Question #1 of 21

Which of the following types of investors is likely to have the shortest investment horizon?

A) Foundation.

B) Property and casualty insurance company.

C) Life insurance company.

Explanation

Foundations and life insurance companies typically have long investment horizons. Property and casualty insurance companies typically have shorter investment horizons than life insurance companies because claims against their policies occur sooner on average.

(Study Session 12, Module 38.1, LOS 38.b)

Question #2 of 21

In a defined benefit pension plan:

A) the employee is promised a periodic payment upon retirement.

B) the employer's pension expense is equal to its contributions to the plan.

C) the employee is responsible for making investment decisions.

Explanation

In a defined benefit pension plan, a periodic payment, typically based on the employee's salary, is promised to the employee upon retirement and the employer contributes to an investment trust that generates the principal growth and income to meet the pension obligation. The employees do not direct the investments in their accounts as they do in a defined contribution plan. Pension expense for a defined benefit plan has several components, including service cost, prior service cost, and interest cost, and depends on actuarial assumptions and the expected rate of return on plan assets.

(Study Session 12, Module 38.1, LOS 38.c)

Question #3 of 21

High risk tolerance, a long investment horizon, and low liquidity needs are *most likely* to characterize the investment needs of a(n):

A) bank.

B) insurance company.

C) defined benefit pension plan.

Explanation

A defined benefit pension plan typically has a long investment time horizon, low liquidity needs, and high risk tolerance. Insurance companies and banks typically have low risk tolerance and high liquidity needs. Banks and property and casualty insurers typically have short investment horizons.

(Study Session 12, Module 38.1, LOS 38.b)

Question #4 of 21

A pool of investment assets owned by a government is *best* described as a(n):

A) sovereign wealth fund.

B) official reserve fund.

C) state managed fund.

Explanation

A sovereign wealth fund is a pool of investment assets owned by a government.

(Study Session 12, Module 38.1, LOS 38.b)

Question #5 of 21

The portfolio approach to investing is *best* described as evaluating each investment based on its:

A) potential to generate excess return for the investor.

B) fundamentals such as the financial performance of the issuer.

C) contribution to the portfolio's overall risk and return.

Explanation

The portfolio approach to investing refers to evaluating individual investments based on their contribution to the overall risk and return of the investor's portfolio.

(Study Session 12, Module 38.1, LOS 38.a)

Question #6 of 21

The top-down analysis approach is *most likely* to be employed in which step of the portfolio management process?

A) The feedback step.

B) The planning step.

C) The execution step.

Explanation

Top-down analysis would be used to select securities in the execution step.

(Study Session 12, Module 38.1, LOS 38.d)

Question #7 of 21

Identifying a benchmark for a client portfolio is *most likely* to be part of the:

A) execution step.

B) planning step.

C) feedback step.

Explanation

Identification of the client's benchmark would be established in the planning step, to allow assessment of performance in the feedback step.

(Study Session 12, Module 38.1, LOS 38.d)

Question #8 of 21

Which of the following would be assessed first in a top-down valuation approach?

A) Industry return on equity (ROE).

B) Industry risks.

C) Fiscal policy.

Explanation

In the top-down valuation approach, the investor should analyze macroeconomic influences first, then industry influences, and then company influences. Fiscal policy, as part of the macroeconomic landscape, should be analyzed first.

(Study Session 12, Module 38.1, LOS 38.d)

Question #9 of 21

In the top-down approach to asset allocation, industry analysis should be conducted before company analysis because:

A) the goal of the top-down approach is to identify those companies in non-cyclical industries with the lowest P/E ratios.

B) an industry's prospects within the global business environment are a major determinant of how well individual firms in the industry perform.

C) most valuation models recommend the use of industry-wide average required returns, rather than individual returns.

Explanation

In general, an industry's prospects within the global business environment determine how well or poorly individual firms in the industry do. Thus, industry analysis should precede company analysis. The goal is to find the best companies in the most promising industries; even the best company in a weak industry is not likely to perform well.

(Study Session 12, Module 38.1, LOS 38.d)

Question #10 of 21

Which of the following actions is *best* described as taking place in the execution step of the portfolio management process?

A) Developing an investment policy statement.

B) Choosing a target asset allocation.

C) Rebalancing the portfolio.

Explanation

The three major steps in the portfolio management process are (1) planning, (2) execution, and (3) feedback. The planning step includes evaluating the investor's needs and preparing an investment policy statement. The execution step includes choosing a target asset allocation, evaluating potential investments based on top-down or bottom-up analysis, and constructing the portfolio. The feedback step includes measuring and reporting performance and monitoring and rebalancing the portfolio.

(Study Session 12, Module 38.1, LOS 38.d)

Question #11 of 21

A mutual fund that invests in short-term debt securities and maintains a net asset value of $1.00 per share is *best* described as a:

A) money market fund.

B) balanced fund.

C) bond mutual fund.

Explanation

Money market funds invest primarily in short-term debt securities and are managed to maintain a constant net asset value, typically one unit of currency per share. A bond mutual fund typically invests in longer-maturity securities than a money market fund. A balanced fund invests in both debt and equity securities.

(Study Session 12, Module 38.2, LOS 38.e)

Question #12 of 21

In the Markowitz framework, an investor should *most* appropriately evaluate a potential investment based on its:

A) effect on portfolio risk and return.

B) expected return.

C) intrinsic value compared to market value.

Explanation

Modern portfolio theory concludes that an investor should evaluate potential investments from a portfolio perspective and consider how the investment will affect the risk and return characteristics of an investor's portfolio as a whole.

(Study Session 12, Module 38.1, LOS 38.a)

Question #13 of 21

Which of the following is typically the *first general step* in the portfolio management process?

A) Specify capital market expectations.

B) Develop an investment strategy.

C) Write a policy statement.

Explanation

The policy statement is the foundation of the entire portfolio management process. Here, both risk and return are integrated to determine the investor's goals and constraints.

(Study Session 12, Module 38.1, LOS 38.d)

Question #14 of 21

Which of the following statements about the steps in the portfolio management process is NOT correct?

A) Implementing the plan is based on an analysis of the current and future forecast of financial and economic conditions.

B) Developing an investment strategy is based on an analysis of historical performance in financial markets and economic conditions.

C) Rebalancing the investor's portfolio is done on an as-needed basis, and should be reviewed on a regular schedule.

Explanation

Developing an investment strategy is based primarily on an analysis of the *current and future* financial market and economic conditions. Historical analysis serves to help develop an expectation for future conditions.

(Study Session 12, Module 38.1, LOS 38.d)

Question #15 of 21

A pooled investment with a share price significantly different from its net asset value (NAV) per share is *most likely* a(n):

A) open-end fund.

B) exchange-traded fund.

C) closed-end fund.

Explanation

Closed-end funds' share prices can differ significantly from their NAVs. Open-end fund shares can be purchased and redeemed at their NAVs. Market forces keep exchange-traded fund share prices close to their NAVs because arbitrageurs can profit by trading when there are differences.

(Study Session 12, Module 38.2, LOS 38.e)

Question #16 of 21

Which of the following pooled investments is *least likely* to employ large amounts of leverage?

A) Private equity buyout fund.

B) Global macro hedge fund.

C) Venture capital fund.

Explanation

Hedge funds and buyout firms typically employ high leverage to acquire assets. Venture capital typically involves an equity interest.

(Study Session 12, Module 38.2, LOS 38.e)

Question #17 of 21

In a defined contribution pension plan, investment risk is borne by the:

A) employee.

B) employer.

C) plan manager.

Explanation

In a defined contribution plan, the employee makes the investment decisions and assumes the investment risk.

(Study Session 12, Module 38.1, LOS 38.c)

Question #18 of 21

Which of the following institutional investors is *most likely* to have low liquidity needs?

A) Bank.

B) Property insurance company.

C) Defined benefit pension plan.

Explanation

A defined benefit pension plan has less need for liquidity than a bank or a property and casualty insurance company. Banks have high liquidity needs because assets may have to be sold quickly if depositors withdraw their funds. Property and casualty insurance companies need to keep liquid assets to meet claims as they arise.

(Study Session 12, Module 38.1, LOS 38.b)

Question #19 of 21

The ratio of an equally weighted portfolio's standard deviation of return to the average standard deviation of the securities in the portfolio is known as the:

A) Sharpe ratio.

B) relative risk ratio.

C) diversification ratio.

Explanation

The diversification ratio is calculated by dividing a portfolio's standard deviation of returns by the average standard deviation of returns of the individual securities in the portfolio (sometimes calculated as the average annualized standard deviation of portfolio securities selected at random over the historical measurement period).

(Study Session 12, Module 38.1, LOS 38.a)

Question #20 of 21

A pooled investment fund buys all the shares of a publicly traded company. The fund reorganizes the company and replaces its management team. Three years later, the fund exits the investment through an initial public offering of the company's shares. This pooled investment fund is *best* described as a(n):

A) venture capital fund.

B) event-driven fund.

C) private equity fund.

Explanation

A private equity fund or buyout fund is one that acquires entire public companies, takes them private, and reorganizes the companies to increase their value. An event-driven fund is a hedge fund that invests in response to corporate events such as mergers or acquisitions. Venture capital funds invest in start-up companies.

(Study Session 12, Module 38.2, LOS 38.e)

Question #21 of 21

Promised payments to pension beneficiaries are a responsibility of the plan sponsor in:

A) both a defined benefit plan and a defined contribution plan.

B) a defined contribution plan only.

C) a defined benefit plan only.

Explanation

In a defined benefit plan the promised payments to beneficiaries are a responsibility of the firm sponsoring the plan. In a defined contribution plan no fixed payments are promised to beneficiaries.

(Study Session 12, Module 38.1, LOS 38.c)