session 18, LOS 64.c)