Question #1 of 28

Brian Nebrik, CFA, meets with a new investment management client. They compose a statement that defines each of their responsibilities concerning this account and choose a benchmark index with which to evaluate the account's performance. Which of these items should be included in the client's Investment Policy Statement (IPS)?

A) Only one of these items.

B) Both of these items.

C) Neither of these items.

Explanation

Two of the major components of an IPS should be a statement of the responsibilities of the investment manager and the client, and a performance evaluation benchmark.

(Study Session 13, Module 41.1, LOS 41.b)

Question #2 of 28

A return objective is said to be relative if the objective is:

A) compared to a specific numerical outcome.

B) stated in terms of probability.

C) based on a benchmark index or portfolio.

Explanation

Relative return objectives are stated relative to specified benchmarks, such as LIBOR or the return on a stock index. Absolute return objectives are stated in terms of specific numerical outcomes, such as a 5% return. *Risk* objectives (either absolute or relative) may be stated in terms of probability, such as "no more than a 5% probability of a negative return."

(Study Session 13, Module 41.1, LOS 41.c)

Question #3 of 28

Which of the following statements about risk and return is *least accurate*?

A) Return objectives may be stated in absolute terms.

B) Risk and return may be considered on a mutually exclusive basis.

C) Specifying investment objectives only in terms of return may expose an investor to inappropriately high levels of risk.

Explanation

Risk and return must always be considered together when expressing investment objectives. Return objectives may be expressed either in absolute terms (dollar amounts) or in percentages.

(Study Session 13, Module 41.1, LOS 41.c)

Question #4 of 28

Which of the following is NOT a rationale for the importance of the policy statement in investing? It:

A) forces investors to understand their needs and constraints.

B) helps investors understand the risks and costs of investing.

C) identifies specific stocks the investor may wish to purchase.

Explanation

The policy statement outlines broad objectives and constraints but does not get into the details of specific stocks for investment.

(Study Session 13, Module 41.1, LOS 41.a)

Question #5 of 28

Which of the following *best* describes the importance of the policy statement? It:

A) limits the risks taken by the investor.

B) outlines the best investments.

C) states the standards by which the portfolio's performance will be judged.

Explanation

The policy statement should state the performance standards by which the portfolio's performance will be judged and specify the benchmark that represents the investors risk preferences.

(Study Session 13, Module 41.1, LOS 41.a)

Question #6 of 28

An individual investor specifies to her investment advisor that her portfolio must produce a minimum amount of cash each period. This investment constraint is *best* classified as:

A) legal and regulatory.

B) unique circumstances.

C) liquidity.

Explanation

Liquidity constraints arise from an investor's need for spendable cash.

(Study Session 13, Module 41.1, LOS 41.e)

Question #7 of 28

Which of the following is *least likely* to be considered a constraint when preparing an investment policy statement?

A) Tax concerns.

B) Risk tolerance.

C) Liquidity needs.

Explanation

The constraints are: liquidity needs, time horizon, taxes, legal and regulatory factors, and unique needs and preferences. Risk tolerance is included in the investment objectives of the policy statement, not in the constraints.

(Study Session 13, Module 41.1, LOS 41.e)

Question #8 of 28

Which of the following statements about the importance of risk and return in the investment objective is *least* accurate?

A) The investor's risk tolerance is likely to determine what level of return will be feasible.

B) Expressing investment goals in terms of risk is more appropriate than expressing goals in terms of return.

C) The return objective may be stated in dollar amounts even if the risk objective is stated in percentages.

Explanation

Expressing investment goals in terms of risk is *not* more appropriate than expressing goals in terms of return. The investment objectives should be stated in terms of both risk and return. Risk tolerance will likely help determine what level of expected return is feasible.

(Study Session 13, Module 41.1, LOS 41.c)

Question #9 of 28

The major components of a typical investment policy statement (IPS) *least likely* include:

A) duties and responsibilities of investment manager, custodian, and client.

B) investment objectives, constraints, and guidelines.

C) investment manager's compensation.

Explanation

Investment manager's compensation is not among the major components of a typical IPS. The major components include a description of the client; a statement of purpose; a statement of duties and responsibilities; procedures to update the IPS; investment objectives; investment constraints; investment guidelines; and benchmark for evaluation of performance.

(Study Session 13, Module 41.1, LOS 41.b)

Question #10 of 28

Which of the following statements about risk and return is NOT correct?

A) Return-only objectives provide a more concise and efficient way to measure performance for investment managers.

B) Return objectives should be considered in conjunction with risk preferences.

C) Return objectives may be stated in dollar amounts.

Explanation

Return-only objectives may actually lead to unacceptable behavior on the part of investment managers, such as excessive trading (churning) to generate excessive commissions.

(Study Session 13, Module 41.1, LOS 41.c)

Question #11 of 28

Which of the following statements about risk is NOT correct? Generally, greater:

A) existing wealth allows for greater risk.

B) spending needs allows for greater risk.

C) insurance coverage allows for greater risk.

Explanation

Greater spending needs usually allow for *lower* risk because there is a definite need to ensure that the return may adequately fund the spending needs (a "fixed" cost).

(Study Session 13, Module 41.1, LOS 41.d)

Question #12 of 28

Which of the following statements about investment constraints is *least* accurate?

A) Unwillingness to invest in gambling stocks is a constraint.

B) Investors concerned about time horizon are not likely to worry about liquidity.

C) Diversification efforts can increase tax liability.

Explanation

Investors with a time horizon constraint may have little time for capital appreciation before they need the money. Need for money in the near term is a liquidity constraint. Time horizon and liquidity constraints often go hand in hand. Diversification often requires the sale of an investment and the purchase of another. Investment sales often trigger tax liability. Younger investors should take advantage of tax deferrals while they have time for the savings to compound, and while they are in their peak earning years. Many retirees have little income and face less tax liability on investment returns.

(Study Session 13, Module 41.1, LOS 41.e)

Question #13 of 28

All of the following are investment constraints EXCEPT:

A) tax concerns.

B) liquidity needs.

C) pension plan contributions of the employer.

Explanation

Investment constraints include: liquidity needs, time horizon, tax concerns, legal and regulatory factors and unique needs and preferences. While employer contributions may be of interest, and an issue in some instances, it is not classified as a specific investment constraint.

(Study Session 13, Module 41.1, LOS 41.e)

Question #14 of 28

A firm that invests the majority of a portfolio to track a benchmark index, and uses active investment strategies for the remaining portion, is said to be using:

A) strategic asset allocation.

B) risk budgeting.

C) a core-satellite approach.

Explanation

With a core-satellite approach, a firm invests the majority of a portfolio passively and uses active strategies for the remaining portion. Strategic asset allocation refers to specifying the percentages of a portfolio's value to allocate to specific asset classes. Risk budgeting refers to allocating a portfolio's overall permitted risk among strategic asset allocation, tactical asset allocation, and security selection.

(Study Session 13, Module 41.1, LOS 41.g)

Question #15 of 28

When preparing a strategic asset allocation, how should asset classes be defined with respect to the correlations of returns among the securities in each asset class?

A) Low correlation within asset classes and low correlation between asset classes.

B) Low correlation within asset classes and high correlation between asset classes.

C) High correlation within asset classes and low correlation between asset classes.

Explanation

The portfolio diversification benefits from strategic asset allocation result from low correlations of returns between asset classes. Asset classes should consist of assets with similar characteristics and investment performance, which means correlations within an asset class are relatively high.

(Study Session 13, Module 41.1, LOS 41.f)

Question #16 of 28

The manager of the Fullen Balanced Fund is putting together a report that breaks out the percentage of the variation in portfolio return that is explained by the target asset allocation, security selection, and tactical variations from the target, respectively. Which of the following sets of numbers was the *most likely* conclusion for the report?

A) 33%, 33%, 33%.

B) 50%, 25%, 25%.

C) 90%, 6%, 4%.

Explanation

Several studies support the idea that approximately 90% of the variation in a single portfolio's returns can be explained by its target asset allocations, with security selection and tactical variations from the target (market timing) playing a much less significant role. In fact, for actively managed funds, actual portfolio returns are slightly less than those that would have been achieved if the manager strictly maintained the target allocation, thus illustrating the difficultly of improving returns through security selection or market timing.

(Study Session 13, Module 41.1, LOS 41.g)

Question #17 of 28

While assessing an investor's risk tolerance, a financial adviser is *least likely* to ask which of the following questions?

A) “How much insurance coverage do you have?”

B) “What rate of investment return do you expect?”

C) “Is your home life stable?”

Explanation

While the degree of risk tolerance will have an affect on expected returns, assessing the risk tolerance comes first, and the resulting set of feasible returns follows. The other questions address risk tolerance.

(Study Session 13, Module 41.1, LOS 41.d)

Question #18 of 28

Which of the following should *least likely* be included as a constraint in an investment policy statement (IPS)?

A) Constraints put on investment activities by regulatory agencies.

B) How funds are spent after being withdrawn from the portfolio.

C) Any unique needs or preferences an investor may have.

Explanation

How funds are spent after withdrawal would not be a constraint of an IPS.

(Study Session 13, Module 41.1, LOS 41.e)

Question #19 of 28

A portfolio manager who believes equity securities are overvalued in the short term reduces the weight of equities in her portfolio to 35% from its longer-term target weight of 40%. This decision is *best* described as an example of:

A) strategic asset allocation.

B) tactical asset allocation.

C) rebalancing.

Explanation

Tactical asset allocation refers to deviating from a portfolio's target asset allocation weights in the short term to take advantage of perceived opportunities in specific asset classes. Strategic asset allocation is determining the target asset allocation percentages for a portfolio. Rebalancing is periodically adjusting a portfolio back to its target asset allocation.

(Study Session 13, Module 41.1, LOS 41.g)

Question #20 of 28

Which of the following factors is *least likely* to affect an investor's risk tolerance?

A) Number of dependent family members.

B) Level of inflation in the economy.

C) Level of insurance coverage.

Explanation

The level of inflation in the economy should be considered in determining the *return* objective. Risk tolerance is a function of the investor's psychological makeup and the investor's personal factors such as age, family situation, existing wealth, insurance coverage, current cash reserves and income.

(Study Session 13, Module 41.1, LOS 41.d)

Question #21 of 28

Which of the following would *least likely* be considered a minimum requirement of an IPS? A(n):

A) benchmark portfolio.

B) target return figure.

C) investment strategy based on client circumstances and constraints.

Explanation

An IPS does not necessarily, or even typically, require a target return because future market movements are either difficult or impossible to predict with any degree of accuracy. At a minimum the IPS should contain a clear statement of client circumstances and constraints, and investment strategy consistent with these, and a benchmark portfolio or instrument against which to evaluate portfolio returns.

(Study Session 13, Module 41.1, LOS 41.b)

Question #22 of 28

An endowment is required by statute to pay out a minimum percentage of its asset value each period to its beneficiaries. This investment constraint is *best* classified as:

A) legal and regulatory.

B) liquidity.

C) unique circumstances.

Explanation

Legal and regulatory constraints are those that apply to an investor by law.

(Study Session 13, Module 41.1, LOS 41.e)

Question #23 of 28

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

A) A benchmark against which to judge performance.

B) Procedures to update the IPS when circumstances change.

C) An investment strategy based on the investor's objectives and constraints.

Explanation

At a minimum an IPS should contain a clear statement of client circumstances and constraints, an investment strategy based on these, and some benchmark against which to evaluate the account performance. The investment must periodically update the IPS as circumstances change, but explicit procedures for these updates are not necessarily included in the IPS itself.

(Study Session 13, Module 41.1, LOS 41.a)

Question #24 of 28

Which of the following statements is NOT consistent with the assumption that individuals are risk averse with their investment portfolios?

A) Higher betas are associated with higher expected returns.

B) Many individuals purchase lottery tickets.

C) There is a positive relationship between expected returns and expected risk.

Explanation

Investors are *risk averse*. Given a choice between two assets with equal rates of return, the investor will always select the asset with the lowest level of risk. This means that there is a positive relationship between expected returns (ER) and expected risk and the risk return line (capital market line [CML] and security market line [SML]) is upward sweeping. However, investors can be risk averse in one area and not others, as evidenced by their purchase of lottery tickets.

(Study Session 13, Module 41.1, LOS 41.d)

Question #25 of 28

Which of the following asset class specifications is *most appropriate* for asset allocation purposes?

A) Emerging markets.

B) Domestic bonds.

C) Consumer discretionary.

Explanation

An asset class should be specified by type of security (e.g., stocks, bonds, alternative assets, cash) and can then be further subdivided by region or industry classification. An asset class defined only as "emerging markets" or "consumer discretionary firms" should identify the type of securities (e.g., equities or debt).

(Study Session 13, Module 41.1, LOS 41.f)

Question #26 of 28

When developing the strategic asset allocation in an IPS, the correlations of returns:

A) among asset classes should be relatively high.

B) within an asset class should be relatively low.

C) within an asset class should be relatively high.

Explanation

Asset classes are defined such that correlations of returns *within* an asset class are relatively high. Low correlations of returns *among* asset classes increase the benefits of diversification across asset classes.

(Study Session 13, Module 41.1, LOS 41.f)

Question #27 of 28

An investment manager has constructed an efficient frontier based on a client's investable asset classes. The strategic asset allocation for the client should be the asset allocation of one of these efficient portfolios, selected based on:

A) a risk budgeting process.

B) the relative valuations of the investable asset classes.

C) the client’s investment objectives and constraints.

Explanation

After defining the investable asset classes and constructing an efficient frontier of possible portfolios of these asset classes, the manager should choose the efficient portfolio that best suits the investor's objectives and constraints as specified in the IPS. The investor's strategic asset allocation can then be defined as the asset allocation of the chosen portfolio. Tactical asset allocation based on relative valuation of asset classes would require the manager to deviate from the strategic asset allocation. Risk budgeting refers to the practice of determining an overall risk limit for a portfolio and allocating that risk to strategic asset allocation, tactical asset allocation, and security selection decisions.

(Study Session 13, Module 41.1, LOS 41.g)

Question #28 of 28

All of the following affect an investor's risk tolerance EXCEPT:

A) tax bracket.

B) family situation.

C) years of experience with investing in the markets.

Explanation

Tax concerns play an important role in investment planning. However, these constitute an investment constraint, not an investment objective (i.e. risk tolerance).

(Study Session 13, Module 41.1, LOS 41.d)