Q.2824 Which of the following is *most likely* a type of investor with a high-risk tolerance and low liquidity needs?

A. Banks.

B. Insurance companies.

C. Defined benefit pension plans.

The correct answer is **C.**

Defined benefit pension plans have high-risk tolerance and low(er) liquidity need. Banks and insurers have low-risk tolerance and high liquidity needs.
A is incorrect. Banks have a fundamentally different risk profile and liquidity needs compared to defined benefit pension plans. Banks are highly regulated entities that are required to maintain sufficient liquidity to meet short-term withdrawals and other financial obligations. They are also exposed to various types of risks, including credit risk, market risk, and operational risk, which necessitates a more conservative investment approach. Banks typically prioritize stability and liquidity over high returns, leading them to invest in lower-risk, highly liquid assets such as government securities and high-grade corporate bonds. This conservative investment strategy reflects their low-risk tolerance and high liquidity needs.

B is incorrect. Insurance companies, similar to banks, have low-risk tolerance and high liquidity needs, although their investment strategies may vary depending on the type of insurance they provide. Life insurance companies, for example, may have longer investment horizons and slightly higher risk tolerance compared to property and casualty insurers, but overall, insurance companies must ensure they have sufficient liquidity to pay out claims. This requirement influences their investment decisions, leading them to allocate a significant portion of their portfolio to liquid, lower-risk assets. While they may invest in a broader range of assets than banks, including equities and real estate, the need to maintain liquidity to cover potential claims limits their ability to take on high-risk investments.

CFA Level I, Portfolio Management, Learning Module 3: Portfolio Management: An Overview. LOS (c): Describe types of investors and distinctive characteristics and needs of each.

Q.2825 Which of the following is the most appropriate income need of a bank as an investor?

A. Pay interests.

B. Finance daily expenses.

C. Pay pension benefits to its employees.

The correct answer is **A.**

Banks invest mostly to pay interest to the depositors. Banks are financial intermediaries that accept deposits and lend money. Banks often have excess reserves that are invested in relatively conservative and very short-duration fixed-income investments, with a goal of earning an excess return above interest obligations due to depositors.
B is incorrect. Financing daily expenses through investment income is not the primary income need of a bank as an investor. While banks do incur daily operational expenses, these are generally covered by the bank's net interest income (the difference between interest earned on loans and investments and interest paid to depositors), fees, and other sources of revenue. Investments are primarily aimed at generating returns to cover interest obligations to depositors and not for directly financing daily operational expenses.

C is incorrect. Paying pension benefits to its employees, although a significant financial obligation for a bank, is not the primary reason banks invest. Pension obligations are typically managed through dedicated pension funds or similar financial arrangements, which may include a portfolio of investments designed to meet these long-term liabilities. The primary purpose of a bank's investment activities is to generate income to pay interest to depositors and ensure liquidity and profitability, rather than directly funding pension benefits.

CFA Level I, Portfolio Management, Learning Module 3: Portfolio Management: An Overview. LOS (e): Describe aspects of the asset management industry.

Q.2826 Wrap n Roll is a food chain based in Nevada. The company is respected in its industry for the treatment of its employees. Wrap n Roll has decided to invest in a pension plan where employee payouts are computed using a formula that considers factors such as length of employment and salary history. Considering Wrap n Roll's requirement, which of the following is the *most* appropriate pension plan?

A. Defined benefit plans.

B. Defined contribution plan.

C. Fixed asset pension plan.

The correct answer is **A.**

A defined benefit pension plan promises to pay certain benefits to its employees. In defined benefit plans, the employer assumes the investment risk of the plan. In a defined contribution plan, only contributions to the account are guaranteed, not the future benefits. It is a retirement plan in the employee’s name usually funded by both the employee and the employer. With DC plans, individuals will invest part of their wages while working, expecting to draw on the accumulated funds to provide income during retirement. The employee accepts the investment and inflation risk and is responsible for ensuring that there are enough assets in the plan to meet their needs upon retirement.

B is incorrect. Defined contribution plans are retirement savings plans where the benefit is determined by the contributions made to the plan and the investment performance of those contributions. Unlike defined benefit plans, defined contribution plans do not guarantee a specific amount of benefit at retirement. Instead, employees bear the investment risk, and the retirement benefit depends on the amount of contributions made and the performance of the investments chosen. This does not align with Wrap n Roll's requirement for a pension plan that calculates payouts based on length of employment and salary history.

C is incorrect. Fixed asset pension plans are not a commonly recognized category within pension plans. The term might be confused with fixed benefit or defined benefit plans, but as it stands, it does not represent a standard option in pension planning. Therefore, it cannot be considered the most appropriate pension plan for Wrap n Roll's specific requirements. Defined benefit plans, which offer predetermined benefits based on salary history and length of service, are a more fitting choice for the company's objectives.

CFA Level I, Portfolio Management, Learning Module 3: Portfolio Management: An Overview. LOS (d): Describe defined contribution and defined benefit pension plans.

Q.2827 Which of the following statements regarding the Portfolio Management Process are accurate?

I. The planning step begins with the formation of an Investment Policy Statement (IPS).
II. The execution step includes a top-down analysis of assets.
III. The feedback step deals with the bottom-up analysis.

A. Statements I & II only.

B. Statements I & III only.

C. Statements I, II & III.

The correct answer is **A.**

The Portfolio Management Process has three steps:

I. The planning step begins with the formation of an Investment Policy Statement.
II. The execution step deals with asset allocation using a top-down or bottom-up analysis.
III. The feedback step involves monitoring and rebalancing the portfolio.

CFA Level I, Portfolio Management, Learning Module 3: Portfolio Management: An Overview. LOS (b): Describe the steps in the portfolio management process.

Q.2829 Which of the following mutual funds gives an investor the option to invest additional funds without additional fees?

A. Open-end no-load fund.

B. Open-end front-load fund.

C. Closed-end front-load fund.

The correct answer is **A.**

Open-end funds allow investors to invest additional funds in the mutual fund. No-load funds do not charge additional fees on the purchase of additional fund shares or redemption of shares.

B is incorrect. Load funds are funds in which in addition to the annual fee, a percentage fee is charged to invest in the fund and/or for redemptions from the fund.

C is incorrect. Closed-end funds do not allow new investments into the fund.
CFA Level I, Portfolio Management, Learning Module 3: Portfolio Management: An Overview. LOS (f): Describe mutual funds and compare them with other pooled investment products.

Q.2832 Escobar Slim recently inherited $40 million from his father's coal mine business. Slim does not have a sound knowledge of the stock market, but he wants to invest in a passively managed mutual fund that provides as much return as the Nasdaq Composite. Which of the following is the most appropriate mutual fund for Escobar Slim?

A. Index fund.

B. Stock mutual fund.

C. Money market fund.

The correct answer is **A.**

Index funds are passively managed mutual funds that replicate a specific index like the Nasdaq Composite.

Stock Mutual Funds will include selective stocks from a specific index and can underperform or outperform the index. Money Market Funds invests in short-term debt securities and are actively managed.
B is incorrect. Stock mutual funds, while they invest in stocks similar to those found in indices like the Nasdaq Composite, do not aim to replicate the performance of an index. Instead, they are actively or passively managed to achieve returns that can either outperform or underperform the target index. The selection of stocks is based on the fund manager's research and strategy, which may not align with Slim's desire for an investment that provides returns similar to the Nasdaq Composite.

C is incorrect. Money market funds invest in short-term debt securities such as treasury bills, commercial paper, and certificates of deposit. They are designed to offer investors high liquidity with a very low level of risk. While money market funds are known for their stability and preservation of capital, they do not aim to replicate the performance of stock indices like the Nasdaq Composite and typically offer lower returns compared to stock or index funds. Therefore, a money market fund would not meet Slim's objective of investing in a fund that provides returns similar to the Nasdaq Composite.

CFA Level I, Portfolio Management, Learning Module 3: Portfolio Management: An Overview. LOS (f): Describe mutual funds and compare them with other pooled investment products.

Q.2833 Which of the following is/are the *most likely* correct statements regarding similarities and differences between exchange-traded funds and closed-end funds?

I. Both types of funds are passively managed to match a particular index.
II. In both types of funds, the market price of shares and the net asset value (NAV) can differ significantly.
III. Both types of funds can be sold and purchased on the open market.

A. III only.

B. I & III only.

C. I & II only.

The correct answer is **A.**

ETFs and closed-end funds are sold and purchased on the open market rather than from the fund itself. Options I & II are incorrect. ETFs are passively managed to match the index, while closed-end funds are actively managed. In closed-end funds, the market price of shares and the NAV differ significantly, whereas ETFs are designed to keep their share price close to the NAVs.
B is incorrect. It suggests that both ETFs and CEFs are passively managed to match a particular index. While many ETFs are indeed passively managed with the goal of replicating the performance of a specific index, CEFs are typically actively managed. Active management in CEFs involves a fund manager making investment decisions with the aim of outperforming a benchmark index, rather than merely matching it. This fundamental difference in management style is crucial for understanding the distinct characteristics and investment strategies associated with each type of fund.

C is incorrect. It indicates that the market price of shares and the net asset value (NAV) can differ significantly in both ETFs and CEFs. While it is true that CEFs often exhibit significant discrepancies between their market price and NAV due to the fixed number of shares and market demand dynamics, ETFs are structured to minimize such discrepancies. ETFs employ a mechanism involving authorized participants who can create or redeem shares in large blocks, known as creation units. This process helps to ensure that the ETF's market price stays closely aligned with its NAV. Therefore, the statement that both types of funds typically experience significant differences between market price and NAV does not accurately apply to ETFs.

CFA Level I, Portfolio Management, Learning Module 3: Portfolio Management: An Overview. LOS (e): Describe aspects of the asset management industry.

Learning Module 4: Basics of Portfolio Planning & Construction

Q.138 What should an Investment Policy Statement *most likely* contain?

A. It should describe the context, the investor and the structure of the investment.

B. It should describe the overall investment objective.

C. It should state the stocks and derivatives the investor will purchase.

The correct answer is **B.**

The Investment Policy Statement provides the general investment goals and objectives, not specifically the stocks and derivatives the investor will purchase.
A is incorrect. While it is true that an Investment Policy Statement should provide some context about the investor and possibly the structure of the investment, this choice does not capture the essence of what an IPS primarily aims to achieve. The main purpose of an IPS is not to describe the investor or the investment structure in detail but to establish clear and measurable investment objectives and guidelines. This includes defining the risk tolerance, investment horizon, asset allocation, and criteria for selecting and monitoring investments. While context and structure are important, they are secondary to the core objective of outlining the investment strategy and goals.

C is incorrect. Stating the specific stocks and derivatives the investor will purchase is too prescriptive for an Investment Policy Statement. An IPS is meant to provide a high-level strategy and set of guidelines rather than dictate specific investment choices. The investment landscape is dynamic, and specific investment opportunities may change over time. Therefore, an IPS focuses on setting the criteria for investment selection and the overall strategic approach rather than listing specific securities. This allows for flexibility in the investment process and ensures that the investment strategy can adapt to changing market conditions while still adhering to the investor's long-term objectives and risk tolerance.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (b): Describe the major components of an IPS.

Q.139 Which of these is *not* one of the two major components of an Investment Policy Statement?

A. Statement of the responsibilities of the investment manager and the client

B. Performance evaluation benchmark

C. The investment manager's compensation

The correct answer is **C.**

The two major components of an Investment Policy statement are the investment manager's statement of the responsibilities and the performance evaluation benchmark.
A is incorrect. The statement of the responsibilities of the investment manager and the client is indeed one of the two major components of an Investment Policy Statement. This section of the IPS is crucial as it clearly delineates the roles and responsibilities of each party involved in the investment process. It ensures that both the investment manager and the client have a mutual understanding of their respective duties, which can include investment decision-making, reporting requirements, and other critical tasks necessary for the effective management of the portfolio. By establishing these responsibilities upfront, the IPS helps prevent misunderstandings and sets the foundation for a transparent and accountable investment management relationship.

B is incorrect. The performance evaluation benchmark is the second major component of an Investment Policy Statement. This benchmark is essential for measuring the performance of the investment portfolio against a relevant and agreed-upon standard. It provides a clear and objective way to assess how well the investment strategy is performing in relation to the market or to specific investment goals. The inclusion of a performance evaluation benchmark in the IPS is vital for ensuring that the investment manager's performance can be quantitatively evaluated over time. This allows for adjustments to be made if the portfolio is not meeting its objectives, thereby ensuring that the client's investment goals are being actively pursued.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (b): Describe the major components of an IPS.

Q.140 Which of the following statements is *most likely* accurate?

A. High levels of uncertainty are associated with low potential returns.

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

C. Return objectives should be considered in conjunction with risk preferences.

The correct answer is **C.**

Risk and return are mutually inclusive.
NOTE: For option A), high levels of uncertainty = high levels of risk, so high potential returns.
A is incorrect. This statement contradicts the fundamental finance principle of the risk-return tradeoff, which posits that higher risk (or uncertainty) is generally associated with the potential for higher returns. The rationale behind this is that investors need to be compensated for taking on additional risk, and this compensation comes in the form of higher expected returns. Therefore, high levels of uncertainty or risk are more likely to be associated with high potential returns, not low ones.

B is incorrect. This perspective is fundamentally flawed in the context of financial decision-making. Risk and return are intrinsically linked and cannot be separated when evaluating investment opportunities. The relationship between risk and return is a core concept in finance, indicating that the expected return on an investment is directly related to the level of risk associated with it.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (c): Describe risk and return objectives and how they may be developed for a client.

Q.767 Which of the following is *least likely* a characteristic of hedge funds?

A. Hedge funds usually have restricted liquidity.

B. Hedge funds are readily available to all investors.

C. Management fees are not only a fixed percentage of the funds under management, but managers also collect fees based on performance.

The correct answer is **B.**

Hedge funds are not readily available to all investors. They typically require a high minimum investment and often have restricted liquidity by allowing only periodic (e.g., quarterly) withdrawals or having a long fixed-term commitment. In addition, hedge funds typically charge two distinct fees: a traditional asset-based management fee (AUM fee) and an incentive (or performance) fee in which the hedge fund earns a portion of the fund's realized capital gains.
A is incorrect. Hedge funds usually have restricted liquidity, which is a characteristic feature of these investment vehicles. Unlike mutual funds or exchange-traded funds (ETFs), hedge funds often impose lock-up periods during which investors cannot withdraw their capital. These lock-up periods can range from a few months to several years, depending on the specific hedge fund's strategy and structure. Additionally, even after the lock-up period, withdrawals may only be permitted at certain intervals, such as quarterly or semi-annually. This restricted liquidity is a measure to ensure that the fund managers have a stable capital base to execute long-term or illiquid investment strategies without the need to prematurely liquidate positions to meet redemption requests.

C is incorrect. It is indeed a characteristic of hedge funds to charge both a management fee and a performance fee. The management fee is typically a fixed percentage of the assets under management (AUM), usually ranging from 1% to 2% annually. The performance fee, on the other hand, is a feature that aligns the interests of the hedge fund managers with those of the investors. This fee is a percentage of the fund's profits, often around 20%, and is only charged if the fund achieves a certain level of performance. This fee structure incentivizes managers to seek the highest possible returns for their investors, as their compensation is directly tied to the fund's success. This dual fee structure is a hallmark of hedge funds and distinguishes them from other types of investment funds, which may only charge a management fee.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (e): Describe the investment constraints of liquidity, time horizon, tax concerns, legal and regulatory factors, and unique circumstances and their implications for the choice of portfolio assets.

Q.793 With respect to the Investment Policy Statement (IPS), which of the following statements is *least likely* accurate?

A. The IPS is a one-time exercise undertaken at the beginning of the portfolio construction.

B. The IPS typically includes the client's investment objectives and the constraints that apply to the client's portfolio.

C. Maintaining an IPS or any other similar document for the clients may be required by the laws and regulations of a particular country.

The correct answer is **A.**

Although the IPS is the starting point of the portfolio management process, it should be reviewed regularly to ensure its consistency with the client's circumstances and requirements.
B is incorrect. This option inaccurately implies that the IPS might not always include the client's investment objectives and constraints. In reality, the inclusion of investment objectives and constraints is a fundamental aspect of the IPS. These elements are critical for defining the scope of the investment strategy, setting performance expectations, and establishing boundaries within which the portfolio should be managed. The IPS is specifically designed to articulate these aspects clearly and concisely, providing a structured framework for investment decision-making and portfolio management.

C is incorrect. This statement suggests that maintaining an IPS or a similar document might not be a regulatory requirement in some jurisdictions. While it is true that the specific requirements regarding the IPS can vary by country, the practice of maintaining a comprehensive document that outlines the investment strategy, objectives, and constraints is widely recognized as a best practice in the investment management industry. Regulatory bodies in many countries either require or strongly recommend the use of an IPS to ensure that investment advisors act in the best interests of their clients, maintain transparency, and adhere to a disciplined investment process. Therefore, the statement underestimates the importance and prevalence of the IPS in guiding investment practices and ensuring compliance with regulatory standards.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (b): Describe the major components of an IPS.

Q.794 Which of the following sections of an Investment Policy Statement (IPS) provides relevant information on specific types of assets that have been excluded from the portfolio?

A. Investment guidelines

B. Investment objectives

C. Investment constraints

The correct answer is **A.**

The investment guidelines section of an IPS provides information about how the policy should be executed and on specific types of assets excluded from the investment, if any.

B is incorrect. The investment objectives section of an IPS outlines the financial goals and return expectations of the client. While it provides a broad overview of what the investment strategy aims to achieve, it does not typically detail specific exclusions or restrictions on asset classes. The focus here is more on the desired outcomes, such as capital preservation, income generation, or growth, rather than on the means of achieving these outcomes through specific investment choices.

C is incorrect. Investment constraints detail the various limitations and considerations that must be taken into account when managing the portfolio. These can include liquidity needs, time horizon, tax considerations, legal requirements, and unique circumstances. While investment constraints can influence which assets may be deemed suitable or unsuitable for the portfolio, they do not directly specify excluded assets. Instead, they provide a framework for making investment decisions that accommodate the client's specific situation and requirements.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (e): Describe the investment constraints of liquidity, time horizon, tax concerns, legal and regulatory factors, and unique circumstances and their implications for the choice of portfolio assets.

Q.797 With respect to return objectives, which of the following is the *least likely* accurate?

A. Return objective should be consistent with risk objective and also with the current economic and market environment.

B. For taxable investors, only after-tax bases should be used for analyzing return.

C. Return objectives should be stated only on an absolute basis.

The correct answer is **C.**

Return objectives may be stated on an absolute or a relative basis. An example of an absolute objective is achieving a particular rate of return. For a relative objective, it may be stated as relative to a benchmark return such as the S&P 500.
A is incorrect. This alignment ensures that the investment strategy is realistic and tailored to the investor's risk tolerance, financial situation, and goals. It also acknowledges that return expectations should be adaptable to changing market conditions, which is crucial for maintaining a relevant and effective investment approach.

B is incorrect. For taxable investors, analyzing returns on an after-tax basis is indeed crucial. Taxes can significantly impact the net return an investor receives, and different investment vehicles and strategies can have varying tax implications. By considering the after-tax return, investors can make more informed decisions that align with their financial goals and tax situation. This approach ensures that return objectives are realistic and achievable, taking into account the tax consequences of investment decisions.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS(c): Describe risk and return objectives and how they may be developed for a client.

Q.799 Illiquid and risky investments are more suitable for an investor with which of the following requirements?

A. The investor's huge tax liability payment is due for in six months.

B. The investor's main purpose of investment is to plan for retirement.

C. The investor has to incur expenses for his children's education in a short span of time.

The correct answer is **B.**

The investment objective of retirement suggests a greater time horizon as compared to the other two options. Illiquid and risky investments may not be suitable for an investor with a short time horizon because the investor may not have enough time to recover from losses.
A is incorrect. The investor may need to access funds quickly to meet the tax payment obligation. The short time frame does not provide enough time to recover from potential losses that might occur with such investments, and the illiquidity could prevent the investor from selling the investment at a fair price in a timely manner.

C is incorrect. The priority is preserving capital to ensure that the funds are available when needed for educational expenses. The risk of loss and the difficulty in quickly converting these investments into cash could jeopardize the investor's ability to meet the upcoming financial obligations for their children's education.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS(e): Describe the investment constraints of liquidity, time horizon, tax concerns, legal and regulatory factors, and unique circumstances and their implications for the choice of portfolio assets.

Q.800 Which of the following constitutes a legal or regulatory constraint and should be noted down in the Investment Policy Statement (IPS) of an investor?

A. The investor has personal objections to certain companies due to the environmental impact of business activities of those companies.

B. The investor is the director of the company and has access to material non-public information.

C. The investor has a huge liability to outside parties and there are chances that he might be declared insolvent in a short time.

The correct answer is **B.**

When an individual has access to material non-public information about a particular security, this situation forms a legal constraint depending upon the laws of the specific country.
A is incorrect. Personal objections to investing in certain companies due to their environmental impact, while important for ethical or socially responsible investing, do not constitute a legal or regulatory constraint. These preferences are part of the investor's ethical or moral values and should be noted in the IPS under ethical or social constraints rather than legal or regulatory constraints. While these considerations are crucial for aligning the investment strategy with the investor's values, they do not carry the same legal implications as insider trading laws.

C is incorrect. The potential for an investor to be declared insolvent due to huge liabilities to outside parties is a financial constraint and should be noted in the IPS as such. This situation impacts the investor's risk tolerance and liquidity needs but does not directly relate to legal or regulatory constraints on investment activities. Financial constraints are critical for developing an investment strategy that addresses the investor's financial situation and goals, but they do not have the same legal implications as having access to material non-public information.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (e): Describe the investment constraints of liquidity, time horizon, tax concerns, legal and regulatory factors, and unique circumstances and their implications for the choice of portfolio assets.

Q.801 Which of the following is CORRECT in terms of the principles of strategic asset allocation while constructing a portfolio?

A. The portfolio's total risk accounts for most of its change in value over the long-term.

B. The portfolio's systematic risk accounts for most of its change in value over the long-term.

C. The portfolio's non-systematic risk accounts for most of its change in value over the long-term.

The correct answer is **B.**

One of the principles of the strategic asset allocation is that a portfolio's systematic risk accounts for most of its change in value over the long-term, which is related to the economic system and this risk cannot be eliminated even by holding a diversified portfolio.
A is incorrect. This option suggests that the portfolio's total risk, which includes both systematic and non-systematic risk, accounts for most of its change in value over the long term. While total risk does impact a portfolio's performance, strategic asset allocation primarily focuses on managing systematic risk. Non-systematic risk, or specific risk, relates to factors that can affect individual securities or specific sectors and can be mitigated through diversification. Therefore, stating that total risk accounts for most of the portfolio's change in value overlooks the importance of distinguishing between systematic and non-systematic risk in strategic asset allocation.

C is incorrect. The effects of specific risks tend to cancel out across different investments. Therefore, suggesting that non-systematic risk accounts for most of the portfolio's change in value over the long term does not align with the principles of strategic asset allocation.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (g): Describe the principles of portfolio construction and the role of asset allocation in relation to the IPS.

Q.802 Apart from the exposures to systematic risk factors specified in the strategic asset allocation, the returns of an investment strategy depend on which of the following other sources?

A. Tactical asset allocation

B. Security selection

C. Both A) and B)

The correct answer is **C.**

Both the tactical asset allocation and the selection of security play an important role in determining the return of an investment strategy.
A is incorrect. Tactical asset allocation alone is not the sole determinant of an investment strategy's returns. While it plays a significant role in adjusting the asset mix in response to short-term market conditions, it does not account for the impact of selecting individual securities within those asset classes. Tactical asset allocation focuses on the broader allocation decisions rather than the specific investment choices within each asset class.

B is incorrect. Similarly, security selection on its own does not encompass all the factors that influence the returns of an investment strategy. While selecting high-performing securities is crucial, it does not capture the strategic adjustments made to the overall asset allocation in response to changing market conditions. Security selection is focused on identifying opportunities within specific asset classes, but it does not address the allocation between different asset classes that can also significantly impact overall investment performance.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (g): Describe the principles of portfolio construction and the role of asset allocation in relation to the IPS.

Q.803 Which of the following BEST describes the rebalancing policy?

A. An attempt to generate a higher return than the asset class benchmark

B. The set of rules to guide the process of restoring the portfolio's original exposures to systematic risk factors

C. The decision to deliberately deviate from the policy portfolio

The correct answer is **B.**

When a certain threshold deviation from the policy weights breaches, the portfolio needs to be rebalanced back to the policy weights and the set of rules to guide this is known as the rebalancing policy.
A is incorrect. Attempting to generate a higher return than the asset class benchmark is not the primary goal of a rebalancing policy. While rebalancing can potentially lead to improved performance by capitalizing on the mean-reversion tendencies of asset prices, its main purpose is risk management through maintaining the portfolio's intended asset allocation. This option confuses rebalancing with active management strategies aimed at outperforming benchmarks.

C is incorrect. The decision to deliberately deviate from the policy portfolio is more closely related to tactical asset allocation or active management strategies, where an investor or manager makes intentional adjustments to the portfolio's asset mix in an attempt to take advantage of short-term market opportunities or to avoid market downturns. Rebalancing policy, on the other hand, is a systematic approach aimed at maintaining the portfolio's original strategic asset allocation, rather than seeking to deviate from it for potential short-term gains.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (g): Describe the principles of portfolio construction and the role of asset allocation in relation to the IPS.

Q.1185 Nisha Mazhar is a risk analyst, and she has been given the task to identify the factor that helps measure her organization's risk tolerance. Which of the following factors will help Mazhar complete her task?

A. Market demand

B. Financial strength

C. Interest rates

The correct answer is **B.**

Factors that determine the risk tolerance of an organization include: financial strength, ability to bear losses, regulatory environment, ability to respond to negative events and expertise in the current line of business.

A is incorrect. Market demand, while important for strategic planning and operational adjustments, does not directly measure an organization's risk tolerance. Market demand can influence revenue projections and affect the company's competitive position, but it does not provide insight into the organization's capacity to absorb losses or withstand financial stress. Risk tolerance is more closely related to the internal financial and operational capabilities of the organization rather than external market conditions.

C is incorrect. Interest rates are a factor that can influence the cost of borrowing and the return on investments, thereby affecting an organization's financial performance. However, interest rates alone do not measure an organization's risk tolerance. While changes in interest rates can impact the economic environment in which a company operates, risk tolerance is determined by the company's internal financial strength and ability to manage and absorb risks. Interest rates are just one of many external factors that a risk analyst would consider in the broader context of risk management and financial planning.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (c): Describe risk and return objectives and how they may be developed for a client.

Q.1280 Which of the following is the appropriate reason for writing an Investment Policy Statement (IPS)?

A. It provides the investor's return goals and risk tolerance.

B. It provides details regarding the investment style of the manager.

C. It provides details of policies regarding fund management.

The correct answer is **A.**

An IPS provides details regarding the investor's goal in terms of risk and return.
B is incorrect. While it might seem that detailing the investment style of the manager is a primary reason for an IPS, this is not its core purpose. The investment style of the manager is indeed an important aspect of the investment process, but it is secondary to defining the investor's return goals and risk tolerance. The IPS primarily focuses on the investor's objectives and constraints, and while it may reference the investment style or strategy to be employed, this is done within the context of achieving the investor's specified goals.

C is incorrect. Providing details of policies regarding fund management is another aspect that might be included in an IPS, but it is not the primary reason for its creation. Policies regarding fund management, such as rebalancing procedures, selection criteria for investments, and monitoring and reporting requirements, support the main objective of aligning the investment strategy with the investor's goals and risk tolerance. However, the essence of the IPS is to document the investor's financial objectives and how these will be achieved, making the detailing of fund management policies a supportive rather than a primary function.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (c): Describe risk and return objectives and how they may be developed for a client.

Q.1281 Which of the following is *least likely* a component of an Investment Policy Statement?

A. The description of the client

B. Investment constraints

C. The manger's investment style

The correct answer is **C.**

The manager's portfolio management style is not mentioned in an IPS.
A is incorrect. The description of the client is a fundamental component of an Investment Policy Statement. This section provides a comprehensive overview of the client's financial situation, including their goals, risk tolerance, and investment horizon. It sets the foundation for the investment strategy and helps ensure that the portfolio is aligned with the client's objectives and needs. Including detailed client information in the IPS ensures that the investment strategy remains client-focused and tailored to their specific circumstances.

B is incorrect. Investment constraints are another crucial element of an Investment Policy Statement. These constraints can include liquidity needs, time horizon, tax considerations, legal restrictions, and unique preferences or circumstances of the client. By clearly defining these constraints in the IPS, the investment manager can develop and implement a strategy that respects these limitations while striving to achieve the client's financial goals. Recognizing and addressing these constraints is essential for creating a realistic and effective investment plan.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (b): Describe the major components of an IPS.

Q.1283 John Keller mentioned in his Investment Policy Statement that his portfolio's return should not go below 10% at the end of every year. Which of the following types of risk objectives does Keller have?

A. Absolute risk objective

B. Relative risk objective

C. Risk-minimizing objective

The correct answer is **A.**

An absolute risk objective provides risk objectives in absolute terms.
B is incorrect. This option suggests that Keller has a relative risk objective, which is not the case. A relative risk objective involves setting the portfolio's performance goals in relation to a benchmark or index. For example, aiming to outperform the S&P 500 by 2% annually. Keller's objective does not mention any comparison to market indices or benchmarks; instead, it sets a specific minimum return, which aligns with the definition of an absolute risk objective.

C is incorrect. The risk-minimizing objective is focused on reducing the risk to the lowest possible level, often without specifying a particular return threshold. While minimizing risk might be a concern for many investors, Keller's objective explicitly states a minimum return goal rather than focusing solely on minimizing risk. Therefore, this option does not accurately describe Keller's risk objective, which is clearly defined in terms of achieving a minimum return rather than minimizing risk exposure.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (c): Describe risk and return objectives and how they may be developed for a client.

Q.1284 An investor has just lost his job and has mortgages payments to make. He believes that investing in technology stocks can earn him sufficient returns to pay for them. Assuming these circumstances, evaluate his risk tolerance.

A. The investor has a high ability to take risk but no willingness to take risk.

B. The investor has a high willingness to take risk but low ability to take risk.

C. The investor has a high risk tolerance and a high ability to take risk.

The correct answer is **B.**

The ability to take risk depends on the financial circumstances and the willingness to take risk depends on the investor's attitude. In this case, the investor has a high willingness to take risk but low ability to take risk.

A is incorrect. This option suggests that the investor has a high ability to take risk but no willingness to take risk, which contradicts the scenario described. The investor's consideration of investing in technology stocks to generate income for mortgage payments clearly indicates a willingness to engage in riskier investments. However, the recent job loss significantly impacts the investor's financial stability, thereby reducing their ability to take on risk, not their willingness.

C is incorrect. While the investor demonstrates a high willingness to take on risk by considering investments in technology stocks, their ability to take risk is compromised by their current financial situation, including the loss of a job and the need to make mortgage payments. High risk tolerance and ability to take risk would imply both financial stability and a psychological readiness to engage in risky investments, which does not align with the investor's circumstances.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (d): Distinguish between the willingness and the ability (capacity) to take risk in analyzing an investor's financial risk tolerance.

Q.1285 Which of the following is a relative risk objective?

A. Returns should not go below 18% in 6-months.

B. The total loss on the portfolio should not be more than $8 million in 6-months.

C. The returns should not be below 10% of the returns on the S&P 500 index.

The correct answer is **C.**

Relative risk objectives provide a relative measure of risk relative to the S&P 500, the LIBOR, etc.
A is incorrect. This option suggests a specific return target (returns should not go below 18% in 6 months), which is an example of an absolute risk objective rather than a relative one. Absolute risk objectives focus on achieving specific return thresholds or limiting losses to a certain amount, without reference to the performance of a benchmark or index. They are concerned with the actual outcomes of the investment, irrespective of how the broader market or a specific benchmark performs.

B is incorrect. This option, which states that the total loss on the portfolio should not be more than $8 million in 6 months, also represents an absolute risk objective. Similar to option A, it sets a specific threshold for losses, focusing on limiting the absolute amount of potential loss within a given timeframe. This type of objective does not take into account the performance of any external benchmark or index, but rather aims to control the direct financial risk to the investment or portfolio.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (c): Describe risk and return objectives and how they may be developed for a client.

Q.1288 Which of the following is *least likely* an investment constraint for an investor?

A. Tax situation

B. Legal and regulatory constraints

C. Management fees

The correct answer is **C.**

Management fees, while an important consideration in the selection of investment vehicles and strategies, are least likely to be considered an investment constraint in the traditional sense. Investment constraints typically include factors that directly limit or guide the investment decision-making process, such as liquidity needs, tax considerations, time horizon, legal and regulatory requirements, and unique circumstances specific to the investor. These constraints are fundamental in developing an investment policy statement and guiding the strategic asset allocation process.

A is incorrect. The tax situation of an investor is a critical investment constraint. Taxes can significantly affect the net return on investments, and different investment vehicles and strategies can have vastly different tax implications. For example, interest income may be taxed at a different rate than dividend income or capital gains. Tax-exempt investors, such as certain pension funds or charitable organizations, may have different investment considerations than taxable entities or individuals. Therefore, understanding and considering an investor's tax situation is essential in the investment decision-making process.

B is incorrect. Legal and regulatory constraints are fundamental investment constraints that must be considered in the investment decision-making process. These constraints can vary widely among investors depending on their jurisdiction, the legal structure of their investment accounts, and their status as retail or institutional investors. For example, pension funds and insurance companies are subject to specific regulatory requirements that can influence their investment choices. Similarly, individual investors may face legal restrictions related to accredited investor status or investment in certain types of securities. Ignoring legal and regulatory constraints can result in significant legal and financial consequences, making it a crucial consideration for all investors.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (e): Describe the investment constraints of liquidity, time horizon, tax concerns, legal and regulatory factors, and unique circumstances and their implications for the choice of portfolio assets.

Q.1289 An investor directs his portfolio manager not to invest in shares of DC Oil Transporting Company which has been accused of releasing chemical waste into the ocean. Which type of investment constraint is it?

A. Legal and regulatory

B. Unique circumstance

C. Anti-dumping tax

The correct answer is **B.**

The investor's directive to the portfolio manager not to invest in shares of DC Oil Transporting Company, which has been accused of releasing chemical waste into the ocean, is an example of a unique circumstance constraint. Unique circumstances constraints are those that reflect the specific ethical, moral, or personal preferences of an investor. These constraints are tailored to the individual investor's values or beliefs and can include a wide range of considerations, such as environmental, social, and governance (ESG) criteria, religious beliefs, or ethical stances against certain business practices. In this case, the investor's decision to exclude DC Oil Transporting Company from their portfolio due to environmental concerns falls squarely within the realm of unique circumstances, as it reflects a personal ethical stance against investing in companies with poor environmental practices.

A is incorrect. Legal and regulatory constraints refer to the limitations placed on investment choices by laws, regulations, or legal agreements. These constraints can include restrictions on certain types of investments due to regulatory requirements, legal considerations related to the investor's status (such as accredited investor status), or compliance with laws such as those against money laundering.

C is incorrect. An anti-dumping tax is a tariff imposed by a government on foreign imports that it believes are priced below fair market value, often to protect domestic industries from unfair competition. This type of constraint is related to governmental trade policies and has no direct relevance to an individual investor's personal investment choices or ethical considerations.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (e): Describe the investment constraints of liquidity, time horizon, tax concerns, legal and regulatory factors, and unique circumstances and their implications for the choice of portfolio assets.

Q.1290 Which of the following specifies the percentage of each asset included in each asset class?

A. Investment Policy Statement (IPS)

B. Investment constraints

C. Strategic asset allocation

The correct answer is **C.**

The strategic asset allocation specifies the percentage of each asset included in each asset class.
A is incorrect. The Investment Policy Statement (IPS) is a document that outlines an investor's investment goals and strategies, including risk tolerance, investment objectives, and constraints. While it serves as a strategic guide for making investment decisions and may include guidelines for asset allocation, it does not specify the exact percentage of each asset included in each asset class. The IPS provides a framework for the investment process but leaves the specifics of asset allocation to be determined by the strategic asset allocation process.

B is incorrect. Investment constraints are limitations or restrictions on the investment process that reflect an investor's specific financial situation, risk tolerance, liquidity needs, time horizon, legal requirements, and tax considerations. These constraints are critical in shaping the investment strategy and asset allocation; however, they do not directly specify the percentage of each asset included in each asset class. Instead, they influence how the strategic asset allocation is designed to meet the investor's goals within the defined constraints.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (g): Describe the principles of portfolio construction and the role of asset allocation in relation to the IPS.

Q.1292 Which of the following is appropriate for a manager who deviates from strategic asset allocation weights to take advantage of short-term opportunities?

A. Strategic asset allocation

B. Tactical asset allocation

C. Opportunistic selection

The correct answer is **B.**

In tactical asset allocation, the manager deviates from strategic asset allocation weights to take advantage of short-term opportunities.
A is incorrect. Strategic asset allocation refers to the long-term investment strategy that establishes a fixed asset mix target. This target is based on an investor's goals, risk tolerance, and investment horizon. Strategic asset allocation does not involve frequent adjustments in response to market conditions or short-term opportunities. Instead, it focuses on maintaining a predetermined balance of asset classes over time, making it unsuitable for exploiting short-term market opportunities.

C is incorrect. Opportunistic selection might seem like a suitable strategy for taking advantage of short-term opportunities; however, it lacks the structured approach of tactical asset allocation. Opportunistic selection can be more speculative and may not necessarily involve a disciplined strategy of adjusting the asset mix in response to specific market conditions or economic forecasts. While opportunistic selection can be part of a broader investment strategy, tactical asset allocation provides a more systematic and defined framework for temporarily deviating from strategic asset allocation weights with the aim of enhancing portfolio performance or managing risk in the short term.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (g): Describe the principles of portfolio construction and the role of asset allocation in relation to the IPS.

Q.1293 During the strategic asset allocation, which of the following leads to greater diversification benefits?

A. Low correlation within the asset classes

B. Low correlation between asset classes

C. High correlation between the asset classes

The correct answer is **B.**

A low correlation between asset classes leads to greater diversification benefits.
A is incorrect. While low correlation within asset classes can contribute to diversification, it does not offer the same level of diversification benefits as low correlation between different asset classes. Within an asset class, investments tend to be more closely related in terms of their risk and return characteristics. For instance, different stocks within the technology sector may have low correlation with each other, but they are still subject to the same sector-specific risks. Therefore, diversification within an asset class, although beneficial, is limited in its ability to reduce risk compared to diversification across different asset classes.

C is incorrect. High correlation between asset classes is detrimental to diversification benefits. When asset classes move in the same direction at the same time, the risk of the portfolio tends to be higher, and the potential for mitigating losses through diversification is reduced. In extreme cases, if all asset classes in a portfolio are highly correlated and experience a downturn simultaneously, the portfolio could suffer significant losses. Therefore, high correlation between asset classes is the opposite of what is sought for effective diversification in strategic asset allocation.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (g): Describe the principles of portfolio construction and the role of asset allocation in relation to the IPS.

Q.1294 Which of the following strategies refers to the attempt to generate higher returns than the asset class benchmark by selecting securities with a higher expected return?

A. Security selection.

B. Tactical asset allocation.

C. Strategic asset allocation.

The correct answer is **A.**

Security selection involves choosing individual securities within an asset class that are expected to outperform the asset class benchmark. This process deviates from the index weights assigned to individual securities and aims to add value through superior security selection. In contrast, strategic asset allocation is the long-term allocation of assets based on the investor's risk tolerance, investment objectives, and time horizon, while tactical asset allocation is the short-term adjustment of asset class weights based on near-term market forecasts.

B is incorrect. Tactical asset allocation is incorrect because it involves short-term adjustments to the asset class weights in a portfolio based on near-term market forecasts. It is a deliberate deviation from the strategic asset allocation (SAA) with the intent to capitalize on perceived short-term market opportunities. While tactical asset allocation can impact overall returns, it is not focused on selecting individual securities with higher expected returns, but rather on adjusting the overall asset class exposures in the portfolio.

C is incorrect. Strategic asset allocation is incorrect because it refers to the long-term allocation of assets in a portfolio based on the investor's risk tolerance, investment objectives, and time horizon. It establishes the policy weights for different asset classes and is not concerned with the selection of individual securities. The goal of strategic asset allocation is to create a balanced portfolio that can achieve the desired risk-return profile over the long term, rather than actively seeking higher returns through individual security selection.
CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (g): Describe the principles of portfolio construction and the role of asset allocation in relation to the IPS.

Q.1296 Which of the following strategies allocates the majority portion to passively managed indices and a small portion to actively managed indices?

A. Passive portfolio management

B. Strategic asset allocation

C. Core-satellite approach

The correct answer is **C.**

The core-satellite approach allocates the majority portion of an investment to passively managed indices and a small portion to actively managed indices.
A is incorrect. Passive portfolio management refers to a strategy that aims to replicate the performance of a market index or benchmark. It involves buying a portfolio of securities that mirror the constituents of the index, with minimal buying and selling of assets. This strategy does not involve a deliberate allocation to actively managed indices, which is a key component of the core-satellite approach. Passive management focuses on long-term investment in the market as a whole, with the belief that it is difficult or impossible to consistently outperform the market through active management.

B is incorrect. Strategic asset allocation is a portfolio strategy whereby the investor sets target allocations for various asset classes and periodically rebalances the portfolio back to these targets. This rebalancing can be done to maintain a desired level of asset allocation or risk. While strategic asset allocation may involve both actively and passively managed investments, it does not specifically prescribe a majority allocation to passively managed indices with a smaller portion allocated to actively managed indices. Instead, it focuses on achieving a balanced investment portfolio that aligns with the investor's risk tolerance, investment goals, and time horizon, without a specific emphasis on the core-satellite approach's distinct structure.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (g): Describe the principles of portfolio construction and the role of asset allocation in relation to the IPS.

Q.1297 Which type of portfolio manager allocates the larger portion of investments to exchange-traded funds?

A. Passive managers

B. Active managers

C. Hedge fund managers

The correct answer is **A.**

A passive manager holds just the market portfolio. Passive managers allocate all of their investments to track indices. Exchange-traded funds track indices.

B is incorrect. Active managers typically focus on selecting individual stocks or securities with the aim of outperforming a benchmark index. This approach involves frequent buying and selling of assets to capitalize on market opportunities, which contrasts with the passive strategy of holding a diversified portfolio that tracks an index. While active managers may include ETFs in their portfolios, they generally allocate a smaller portion to these instruments compared to passive managers. Active management relies on the skill, research, and decisions of the manager to achieve excess returns, which often leads to higher transaction costs and management fees.

C is incorrect. Hedge fund managers employ a wide range of investment strategies, including but not limited to, long-short equity, market neutral, arbitrage, and global macro strategies. While some hedge funds might use ETFs as part of their investment strategy, their primary focus is often on achieving absolute returns through active management and the use of complex instruments, including derivatives, leverage, and short selling. The allocation to ETFs by hedge fund managers is typically strategic and specific to certain situations, rather than a predominant feature of their investment approach. Therefore, hedge fund managers do not generally allocate the larger portion of investments to ETFs as their strategies are more varied and complex.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (g): Describe the principles of portfolio construction and the role of asset allocation in relation to the IPS.

Q.1298 Shaikh Hamid is 20 years old self-made millionaire who has $1 million of annual income with no mortgages. Because of the high volatility in small-cap stocks, Hamid is unsure about his investments in small-cap stocks. As the investment manager of Hamid, analyze his risk tolerance.

A. Hamid has a high risk ability and a high willingness to take risk.

B. Hamid has a low risk ability and a high willingness to take risk.

C. Hamid has a high risk ability and a low willingness to take risk.

The correct answer is **C.**

The ability to take risk depends on financial circumstances and the willingness to take risk depends on the investor's attitude. Hamid has a high risk ability and a low willingness to take risk.

A is incorrect. It suggests that Hamid has both a high risk ability and a high willingness to take risk. While it is true that Hamid has a high risk ability due to his financial situation and age, his uncertainty about investing in small-cap stocks indicates a low willingness to take on risk, making this option inaccurate.

B is incorrect. It underestimates Hamid's risk ability. It suggests that Hamid has a low risk ability, which contradicts his financial stability, significant annual income, lack of debt, and long investment horizon.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (d): Distinguish between the willingness and the ability (capacity) to take risk in analyzing an investor’s financial risk tolerance.

Q.2823 Which of the following is *least likely* true regarding insurance companies?

A. Property insurance companies have short-term investment horizons.

B. Insurance companies have high liquidity needs as compared to endowment funds.

C. Insurance companies invest customer claims with the objective of funding customer premiums.

The correct answer is **C.**

Insurance companies do not typically invest customer claims with the objective of funding customer premiums. Instead, they invest the premiums they collect from customers to generate returns and ensure they have the financial resources to pay out claims when they arise. The investment of customer premiums is primarily aimed at earning investment income and covering operating costs, including claims payments.

A is incorrect. Property insurance claims can be unpredictable and may require significant payouts in a short period, especially in the event of natural disasters or other large-scale property damage incidents. Therefore, maintaining investments that can be quickly liquidated without significant loss is essential for these companies to meet their claims obligations promptly.

B is incorrect. The assertion that insurance companies have high liquidity needs as compared to endowment funds is accurate. Insurance companies, especially those dealing with life, property, and casualty insurance, face uncertain timing and amounts of claims. This uncertainty necessitates maintaining a higher level of liquidity to ensure that claims can be paid out promptly, regardless of when they arise. Endowment funds, on the other hand, have a more predictable and stable payout structure, typically aimed at funding specific long-term objectives such as scholarships or institutional support. This allows endowment funds to allocate a larger portion of their portfolio to less liquid, potentially higher-yielding investments, as their need for immediate liquidity is generally lower than that of insurance companies.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (e): Describe the investment constraints of liquidity, time horizon, tax concerns, legal and regulatory factors, and unique circumstances and their implications for the choice of portfolio assets.

Q.2890 Which of the following is *least likely* a component of an Investment Policy Statement (IPS)?

A. Duties and responsibilities of the investment manager

B. Procedures to update the IPS

C. Investment expertise of the investment manager

The correct answer is **C.**

An IPS does not carry information regarding investment areas or the investment focus of the management firm as this information is provided in the firm's investment brochure.
A is incorrect. The duties and responsibilities of the investment manager are a fundamental component of an IPS. This section of the IPS clarifies the roles of the investment manager, setting clear expectations for both the manager and the client. It includes the scope of the manager's authority, decision-making responsibilities, and any specific tasks they are expected to perform. By defining these duties, the IPS helps to prevent misunderstandings and conflicts, ensuring that the investment process runs smoothly and efficiently.

B is incorrect. Procedures to update the IPS are also an essential component. The investment environment and the client's financial situation, goals, and risk tolerance can change over time. Therefore, it is necessary to have a process in place for reviewing and updating the IPS to reflect these changes. This section of the IPS outlines how and when the document will be reviewed, who is responsible for initiating reviews, and under what circumstances revisions will be made. Including procedures for updating the IPS ensures that the investment strategy remains relevant and aligned with the client's current needs and objectives.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (b): Describe the major components of an IPS.

Q.2891 Which of the following investment policy statements is the most appropriate IPS?

A. Amir Khan aims to earn significant returns on its portfolio of $2 million in 4 years.

B. The goal of Jack Wilson, a high net worth individual, is to earn a 20% return on its portfolio from oil sector stocks within the time frame of 5 years.

C. Michael Trott's investment goal is to beat the Dow Jones Industrial index by 3%.

The correct answer is **B.**

Option B) is correct because it is the most appropriate IPS among the three. Jack Wilson's IPS defines the return goal and the time frame clearly. However, it does not express the risk goals.
Amir Khan's IPS does not define the return or risk goals of the client.
Michael Trott's IPS provides return goals, but it does not provide any time frame.

A is incorrect. Amir Khan's statement lacks specificity in terms of the desired return and does not mention any risk considerations or specific investment focus. Simply aiming to earn "significant returns" on a portfolio of $2 million in 4 years is too vague to be actionable or measurable. An effective IPS should provide clear objectives that enable the investor and the investment manager to align the investment strategy with the investor's goals, risk tolerance, and time horizon. Without a defined return goal or risk parameters, it is challenging to devise a strategic investment plan or evaluate performance.

C is incorrect. Michael Trott's investment goal of beating the Dow Jones Industrial index by 3% provides a clear return objective but fails to specify a time frame for achieving this goal. An IPS without a defined time horizon lacks a critical component necessary for planning and assessing the suitability of investment strategies. Additionally, while aiming to outperform a specific benchmark is a common objective, the absence of a time frame and risk considerations limits the effectiveness of the IPS. It is essential for an IPS to encompass all key elements, including investment objectives, time horizon, and risk tolerance, to guide the investment process effectively and measure success accurately.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (b): Describe the major components of an IPS.

Q.2892 Which of the following is *least likely* an example of an absolute risk objective?

A. The portfolio must not decrease in value by more than 4% at any point in a quarter.

B. The portfolio must not have greater than a 10% probability of a loss of $100,000 in 12 months.

C. The portfolio must not have greater than a 5% probability of returns less than 95% of the S&P 500's returns in 6 months.

The correct answer is **C.**

Absolute risk objectives focus on the actual losses or gains of a portfolio without comparing them to any benchmark or index. They are concerned with the magnitude of potential loss or the volatility of the portfolio itself. In contrast, relative risk objectives involve comparing the performance of a portfolio to that of a benchmark or index to assess its relative performance. Since option C involves comparing the portfolio's returns to the S&P 500's returns, it is inherently a relative risk measure, not an absolute one.

A is incorrect. It is an example of an absolute risk objective. This option specifies a clear, quantifiable limit on the portfolio's potential decrease in value, without making any reference to a benchmark or external index. It sets a standalone criterion for the portfolio's performance, focusing on the absolute outcome of not losing more than 4% in value within a quarter. This type of objective is concerned with the direct outcomes of investment decisions, irrespective of the market or any external performance measures, which is characteristic of absolute risk objectives.

B is incorrect. It also represents an absolute risk objective. This option outlines a specific probability threshold for a monetary loss within a certain time frame, which is a direct measure of the portfolio's risk of loss. Like option A, it does not compare the portfolio's performance to any external benchmark or index but instead sets an absolute criterion for acceptable risk levels. The focus is on limiting the likelihood of a direct, quantifiable loss, which aligns with the principles of absolute risk management. By setting a maximum acceptable probability for a specific loss, it aims to control the portfolio's absolute risk exposure without regard to relative performance metrics.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (c): Describe risk and return objectives and how they may be developed for a client.

Q.2893 Which of the following *least likely* depicts the investor's ability to take risk?

A. Seventy percent of the investor's home mortgage has already been paid.

B. The investor has net assets of $470,000 and an investment horizon of 14 years.

C. The investor is a Ph.D. in Economics and understands the risk associated with the stock markets.

The correct answer is **C.**

Option C) depicts the investor's willingness to take risk; not its ability to take risk.
Longer time horizons, greater net assets, having a secure job, and insurance of assets provide information regarding the investor's ability to take risk.

A is incorrect. The investor is less likely to need to liquidate investments to cover debt obligations, allowing for a longer-term investment perspective that can tolerate the volatility associated with higher-risk investments.

B is incorrect. Having net assets of $470,000 and an investment horizon of 14 years provides a solid financial foundation and a sufficiently long time frame for investing. These factors collectively enhance the investor's ability to take risk. A substantial asset base gives the investor a buffer to absorb potential losses without jeopardizing their financial security. Additionally, a longer investment horizon allows for the possibility of recovering from short-term market fluctuations. The combination of a significant asset base and a long-term investment perspective enables the investor to consider higher-risk investment options that may offer higher returns over time, as they have the financial resilience and time to ride out market volatility.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (d): Distinguish between the willingness and the ability (capacity) to take risk in analyzing an investor’s financial risk tolerance.

Q.2894 Which of the following investors has the highest ability to take risk?

A. A 24-years old unemployed finance graduate with student loans amounting to $80,000 but in-depth knowledge of financial markets.

B. A 55-years old war veteran with $400,000 in savings and medical insurance but no knowledge of investments.

C. A married couple in their 30's with 4 kids and contractual jobs.

The correct answer is **B.**

The 55-years old war veteran has the highest ability to take risk as he has savings and medical insurance which means he does not expect any liability in the future. His lack of financial knowledge depicts a lower willingness to take risk.

A 24-years old finance graduate only has high knowledge and willingness to take risk but his ability is limited as he does not have a stable income.
A couple in their 30's with contractual jobs and 4 kids probably have future liabilities (medical, children's education, etc.). Therefore, the couple's ability to take risk is limited.
A is incorrect. While the 24-year-old finance graduate possesses in-depth knowledge of financial markets, which may increase his willingness to take on risk, his current financial situation severely limits his ability to do so. Being unemployed and burdened with $80,000 in student loans creates a precarious financial position that necessitates a more conservative approach to risk. The lack of a stable income means that any losses incurred from high-risk investments could exacerbate his financial strain, making it imprudent to engage in such activities despite his understanding of the markets.

C is incorrect. The married couple in their 30s with four kids and contractual jobs face significant financial responsibilities and uncertainties that constrain their ability to take on risk. The need to provide for their children's current and future needs, such as education and healthcare, coupled with the lack of job security inherent in contractual employment, necessitates a cautious approach to investment. These factors create a scenario where the couple must prioritize financial stability and security over the pursuit of potentially higher returns through riskier investments. Their situation underscores the importance of considering not just the willingness but also the capacity to bear risk when evaluating an individual's or family's investment strategy.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (d): Distinguish between the willingness and the ability (capacity) to take risk in analyzing an investor's financial risk tolerance.

Q.2895 Which of the following is the appropriate definition of a relative risk objective?

A. A relative risk objective states the probability by which a portfolio can assume risk.

B. A relative risk objective defines the percentage by which a fund can lose value.

C. A relative risk objective mentions a percentage by which a portfolio can take risk as compared to a benchmark.

The correct answer is **C.**

Relative risk objectives define a percentage of value that a fund can lose as compared to its benchmark. For example, 'no greater than a 5% probability of returns more than 3% below the return of the PSX in 12 months' would be a relative risk objective.
A is incorrect. This option suggests that a relative risk objective states the probability by which a portfolio can assume risk. However, this interpretation is misleading. Relative risk objectives do not directly state probabilities but rather set benchmarks for risk in relation to a specific standard, such as a market index. The focus is on comparing the portfolio's risk level to that of the benchmark, rather than quantifying the risk in terms of probabilities. Therefore, this option does not accurately capture the essence of a relative risk objective.

B is incorrect. This option defines a relative risk objective as the percentage by which a fund can lose value. While it is true that relative risk objectives can involve comparisons of potential losses, this definition is too narrow and does not fully encompass the concept. Relative risk objectives are not solely about potential losses but more broadly about how the risk level of a portfolio compares to a benchmark. This comparison can include various aspects of risk and performance, not just the potential for loss. Therefore, this option fails to provide a comprehensive definition of a relative risk objective.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (g): Describe the principles of portfolio construction and the role of asset allocation in relation to the IPS.

Q.2898 During a meeting with his investment manager, an investor requested the manager not to invest his money in the Republic of Somalia as the investors believe that the taxes that Somalia collects on investments are used for arms manufacturing. Determine the most appropriate categorization of the investor's request.

A. The investor's request should be categorized under tax constraints.

B. The investor's request should be categorized under legal constraints.

C. The investor's request should be categorized under unique constraints.

The correct answer is **C.**

The investor's request to avoid investing in the Republic of Somalia due to concerns about the use of tax revenues for arms manufacturing should be categorized under unique constraints. Unique constraints refer to specific preferences, ethical considerations, or personal beliefs that influence an investor's decision-making process. These constraints are highly individualized and can vary significantly from one investor to another. In this case, the investor's ethical stance against contributing to arms manufacturing through taxes collected on investments represents a unique constraint. This categorization acknowledges the personal and ethical dimensions of investment decisions, beyond mere financial considerations.
A is incorrect. Tax constraints typically refer to considerations related to the optimization of tax liabilities and the impact of taxation on investment returns. While the investor's concern involves taxes, it is not about the tax treatment or optimization but rather the ethical implications of how tax revenues are used. Therefore, categorizing the investor's request under tax constraints would not accurately capture the essence of the concern, which is fundamentally ethical rather than financial.

B is incorrect. Legal constraints pertain to the adherence to laws, regulations, and legal standards that govern investment activities. These constraints ensure that investments comply with the legal framework of the jurisdictions in which they operate. The investor's request, however, does not relate to legal compliance or regulatory issues. Instead, it is based on a personal ethical stance against investing in a country where tax revenues may be used in a manner that the investor finds objectionable. Thus, the request does not fit within the scope of legal constraints, as it is driven by personal values rather than legal requirements.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (e): Describe the investment constraints of liquidity, time horizon, tax concerns, legal and regulatory factors, and unique circumstances and their implications for the choice of portfolio assets.

Q.2899 Which of the following portfolios will lead to higher risk reduction through diversification?

A. A portfolio consisting of 3 sectors with a high correlation of assets within the sectors and a high correlation of sectors with each other.

B. A portfolio consisting of 3 sectors with a high correlation of assets within the sectors and a low correlation of sectors with each other.

C. A portfolio consisting of 3 sectors with a low correlation of assets within the sectors and a high correlation of sectors with each other.

The correct answer is **B.**

The portfolio that will lead to the lowest risk through diversification would be when the assets under the asset classes are highly correlated with each other while the asset classes have a low correlation with each other.
A is incorrect. The similar price movements across the portfolio mean that when one asset or sector experiences a downturn, it is likely that others will as well, leading to a compounded negative effect on the portfolio's value.

C is incorrect. Despite the diversification within each sector, the similar movement among the sectors means that broader market or economic events affecting one sector are likely to affect the others in a similar manner. Thus, the portfolio's risk is not significantly reduced compared to a portfolio where sectors have low correlations with each other.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (g): Describe the principles of portfolio construction and the role of asset allocation in relation to the IPS.

Q.2900 The process of determining the specific percentage to be allocated to specific sectors after analyzing the investor's objectives and constraints is called:

A. Security selection.

B. Passive management.

C. Strategic asset allocation.

The correct answer is **C.**

Strategic asset allocation is the process that involves determining the specific percentage to be allocated to each specific asset class after analyzing the investor's objectives and constraints.
A is incorrect. Security selection refers to the process of choosing individual securities, such as stocks or bonds, within each asset class for investment. This process comes after determining the overall asset allocation and involves analyzing the financial health, market position, and growth prospects of specific companies or issuers. While security selection is an important aspect of portfolio management, it is distinct from the broader strategy of allocating assets among different classes to achieve diversification and risk management objectives.

B is incorrect. Passive management is an investment strategy that involves replicating a market index or benchmark rather than attempting to outperform it through active security selection or market timing. Passive management strategies typically involve investing in index funds or exchange-traded funds (ETFs) that track the performance of a specific index. While passive management can influence the types of assets included in a portfolio, it does not involve the active decision-making process of determining the specific percentages to be allocated to different asset classes based on an investor's objectives and constraints, which is the essence of strategic asset allocation.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (g): Describe the principles of portfolio construction and the role of asset allocation in relation to the IPS.

Q.2901 The manager of a pension fund recently deviated from the predetermined weights of asset classes of the pension fund portfolio to take short-term opportunities. This strategy of varying weights is known as:

A. Technical asset allocation.

B. Tactical asset allocation.

C. Risk budgeting.

The correct answer is **B.**

Tactical asset allocation is the process by which a manager deviates from the strategical asset allocation weights to capitalize on short-term expected returns.
A is incorrect. Technical asset allocation refers to the use of historical price data and technical indicators to make investment decisions. This approach focuses on identifying patterns or trends in asset prices to forecast future market movements. While technical analysis can play a role in tactical asset allocation decisions, it is not synonymous with the strategic decision-making process of adjusting portfolio weights based on short-term market opportunities. Technical asset allocation is more about the timing of trades and less about the strategic adjustment of asset class weights in a portfolio.

C is incorrect. Risk budgeting is a portfolio construction technique that allocates risk, rather than capital, across various assets or strategies based on their expected contribution to the overall portfolio risk. This approach focuses on managing and optimizing the risk-return profile of a portfolio by understanding and controlling the sources of risk. While risk budgeting can influence asset allocation decisions, it is fundamentally different from tactical asset allocation. Tactical asset allocation specifically involves making short-term adjustments to the portfolio's asset class weights to exploit market opportunities, whereas risk budgeting is concerned with the distribution of risk across the portfolio to achieve a desired risk level or risk-return trade-off.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (g): Describe the principles of portfolio construction and the role of asset allocation in relation to the IPS.

Q.2902 A 40-years old manager at one of the biggest law firms in New York with net assets of $1,070,000 and basic social security believes that investing in stocks is most profitable when the stock is less volatile because the stock market is rigged. Using the above assumptions, determine the ability and the willingness of the investor.

A. High ability and high willingness to take risk

B. High ability and low willingness to take risk

C. Low ability but high willingness to take risk

The correct answer is **B.**

As the investor has a longer time-frame, i.e., 20 years to his retirement, sound savings and social security, his ability to take risk is high. However, as per his beliefs, it seems his knowledge of the stock market is limited. Therefore, his willingness to take risk is also limited.
A is incorrect. This option suggests that the investor has both a high ability and a high willingness to take on risk. While the investor's financial situation and time horizon indeed indicate a high ability to take on risk, his beliefs about the stock market suggest a cautious or skeptical attitude towards investing in volatile stocks. The investor's perception that the stock market is "rigged" and his preference for less volatile stocks indicate a low willingness to engage in riskier investment strategies, despite having the financial capacity to do so.

C is incorrect. This option suggests that the investor has a low ability but high willingness to take on risk. This interpretation is not supported by the information provided. The investor's substantial net assets and the long time horizon until retirement clearly indicate a high ability to take on financial risks. However, his beliefs about the stock market and preference for less volatile stocks reflect a cautious approach to investing, indicating a low willingness to take on risk. The investor's financial situation and safety nets like social security support a high ability to absorb risk, but his personal beliefs and investment preferences suggest a reluctance to engage in high-risk investment strategies.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (d): Distinguish between the willingness and the ability (capacity) to take risk in analyzing an investor’s financial risk tolerance.

Q.2903 A hedge-fund manager based in Dubai overweights the media sector stocks as compared to the medical sector stocks from the Dubai Index and he does not plan to rebalance the portfolio. This process of overweighting a specific asset class or sector is *most likely* referred to as:

A. Tactical asset allocation.

B. Strategic asset allocation.

C. Securities selection.

The correct answer is **C.**

Securities selection is the process of determining which financial securities are included in a specific portfolio. Therefore, the process of overweighting/underweighting a specific asset class or the process of deviating from index weights of specific individual securities within an asset class is known as securities selection.
A is incorrect. Tactical asset allocation (TAA) is a dynamic investment strategy that actively adjusts a portfolio's asset allocation targeting short-term gains.

B is incorrect. Strategic asset allocation refers to setting target allocations for various asset classes and rebalancing periodically.

Note: It can sometimes be confusing to differentiate between strategic asset allocation and securities selection. However, remember that strategic asset allocation involves setting target allocations for various asset classes and rebalancing the portfolio periodically, whereas securities selection is simply the process of selecting the securities.

CFA Level I, Portfolio Management, Learning Module 4: Basics of Portfolio Planning & Construction. LOS (f): Explain the specification of asset classes in relation to asset allocation.