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Question 1

Question Type: **MultipleChoice**

Which of the following portfolios best represents a suitable asset allocation for a risk-averse investor?

i. Cash/money market fund: 20%; government bonds: 10%; investment-grade bonds: 15%; foreign stocks: 10%; blue-chip stocks: 25%; high-yield bonds: 10%; small cap stocks: 10%

ii. Cash/money market fund: 30%; government bonds: 20%; investment-grade bonds: 15%; foreign stocks: 3%; blue-chip stocks: 25%; high-yield bonds: 0%; small cap stocks: 7%

iii. Cash/money market fund: 10%; government bonds: 5%; investment- grade bonds: 10%; foreign stocks: 15%; blue-chip stocks: 25%; high-yield bonds: 10%; small cap stocks: 25%

Options:

A- I

B- II

C- III

D- None of the above; a risk -averse investor should be entirely invested in government securities and/or money market funds.

Answer:

B

Explanation:

The asset allocation described in Selection II best represents a suitable asset allocation for a risk-averse investor. A risk-averse investor will have the greatest percentage of his funds invested in cash/money market fund. The bulk of his remaining funds will be invested in high-quality bonds, e.g., U.S. government bonds and investment-grade corporate bonds, and blue-chip stocks. He may choose to invest a little in foreign stocks and in small caps for additional diversification and a bit more growth potential. The portfolio presented in Selection II has 30% invested in the money market fund, 35% in high-quality bonds, 25% in blue-chip stocks and only 3% in foreign stocks and 7% in small caps. In contrast, Selection I has a riskier allocation with 20% invested in the money market fund and only 50% invested in high-quality bonds and blue chip stocks; the remaining 30% is invested in riskier assets-high-yield (junk) bonds, foreign stocks, and small cap stocks. Selection III is riskier still with only 10% in a money market fund, 40% in high -quality bonds and blue-chips, and 50% in the riskier three asset categories. Even a risk-averse investor should not be entirely invested in government securities and/or money-market funds; his purchasing power risk would be extremely high, and he would have no opportunity for capital appreciation.

Question 2

Question Type: **MultipleChoice**

A person's discretionary income is:

Options:

A- the amount that can be allocated to speculative investments.

B- his income after tax.

C- the income that he has left to spend or save after having paid taxes on the income and for all of the necessities, e.g., housing, food, clothing, transportation, utilities, etc.

D- the amount of his income that is needed to pay his regular monthly bills, e.g., rent, food, gasoline, utilities, health insurance, etc.

Answer:

C

Explanation:

A person's discretionary income is the income that he has left to spend or save after having paid taxes on the income and for all of the necessities, e.g., housing food, clothing, transportation, utilities, etc. His income after tax is referred to as his disposable income.

Question 3

Question Type: **MultipleChoice**

Paul is 36 years old and is married with two children, ages eight and ten. Paul lays carpet for a living, working as an independent contractor, and earns about $35,000 a year. His wife, Paula, is 33 years old, drives a school bus and earns only $18,000 a year, but her job provides the family with low-cost health insurance. They live conservatively and barely make ends meet. Paula recently inherited $180,000, however, and the couple would like to invest it, with the goal that they can both retire when Paul turns 62. The inheritance also included an educational endowment for their children, so they will not have to worry about saving for their children's college educations.

Which of the following would not be a suitable recommendation for the allocation of their investment monies?

Options:

A- municipal bond fund

B- aggressive growth stock fund

C- Roth IRA

D- life insurance

Answer:

A

Explanation:

Given that their combined income is only $53,000, Paul and Paula's marginal tax rate is low, so a municipal bond fund would not be a good recommendation for the allocation of their investment monies. Municipal bonds offer lower returns, and the couple would get little or no benefit from the tax-free interest income that these bonds provide. Their investment horizon is long enough (26 years) for them to invest some of their money in an aggressive growth stock fund, which has higher risk but also provides the higher expected returns that they may need to be able to retire when Paul turns 62. A Roth IRA is preferred over a traditional IRA in their situation. Although the traditional IRA would allow them to deduct their contributions, they already pay little or no taxes. Contributions to a Roth IRA are made out of after-tax income, but the contributions themselves can be withdrawn at any time without penalty if Paul and Paula run into some unexpected expenses, and the earnings grow tax-deferred and will be completely tax-free if they make no withdrawals until the age of 59 . Given the ages of their children, a life insurance policy that will help provide for them if one or both of the parents die, should be strongly recommended.

Question 4

Question Type: MultipleChoice

Yvette is a recently-widowed 63-year-old. The couple had no children, and when her husband died, she was the beneficiary of his $45,000 life insurance policy. She also receives benefits from his retirement plan and social security, but this income falls about $300 short of covering her regular monthly expenses, which includes a sizeable amount for health insurance. In the months since her husband's death, she sold their larger home and purchased a condominium, netting $80,000 from the combined transactions. Yvette was a homemaker all her life, and her husband handled all their finances, so Yvette is just learning how to balance her checkbook. One thing she does know is that she is going to have to purchase a new car within the next few months. Yvette is in good health and expects to live at least another 25 years.

Which of the following types of investments should be included in recommending an asset allocation to Yvette?

Options:

A- life insurance policy

B- money market fund

C- aggressive growth stock fund

D- municipal bond fund

Answer:

B

Explanation:

Given her age, her stated need to buy a new car within the next few months, and the fact that she is experiencing a monthly cash shortfall, Yvette has a need for liquidity, which the money market fund will provide. She will need the cash to buy a car, and she needs to have cash readily available to pay for some unexpected expenses as well since her income stream is fixed and isn't currently covering her needs. A life insurance policy is definitely not an appropriate choice since it doesn't appear that there is anyone dependent on Yvette for his well-being. An aggressive growth stock fund would be too risky, given her age and background, and based on the facts, her marginal tax rate should be extremely low, which does not make the municipal bond fund a good choice since she would be earning a lower return with little or no benefit.

Question 5

Question Type: MultipleChoice

A passive asset allocation strategy that involves establishing specific targeted percentages for the various asset classes and rebalancing only as necessary to maintain those percentages as long as the investor's investment objectives remain unchanged is called:

Options:

A- strategic asset allocation.

B- tactical asset allocation.

C- interactive asset allocation.

D- dynamic asset allocation.

Answer:

A

Explanation:

A passive asset allocation strategy that involves establishing specific target percentages for the various asset classes and rebalancing only as necessary to maintain those percentages as long as the investor's investment objectives remain unchanged is called strategic asset allocation. Tactical asset allocation is an active strategy that involves trying to time the market to some extent. Dynamic asset allocation is also an active strategy in which the portfolio mix is adjusted as markets rise and fall, such that the weighting is heaviest in those asset classes that can be expected to perform well under the current economy. Interactive asset allocation is a fictitious strategy.

Question 6

Question Type: MultipleChoice

Asset allocation involves:

Options:

A- selecting the investments that are expected to offer the highest return over your client's investment horizon.

B- determining the percentages that your client should be investing in various types of investments (e.g., stocks, bonds) based on his investment objectives.

C- selecting the investments that will expose your client to the least amount of risk.

D- determining the specific stocks and bonds in which your client should invest his funds.

Answer:

B

Explanation:

Asset allocation involves determining the percentages that your client should be investing in various types of investments (e.g., stocks, bonds) based on his investment objectives. You should not necessarily select investments that are expected to offer the highest return for a risk-averse client because higher returns entail more risk exposure. Nor should you necessarily select investments that will expose your client to the least amount of risk. These may not offer the client the return he needs to achieve his investment goals. Asset allocation refers only to determining the types of investments, not the specific investments within each category. Specific investment selection is the next step after the asset allocation decision is made.

Question 7

Question Type: MultipleChoice

The stock of eBay, Inc. (EBAY) currently has a beta of 1.67. Based on this, which of the following statements are necessarily true?

i. If the market is up 5%, an investor can expect the returns on eBay to increase by 1.67 times this amount, or 8.35%.

ii. eBay would be a particularly good investment for an investor with a short investment horizon.

iii. The returns on eBay are more volatile than the returns on the market in general.

IV. eBay has more unsystematic risk than the market in general.

Options:

A- I only

B- I and II only

C- I and III only

D- I, II, III, and IV

Answer:

C

Explanation:

Only Selections I and III are necessarily true. eBay's beta of 1.67 means that if the market is up 5%, an investor can expect the returns on eBay to increase by 1.67 times this amount, or 8.35%, and since eBay's beta is greater than 1.0, we can say that the stock's returns are more volatile than the returns on the market in general. Although eBay may have more unsystematic risk than the market in general, beta is not a measure of this. Beta is a measure of the market, or systematic, risk of the stock.

Question 8

Question Type: MultipleChoice

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Which of the following investor characteristics is inconsistent with an aggressive investment strategy?

i. short investment horizon

ii. high risk tolerance

iii. young

Options:

A- I and II

B- I, II, and III

C- I only

D- III only

Answer:

C

Explanation:

The investor characteristic that is inconsistent with an aggressive investment strategy is a short investment horizon. The shorter the investment horizon, the less aggressive the investment strategy should be, all else equal, because a shorter investment horizon means the investor has less opportunity to ride the up-and-down waves of the market.

Question 9

Question Type: MultipleChoice

Rank the following funds in order of their relative risk, from highest to lowest:

i. growth fund

ii. high-yield bond fund

iii. high-grade bond fund

IV. international fund

Options:

A- IV, I, II, III

B- I, IV, III, II

C- II, IV, I, III

D- IV, II, I, III

Answer:

A

Explanation:

The funds ordered by their relative risk from highest to lowest are IV, I, II, III. The highest risk is an international fund that invests in foreign securities, which exposes the investor to more currency exchange risk and some social and political risk as well. Next is the growth fund that invests most of its funds in domestic stocks, which are riskier than bonds. The high-yield bond fund is a junk bond fund and, as such, is next in the list. The high-grade bond fund invests mostly in investment-grade bonds, which offer investors a moderate risk exposure and is the least risky of the choices listed.

Question 10

Question Type: MultipleChoice

Your cousin has recently attended a seminar on the benefits of diversification. Based on what he learned, he decided to sell the shares he had in a large stock growth fund and put 50% of his money in hotel stocks and 50% in airline stocks. Based on this information, you can tell him:

Options:

A- that he's wise beyond his years.

B- that he's less diversified than he was before.

C- that he's less diversified than he was before, but can expect a higher rate of return.

D- none of the above.

Answer:

B

Explanation:

If your cousin sold his shares in a large stock growth fund and put 50% of his money in hotel stocks and 50% in airline stocks, you can tell him that he's less diversified than he was before. The large stock growth fund was invested in many more industries than two-industries whose returns are less likely to move together than stocks in the hotel and airline industries. His expected return will not necessarily be higher and may even be lower; he's just exposed to more risk. The return that can be expected from an investment is based on its non-diversifiable, or market, risk. An investor cannot expect a higher return by putting all his eggs in one (or in this case, two) baskets.