Question #1 of 20

Question ID: 1580676

What is the major difference between dynamic asset allocation and static asset allocation?

Dynamic asset allocation:

A) considers more than one asset class, while static asset allocation only considers one asset class at a time.

B) considers asset and liability management simultaneously, while static asset allocation does not.

C) **takes a multiperiod view of the investment horizon, while static asset allocation does not.**

Explanation

Dynamic asset allocation takes a multiperiod view of the investment horizon, while static asset allocation does not. Dynamic asset allocation and static asset allocation both can be used for asset-only or asset-liability approaches to strategic asset allocation. Both dynamic and static asset allocation approaches consider more than one asset class.

(Module 3.6, LOS 3.i)

Question #2 of 20

Question ID: 1580654

Carla Smitz, CFA, is working with new, young clients Terry and Janice Dillard to develop their investment policy statement (IPS). Smitz should *most likely* take into consideration:

A) their risk tolerance.

B) their human capital.

C) **both their human capital and risk tolerance.**

Explanation

If the clients do not have an IPS, the manager should consider everything that relates to their complete financial situation.

(Module 3.2, LOS 3.b)

Question #3 of 20

Question ID: 1580651

Which of the following is not part of an effective investment governance model?

A) Determining manager compensation. ✓

B) Establishing client objectives. ✗

C) The process of setting an asset allocation. ✗

Explanation

Determining manager compensation is not directly one of the elements. These are the six elements:

- Establish long-term and short-term investment objectives.
- Allocate the rights and responsibilities of all the involved parties.
- Specify processes for creating an investment policy statement (IPS).
- Specify processes for creating a strategic asset allocation.
- Apply a reporting framework to monitor the investment program's stated goals and objectives.
- Include a periodic review of the governance policies by an independent third party.

(Module 3.1, LOS 3.a)

Question #4 of 20

Question ID: 1580680

Tactical asset allocation analysis:

A) is often based on deviant beliefs. ✓

B) assumes that the investor's risk tolerance decreases with wealth. ✗

C) assumes lack of inefficiencies in the market. ✗

Explanation

Tactical asset analysis often operates on the assumption that the market overreacts to information.

Tactical asset analysis is typically performed routinely as part of a continuing asset management, attempts to take advantage of perceived inefficiencies in the relative prices of securities in different asset classes, and assumes that investor's risk tolerance is unaffected by changes in wealth.

(Module 3.6, LOS 3.j)

Question #5 of 20

Question ID: 1551635

Which of the following investment objectives is *most likely* associated with asset-only asset allocation approaches?

A) Maximizing expected return per unit of risk. ✓

B) Funding liabilities when they come due. ✗

C) Meeting specific goals within a certain degree of confidence. ✗

Explanation

The investment objective for an asset-only asset allocation is to maximize the expected return per unit of risk (e.g., maximize the Sharpe ratio).

(Module 3.3, LOS 3.c)

Question #6 of 20

Question ID: 1580679

Strategic asset allocation analysis:

A) is usually done more frequently than tactical asset allocation. ✗

B) often results in a buy-and-hold strategy. ✗

C) often results in constant mix strategies. ✓

Explanation

This is often expressed as a percentage of total value invested in each asset class.

Strategic asset allocation analysis is usually done whenever the investor's circumstances change significantly and is often done as frequently as yearly. It is based on long-run capital market conditions, and it requires transactions to rebalance the mix periodically.

(Module 3.6, LOS 3.j)

Question #7 of 20

Question ID: 1580673

With respect to the global market portfolio, which of the following statements is *least accurate*?

The global market portfolio:

A) is the portfolio that minimizes unsystematic risk.

B) contains only asset classes that trade throughout the capital markets.

C) lies on the steepest-sloping and feasible capital market line.

Explanation

The global market portfolio is the portfolio that is defined at the tangency point of the capital market line (CML) that joins the risk-free asset and the efficient frontier (i.e., the feasible CML that maximizes the Sharpe ratio) and is fully diversified; thus, it has minimized company-specific unsystematic risk. It includes all assets—whether traded in the capital markets or not. Hence, it contains market risk (systematic risk), which theoretically cannot be further diversified. The resulting weights are based on market capitalization.

(Module 3.6, LOS 3.h)

Question #8 of 20

Question ID: 1580659

Regarding asset allocation risk measures, which of the following statistical risk measures is *most likely* associated with a defined benefit plan using an asset-only approach?

A) The standard deviation of the surplus.

B) The standard deviation of the funding ratio.

C) The standard deviation of the overall portfolio.

Explanation

For an asset-only approach, the relevant risk measure is the standard deviation of portfolio returns, which incorporates asset class volatilities and asset class return correlations. This case specifically says an asset-only approach is being used, and that is not uncommon for DB plans. Arguably, a liability-relative style is more appropriate, but the asset-only approach can implicitly deal with the liabilities by targeting a rate of return sufficient to meet the liability payouts.

(Module 3.3, LOS 3.d)

Question #9 of 20

Question ID: 1580663

Which of the following would indicate that the asset classes used for describing the returns of a portfolio are desirable?

A) High R-squared and large confidence intervals. ✗

B) Low R-squared and easily measured manager asset proportions. ✗

C) High R-squared and easily measured manager asset proportions. ✓

Explanation

Desirable asset classes would explain a high proportion of portfolio returns—and, thus, have a high R-squared. The asset mix proportions for each manager should be easily measured.

(Module 3.4, LOS 3.e)

Question #10 of 20

Question ID: 1551637

Which one of the following *most closely* matches an advantage of the asset-liability approach over the asset-only approach to strategic asset allocation?

A) Liabilities and assets are highly correlated. ✗

B) Liability funding is more accurately controlled. ✓

C) Asset classes have different systematic risk exposures. ✗

Explanation

The asset-liability approach to strategic asset allocation is desirable because liabilities are more accurately controlled.

(Module 3.3, LOS 3.d)

Question #11 of 20

Question ID: 1551655

Strategic asset allocation reflects what systematic risk exposure?

A) Investor's desired systematic risk exposure. ✓

B) Long-term systematic risk exposure. ✗

C) Asset class systematic risk. ✗

Explanation

Strategic asset allocation reflects the investor's desired systematic risk exposure.

(Module 3.5, LOS 3.g)

Question #12 of 20

Question ID: 1580662

Which of the following characteristics of asset classes is *most* desirable? Asset classes should:

A) be mutually exclusive. ✓

B) have an index. ✗

C) be correlated with each other. ✗

Explanation

Desirable characteristics of asset classes are as follows: they cannot be classified into more than one asset class (be mutually exclusive), they should not be highly correlated with each other, the assets within an asset class have similar descriptive as well as statistical characteristics, are sufficiently liquid, and they cover the majority of all investable assets.

(Module 3.4, LOS 3.e)

Question #13 of 20

Question ID: 1580667

Regarding the use of risk factors when making asset allocation decisions, which of the following statements is *most correct*?

A) Multifactor models can be used to isolate systematic risk exposures. ✓

B) Risk factors are as easy to invest in as an asset class. ✗

C) Risk factors cannot be used as units of analysis in asset allocation. ✗

Explanation

Multifactor models can be used for asset allocation by creating factor portfolios, which isolate systematic risk exposures (i.e., nondiversifiable risks). Risk factors can be used as units of analysis in asset allocation. But one problem is that it is not always easy to determine how to invest in those identified risk factors. Some may be investable, and others may not. Asset classes are, by definition, assets that are owned and investable—though the cost and ease of investing varies.

(Module 3.4, LOS 3.f)

Question #14 of 20

Question ID: 1580660

Which of the following statements about the liability-relative and/or goals-based approaches is *least accurate*?

A) Both approaches consider assets in the context of meeting liabilities. ✗

B) Mean-variance optimization (MVO) is appropriate for both approaches. ✗

C) Surplus optimization is an example of the goals-based approach. ✓

Explanation

Surplus optimization is an example of the liability-relative (not goals-based) approach, and liability-relative is based on principles from mean-variance asset allocation.

Both the liability-relative and goals-based approaches consider assets relative to liabilities. The main difference between the two approaches is that the liability-relative approaches focus on institutional investor liabilities, while the goals-based approaches focus on individual investor liabilities.

MVO is appropriate for asset-only and liability-relative approaches by incorporating expected returns, volatility, and correlations of asset classes. It is also applicable for the goals-based approach, whereby MVO is structured to maximize expected returns for a given level of risk or to meet a specified probability of success. MVO is then carried out for each goal portfolio rather than for the entire portfolio.

(Module 3.3, LOS 3.c)

Question #15 of 20

Question ID: 1580666

According to the modern portfolio theory, which risk is rewarded?

A) Total risk. ✗

B) Efficient risk. ✗

C) Systematic risk. ✓

Explanation

According to modern portfolio theory, only systematic risk is rewarded. Total risk (may be measured by standard deviation) comprises systematic and unsystematic risk.

(Module 3.4, LOS 3.f)

Question #16 of 20

Question ID: 1580671

Which of the following statements regarding the strategic asset allocation process is *least accurate*?

A) The strategic asset allocation must be rebalanced periodically for changes in the valuation of the various asset classes in the portfolio.

B) The strategic asset allocation review is typically performed once per year.

C) **Strategic asset allocation, similar to tactical asset allocation, employs a short-run capital market projection.**

Explanation

Strategic asset allocation employs a long-term capital market projection.

(Module 3.5, LOS 3.g)

Question #17 of 20

Question ID: 1551629

Which of the following statements regarding the portfolio management process is *least accurate*?

A) **The general portfolio construction, monitoring, and revising process is the same for both individuals and institutional investors.**

B) Capital market expectations are used to determine the appropriate asset classes for the client's strategic asset allocation.

C) The investment advisor should consider the client's entire conventional balance sheet.

Explanation

The investment advisor should consider the client's entire economic (not conventional) balance sheet. For individuals, the economic balance sheet would include human capital on the asset side.

The general process of constructing, monitoring, and revising portfolios is the same for both individuals and institutional investors.

Capital market expectations are the macroeconomic circumstances used to determine the appropriate asset classes for the client's strategic asset allocation based on risk and return in relation to the client's investment policy statement (IPS).

(Module 3.1, LOS 3.a)

Question #18 of 20

Question ID: 1580652

Decision-reversal risk is likely to:

A) occur when an investor changes investment strategy. ✗

B) occur in large institutional portfolios with exposure to alternative investments. ✗

C) create a skewed distribution of portfolio return. ✓

Explanation

Decision-reversal risk is thoughtlessly reversing a previous investment decision at the worst time; it is much more than merely changing investment strategy as the key words are *worst time*. It commonly occurs when less knowledgeable investors get into complex positions they do not understand, panic when things don't go well, and sell. Thoughtless selling when an asset is down would likely reduce upside recovery and create negative (cut of the upside) skew in the returns.

It refers primarily to the investor panicking and is presumably less common in more knowledgeable institutional investors who have more access to investment information.

(Module 3.1, LOS 3.a)

Question #19 of 20

Question ID: 1580665

Regarding the classification of sub-asset classes, which of the following statements is *most correct*?

A) Correlations between sub-asset classes within a broader asset class are likely to be high. ✓

B) Correlations between broad asset classes are likely to be high. ✗

C) Increasing granularity in asset classes is important to the strategic asset allocation process. ✗

Explanation

Sub-asset classes are divisions within a class, such as value versus growth within the equity class. They will not be as different from each other as the differences between broad asset classes (such as equity vs. fixed income). In other words, sub-assets within a broad class are relatively more highly correlated than broad asset classes are to each other. Broad asset classes are most important in SAA, not creating lots of sub-asset classes—which is what increasing granularity means. More sub-asset classes can be useful in TAA or strategy implementation.

(Module 3.4, LOS 3.e)

Question #20 of 20

Question ID: 1580681

Several investment decisions remain to be made following the selection of an appropriate strategic asset allocation (SAA). These include the decision on how to rebalance the SAA back to the target allocations. Which of the following statements is *least accurate* regarding a rebalancing scheme?

A) Rebalancing triggers include calendar month, relative deviations from targets, and absolute deviations from target. ✗

B) Rebalancing is required as part of a risk budget. ✓

C) Rebalancing must consider both the transaction cost and liquidity of the assets being rebalanced. ✗

Explanation

Rebalancing is part of managing risk, but it is not necessarily part of the risk budgeting approach to portfolio management. Traditional rebalancing triggers include calendar (time), relative deviations from targets, and absolute deviations from target. Rebalancing rules are heavily dependent on the underlying liquidity of the assets and the associated cost of transacting. Rebalancing rules can often include a level of discretion of the responsible party; sometimes, this decision is influenced by the momentum of a particular asset class.

(Module 3.6, LOS 3.j)