Set 1 Questions

1. In order to optimize the risk and return of a portfolio an investor must:
   A. analyze the risk return trade-off of all individual securities.
   B. analyze the risk return trade-off of the portfolio as a whole because unsystematic risk can be diversified away.
   C. analyze the risk return trade-off of the portfolio as a whole because systematic risk can be diversified away.

2. Which of the following is *least likely* a component of the planning stage in portfolio management?
   A. Attributing of portfolio returns.
   B. Developing an IPS.
   C. Analyzing objectives and constraints.

3. Which of the following is *not* a role of the investment policy statement?
   A. To record the investment strategy and investment style of the portfolio manager.
   B. To adhere to the investment objectives and constraints.
   C. To allow portfolio managers to shift investment strategy whenever deemed feasible.

4. Which of the following is *not* a component of an investment policy statement?
   A. Client description.
   B. Duties and responsibilities of the portfolio manager.
   C. Summary of past returns generated by the portfolio.

5. Which of the following statements about investment strategies is *most likely* true?
   A. A passive investment strategy is highly responsive to changing market expectations.
   B. Active management strategies involve generating excess risk-adjusted returns.
   C. Index-tilting is an example of a passive strategy.

6. Gemma Mathews is an individual investor employing the services of Serbi Capital. She tells the portfolio manager that her time horizon is short as she is well into her retirement period. Which of the following is *most* likely a suitable strategic allocation for Gemma?
   A. 70% Equities, 30% Bonds.
   B. 50% Equity, 30% Real Estate and 20% Bonds.
   C. 20% Equity, 80% Bonds.

7. Which of the following *most likely* indicates a large risk appetite?
   A. Spending and obligation exceed investment returns.
   B. Short time horizon with low wealth levels.
   C. Multiple alternate sources of income.

8. Terra Farma is in her early thirties and has a stable, well-paying job at a large multinational firm. She has a portfolio gifted to her by her father who is now concentrating on the family's business. Terra is risk averse and is not willing to take a large amount of risk in her portfolio. The portfolio manager should *most likely*:

A. assume a low risk tolerance.
B. counsel the investor and reach a resolution on the risk objective.
C. assume a high risk tolerance.

9. John Cramer employs the services of Optimaton Capital for managing his portfolio. John's primary concern is that he should receive a regular income from the portfolio. The portfolio manager's *most likely* response should be to:
A. invest in stocks that offer regular dividends but low total return.
B. invest in stocks that offer the highest total return at an acceptable level of risk.
C. invest in stocks that are least risky.

10. Bob Wiley is a single father with two children. Wiley has a secure job at a large multinational and has more than 30 years left to retirement. He constructs an equity portfolio for financing his children's college education who will be entering college next year. Which of the following statements is *most likely* correct?
A. The time horizon is long and risky securities should be selected.
B. The time horizon is long and less risky securities should be selected.
C. The time horizon is short and less risky securities should be selected.

11. With respect to the Code of Ethics and Standards of Professional Conduct, CFA Institute members and candidates *must*:
A. recognize where it might be necessary to deviate from the Code of Ethics and Standards of Professional Conduct if it is in the best interest of the client.
B. discuss with the investor when deviating from Standards of Professional Conduct and do so only if he can justify the need to deviate from the standards.
C. ensure compliance to Code of Ethics and Standards of Professional Conduct at all times and educate the client where necessary.

Set 1 Solutions

1. **B** is correct. An investor must analyze the risk return trade-off of the portfolio as a whole as unsystematic risk pertaining to individual investments can be diversified away by combining investments. Section 3. LO.a.

2. **A** is correct. Return attribution is not part of the planning stage. It is done after the portfolio has been constructed and returns have been made. Section 5.1. LO.b.

3. **C** is correct. The IPS acts as an investment guideline for the parties involved. It specifies the investment's goals and objectives and mentions the investment strategy. Furthermore, it details the reporting, rebalancing and investment communication format and frequency. The portfolio manager is not at liberty to alter investment strategy when deemed feasible. Client approval and acceptance is mandatory. Section 5.1.2. LO.c.

4. **C** is correct. Past return summaries are not included in the IPS as it is primarily a document governing investment goals/constraints and investment strategy. Section 5.1.2. LO.c.

5. **B** is correct. Active strategies aim to generate a positive alpha, or positive excess risk-adjusted returns and are highly responsive to changing market expectations. An index-tilt strategy is an example of a semi-active approach. Section 5.1.2. LO.d.

6. **C** is correct. When time horizon is short, the investment strategy should be conservative. Twenty percent in equities and eighty percent in bonds seems the least risky allocation among the choices given. Section 5.1.4, 6.2.2. LO.d.

7. **C** is correct. Alternate sources of income increase the amount of risk an investor can take with his/her portfolio. If spending and liabilities exceed investment returns for an investor who depends on income from his portfolio, then risk appetite is low. A short time horizon with low wealth levels is also indicative of a low risk appetite. Section 6.1.1. LO.e.

8. **B** is correct. Terra's ability to take risk is high as she has long years of employment left and has a secure job. Her family also owns a business so that is additional financial support. As her willingness to take risk is low, there's a conflict between willingness and ability, which requires education and resolution with the investor. Section 6.1.1. LO.e.

9. **B** is correct. The return objective should always be evaluated from a total return perspective. Hence the portfolio manager should focus on total return rather than only dividends yield or only capital appreciation. Section 6.1.2. LO.e.

10. **C** is correct. Even though the investor has a longer time till retirement the objective of the portfolio is to fund the college fees of his children which become due in one year. For this reason, the time horizon of the portfolio is short and less risky securities should be selected. Section 6.2.2. LO.f.

11. **C** is correct. The portfolio manager should always ensure compliance to the CFA Institute Code of Ethics and Standards of Professional Conduct. Hence educate the client when a conflict arises. Section 9. LO.g.

Set 2 Questions

The following information relates to questions 1 – 5.

Carla John and Sima Rose are Separately Managed Accounts (SMA) managers at Carlington Investments. They are discussing the investment portfolio and investment policy for a client, Julia Bart. John and Rose differ in their opinions regarding the preparation of an Investment Policy Statement.

John states, "Investment policy should be standardized for all clients. We can make four different standard policy statements and let our clients choose from these instead of spending time preparing a policy statement for each client."

Sima states, "It's not prudent to develop a long-term investment policy as market conditions change constantly. It is therefore better that the portfolio manager has the freedom to react to changing conditions."

Bart is in her early thirties and intends to maintain an investment portfolio till her retirement. She has a large asset base comprising of real estate, stocks and bonds. The value of her assets stands at $50 million. She currently receives an investment income from her portfolio and earns a fixed salary as head of the marketing department of a large consumer goods manufacturer. Bart expects to retire in thirty years. Her income is enough to meet her living expenses. She is unmarried and has no children. Her parents live abroad and run a family business. In her meeting with Carlignton’s account managers, Julia has mentioned that she would not like to take excessive risk.

1. Regarding the opinions on the investment policy statement, who is correct?
   A. Carla only.
   B. Sima only.
   C. Neither Carla, nor Sima.

2. Which of the following is the *most* appropriate factor in determining Bart's return objective? It is:
   A. return desires.
   B. return requirement.
   C. ability to take risk.

3. Julia's ability to take risk is *best* described as:
   A. below average.
   B. average.
   C. above average.

4. Bart’s liquidity requirement is *best* described as:
   A. high.
   B. low.
   C. cannot be determined.

5. Bart's time horizon is *best* described as:
   A. short term, single-stage.
   B. long term, single-stage.
   C. long term, multistage.

The following information relates to questions 6 – 10.

Danny Corvo, aged 40, just completed the sale of his technology start-up DMX, a customer loyalty platform to a public listed company PSMX Ltd. for cash and stock. The terms of the sale specify that Danny cannot sell the stock in PSMX for the next four years during which he will be a director in the company.

Danny meets with Jonathan Levi, a portfolio manager at Cassa Inc. to discuss his investment needs. He shares the following information with him:

"My income as director at PSMX will be more than enough to cover all of my living expenses and save at least $70,000 annually, so I do not plan to withdraw funds from my portfolio. I would have preferred selling DMX for cash, but by accepting the restricted stock, the total sales proceeds were almost twice as much as in a cash sale. I want this wealth to last a long time as this portfolio will fund my retirement when I turn 60. I want a stable return of 8 - 10 % annually with moderate volatility."

Jonathan drafts an investment policy statement for Danny with the following elements:

- A return objective of 8-10%
- A 9% standard deviation objective
- An appropriate time horizon
- No liquidity needs

Jonathan considers the following investment options for Danny given in Exhibit 1.

Exhibit 1: Investments available for Danny

Name	Return	Standard deviation
ABX aggressive FOF	15%	15%
Shire Ltd.	10%	13%
Delta Pharm.	7%	12%

6. The most appropriate time horizon that Jonathan should include in the investment policy statement is a:
   A. single 4-year period.
   B. single 24-year period.
   C. 4-year/20-year multi-stage period.

7. If Jonathan uses investments from Exhibit 1 only, which of Danny's objectives is *least likely* to be satisfied?
   A. Return objective.

B. Risk tolerance.
C. Liquidity constraint.

8. Which of the following investments would *least likely* satisfy Danny's return objective?
   A. A combination of Delta Pharm and Shire Ltd.
   B. Delta Pharm only.
   C. A combination of ABX aggressive FoF and Shire Ltd.

9. Is the liquidity constraint defined by Jonathan suitable for Danny?
   A. Yes.
   B. No.
   C. Liquidity needs cannot be determined from the information.

10. Once the IPS is formulated, is there a need for Jonathan to update it?
    A. Yes, because client circumstances may change over time.
    B. No, because the IPS is for long term.
    C. No, because the IPS cannot be changed once finalized.

The following information relates to question 11.

Katia Vlahd, CFA, a portfolio manager at Victor Investment Advisory, meets with a high-net-worth client to discuss his investment needs. After the meeting, Vlahd formulates the client's investment policy statement which contains the following objective: "The portfolio's total pre-tax real return should on average be in excess of 9% annually in order for him to have sufficient income to meet both his current and expected future spending needs."

11. Given the client's investment policy objectives, which of the following is *least likely* to be considered by Vlahd?
    A. Inflation rates.
    B. Tax rates.
    C. Benchmark returns.

The following information relates to questions 12 – 13.

Peter Chan, investment advisor at Helmut Capital, meets with a client and describes the first step of the portfolio management process – the planning step, which comprises of four parts:
I - identify the investment objectives and constraints
II - create an investment policy statement
III – develop a long-term market strategy
IV - determine a strategic asset allocation

Chan's client is a private university with a newly formed endowment fund that has just received a donation of $100 million to provide scholarships to students. The endowment will continue to receive funds in future to support its scholarship program related expenses in perpetuity. Chan makes the following recommendations regarding the endowment fund portfolio's objectives and constraints to his portfolio manager:

I. The endowment requires a rate of return that will that will cover annual spending, investment expenses, and expected inflation.
II. The investor's ability to take risk is average to above average because of its large asset base and inflow of additional funds in future, but prefers low to moderate volatility determined by its spending needs.
III. The time horizon is short because of annual payment of expenses.

12. Regarding the parts involved in the planning step of the portfolio management process, Chan is *least likely* correct with respect to:
    A. identifying the investment objectives and constraints.
    B. developing a market strategy.
    C. determining a strategic asset allocation.

13. Regarding the endowment fund's investment objectives and constraints, Chan is *least likely* correct with respect to:
    A. return requirement.
    B. risk tolerance.
    C. time horizon.

Set 2 Solutions

1. C is correct. Both Carla and Sima are wrong about the investment policy statement. The IPS should identify pertinent investment objectives and constraints for a particular investor. "Clearly identified objectives and constraints ensure that the policy statement is accurate and relevant to the investor's specific situation and desires. The IPS provides a long-term plan for an investor and a basis for making disciplined investment decisions over time. The absence of an investment policy statement reduces decision making to an individual-event basis and often leads to pursuing short-term opportunities that may not contribute to, or may even detract from, reaching long-term goals." Section 5.1. LO.c.

2. C is correct. An investor's ability to take risk puts an upper limit on the return objective. Section 6.1.1.- 6.1.2. LO.e.

3. C is correct. Bart has a large asset base, additional source of income, a long time horizon and no family members to support. These factors indicate an above-average ability to take risk. Section 6.1.1. LO.e.

4. B is correct. Bart has a long time horizon and does not need to withdraw from her portfolio to cover living expenses as she has an alternate source of income for that purpose. This shows that she has a low requirement for liquidity. Section 6.2.1. LO.e.

5. C is correct. Bart's time horizon is long—she is in her early thirties and plans to retire in another thirty years. The time horizon consists of two stages: the first stage extends to her retirement; the second stage may last for 20 years or more and extends from retirement until her death. Section 6.2.2. LO.f.

6. C is correct. A 4-year/20-year multi-stage period is the most appropriate time horizon. Danny must first consider his concentrated restricted PSMX holdings that reduces diversification during the first four years while still addressing his long-term objectives to fund his retirement. Section 6.2.2. LO.f.

7. B is correct. All investments in Exhibit 1 carry a standard deviation of over 9% hence choosing investments only from Exhibit 1 will not satisfy the risk tolerance objective. Section 6.1.1. LO.e.

8. B is correct. Delta Pharm. has a return of 7% and investment in Delta Pharm alone will not meet his return objective of 8-10% return. The remaining two combinations may satisfy his return objective. Section 6.1.2. LO.e.

9. A is correct. The liquidity objective is suitable for Danny as he has sufficient income to cover living expenses and saves annually. There are no anticipated liquidity needs arising from any event in the near future. He also seeks to use the portfolio to fund his retirement therefore has no immediate liquidity needs from it. Section 6.2.1. LO.e.

10. A is correct. A client's circumstances can change over time and portfolio managers need to be aware of these changes and update the IPS accordingly. Section 5.2-5.3. LO.c, d.

11. C is correct. Benchmark return is least likely important because Vlahd has stated the client's target real, after-tax return in terms of a 9% absolute amount. Section 6.1.2. LO.e.

12. B is correct. The planning step involves: identifying and specifying the investor's objectives and constraints, creating the investment policy statement, forming capital market expectations, and creating the strategic asset allocation. Section 5.1. LO.b.

13. C is correct. Endowment funds exist in perpetuity hence the time horizon should be defined as long-term, even for a newly formed fund. Although it is newly formed, the fund has started with a large gift and anticipates more donations in future. Section 6. LO.e.