Question #1 of 10

Question ID: 1587539

If an investment is held in an account that is taxed annually, the government bears:

A) some of the investment risk.

B) none of the investment risk.

C) all of the investment risk.

Explanation

If the investment returns are taxed solely as income at the tax rate *t* and the pretax standard deviation of returns is *S*, then the investor's after-tax risk is S × (1 − t), and the government bears a portion of the risk.

(Module 5.1, LOS 5.b)

Question #2 of 10

Question ID: 1587546

Goals-based investing is most directly useful to counter:

A) the illusion of control.

B) loss aversion.

C) representativeness.

Explanation

The answer is loss aversion based specifically on what the reading says. You have taken at least two CFA exams and know such picky questions are unusual. Exhibit good judgment, give your best guess, and move on.

(Module 5.3, LOS 5.e)

Question #3 of 10

Question ID: 1551742

If an investment is held in a tax-exempt account, then the investor bears:

A) none of the investment risk.

B) all of the investment risk.

C) some of the investment risk.

Explanation

In a taxable account, losses realized result in a reduction in taxes that serve to offset the magnitude of the loss. Thus, some of the downside risk is transferred to the government. In a tax-exempt account, the variability of returns is not affected by the taxes.

(Module 5.1, LOS 5.b)

Question #4 of 10

Question ID: 1587541

The Howarth School Foundation (HSF) has historically provided 30% of the annual operating costs of running the Howarth law school. Recent changes in government funding mean that previously fully funded scholarships will now only be 40% funded, and that the HSF must provide more support to the school. Based on this information, the HSF will *most likely*:

A) decrease the allocation to private equity to increase the liquidity of the portfolio.

B) increase the allocation to riskier timber and farmland to generate higher expected return and cover the required outflows.

C) increase the allocation to zero-coupon bonds to increase duration.

Explanation

The school is becoming more dependent on the foundation, decreasing the ability to take risk and increasing liquidity demands for payouts to the school. Shifting to more liquid investments makes sense. Higher duration is not relevant and is probably riskier—plus, zero-coupons provide no regular cash flow. Higher return may seem logical, but taking more risk to get it is not appropriate when the ability to take risk has declined—plus, land is an illiquid asset.

(Module 5.2, LOS 5.c)

Question #5 of 10

Question ID: 1587535

Julia Adamson is 77 years old, with a life expectancy of nine years. Adamson has told her portfolio manager that her portfolio needs to fund three buckets that each allow her to maintain her current standard of living: (1) from now until age 80, (2) age 80 to 90, and (3) age 90 to 100. Which of the three buckets should allow for the highest allocation to risky investments?

A) Bucket 2 (age 80 to 90).

B) Bucket 3 (age 90 to 100).

C) Bucket 1 (until age 80).

Explanation

Given Adamson's life expectancy of nine years, Buckets 1 and 2 have the greatest priority. Investments allocated to those two buckets should be more conservative, with a greater emphasis on liquidity. Bucket 3 is at least four years outside of her life expectancy range; therefore, it can be invested in higher risk investments to ensure asset growth for the longer term, should she exceed her nine-year life expectancy.

(Module 5.1, LOS 5.a)

Question #6 of 10

Question ID: 1587534

Global Auto Ltd. (GAL) maintains a fully funded $500 million pension fund for its defined benefit pension plan that is now closed to new employees. GAL's retirement age is 62, and the average age of the company's pension plan beneficiaries is 55. However, there is an upcoming change in pension legislation that will allow employees to retire earlier, at age 58. The pension fund is currently invested as follows:

- 20% domestic equities
- 20% foreign equities
- 30% domestic bonds with a duration of 15 years
- 30% alternative investments (equally invested in real estate, hedge funds, and private equity)

The *most appropriate* strategy by GAL's pension fund manager would be to reduce the allocation to:

A) alternative investments and increase the allocation to domestic equities.

B) **alternative investments and equities and increase the allocation to fixed income with a shorter duration.**

C) domestic and foreign equities and increase the allocation to fixed income with a shorter duration.

Explanation

Although the pension plan is currently fully funded, it has a high exposure to potentially illiquid alternative investments. In addition, the duration of its fixed-income portfolio is too high and exceeds the average time until retirement (7 years, assuming age 62 retirement age). Furthermore, the reduction in the average retirement age to 58 will result in increased liquidly needs. The fund needs to reduce its allocation to riskier assets (alternative investments and equity) and increase its allocation to less risky assets (fixed income with a lower duration).

(Module 5.1, LOS 5.a)

Question #7 of 10

Question ID: 1587544

The strategic asset allocation, current allocation, and upper and lower policy limits for a retirement portfolio are shown in the following table.

Asset Class	Current Weight	SAA	Upper Limit	Lower Limit
Fixed income	35%	40%	45%	35%
Domestic equity	60%	50%	60%	40%
Real estate	5%	10%	15%	5%

The portfolio manager takes a discretionary approach to tactical asset allocation. She follows various indicators that she believes are useful in evaluating specific asset classes. Her current observations and interpretations are as follows:

- Equity brokers have reported that margin borrowing levels increased dramatically over the last two months and now sit at their highest levels for 15 months—a bearish sign.
- Real estate indices have started to rise, suggesting the market may be "heating up"—a bullish sign.
- Indications from the Federal Reserve are that interest rates will rise several times in the next 12 months—a clearly obvious sign.

Which of the following tactical allocation shifts is the manager *most likely* to make?

A) Increase the weighting to real estate.

B) Increase the weighting to domestic equity.

C) Decrease the weighting to fixed income.

Explanation

She is bullish on RE, and RE is at the bottom of her range; she should increase the allocation, if possible. Admittedly, RE is a less liquid asset. She is bearish on equity and would not want to increase the weight. Increasing interest rates is bearish for bonds, but she is already at the bottom of the range. Avoid convoluted arguments that to change one weight, she must do something else as well. That is not a direct answer to the question, was not asked, and we'd be guessing what that other action is. She may already have some cash assets.

(Module 5.2, LOS 5.d)

Question #8 of 10

Question ID: 1587536

Dan Vustings, 51, is a senior account executive at an advertising agency in San Francisco. He currently has sufficient capital in his two investment portfolios to retire in 14 years. His capital is evenly split between a taxable portfolio, which he uses to fund current consumption goals and a tax-deferred retirement account. Vustings received advice from an investment manager last year who suggested the following asset allocation:

- High-yield bonds: 15%
- High-dividend-yield equities: 50%
- High growth equities: 35%

Vustings has the same allocation in both the taxable and the retirement account. Which of the following allocations would be *most likely* to improve the efficiency of the portfolios, ignoring rebalancing or withdrawal penalties?

A) Increase the allocation to high-yield bonds in the retirement account, and increase the allocation to high growth equity investments in the taxable account.

B) Increase the allocation to high-dividend yield equities in the taxable account, and increase the allocation to high growth equities in the retirement account.

C) Increase the allocation to high-yield bonds in the taxable account, and increase the allocation to high growth equities in the retirement account.

Explanation

Assets subject to the highest rates of tax should be first allocated to tax-advantaged accounts. Interest on high-yield bonds is typically taxed at a higher rate than dividend income —which, in turn, is taxed at a higher rate than capital gains. Vustings should, therefore, allocate high-yield bonds first to the retirement account, and leave the high growth equity in the taxable account.

(Module 5.1, LOS 5.b)

Question #9 of 10

Question ID: 1587538

Ruby Pascal is an institutional money manager managing a $200 million portfolio. The cost basis of each of five selected assets from the portfolio is above market value, and Pascal decides to sell those assets. The *least likely* reason for the sale is:

A) to engage in tax loss harvesting.

B) to realize capital gains to generate profits for the portfolio.

C) to realize capital losses against current or future realized capital gains.

Explanation

Before a sale, when the cost basis of an asset *exceeds* its market value, the asset has an unrealized *loss*. The primary reason for selling assets with unrealized losses is to engage in tax loss harvesting. Tax loss harvesting involves realizing capital losses against current or future realized capital gains to reduce the portfolio's overall tax liability.

(Module 5.1, LOS 5.b)

Question #10 of 10

Question ID: 1587542

The $250 million endowment of Stevenson University (SU) has a target 4% spending rate to support research at SU. The endowment is currently invested as follows: 30% domestic equities, 20% foreign equities, 20% domestic fixed income, and 30% foreign fixed income. Last month, the endowment received a $150 million donation from a philanthropist—the largest ever in its history. Which of the following approaches by SU endowment's portfolio managers would be *most appropriate*?

A) Invest the additional $150 million in riskier assets to increase the potential of higher portfolio returns.

B) Evaluate opportunities of adding new asset classes and changing the asset class weights on the combined $400 million portfolio.

C) **Invest the additional $150 million using the same asset allocation and weights as the existing portfolio, in line with the portfolio's strategic asset allocation.**

Explanation

With the additional donation, the endowment's size increased materially (i.e., 60%). Therefore, it allows the portfolio managers to take a holistic view of the portfolio by exploring new asset classes that may have been unavailable under the previous portfolio size as well as to reevaluate the portfolio's asset allocation, liquidity, and time horizon.

Investing the donation simply using the existing asset allocation ignores the potential for new asset classes and the revised asset set and risk opportunities. Investing the donation simply in riskier assets ignores the existing assets and fails to take a holistic view of the portfolio.

(Module 5.2, LOS 5.c)