Portfolio Management and Basics of Portfolio Planning

Test ID: 7697065

Question #1 of 47

Question ID: 414946

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

- ✗ **A) Rebalancing the investor's portfolio is done on an as-needed basis, and should be reviewed on a regular schedule.**
- ✗ **B)** Implementing the plan is based on an analysis of the current and future forecast of financial and economic conditions.
- ✓ **C)** Developing an investment strategy is based on an analysis of historical performance in financial markets and economic conditions.

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.

Question #2 of 47

Question ID: 415097

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

- ✓ **A) Many individuals purchase lottery tickets.**
- ✗ **B)** Higher betas are associated with higher expected returns.
- ✗ **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.

Question #3 of 47

Question ID: 415100

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

- ✗ **A) Diversification efforts can increase tax liability.**
- ✓ **B)** Investors concerned about time horizon are not likely to worry about liquidity.
- ✗ **C)** Unwillingness to invest in gambling stocks is a constraint.

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.

Question #4 of 47

Question ID: 414943

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

- ✗ **A)** **state managed fund.**
- ✗ **B)** official reserve fund.
- ✓ **C)** sovereign wealth fund.

Explanation

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

Question #5 of 47

Question ID: 414951

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

- ✗ **A)** **exchange-traded fund.**
- ✗ **B)** open-end 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.

Question #6 of 47

Question ID: 415111

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)** **risk budgeting.**
- ✓ **B)** a core-satellite approach.
- ✗ **C)** strategic asset allocation.

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.

Question #7 of 47

Question ID: 415090

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

- ✓ **A) investment manager's compensation.**
- ✗ **B)** duties and responsibilities of investment manager, custodian, and client.
- ✗ **C)** investment objectives, constraints, and guidelines.

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.

Question #8 of 47

Question ID: 414953

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) balanced fund.**
- ✓ **B)** money market 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.

Question #9 of 47

Question ID: 415096

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

- ✓ **A) spending needs allows for greater risk.**
- ✗ **B)** existing wealth 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).

Question #10 of 47

Question ID: 414941

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)** defined benefit pension plan.

✗ **C)** insurance company.

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.

Question #11 of 47

Question ID: 434362

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

✗ **A) feedback step.**

✓ **B)** planning step.

✗ **C)** execution step.

Explanation

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

Question #12 of 47

Question ID: 414947

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

✓ **A) Write a policy statement.**

✗ **B)** Specify capital market expectations.

✗ **C)** Develop an investment strategy.

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.

Question #13 of 47

Question ID: 415095

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

✓ **A) Level of inflation in the economy.**

✗ **B)** Number of dependent family members.

✗ **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.

Question #14 of 47

Question ID: 414949

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)** most valuation models recommend the use of industry-wide average required returns, rather than individual returns.
- ✓ **C)** an industry's prospects within the global business environment are a major determinant of how well individual firms in the industry perform.

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.

Question #15 of 47

Question ID: 414944

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

- ✗ **A)** **employer.**
- ✗ **B)** plan manager.
- ✓ **C)** employee.

Explanation

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

Question #16 of 47

Question ID: 415104

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)** liquidity.
- ✗ **C)** unique circumstances.

Explanation

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

Question #17 of 47

Question ID: 414938

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

- ✗ **A)** **intrinsic value compared to market value.**
- ✗ **B)** expected return.
- ✓ **C)** effect on portfolio risk and return.

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.

Question #18 of 47

Question ID: 415093

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

- ✗ **A)** **Return objectives may be stated in absolute terms.**
- ✗ **B)** Specifying investment objectives only in terms of return may expose an investor to inappropriately high levels of risk.
- ✓ **C)** Risk and return may be considered on a mutually exclusive basis.

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.

Question #19 of 47

Question ID: 414940

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

- ✓ **A)** **contribution to the portfolio's overall risk and return.**
- ✗ **B)** potential to generate excess return for the investor.
- ✗ **C)** fundamentals such as the financial performance of the issuer.

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.

Question #20 of 47

Question ID: 415086

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

✗ **A) helps investors understand the risks and costs of investing.**

✗ **B)** forces investors to understand their needs and constraints.

✓ **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.

Question #21 of 47

Question ID: 434360

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.

Question #22 of 47

Question ID: 415099

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

✗ **A) family situation.**

✗ **B)** years of experience with investing in the markets.

✓ **C)** tax bracket.

Explanation

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

Question #23 of 47

Question ID: 414939

The ratio of a 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.

Question #24 of 47

Question ID: 414942

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.

Question #25 of 47

Question ID: 415092

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

- ✗ **A)** **Return objectives may be stated in dollar amounts.**
- ✗ **B)** Return objectives should be considered in conjunction with risk preferences.
- ✓ **C)** Return-only objectives provide a more concise and efficient way to measure performance for investment managers.

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.

Question #26 of 47

Question ID: 472419

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

- ✓ **A)** **within an asset class should be relatively high.**
- ✗ **B)** among asset classes should be relatively high.
- ✗ **C)** within an asset class should be relatively low.

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.

Question #27 of 47

Question ID: 414948

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

- ✗ **A)** **Industry risks.**

✓ **B)** Fiscal policy.

✗ **C)** Industry return on equity (ROE).

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.

Question #28 of 47

Question ID: 415110

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) rebalancing.**

✗ **B)** strategic asset allocation.

✓ **C)** tactical asset allocation.

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.

Question #29 of 47

Question ID: 415091

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

✓ **A) Expressing investment goals in terms of risk is more appropriate than expressing goals in terms of return.**

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

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

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.

Question #30 of 47

Question ID: 415108

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) 90%, 6%, 4%.**

✗ **B)** 33%, 33%, 33%.

✗ **C)** 50%, 25%, 25%.

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.

Question #31 of 47

Question ID: 434361

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.

Question #32 of 47

Question ID: 415109

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

✓ **A) the investment policy statement (IPS).**

✗ **B)** relative valuation of the asset classes.

✗ **C)** a risk budgeting process.

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 as defined 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 the risk among strategic asset allocation, tactical asset allocation, and security selection.

Question #33 of 47

Question ID: 414950

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)** Rebalancing the portfolio.

✓ **C)** Choosing a target asset allocation.

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.

Question #34 of 47

Question ID: 415106

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 high correlation between asset classes.**

✗ **B)** Low correlation within asset classes and low 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.

Question #35 of 47

Question ID: 415107

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

✗ **A) Consumer discretionary.**

✓ **B)** Domestic bonds.

✗ **C)** Emerging markets.

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).

Question #36 of 47

Question ID: 415087

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

✗ **A) allows the investor to judge performance by objective standards.**

✓ **B)** forces investors to take risks.

✗ **C)** specifies a benchmark against which to judge performance.

Explanation

By no means should the policy statement force the investor to take risks. The statement forces investors to *understand* the risks of investing.

Question #37 of 47

Question ID: 415098

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.

Question #38 of 47

Question ID: 415088

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

- ✓ **A)** **states the standards by which the portfolio's performance will be judged.**
- ✗ **B)** outlines the best investments.
- ✗ **C)** limits the risks taken by the investor.

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.

Question #39 of 47

Question ID: 415103

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

- ✗ **A)** **Tax concerns.**
- ✗ **B)** Liquidity needs.
- ✓ **C)** Risk tolerance.

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.

Question #40 of 47

Question ID: 415101

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

- ✗ **A)** **Any unique needs or preferences an investor may have.**

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

✗ **C)** Constraints put on investment activities by regulatory agencies.

Explanation

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

Question #41 of 47

Question ID: 415102

All of the following are investment constraints EXCEPT:

✓ **A)** **pension plan contributions of the employer.**

✗ **B)** liquidity needs.

✗ **C)** tax concerns.

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.

Question #42 of 47

Question ID: 415094

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

✗ **A)** **stated in terms of probability.**

✗ **B)** compared to a specific numerical outcome.

✓ **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."

Question #43 of 47

Question ID: 414952

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.

Question #44 of 47

Question ID: 415089

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)** **Neither of these items.**
- ✓ **B)** Both of these items.
- ✗ **C)** Only one 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.

Question #45 of 47

Question ID: 415105

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)** **liquidity.**
- ✓ **B)** legal and regulatory.
- ✗ **C)** unique circumstances.

Explanation

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

Question #46 of 47

Question ID: 414945

In a defined benefit pension plan:

- ✓ **A)** **the employee is promised a periodic payment upon retirement.**
- ✗ **B)** the employee is responsible for making investment decisions.
- ✗ **C)** the employer's pension expense is equal to its contributions to the plan.

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.

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Question ID: 485793

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.