Question #1 of 32

Question ID: 1574584

Categories of investment constraints in an investment policy statement *least likely* include:

A) liquidity needs.

B) tax concerns.

C) risk tolerance.

Explanation

Risk tolerance and return requirements make up the investment objectives. Investment constraints include liquidity needs, time horizon, tax concerns, legal and regulatory factors, and unique circumstances.

(Module 86.1, LOS 86.e)

Question #2 of 32

Question ID: 1574595

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.

(Module 86.1, LOS 86.g)

Question #3 of 32

Question ID: 1574568

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

A) An investment strategy based on the investor’s objectives and constraints.

B) Procedures to update the IPS when circumstances change.

C) A benchmark against which to judge performance.

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.

(Module 86.1, LOS 86.a)

Question #4 of 32

Question ID: 1574579

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

A) family situation.

B) tax bracket.

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).

(Module 86.1, LOS 86.d)

Question #5 of 32

Question ID: 1574598

Which of the following statements is *most accurate* about integrating ESG considerations into portfolio planning and construction?

A) Integrating ESG considerations into portfolio planning and construction is likely to decrease portfolio returns.

B) Investors who engage in active ownership to pursue their ESG considerations should vote their shares themselves rather than delegating share voting to an investment manager.

C) A broad market index is an inappropriate benchmark for a portfolio that uses negative screening to address the investor’s ESG concerns.

Explanation

If a portfolio's investment universe is constrained by negative screening, an appropriate benchmark is an index that excludes companies or industries that investors with ESG concerns commonly avoid.

Investors engaging in active ownership to pursue their ESG considerations may choose to vote their shares themselves or instruct an investment manager to vote the shares.

The effect of integrating ESG considerations on portfolio returns is uncertain. While limiting the universe of investment choices and incurring the costs involved in considering ESG factors may decrease returns, investing in companies with good corporate governance practices and avoiding those that face ESG-related risks may increase returns.

(Module 86.1, LOS 86.g)

Question #6 of 32

Question ID: 1574581

If an investor's ability to bear risk is low and willingness to bear risk is high, an investment manager should *most appropriately* consider the investor's overall financial risk tolerance to be:

A) low.

B) moderate.

C) high.

Explanation

In general, an advisor should consider an investor's risk tolerance to be the lower of the investor's ability and willingness to bear risk.

(Module 86.1, LOS 86.d)

Question #7 of 32

Question ID: 1574576

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

A) existing wealth allows for greater risk.

B) insurance coverage allows for greater risk.

C) spending needs 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).

(Module 86.1, LOS 86.d)

Question #8 of 32

Question ID: 1574587

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.

(Module 86.1, LOS 86.e)

Question #9 of 32

Question ID: 1574572

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

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

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

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.

(Module 86.1, LOS 86.c)

Question #10 of 32

Question ID: 1574588

Davis Samuel, CFA, is meeting with one of his portfolio management clients, Joseph Pope, to discuss Pope's investment constraints. Samuel has established that:

- Pope plans to retire from his job as a bond salesman in 17 years, after which this portfolio will be his primary source of income.
- Pope has sufficient cash available that he will not need this portfolio to generate cash outflows until he retires.
- Pope, as a registered securities representative, is required to have Samuel send a copy of his account statements to the compliance officer at Pope's employer.
- Pope opposes certain policies of the government of Lower Pannonia and does not wish to own any securities of companies that do business with its regime.

To complete his assessment of Pope's investment constraints, Samuel still needs to inquire about Pope's:

A) tax concerns. ✓

B) unique circumstances. ✗

C) liquidity needs. ✗

Explanation

Of the five categories of investment constraints, the four matters listed are related to Pope's time horizon (years to retirement), liquidity needs (available cash), legal and regulatory factors (required copies of account statements to Pope's compliance officer), and unique needs and preferences (no investments in Lower Pannonia). None of these constraints address Pope's tax situation or the taxable status of the investment account.

(Module 86.1, LOS 86.e)

Question #11 of 32

Question ID: 1574567

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.

(Module 86.1, LOS 86.a)

Question #12 of 32

Question ID: 1574580

Based on a questionnaire about investment risk, an advisor concludes that an investor's risk tolerance is high, but based on an analysis of the client's income needs and time horizon, he concludes the investor's risk tolerance is low. The *most appropriate* action for the advisor is to:

A) emphasize stocks over bonds.

B) emphasize bonds over stocks.

C) educate the client about investment risk and re-administer the questionnaire.

Explanation

When determining an investor's risk tolerance, an advisor must consider both the investor's ability and willingness to bear risk. Even though the investor has a high willingness to bear risk, his ability to take risk (based on his financial situation) is low, and this should take precedence. A portfolio that emphasizes bonds over stocks has less investment risk and is the most appropriate choice.

(Module 86.1, LOS 86.d)

Question #13 of 32

Question ID: 1574589

Which of the following portfolio constraints in the Investment Policy Statement of a local college's endowment *most likely* belongs in the "unique circumstances" category? The endowment is:

A) exempt from taxes.

B) subject to oversight by a regulatory authority.

C) unwilling to invest in companies that sell weapons.

Explanation

Issues involving taxes fall in the tax concerns category, and issues regarding regulation fall in the legal and regulatory factors category. Specific guidance from the investor on permitted businesses for investment is included in unique circumstances.

(Module 86.1, LOS 86.e)

Question #14 of 32

Question ID: 1574592

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 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.

(Module 86.1, LOS 86.f)

Question #15 of 32

Question ID: 1574596

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) a core-satellite approach.

B) risk budgeting.

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.

(Module 86.1, LOS 86.g)

Question #16 of 32

Question ID: 1574583

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

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

B) Any unique needs or preferences an investor may have. ✗

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

Explanation

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

(Module 86.1, LOS 86.e)

Question #17 of 32

Question ID: 1574571

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

A) benchmark portfolio. ✗

B) investment strategy based on client circumstances and constraints. ✗

C) target return figure. ✓

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.

(Module 86.1, LOS 86.b)

Question #18 of 32

Question ID: 1574591

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

A) Emerging markets.

B) Consumer discretionary.

C) Domestic bonds.

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).

(Module 86.1, LOS 86.f)

Question #19 of 32

Question ID: 1574597

An investment manager is *most likely* to be engaging in tactical asset allocation if she:

A) allocates more than the targeted 10% to emerging market bonds because the sector appears to be undervalued.

B) allocates 5% to cash, 20% to fixed income, and 75% to equities based on the investor's long time horizon and high risk tolerance.

C) increases the allocation to tax-free bonds because the investor's effective tax rate has increased.

Explanation

Tactical asset allocation is deviating from a portfolio's strategic asset allocation because an asset class or sector is perceived to be mispriced in the short term. Establishing and updating target weights for asset classes based on the investor's objectives and constraints is strategic asset allocation.

(Module 86.1, LOS 86.g)

Question #20 of 32

Question ID: 1574569

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) Both of these items.

B) Only one 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.

(Module 86.1, LOS 86.b)

Question #21 of 32

Question ID: 1574575

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.

(Module 86.1, LOS 86.d)

Question #22 of 32

Question ID: 1574594

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) the relative valuations of the investable asset classes.

B) a risk budgeting process.

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.

(Module 86.1, LOS 86.g)

Question #23 of 32

Question ID: 1574593

When performing strategic asset allocation, properly defined and specified asset classes should:

A) approximate the investor’s total investable universe as a group.

B) each contain assets that have a broad range of risk and expected return.

C) have high returns correlations with other asset classes.

Explanation

When taken together, the asset classes should approximate the investor's total investible universe. Properly defined and specified asset classes should each have a low return correlation to the other asset classes, and within each asset class should be assets that have similar expected risk and return.

(Module 86.1, LOS 86.f)

Question #24 of 32

Question ID: 1574582

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.

(Module 86.1, LOS 86.e)

Question #25 of 32

Question ID: 1574573

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.

(Module 86.1, LOS 86.c)

Question #26 of 32

Question ID: 1574578

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) “Is your home life stable?”

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

Explanation

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

(Module 86.1, LOS 86.d)

Question #27 of 32

Question ID: 1574570

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

A) the investment manager’s compensation.

B) duties and responsibilities of the investment manager.

C) investment objectives.

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.

(Module 86.1, LOS 86.b)

Question #28 of 32

Question ID: 1574574

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

A) based on a benchmark index or portfolio.

B) stated in terms of probability.

C) compared to a specific numerical outcome.

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."

(Module 86.1, LOS 86.c)

Question #29 of 32

Question ID: 1574577

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.

(Module 86.1, LOS 86.d)

Question #30 of 32

Question ID: 1574586

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.

(Module 86.1, LOS 86.e)

Question #31 of 32

Question ID: 1574585

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

A) Liquidity needs.

B) Risk tolerance.

C) Tax concerns.

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.

(Module 86.1, LOS 86.e)

Question #32 of 32

Question ID: 1574590

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

C) Low 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.

(Module 86.1, LOS 86.f)