

Topic 1: Risk Management: A Helicopter View

Question #1 of 5

Question ID: 438568

The risk of sustaining significant losses due to the inability to take or exit a position at a fair price is most likely:

- A)** credit event risk.
- B)** operational risk.
- C)** liquidity risk.
- D)** market risk.

Explanation

Liquidity risk is the risk of sustaining significant losses due to the inability to take or exit a position at a fair price.

References

Question From: Topic Area 1 > Topic 1 > LO 6

Related Material:

- Key Concepts by LO
-

Question #2 of 5

Question ID: 438569

Funding liquidity risk refers to the risk:

- A)** that a counterparty to a financial transaction will default.
- B)** that an institution will not be able to raise cash necessary to make debt payments.
- C)** that the government will decide to terminate a government-funded program.
- D)** resulting from a large position size in an asset relative to the asset's typical trading lot size.

Explanation

Funding liquidity risk refers to the risk that an institution will not be able to:

- raise cash necessary to make debt payments
- fulfill cash, margin, and collateral requirements of counterparties
- meet capital withdrawals resulting in a loss

References

Question From: Topic Area 1 > Topic 1 > LO 6

Related Material:

- Key Concepts by LO

Question #3 of 5

Question ID: 438572

Value at risk (VaR) is the:

- A)** average loss exceeding a specified threshold.
- B)** the worst possible loss for an asset.
- C)** maximum expected loss for a given confidence level.
- D)** minimum expected loss for a given confidence level.

Explanation

VaR is the maximum expected loss for a given confidence level assuming normal market returns. It is the minimum expected loss for a given significance level.

References

Question From: Topic Area 1 > Topic 1 > LO 3

Related Material:

- Key Concepts by LO

Question #4 of 5

Question ID: 492007

Unexpected volatility in an asset is often called:

- A)** risk.
- B)** an upward earnings surprise.
- C)** asset price instability.
- D)** biased expectations.

Explanation

Risk is described as unexpected volatility in asset prices or earnings.

References

Question From: Topic Area 1 > Topic 1 > LO 1

Related Material:

- Key Concepts by LO

Question #5 of 5

Question ID: 438566

The risk that a counterparty will fail to deliver its obligation is:

- A)** delivery risk.
- B)** model risk.
- C)** settlement risk.
- D)** people risk.

Explanation

Settlement risk is the risk that a counterparty will fail to deliver its obligation.

References

Question From: Topic Area 1 > Topic 1 > LO 6

Related Material:

- Key Concepts by LO

Topic 2: Corporate Risk Management: A Primer

Question #1 of 5

Question ID: 495057

The board of directors should help a company determine whether to hedge specific risk factors. Regarding the role of the board, which of the following statements is incorrect?

- A)** The board needs to help set and communicate the firm's risk appetite in a quantitative and/or qualitative manner.
- B)** The board should clarify its objectives in terms of whether it is accounting or economic profits that are to be hedged.
- C)** The board should ignore time horizon when determining its risk management goals for management to achieve.
- D)** The board must ensure that its goals are stated in a clear and actionable manner.

Explanation

The board must be definitive in the time horizon when determining its risk management goals for management to achieve. For example, the use of a futures contract to hedge future sales receipts will result in a mismatch of profits for accounting purposes.

References

Question From: Topic Area 1 > Topic 2 > LO 3

Related Material:

- Key Concepts by LO
-

Question #2 of 5

Question ID: 495060

Management at Bank ABC is attempting to determine which types of instruments to use for risk management. When comparing exchange-traded instruments to over-the-counter (OTC) instruments, which characteristic should the bank associate with exchange-traded instruments? Exchange-traded instruments:

- A)** contain credit risk by either of the counterparties in the transaction (e.g., default risk).
- B)** are privately traded between a bank and a firm.
- C)** cover only certain underlying assets and are standardized.
- D)** can be customized to suit the firm's risk management needs.

Explanation

Exchange-traded instruments cover only certain underlying assets and are quite standardized (e.g., maturities and strike prices) in order to promote liquidity in the marketplace. OTC instruments are privately traded between a bank and a firm and thus can be customized to suit the firm's risk management needs. In addition, there is credit risk by

either of the counterparties (e.g., default risk) that would generally not exist with exchange-traded instruments.

References

Question From: Topic Area 1 > Topic 2 > LO 5

Related Material:

- Key Concepts by LO
-

Question #3 of 5

Question ID: 495059

When evaluating methods to hedge operational and financial risks, including pricing, foreign currency, and interest rate risk, which of the following risks primarily pertain to the income statement?

- I. Hedging operational risk
 - II. Hedging financial position risk
- A)** Both I and II.
- B)** II only.
- C)** Neither I nor II.
- D)** I only.

Explanation

Hedging operational risk covers a firm's activities in production (costs) and sales (revenue), which is essentially the income statement. Financial position risk pertains to a firm's balance sheet.

References

Question From: Topic Area 1 > Topic 2 > LO 4

Related Material:

- Key Concepts by LO
-

Question #4 of 5

Question ID: 495058

Taylor Lawson is giving a presentation on the differences between static and dynamic hedging strategies. Which of the following statements is correct regarding these two hedging strategies?

- A)** A static hedging strategy recognizes that the attributes of the underlying risky position may change with time.
- B)** A static hedging strategy is a complex process in which the risky investment position is initially determined and an appropriate hedging vehicle is used to match that position as close as possible and for as long as required.
- C)** Significantly more time and monitoring efforts are required with a dynamic hedging strategy compared to a static hedging strategy.

D) A dynamic hedging strategy is a more simple process than a static hedging strategy.

Explanation

A static hedging strategy is a simple process. In contrast, a dynamic hedging strategy is a more complex process that recognizes that the attributes of the underlying risky position may change with time. Significantly more time and monitoring efforts are required with a dynamic hedging strategy.

References

Question From: Topic Area 1 > Topic 2 > LO 4

Related Material:

- Key Concepts by LO
-

Question #5 of 5

Question ID: 495056

Abe Osbourne is a risk analyst who is evaluating the advantages and disadvantages of hedging risk exposures. Which of the following statements does not reflect an advantage of hedging?

- A)** Hedging through the use of derivatives instruments such as swaps and options may be cheaper than purchasing an insurance policy.
- B)** Hedging may decrease the variability of the firm's earnings due to the difference between accounting earnings and cash flows.
- C)** Hedging may allow management to control its financial performance to meet the requirements of the board of directors.
- D)** Hedging may result in operational improvements within a firm.

Explanation

Using hedging activities to decrease the variability of the firm's value may end up increasing the variability of the firm's earnings due to the difference between accounting earnings and cash flows. This is a disadvantage of hedging risk exposures in practice.

References

Question From: Topic Area 1 > Topic 2 > LO 1

Related Material:

- Key Concepts by LO

Topic 3: Corporate Governance and Risk Management

Question #1 of 5

Question ID: 495062

Which of the following actions correctly reflect a specific duty of the risk advisory director? The risk advisory director should review and analyze:

- A)** risk management practices of competitors, but not risk management practices of the industry.
- B)** the firm's risk appetite and its impact on business strategy.
- C)** the firm's financial statements, but not the firm's disclosures.
- D)** any audit reports from internal audits, but not from external audits.

Explanation

The role of the board of directors in governance would include the review and analysis of:

- The firm's risk management policies.
- The firm's periodic risk management reports.
- The firm's appetite and its impact on business strategy.
- The firm's internal controls.
- The firm's financial statements and disclosures.
- The firm's related parties and related party transactions.
- Any audit reports from internal or external audits.
- Corporate governance best practices for the industry.
- Risk management practices of competitors and the industry.

References

Question From: Topic Area 1 > Topic 3 > LO 2

Related Material:

- Key Concepts by LO
-

Question #2 of 5

Question ID: 495063

Regarding the relationship between a firm's risk appetite and its business strategy, which of the following statements is true?

- A)** Consideration must be given to the downside risks of only risky business strategies.
- B)** Business strategy planning meetings require input from the risk management team.
- C)** A firm's risk appetite reflects its ability to minimize risk.
- D)** Business planning activities that exceed risk appetite should be maintained.

Explanation

A firm's risk appetite reflects its tolerance (especially willingness) to accept risk. There must be a logical relationship between the firm's risk appetite and its business strategy. As a result, business strategy planning meetings require input from the risk management team right from the outset to ensure the consistency between risk appetite and business strategy. For example, planning activities are often focused on maximizing the firm's profit but some planned activities may need to be eliminated or modified because they exceed the stated risk appetite. Consideration must also be given to the downside risks of any business strategy.

References

Question From: Topic Area 1 > Topic 3 > LO 3

Related Material:

- Key Concepts by LO
-

Question #3 of 5

Question ID: 495064

Stella Webster, FRM, is assessing the role and responsibilities of her firm's audit committee. Which of the following statements is incorrect regarding the audit committee? The audit committee (as part of the board):

- X **A)** has traditionally been responsible for the accuracy of the firm's financial statements and its regulatory reporting requirements.
- X **B)** must ensure that the firm has taken all steps to avoid the risk that the financial statements are materially misstated as a result of undiscovered errors and/or fraud.
- ✓ **C)** discusses and approves the remuneration of key management personnel.
- X **D)** monitors the underlying systems in place regarding financial reporting, regulatory compliance, internal controls, and risk management.

Explanation

Discussing and approving the remuneration of key management personnel is the role of the compensation committee, not the audit committee.

References

Question From: Topic Area 1 > Topic 3 > LO 4

Related Material:

- Key Concepts by LO
-

Question #4 of 5

Question ID: 495065

Regarding the interdependence of risk management related functional units within a firm, which of the following list of activities are most likely associated with senior management?

- A)** Approves business plans and targets, sets risk tolerance, and ensures performance.
- B)** Establishes and manages risk exposure, ensures timely, accurate, and complete deal capture, and signs off on official P&L.
- C)** Books and settles trades, reconciles front- and back-office positions, and prepares and decomposes daily P&L.
- D)** Develops valuation and finance policy, ensures integrity of P&L, and manages business planning process.

Explanation

The senior management functional unit approves business plans and targets, sets risk tolerance, establishes policy, and ensures performance.

References

Question From: Topic Area 1 > Topic 3 > LO 5

Related Material:

- Key Concepts by LO
-

Question #5 of 5

Question ID: 495061

When adhering to best practices in corporate governance, the board of directors should most likely:

- I. watch out for the interests of the debtholders.
- II. maintain its independence from management.

- A)** Both I and II.
- B)** I only.
- C)** Neither I nor II.
- D)** II only.

Explanation

The board would watch out for the interests of shareholders as well as other stakeholders, such as debtholders, by considering if any of management's decisions contain extreme downside risk. The board should maintain its independence from management. A key measure involved would be that the chief executive officer (CEO) would not also be the chairman of the board because there is already an inherent conflict with the CEO being on both the management team and the board of directors.

References

Question From: Topic Area 1 > Topic 3 > LO 1

Related Material:

- Key Concepts by LO

www.ombookcentre.in

Topic 4: What is ERM?

Question #1 of 5

Question ID: 495070

Steven Marsh is assisting with the implementation of an enterprise risk management (ERM) program for his firm. Specifically, he is analyzing the main components of a strong ERM framework. Which of the following activities is closely associated with the ERM component of portfolio management?

- A)** Quantifies risk exposures for use in risk analysis, measurement, and reporting.
- B)** Provide a holistic view of the firm's risks if these risks are viewed as individual components of the aggregate risks facing the firm.
- C)** Reduces or transfers out risks that are either undesirable risks or are desirable but considered concentrated.
- D)** Communicates a firm's internal risk management process to external stakeholders, including shareholders, creditors, regulators, and the public.

Explanation

Portfolio management provides a holistic view of the firm's risks if these risks are viewed as individual components of the aggregate risks facing the firm. Active portfolio management aggregates risk exposures and allows for diversification of risks (partly through offsetting risk positions) and prudent monitoring of risk concentrations against preset limits. Firms that manage each of their financial risks independently will need to integrate these risks into a comprehensive ERM process to optimize firm risk and return.

References

Question From: Topic Area 1 > Topic 4 > LO 4

Related Material:

- Key Concepts by LO
-

Question #2 of 5

Question ID: 495067

Regarding the primary motivations for a firm to implement an enterprise risk management (ERM) initiative, which of the following motivations are most likely associated with the benefit of improved business performance?

- A)** Integration of risk transfer.
- B)** Integration of business processes.
- C)** Integration of portfolio management.
- D)** Integration of risk organization.

Explanation

There are three primary motivations for a firm to implement an ERM initiative: (1) integration of risk organization, (2)

integration of risk transfer, and (3) integration of business processes. The respective benefits are better organizational effectiveness, better risk reporting, and improved business performance.

References

Question From: Topic Area 1 > Topic 4 > LO 2

Related Material:

- Key Concepts by LO
-

Question #3 of 5

Question ID: 495069

The chief risk officer (CRO) generally reports to the CEO but could also have a dotted line relationship to both the CEO and to the board of directors in order to minimize any potential friction between the CRO and the CEO due to:

- I. basis risk hedging.
- II. regulatory issues.

- A)** Both I and II.
 B) Neither I nor II.
 C) I only.
 D) II only.

Explanation

The dotted line relationship is intended to minimize any potential friction between the CRO and the firm's CEO or other top executives due potentially to excessive risk taking, regulatory issues, or outright fraud by the CEO or executives.

References

Question From: Topic Area 1 > Topic 4 > LO 3

Related Material:

- Key Concepts by LO
-

Question #4 of 5

Question ID: 495066

Bank XYZ's senior management and its board of directors currently receive fragmented risk management information from various functional units. Given the shortcomings of this approach, the chief risk officer (CRO) suggests a more centralized risk management system. Which of the following statements is correct regarding the implementation of an enterprise risk management (ERM) program?

- I. ERM is crucial in establishing a firm-wide, integrated set of policies, procedures, and standards.
- II. ERM is often defined as a process or activity to manage risks.

- A)** I only.

- B)** II only.
- C)** Both I and II.
- D)** Neither I nor II.

Explanation

Since the concept of ERM is relatively new and is still evolving, there is a lack of a standard ERM definition. ERM is often defined as a process or activity to manage risks. ERM is crucial in establishing a firm-wide, integrated set of policies, procedures, and standards. From senior management's perspective, an ERM system provides an invaluable overall risk perspective and control.

References

Question From: Topic Area 1 > Topic 4 > LO 1

Related Material:

- Key Concepts by LO
-

Question #5 of 5

Question ID: 495068

The chief risk officer (CRO) is responsible for all risks facing a company, and is specifically responsible for developing and implementing an enterprise risk management (ERM) strategy. Which of the following statements is correct regarding the role and responsibilities of the CRO?

- A)** The CRO typically reports to the heads of credit, market, operational, and insurance risks.
- B)** The CRO develops a framework of management policies, including setting the overall risk appetite of the firm.
- C)** The creation of the CRO role is the only solution to establishing risk oversight.
- D)** The CRO is a mid-level management responsible for assisting with ERM.

Explanation

The CRO provides overall leadership, vision, and direction for ERM and develops a framework of management policies, including setting the overall risk appetite of the firm. The CRO is a top-level executive responsible for overall risk management in a centralized role. Reporting to the CRO typically are the heads of the various risk functions, including the heads of credit, market, operational, and insurance risks. The creation of the CRO role is not the only solution to establishing top-level risk oversight (the firm's audit committee could also take on this role).

References

Question From: Topic Area 1 > Topic 4 > LO 3

Related Material:

- Key Concepts by LO

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Topic 5: Risk Management, Governance, Culture and Risk Taking in Banks

Question #1 of 5

Question ID: 641289

Regarding implications for a bank if it takes too little or too much risk compared to its optimal level, which of the following statements represents a result from taking on too little risk?

- A)** The bank may generate superior returns for its shareholders.
- B)** The bank may fail to capitalize on enough profitable opportunities.
- C)** The bank may become distressed, which could result in losses for other banks that are counterparties to the subject bank.
- D)** Ultimately, too little risk may increase the value of the subject bank.

Explanation

In general, if a subject bank takes on too little risk, it may fail to capitalize on enough profitable opportunities and, therefore, may generate suboptimal returns for its shareholders. Ultimately, too little risk may decrease the value of the subject bank.

References

Question From: Topic Area 1 > Topic 5 > LO 2

Related Material:

- Key Concepts by LO
-

Question #2 of 5

Question ID: 641291

Which of the following statements is most likely incorrect regarding structural challenges and limitations to effective risk management?

- A)** Effective risk management requires the risk management function within a bank to depend on the activities of its business lines.
- B)** In practice, many risks are nearly or entirely impossible to hedge (e.g., terrorism risk).
- C)** Some risk takers within the bank are motivated to maximize their compensation by taking excessive risks that may ultimately reduce the value of the bank.
- D)** Real-time risk measures do not exist for entire banks.

Explanation

Ideally, effective risk management would require that the risk management function within a bank be *independent* of the activities of its business lines. In addition, there must be a separation between the manager to whom the risk manager reports and the manager of the business line that he is monitoring.

References

Question From: Topic Area 1 > Topic 5 > LO 4

Related Material:

- Key Concepts by LO
-

Question #3 of 5

Question ID: 641290

In which of the following ways can risk management add value for a bank? Risk management adds value:

- X **A)** when requiring all business units to ignore the perspective of the entire bank when making decisions regarding risks.
- ✓ **B)** if taking on incremental risk would otherwise result in excessive total risk and a significant decrease in the bank's value.
- X **C)** if there is a very low cost of having incremental risk above the optimal level.
- X **D)** if incremental changes in risk taken do not result in much change in the value of a bank.

Explanation

If taking on incremental risk would otherwise result in excessive total risk and a significant decrease in the bank's value, then there is added value in having risk management policies to prevent the bank from taking on excessive risk.

References

Question From: Topic Area 1 > Topic 5 > LO 3

Related Material:

- Key Concepts by LO
-

Question #4 of 5

Question ID: 641288

When a bank is attempting to determine their optimal level of risk exposure, which of the following statements is most likely incorrect when targeting a certain default probability?

- ✓ **A)** A bank should always aim to earn the highest credit rating possible.
- X **B)** Aiming for low credit rating (e.g., BBB) may result in lost customers due to the perception that the bank is taking excessive risk.
- X **C)** Aiming for a high credit rating (e.g., AAA) may constrain the bank's risk-taking ability.
- X **D)** Earning a AAA rating would likely involve a large opportunity cost.

Explanation

In general, a bank should not always aim to earn the highest credit rating possible (e.g., AAA). Earning the AAA

rating would likely involve a large opportunity cost as the bank would have to forego risky projects that could otherwise earn high profits.

References

Question From: Topic Area 1 > Topic 5 > LO 1

Related Material:

- Key Concepts by LO
-

Question #5 of 5

Question ID: 641292

Regarding the potential impact of a bank's risk culture on its risk profile and performance, which of the following statements is/are correct?

- I. Companies where managers were perceived as honest and trustworthy were more profitable and were given higher valuations.
 - II. Shareholder governance improvements would change a firm's culture from focusing on end results to focusing on employee integrity and customer service.
- ✓ **A)** I only.
X **B)** Neither I nor II.
X **C)** II only.
X **D)** Both I and II.

Explanation

Statement I is correct. Two studies examined the impact of risk culture. One of these studies concluded that companies where managers were perceived as honest and trustworthy were more profitable and were given higher valuations. The other study concluded that shareholder governance improvements would change a firm's culture from focusing on employee integrity and customer service to focusing on end results.

References

Question From: Topic Area 1 > Topic 5 > LO 5

Related Material:

- Key Concepts by LO

Topic 6: Financial Disasters

Question #1 of 15

Question ID: 438690

The head of the government bond trading desk at Kidder Peabody, Joseph Jett, misreported trades, which allowed him to report substantial profits. Which of the following statements is incorrect regarding the Kidder Peabody case?

- A)** This case demonstrated the importance of investigating large profits from unknown trading strategies.
- B)** The series of events resulted in \$350 million in realized losses for Kidder Peabody.
- C)** Jett's profits came under fire after Kidder Peabody realized that no individual trading strategy could produce the substantial profits that were being reported.
- D)** The trades triggered a loss of confidence in the management of Kidder Peabody.

Explanation

After these errors were detected, \$350 million in falsely reported gains had to be reversed. The series of events did not result in actual losses for the firm since the profits were fake; however, the trades triggered a loss of confidence in the management of Kidder Peabody.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO
-

Question #2 of 15

Question ID: 438684

The high degree of operational risk in the Sumitomo case was illustrated by which of the following?

- I. Lack of informed supervisors to approve large trades.
- II. The trader's ability to keep two sets of trading books and hide trading losses.

- A)** II only.
- B)** Both I and II.
- C)** Neither I nor II.
- D)** I only.

Explanation

The large trades in both the spot and futures market should have required the approval of a supervisor who was informed about the trader's strategies and competent to understand them. The trader's broad authority allowed him to manipulate the reporting system and thereby hide his huge losses.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO
-

Question #3 of 15

Question ID: 438685

All of the following affect the role of operational risk management in preventing large trading losses except:

- X **A)** multiple approvals for large trades by senior management.
- X **B)** the degree of supervision and oversight.
- X **C)** the breadth of responsibilities and power given to traders.
- ✓ **D)** marked-to-market losses.

Explanation

Using the Sumitomo case as an example, Yasuo Hamanaka, a trader, attempted to corner the copper market. His fraudulent activities were possible because of weak operational controls. He was given broad powers, including granting power of attorney to brokerage houses, to create a financing scheme to fund his copper purchases in the spot market. Because of weak management oversight, he was able to keep two sets of books and execute large transactions without approval from senior management that would have been aware of and understood the trading strategies.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO
-

Question #4 of 15

Question ID: 438681

Metallgesellschaft's mismanagement in its long-term fixed contract strategy was evidenced by which of the following?

- I. Refunding payments to customers who willingly paid to cancel their long-term obligations.
- II. Canceling the program too soon while the positive legs of the contracts could have been sold at a profit or used to secure additional financing.

- A)** Neither I nor II.
- B)** II only.
- C)** I only.
- D)** Both I and II.

Explanation

Metallgesellschaft committed both errors in its handling of its liquidity crisis.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO
-

Question #5 of 15

Question ID: 438689

The high degree of operational risk in the Sumitomo case was illustrated by which of the following?

- I. Model risk.
- II. High degree of autonomy, allowing the trader to execute highly levered positions.

- A)** Both I and II.
- B)** II only.
- C)** Neither I nor II.
- D)** I only.

Explanation

The lack of operational oversight gave Sumitomo's copper trader the autonomy to execute large highly-levered transactions in the spot market. Model risk is the risk that a hedging or pricing model is flawed, which is not pertinent in this case.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO
-

Question #6 of 15

Question ID: 438682

Metallgesellschaft could have addressed the cash flow crisis created by their stack-and-roll hedge strategy by:

- I. Selling puts.
- II. Requiring periodic cash settlements from customers.

- A)** I only.
- B)** II only.
- C)** Neither I nor II.
- D)** Both I and II.

Explanation

Metallgesellschaft's long stack-and-roll hedge strategy created interim cash outflows that triggered a liquidity crisis for the firm because petroleum prices dropped dramatically and because the market shifted from backwardation to contango. Requiring periodic cash settlements from its customers on the fixed rate contracts would have mitigated this cash flow crunch. Another solution would have been to purchase put options, which would have generated cash to offset marked-to-market losses and margin calls as spot prices declined. Selling puts would have further exposed the firm to declining petroleum prices.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO
-

Question #7 of 15

Question ID: 438678

Banker's Trust used derivative trades, which promised corporate clients a high-probability, small reduction in funding costs in exchange for a low-probability, large loss. Unfortunately, the derivative trades only resulted in significant losses for its clients. This case demonstrated the importance of:

- A)** matching trades with a client's needs and providing price quotes that are independent from the front office.
- B)** investigating large profits from unknown trading strategies.
- C)** developing more accurate methods for computing collateral when borrowing bonds.
- D)** incorporating liquidity risk into risk models.

Explanation

The actions at Banker's Trust led to tighter controls for dealing with clients at other firms. This case demonstrated the importance of matching trades with a client's needs and providing price quotes that are independent from the front office. It also demonstrated the importance of exercising caution with any form of communication that could eventually be made public, as it could damage a firm's reputation if unethical practices are present.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO
-

Question #8 of 15

Question ID: 438686

All of the following are reasons that Nick Leeson engaged in aggressive speculative trading in the Barings Bank collapse except:

- A)** his authority over settlement operations allowed him to hide trading losses.
- B)** Barings' risk management models were flawed.
- C)** he was attempting to recover previous trading losses.
- D)** Barings' lack of risk management oversight.

Explanation

The collapse of Barings Bank was not an instance of flawed hedging models, but one of poor operational control. Leeson had previously incurred huge trading losses that, if revealed, would have cost him his job. In an effort to recover those losses, he abandoned his hedging strategies and speculated to recoup these losses. His influence and authority in back office operations allowed him to hide his speculative losses and report phantom profits. Leeson ignored and exceeded risk control limits, and senior management's lack of understanding about Leeson's role and oversight allowed his schemes to go undetected.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO
-

Question #9 of 15

Question ID: 438688

Which of the following choices is an example of operational risk in the collapse of Barings?

- A)** Failure to supervise the actions of its trader.
- B)** Much of a company's assets were in illiquid derivative products.
- C)** The Nikkei collapsed due to an earthquake.
- D)** The default of Japanese industrial firms.

Explanation

The failure to supervise the actions of its trader is an example of operational risk.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO
-

Question #10 of 15

Question ID: 438679

Between 1997 and 2002, a currency trader for Allied Irish Bank (AIB), John Rusnak, hid \$691 million in losses from management. Rusnak used a number of deceptive means to hide these losses including:

- I. bullying back-office workers into not following-up on trade confirmations for imaginary trades.
- II. reporting substantial fake gains from small currency arbitrage positions.

- ✓ **A)** I only.
X **B)** Both I and II.
X **C)** II only.
X **D)** Neither I nor II.

Explanation

Management believed that Rusnak was running a small currency arbitrage trading strategy. However, the strategy actually being implemented involved very large currency positions. Rusnak made a point of only reporting modest gains as to not raise any red flags.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO
-

Question #11 of 15

Question ID: 438676

Which of the following are examples of model risk illustrated in the Long-Term Capital Management (LTCM) case?

- I. Poor management oversight.
- II. Financial reporting standards.

- X **A)** II only.
✓ **B)** Neither I nor II.
X **C)** I only.
X **D)** Both I and II.

Explanation

LTCM's models underestimated the extent to which securities prices would move together in times of economic crisis. The models also failed to anticipate that multiple economic shocks might occur in clusters through time (i.e., be positively autocorrelated) as economic history suggests. Poor management oversight and financial reporting standards are not issues in the LTCM case.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO
-

Question #12 of 15

Question ID: 438677

Which of the following factors contributed to the collapse of Barings Bank?

- A)** Basis risk.
- B)** A trader having authority in the settlement process.
- C)** Japanese financial reporting requirements.
- D)** A maturity mismatch between the hedging instrument and the risk being hedged.

Explanation

In an effort to recover trading losses, Nick Leeson abandoned hedged arbitrage strategies on the Nikkei 225 in favor of extremely speculative strategies that exposed the firm to enormous risk in the event of a market downfall. His activities went undetected because his influence on the settlement process and back-office operations allowed him to report phony gains to management. Reporting requirements, basis risk, and maturity mismatch were not factors in the collapse.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO
-

Question #13 of 15

Question ID: 438691

In general, the bankruptcy of Barings Bank might have been avoided with:

- A)** a more moderate use of leverage.
- B)** maturity matching between the hedging instrument and the asset being hedged.
- C)** pricing models less vulnerable to model risk.
- D)** stronger reporting and control systems.

Explanation

In general, the Barings Bank collapse was the result of poor operational controls characterized by poor reporting systems, weak management oversight, and poor organizational structure. Leeson's dual responsibility for trading and settlement enabled him to hide trading losses in accounts that were not reported to management.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO
-

Question #14 of 15

Question ID: 438687

Information systems at Barings Bank were deficient for all of the following reasons except:

- ✓ **A)** technological limitations that hindered accurate financial reporting.
- X **B)** management's failure to audit reporting quality.
- X **C)** incomplete account information on gains and losses.
- X **D)** management's inability to detect the inconsistency of Leeson's trading strategy and profits.

Explanation

The Barings collapse did not result from technological limitations. Management is responsible for auditing and ensuring the quality of the information it receives. Barings management failed to do so and received information without questioning it. Reports contained incomplete account information on gains and losses. Management also failed to detect a signal that something might be wrong in that the size of Leeson's reported profits were inconsistent with and out of proportion to the trading strategy he was supposedly using. Technological limitations were not an issue in the Barings case.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO
-

Question #15 of 15

Question ID: 438683

Nicholas Leeson is identified with which of the following?

- A)** Nikkei stock index futures.
- B)** Metallgesellschaft AG.
- C)** Commodity Futures Trading Commission.
- D)** Sumitomo.

Explanation

Nicholas Leeson was a trader for Barings PLC and was speculating in Nikkei options and futures.

References

Question From: Topic Area 1 > Topic 6 > LO 1

Related Material:

- Key Concepts by LO

Topic 7: Deciphering the Liquidity and Credit Crunch 2007-2008

Question #1 of 10

Question ID: 726916

The financial crisis that stemmed from rising mortgage delinquencies and falling housing prices led to a worldwide liquidity crisis because institutions had:

- A)** become less interconnected.
- B)** generated large maturity mismatches between assets and liabilities.
- C)** held too much equity capital.
- D)** not taken enough leverage.

Explanation

The financial crisis that stemmed from rising mortgage delinquencies and falling housing prices led to a worldwide liquidity crisis because institutions had (1) taken on too much leverage, (2) generated large maturity mismatches between assets and liabilities, and (3) become too interconnected.

References

Question From: Topic Area 1 > Topic 7 > LO 5

Related Material:

- Key Concepts by LO
-

Question #2 of 10

Question ID: 738570

Suppose that two investors, investor A and investor B, each have an original investment position of \$100, with \$10 of equity capital and \$90 of borrowing (i.e., their leverage ratio is 10). Suppose that the investment assets of investor A experience a 5% decline in asset value, from \$100 to \$95, while investor A's leverage ratio remains at 10. Investor B experiences no decline in asset value; however, investor B experiences a decline in the permitted leverage ratio from 10 to 6. Which of the investors would be forced to sell more assets to maintain their leverage ratio?

- A)** Both investors would be forced to sell the same amount of assets.
- B)** Neither investor would be forced to sell assets.
- C)** Investor A.
- D)** Investor B.

Explanation

When investor A's investment assets experience a 5% decline in asset value, from \$100 to \$95, investor A has lost \$5 in capital and only has \$5 remaining. To maintain the leverage ratio of 10, investor A would be forced to sell assets worth \$45 to bring the value of the position down to \$50. When investor B experiences a decline in the

leverage ratio from 10 to 6, investor B's \$10 of equity would support a position value of only \$60, forcing investor B to sell assets worth \$100 - \$60 = \$40.

(See Book 1, Topic 7)

References

Question From: Topic Area 1 > Topic 7 > LO 6

Related Material:

- Key Concepts by LO
-

Question #3 of 10

Question ID: 726914

Regarding the key factors that led to the housing bubble in 2007-2008, which of the following statements is correct?

- X **A)** The Federal Reserve adopted a strict interest rate policy that promoted low interest rates to fend off inflation after the bursting of the internet bubble.
- X **B)** An increase in lending standards and abundance of cheap credit led banks to offer credit at low interest rates and lenient terms.
- ✓ **C)** Cheap money and plentiful borrowing opportunities led to a flood of real estate purchases, which generated a housing boom.
- X **D)** A decrease in demand for U.S. securities by foreign governments experiencing trade surpluses put upward pressure on interest rates.

Explanation

A *decline* in lending standards and abundance of cheap credit led banks to offer credit at low interest rates and lenient terms. This environment of cheap money and plentiful borrowing opportunities led to a flood of real estate purchases, which generated a housing boom. An *increase* in demand for U.S. securities by foreign governments experiencing trade surpluses put *downward* pressure on interest rates. The Fed adopted a */ax* interest rate policy that promoted low interest rates to fend off *deflation* after the bursting of the internet bubble.

References

Question From: Topic Area 1 > Topic 7 > LO 1

Related Material:

- Key Concepts by LO
-

Question #4 of 10

Question ID: 720226

In a recent report on the 2007-2009 liquidity and credit crunch, there are several concepts that describe various factors of the credit crisis. Which of the following statements accurately defines these concepts?

- ✓ **A)** A narrowing of the bid-ask spread results in an increase in market liquidity.

- B)** A liquidity backstop is a temporary halt in funding liquidity to structured investment vehicles (SIVs) in order to minimize credit losses.
- C)** The credit protection buyer in a credit default swap (CDS) receives cash flows from the portfolio that underlies the CDS.
- D)** Because of the forced sale of assets due to declining asset values, a loss spiral generates a lower new position value than a margin spiral.

Explanation

Bid-ask prices are inversely related to market liquidity, and as market liquidity increases, bid-ask prices narrow. Choice a is incorrect. A liquidity backstop is a revolving loan (credit line) extended by sponsor banks to structured investment vehicles to ensure continuity of funding liquidity. Choice c is incorrect. While a loss spiral is accurately described as the forced sale of assets due to a decline in asset values, it results in a higher new position value than under a margin spiral. Choice d is incorrect. Collateralized debt obligations (CDOs), not credit default swaps (CDS), pay out cash flows from a portfolio of debt instruments. The CDS protection buyer makes periodic payments to the protection seller over the life of the contract. (See Book 1, Topic 7)

References

Question From: Topic Area 1 > Topic 7 > LO 6

Related Material:

- Key Concepts by LO
-

Question #5 of 10

Question ID: 726917

Which of the following liquidity definitions is most likely associated with market liquidity?

- A)** The risk that investors may not be able to roll over short-term debt to finance the purchase of an asset.
- B)** The loss that would be sustained by a trader who sells an asset and then immediately buys it back.
- C)** The risk that arises when a decline in the collateral value of an asset results in an increase in margin requirement, requiring additional equity capital.
- D)** The risk that depositors will withdraw funds from banks, or that investors will redeem their shares.

Explanation

Market liquidity can be expressed in the following forms: (1) bid-ask spread, (2) market depth, and (3) market resiliency. The bid-ask spread can be thought of as the loss that would be sustained by a trader who sells an asset and then immediately buys it back. The higher the spread, the lower the market liquidity, and vice versa. The other choices refer to funding liquidity.

References

Question From: Topic Area 1 > Topic 7 > LO 6

Related Material:

- Key Concepts by LO
-

Question #6 of 10

Question ID: 726918

Which of the following liquidity definitions is most likely associated with funding liquidity?

- A)** The risk that investors may not be able to roll over short-term debt to finance the purchase of an asset.
- B)** The number of units of an asset a trader can buy or sell at the current market quote (bid and ask prices).
- C)** The length of time it will take an asset to regain its price after the price has fallen temporarily.
- D)** The loss that would be sustained by a trader who sells an asset and then immediately buys it back.

Explanation

Funding liquidity can be expressed in the following forms: (1) margin/haircut funding risk, (2) rollover risk, and (3) redemption risk. Rollover risk refers to the risk that investors may not be able to roll over short-term debt to finance the purchase of an asset. The other choices refer to market liquidity.

References

Question From: Topic Area 1 > Topic 7 > LO 6

Related Material:

- Key Concepts by LO
-

Question #7 of 10

Question ID: 895765

Regarding the evaporation of liquidity during a financial crisis, which of the following statements is correct in terms of funding liquidity and market liquidity?

- A)** A loss spiral is a positive function of market liquidity.
- B)** In a margin spiral, a trader initiates a sale in order to maintain the leverage ratio (i.e., constant margins).
- C)** A decline in a source of funding has the same effect as an increase in margin.
- D)** The use of a purchased asset effectively as collateral to borrow money against it is referred to as market liquidity.

Explanation

A decline in funding has the same effect as an increase in margin. Choice A refers to funding liquidity and not market

liquidity. Regarding choice c, a loss spiral is a negative function of market liquidity. Choice d refers to loss spiral and not margin spiral. (See Book 1, Topic 7)

References

Question From: Topic Area 1 > Topic 7 > LO 6

Related Material:

- Key Concepts by LO
-

Question #8 of 10

Question ID: 495077

From a risk perspective, which of the following asset-backed security (ABS) tranches will most likely absorb the first losses in the ABS asset pool?

- A)** Mezzanine tranche.
- B)** Equity tranche.
- C)** Senior tranche.
- D)** Super-senior tranche.

Explanation

From a risk perspective, the equity tranche has the highest risk and will absorb the first losses in the ABS asset pool.

References

Question From: Topic Area 1 > Topic 7 > LO 3

Related Material:

- Key Concepts by LO
-

Question #9 of 10

Question ID: 720300

Investors frequently raise money to finance an investment purchase by using leverage and part of their equity to finance the purchase. During the 2007-2009 credit crisis, however, these investors were often forced to sell these investments or other assets due to a decline in their value while maintaining a constant leverage ratio. Raising money to finance investments and the forced sale of assets due to a decline in their value while maintaining a constant leverage ratio, respectively, refer to:

Raising Money to Finance Investments

Forced Sale of Assets

- | | |
|---|---------------|
| <input checked="" type="checkbox"/> A) Funding liquidity | Loss spiral |
| <input checked="" type="checkbox"/> B) Market liquidity | Margin spiral |

- | | |
|-------------------------------|---------------|
| X C) Market liquidity | Loss spiral |
| X D) Funding liquidity | Margin spiral |

Explanation

Funding liquidity refers to leveraged investors who raise money to finance an investment purchase. *Market liquidity* refers to the ease or difficulty of selling an asset to raise money. *Loss spiral* refers to the forced sale of an asset by a leveraged investor due to a decline in the asset's value while the investor maintains a constant leverage ratio. *Margin spiral* refers to the forced sale of an asset as a result of increased margins; that is, as a result of a decline in the leverage ratio. (See Book 1, Topic 7)

References

Question From: Topic Area 1 > Topic 7 > LO 6

Related Material:

- Key Concepts by LO
-

Question #10 of 10

Question ID: 726915

The creation of collateralized debt obligations (CDOs) most likely involves:

- X **A)** the CDO issuer retaining the most senior tranches to give that bank incentive to monitor the loan.
- ✓ **B)** slicing the cash flows from a portfolio of collected debt securities into a number of investable tranches.
- X **C)** selling the equity tranche to institutions that desire or require instruments with high credit ratings.
- X **D)** forming an undiversified portfolio from a small sample of debt securities.

Explanation

The creation of a CDO might be thought of as a three-step process: (1) form a *diversified* portfolio, (2) slice the portfolio into tranches, and (3) sell tranches to investors. Different groups of investors have varying appetites for risk. The most *senior tranches* are sold to institutions that desire or require instruments with high credit ratings, such as pension funds. The *equity tranches* are usually retained by the CDO issuer to give that bank incentive to monitor the loan.

References

Question From: Topic Area 1 > Topic 7 > LO 3

Related Material:

- Key Concepts by LO

www.ombookcentre.in

Topic 8: Getting Up to Speed on the Financial Crisis: A One-Weekend-Reader's Guide

Question #1 of 5

Question ID: 726921

The two main panic periods of the financial crisis were:

- I. August of 2007 with runs on asset backed commercial paper (ABCP).
- II. September 2008 with the filing of bankruptcy by Lehman Brothers.

- A)** II only.
- B)** I only.
- C)** Neither I nor II.
- D)** Both I and II.

Explanation

The two main panic periods of the financial crisis were August of 2007 when runs on asset backed commercial paper (ABCP) occurred and September 2008 when Lehman Brothers filed bankruptcy. The ABCP contained subprime mortgages in the form of MBS and RMBS which decreased in value as homeowners defaulted on their mortgages and MBS were downgraded by rating agencies. In September 2008, Lehman Brothers filed bankruptcy triggering a run on money market funds as Reserve Primary contained commercial paper issued by Lehman.

References

Question From: Topic Area 1 > Topic 8 > LO 5

Related Material:

- Key Concepts by LO
-

Question #2 of 5

Question ID: 726922

The International Monetary Fund (IMF) studied 13 developed countries and their responses to the 2007-2009 financial crisis. They grouped responses into the following measures: interest rate change, liquidity support, recapitalization, liability guarantees, and asset purchases. Which one of these measures was most effective at stabilizing the interbank markets before the Lehman Brothers failure?

- A)** Liquidity support.
- B)** Liability guarantees.
- C)** Asset purchases.
- D)** Interest rate change.

Explanation

The evidence suggests that the most effective measures taken were the *liquidity support* stabilizing the interbank markets before the Lehman failure and *recapitalization* (capital injections), which was considered the most effective tool after the Lehman failure.

References

Question From: Topic Area 1 > Topic 8 > LO 6

Related Material:

- Key Concepts by LO
-

Question #3 of 5

Question ID: 726920

A study of previous major banking crises in developed countries would most likely reveal which of the following events leading up to each crisis?

- A)** decline in private debt.
- B)** significant decrease in housing prices.
- C)** significant increase in credit supply.
- D)** decline in public debt.

Explanation

The recent financial crisis was not unique compared to previous banking crises. It followed a similar pattern of increased public and private debt, increased credit supply, and increased housing prices preceding and leading to the crises.

References

Question From: Topic Area 1 > Topic 8 > LO 4

Related Material:

- Key Concepts by LO
-

Question #4 of 5

Question ID: 726923

Which of the following statements best describes a result of the financial crisis on firms and the economy?

- I. Reduced supply of credit by syndicated lenders.
- II. An increase in borrowing from regulated banks.

- A)** Neither I nor II.
- B)** Both I and II.
- C)** II only.
- D)** I only.

Explanation

A result of the financial crisis on firms and the economy was both a reduced supply of credit by syndicated lenders and an increase in borrowing from regulated banks. Syndicated lenders like regulated banks and other financial intermediaries (e.g. investment banks, hedge funds, private equity, etc.) reduced their supply of credit and thus issued fewer loans to corporations during the crisis. Increased borrowing occurred when commercial and industrial borrowers accessed lines of credit, which had been negotiated before the start of the crisis, from regulated banks.

References

Question From: Topic Area 1 > Topic 8 > LO 7

Related Material:

- Key Concepts by LO
-

Question #5 of 5

Question ID: 726919

Regarding the consequences of the Lehman Brothers failure on the global financial markets, which of the following statements is correct? The failure:

- A)** increased confidence in surviving financial institutions.
- B)** is considered the ending point of the financial crisis.
- C)** resulted in banks spending more cash.
- D)** caused a run on money market mutual funds.

Explanation

The Lehman bankruptcy filing is considered the *tipping point* in the financial crisis. It *eroded confidence* in financial institutions and caused a run on money market mutual funds. This lack of confidence spread across markets and countries, resulting in banks *holding onto cash*, thereby amplifying losses in the subprime mortgage market.

References

Question From: Topic Area 1 > Topic 8 > LO 3

Related Material:

- Key Concepts by LO

www.ombookcentre.in

Topic 9: Risk Management Failures: What Are They and When Do They Happen?

Question #1 of 7

Question ID: 438696

Which of the following statements is incorrect regarding the importance of effectively communicating the results of the risk management process?

- A)** Timely communication that has not been distorted by intermediaries is required to effective communication.
- B)** The risk management process may be harmful if there is miscommunication, and the senior managers get a false sense of security from the information that is provided.
- C)** Risk management efforts are wasted unless the results can be effectively communicated to the appropriate decision makers.
- D)** The purpose of risk management is to allow senior managers of the firm to make the optimal strategic decisions to maximize firm stock price.

Explanation

The purpose of risk management is to allow senior managers of the firm to make the optimal strategic decisions to maximize **firm value**.

References

Question From: Topic Area 1 > Topic 9 > LO 3

Related Material:

- Key Concepts by LO
-

Question #2 of 7

Question ID: 438695

One of the severe consequences of either ignoring or not adequately using data in risk models is that the firm might expand its operations in areas where risks are not being properly considered. Which of the following statements are examples of ignoring or not adequately using data?

- I. The firm assumes global market correlations stay constant during financial crises.
 - II. The firm accepts the assumption that AAA-rated assets are very low risk.
- A)** II only.
 - B)** I only.
 - C)** Neither I nor II.
 - D)** Both I and II.

Explanation

One of the severe consequences of either ignoring or not adequately using data in risk models is that the firm might expand its operations in areas where risks are not being properly considered. For example, blindly accepting a given assumption (i.e., AAA-rated assets are very low risk) and ignoring data that would indicate the contrary. Another risk that is often ignored is increasing correlations during a time of crisis.

References

Question From: Topic Area 1 > Topic 9 > LO 3

Related Material:

- Key Concepts by LO
-

Question #3 of 7

Question ID: 438694

All of the following occurrences are examples of risk mismeasurement, except when risk managers:

- X **A)** do not understand the relationships of the distributions among different positions.
- ✓ **B)** take known and unknown risks into account.
- X **C)** do not understand the distribution of returns of a single risky position.
- X **D)** use subjectivity when measuring extreme and rare events.

Explanation

Risk mismeasurement can occur when risk managers do not understand the distribution of returns of a single risky position or the relationships of the distributions among different positions. One of the key issues for risk managers is the occurrence of extreme events (those events which occur with low frequency, but high severity). Estimates of these rare events require a degree of subjectivity, which clearly has the potential for mismeasurement. Risk mismeasurement can also occur from ignoring relevant risks.

References

Question From: Topic Area 1 > Topic 9 > LO 3

Related Material:

- Key Concepts by LO
-

Question #4 of 7

Question ID: 438693

It is important for a firm to recognize all relevant risks. Failing to manage risk exposure could result from all of the following actions except:

- A)** not communicating risks to top management.
- B)** not using appropriate risk metrics.
- C)** not monitoring risk adequately.
- D)** not measuring unknown risks correctly.

Explanation

The process of risk management can fail if one or more of the following events occur: not measuring **known risks** correctly, not recognizing some risks, not communicating risks to top management, not monitoring risk adequately, not managing risk adequately, and not using the appropriate risk metrics. Unknown risks should be recognized, but not necessarily measured.

References

Question From: Topic Area 1 > Topic 9 > LO 2

Related Material:

- Key Concepts by LO
-

Question #5 of 7

Question ID: 438692

The role of risk management does not involve performing which of the following tasks?

- A)** Communicate all risks to risk-taking decision makers.
- B)** Monitor and manage all risks.
- C)** Make sure the firm takes greater than the necessary amount of risk in order to achieve higher returns.
- D)** Assess all risks faced by the firm.

Explanation

The role of risk management involves performing the following tasks: (1) assess all risks faced by the firm, (2) communicate these risks to risk-taking decision makers, and (3) monitor and manage these risks (make sure that the firm only takes the necessary amount of risk).

References

Question From: Topic Area 1 > Topic 9 > LO 1

Related Material:

- Key Concepts by LO
-

Question #6 of 7

Question ID: 438697

Which of the following statements does not illustrate how firms can fail to correctly monitor and manage risk on an

ongoing basis?

- A)** Some securities have complex relationships with market variables such as interest rate changes.
- B)** Portfolio risk profiles do not change over time.
- C)** A firm does not have an adequate incentive structure.
- D)** A firm does not have an adequate culture that promotes effective risk management.

Explanation

Portfolio risk profiles can change even during the absence of trading. The properties of some securities can change for several reasons (e.g., changes in interest rates, embedded derivatives).

References

Question From: Topic Area 1 > Topic 9 > LO 3

Related Material:

- Key Concepts by LO
-

Question #7 of 7

Question ID: 438698

Predatory trading occurs when:

- A)** a firm with small loss in a given market can influence the activity in that market.
- B)** a borrower becomes worse off after a loan than before.
- C)** other firms in a market see that a large player in the market is in trouble and the other firms attempt to push the price down further in order to hurt the large player.
- D)** there is a misrepresentation in the mortgage application from the borrower side.

Explanation

Predatory trading occurs when other firms in a market see that a large player in the market is in trouble and the other firms attempt to push the price down further in order to hurt the large player. Such activity is difficult to incorporate into risk metrics.

References

Question From: Topic Area 1 > Topic 9 > LO 4

Related Material:

- Key Concepts by LO

Topic 10: The Standard Capital Asset Pricing Model

Question #1 of 50

Question ID: 438614

The market portfolio in the Capital Market Theory contains which types of investments?

- A)** All risky assets in existence.
- B)** All stocks in existence.
- C)** All risky and risk-free assets in existence.
- D)** All stocks and bonds in existence.

Explanation

The market portfolio contains all risky assets in existence. It does not contain any risk-free assets.

References

Question From: Topic Area 1 > Topic 10 > LO 3

Related Material:

- Key Concepts by LO

Question #2 of 50

Question ID: 438591

Given a beta of 1.10 and a risk-free rate of 5 percent, what is the expected rate of return assuming a 10 percent market return?

- A)** 21.5%.
- B)** 10.5%.
- C)** 15.5%.
- D)** 5.5%.

Explanation

$$k = 5 + 1.10 (10 - 5)$$

$$= 5 + 1.10 (5)$$

$$= 5 + 5.5$$

$$= 10.5$$

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #3 of 50

Question ID: 438581

The expected rate of return is 1.5 times the 16% expected rate of return from the market. What is the beta if the risk free rate is 8%?

- A)** 3.
- B)** 2.
- C)** 4.
- D)** 5.

Explanation

$$24 = 8 + \beta (16 - 8)$$

$$24 = 8 + 8\beta$$

$$16 = 8\beta$$

$$16 / 8 = \beta$$

$$\beta = 2$$

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #4 of 50

Question ID: 438612

All portfolios on the capital market line are:

- A)** perfectly negatively correlated.
- B)** distinct from each other.
- C)** unrelated except that they all contain the risk-free asset.
- D)** perfectly positively correlated.

Explanation

The introduction of a risk-free asset changes the Markowitz efficient frontier into a straight line. This straight efficient frontier line is called the capital market line (CML). Since the line is straight, the math implies that any two assets falling on this line will be perfectly, positively correlated with each other. Note: When $r_{a,b} = 1$, then the equation for

risk changes to $sport = W_A s_A + W_B s_B$, which is a straight line.

References

Question From: Topic Area 1 > Topic 10 > LO 3

Related Material:

- Key Concepts by LO
-

Question #5 of 50

Question ID: 438593

Which of the following statements about the security market line (SML) is *least* accurate?

- A)** Securities that plot above the SML are undervalued.
- B)** The market portfolio consists of all risky assets.
- C)** The risk-free rate defines where the SML intersects the vertical axis.
- D)** Securities that plot on the SML have no intrinsic value to the investor.

Explanation

Securities that fall on the SML are properly priced. They have value to an investor in that they still earn a return.

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #6 of 50

Question ID: 438589

Which of the following statements about systematic and unsystematic risk is *least* accurate?

- A)** As compared to a less-diversified portfolio, a diversified portfolio has lower unsystematic risk.
- B)** As an investor increases the number of stocks in a portfolio, the systematic risk will remain constant.
- C)** The unsystematic risk for a specific firm is similar to the unsystematic risk for other firms in the same industry.
- D)** Total risk equals market risk plus firm-specific risk.

Explanation

This statement should read, "The unsystematic risk for a specific firm is *not* similar to the unsystematic risk for other firms in the same industry." Thus, other terms for this risk are firm-specific, or unique, risk.

Systematic risk is *not* diversifiable. As an investor increases the number of stocks in a portfolio the *unsystematic risk* will decrease at a decreasing rate. Total risk equals systematic (market) plus unsystematic (firm-specific) risk.

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #7 of 50

Question ID: 438607

According to capital market theory, which of the following represents the risky portfolio that should be held by all investors who desire to hold risky assets?

- ✓ **A)** The point of tangency between the capital market line (CML) and the efficient frontier.
- X **B)** Any point on the efficient frontier and above the CML.
- X **C)** Any point on the efficient frontier and to the left of the point of tangency between the CML and the efficient frontier.
- X **D)** Any point on the efficient frontier and to the right of the point of tangency between the CML and the efficient frontier.

Explanation

Capital market theory suggests that all investors should invest in the same portfolio of risky assets, and this portfolio is located at the point of tangency of the CML and the efficient frontier of risky assets. Any point below the CML is suboptimal, and points above the CML are not feasible.

References

Question From: Topic Area 1 > Topic 10 > LO 3

Related Material:

- Key Concepts by LO
-

Question #8 of 50

Question ID: 438574

Which of the following statements about risk is **FALSE**?

- X **A)** The market portfolio consists only of systematic risk.
- X **B)** Systematic risk is undiversifiable risk.
- ✓ **C)** Total risk = systematic risk - unsystematic risk.
- X **D)** Unsystematic risk is diversifiable risk.

Explanation

Total risk = systematic risk + unsystematic risk

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #9 of 50

Question ID: 438605

The Capital Market Line (CML) shows that under certain assumptions, when a portfolio on the Markowitz efficient frontier is combined with an investment in a risk-free asset:

- ✓ **A)** there is a positive linear relationship between portfolio risk and expected return.
- ✗ **B)** the maximum attainable expected return results from a 100% allocation to the frontier portfolio and a 0% allocation to the risk-free asset.
- ✗ **C)** all portfolios on the Markowitz efficient frontier are dominated in terms of risk and return by a portfolio on the CML.
- ✗ **D)** a 100% allocation to the risk-free asset results in a portfolio with an expected return and standard deviation of zero.

Explanation

Under the assumptions of the capital market theory, the CML represents the positive linear relationship between portfolio risk (standard deviation of returns) and expected return. Not every portfolio on the Markowitz efficient frontier is dominated by a portfolio on the CML: the market (tangency) portfolio lies on both. An expected return greater than that of the market portfolio can be attained by borrowing at the risk-free rate and investing the borrowed funds in the frontier portfolio (allocating more than 100% of assets to the frontier portfolio). A portfolio with a 100% allocation to the risk-free asset will have a standard deviation of zero and an expected return equal to the risk-free rate.

References

Question From: Topic Area 1 > Topic 10 > LO 3

Related Material:

- Key Concepts by LO
-

Question #10 of 50

Question ID: 438620

Luis Green is an investor who uses the security market line to determine whether securities are properly valued. He is evaluating the stocks of two companies, Mia Shoes and Video Systems. The stock of Mia Shoes is currently trading at \$15 per share, and the stock of Video Systems is currently trading at \$18 per share. Green expects the prices of both stocks to increase by \$2 in a year. Neither company pays dividends. Mia Shoes has a beta of 0.9 and

Video Systems has a beta of (-0.30). If the market return is 15 percent and the risk-free rate is 8 percent, which trading strategy will Green employ?

Mia Shoes Video Systems

- | | | |
|-------------|------|------|
| X A) | Buy | Sell |
| X B) | Buy | Buy |
| X C) | Sell | Sell |
| ✓ D) | Sell | Buy |

Explanation

The required return for Mia Shoes is $0.08 + 0.9 \times (0.15 - 0.08) = 14.3\%$. The forecast return is $\$2/\$15 = 13.3\%$. The stock is overvalued and the investor should sell it. The required return for Video Systems is $0.08 - 0.3 \times (0.15 - 0.08) = 5.9\%$. The forecast return is $\$2/\$18 = 11.1\%$. The stock is undervalued and the investor should buy it.

References

Question From: Topic Area 1 > Topic 10 > LO 4

Related Material:

- Key Concepts by LO
-

Question #11 of 50

Question ID: 438588

Total Quality Inc. has a beta of 1.15. If the expected return on the market is 12 percent, and the risk-free rate is 6 percent, what is the expected return for Total Quality?

- ✓ **A)** 12.90%.
- X **B)** 10.15%.
- X **C)** 14.00%.
- X **D)** 11.69%.

Explanation

Expected return = $R_f + \beta(R_M - R_f) = 6 + 1.15 (12-6) = 12.90\%$

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #12 of 50

Question ID: 438623

An investor believes Stock M will rise from a current price of \$20 per share to a price of \$26 per share over the next year. The company is not expected to pay a dividend. The following information pertains:

- $R_F = 8\%$
- $ER_M = 16\%$
- Beta = 1.7

Should the investor purchase the stock?

- A)** Yes, because it is overvalued.
 B) No, because it is undervalued.
 C) No, because it is overvalued.
 D) Yes, because it is undervalued.

Explanation

In the context of the SML, a security is underpriced if the required return is less than the holding period (or expected) return, is overpriced if the required return is greater than the holding period (or expected) return, and is correctly priced if the required return equals the holding period (or expected) return.

Here, the holding period (or expected) return is calculated as: $(\text{ending price} - \text{beginning price} + \text{any cash flows/dividends}) / \text{beginning price}$. The required return uses the equation of the SML: $\text{risk free rate} + \text{Beta} * (\text{expected market rate} - \text{risk free rate})$.

$ER = (26 - 20) / 20 = 0.30$ or 30%, $RR = 8 + (16 - 8) \times 1.7 = 21.6\%$. The stock is underpriced therefore purchase.

References

Question From: Topic Area 1 > Topic 10 > LO 4

Related Material:

- Key Concepts by LO

Question #13 of 50

Question ID: 438592

If the standard deviation of the market's returns is 5.8%, the standard deviation of a stock's returns is 8.2%, and the covariance of the market's returns with the stock's returns is 0.003, what is the beta of the stock?

- A)** 1.07.
 B) 1.12.
 C) 0.89.
 D) 0.05.

Explanation

The formula for beta is: $(\text{Cov}_{\text{stock,market}}) / (\text{Var}_{\text{market}})$, or $(0.003) / (0.058)^2 = 0.89$

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #14 of 50

Question ID: 438598

Which of the following is an assumption of capital market theory? All investors:

- A)** have multiple-period time horizons.
- B)** select portfolios that lie above the efficient frontier to optimize the risk-return relationship.
- C)** select portfolios that lie below the efficient frontier to optimize the risk-return relationship.
- D)** see the same risk/return distribution for a given stock.

Explanation

All investors select portfolios that *lie along* the efficient frontier, based on their utility functions. All investors have the same *one-period* time horizon, and have the same risk/return expectations.

References

Question From: Topic Area 1 > Topic 10 > LO 2

Related Material:

- Key Concepts by LO
-

Question #15 of 50

Question ID: 438597

Which of the following is **NOT** an assumption of capital market theory?

- A)** Interest rates never change from period to period.
- B)** There are no taxes or transaction costs.
- C)** Investors can lend at the risk-free rate, but borrow at a higher rate.
- D)** The capital markets are in equilibrium.

Explanation

Capital market theory assumes that investors can borrow or lend at the *risk-free* rate. All the other statements are basic assumptions of capital market theory.

References

Question From: Topic Area 1 > Topic 10 > LO 2

Related Material:

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- Key Concepts by LO
-

Question #16 of 50

Question ID: 438577

Which of the following statements regarding the Capital Asset Pricing Model is /least accurate?

- X **A)** Its accuracy depends upon the accuracy of the beta estimates.
- ✓ **B)** It is when the security market line (SML) and capital market line (CML) converge.
- X **C)** It is useful for determining an appropriate discount rate.
- X **D)** It relies on the existence of a risk-free asset.

Explanation

The CML plots expected return versus standard deviation risk. The SML plots expected return versus beta risk. Therefore, they are lines that are plotted in different two-dimensional spaces and will not converge.

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #17 of 50

Question ID: 438615

The capital market line results from combining the efficient frontier with a risk-free asset. Given the availability of risky assets and a risk-free asset, the best combinations of risk and return are represented by:

- X **A)** combinations of the market portfolio and minimum variance portfolio of risky assets.
- ✓ **B)** combinations of the minimum variance portfolio of risky assets and the risk-free asset.
- ✓ **C)** combinations of the market portfolio and risk-free borrowing or lending.
- X **D)** the efficient frontier of risky assets.

Explanation

The best combinations of risk and return are represented by combinations of the market portfolio and risk-free borrowing or lending.

References

Question From: Topic Area 1 > Topic 10 > LO 3

Related Material:

- Key Concepts by LO
-

Question #18 of 50

Question ID: 438596

Which is **NOT** an assumption of capital market theory?

- A)** There are no taxes or transaction costs.
- B)** Investments are not divisible.
- C)** There is no inflation.
- D)** All investors have homogeneous expectations.

Explanation

Capital market theory assumes that all investments are infinitely divisible. The other statements are basic assumptions of capital market theory.

References

Question From: Topic Area 1 > Topic 10 > LO 2

Related Material:

- Key Concepts by LO
-

Question #19 of 50

Question ID: 438622

A portfolio manager wants to purchase stocks with betas that are greater than the market beta. He has asked his analyst to evaluate two stocks, Stock X and Stock Y, and determine if their betas are greater than the market beta. The following information about Stocks X and Y is available to the analyst:

Stock X Stock Y

Standard deviation of returns 0.15 0.16

Covariance between the return on the market and: 0.014 0.021

The return on the market is 0.12 and the standard deviation of returns on the market is 0.13.

Which of the stocks should the analyst recommend?

| Recommend X Recommend Y

- | | | |
|---|-----|-----|
| <input checked="" type="checkbox"/> A) | Yes | No |
| <input checked="" type="checkbox"/> B) | No | No |
| <input checked="" type="checkbox"/> C) | No | Yes |
| <input checked="" type="checkbox"/> D) | Yes | Yes |

Explanation

The analyst should recommend the stock if the stock's beta is greater than 1.

Stock X's beta = $0.014/(0.13)^2 = 0.82$.

Stock Y's beta = $0.021/(0.13)^2 = 1.24$.

References

Question From: Topic Area 1 > Topic 10 > LO 4

Related Material:

- Key Concepts by LO
-

Question #20 of 50

Question ID: 438575

The expected rate of return is twice the 12% expected rate of return from the market. What is the beta if the risk-free rate is 6%?

- A)** 2.
 B) 4.
 C) 5.
 D) 3.

Explanation

$$24 = 6 + \beta (12 - 6)$$

$$18 = 6\beta$$

$$\beta = 3$$

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #21 of 50

Question ID: 438610

For an investor to move further up the Capital Market Line than the market portfolio, the investor must:

- A)** diversify the portfolio even more.
 B) borrow and invest in the market portfolio.
 C) continue to invest only in common stocks.
 D) reduce the portfolio's risk below that of the market.

Explanation

Portfolios that lie to the right of the market portfolio on the capital market line ("up" the capital market line) are created by borrowing funds to own more than 100% of the market portfolio (M).

The statement, "diversify the portfolio even more" is incorrect because the market portfolio is fully diversified.

References

Question From: Topic Area 1 > Topic 10 > LO 3

Related Material:

- Key Concepts by LO
-

Question #22 of 50

Question ID: 438599

Which of the following statements about asset pricing models is *most* accurate?

- X **A)** It is difficult for the individual investor to achieve the benefits from diversification because significantly reducing risk requires the purchase of approximately 1,000 securities.
- ✓ **B)** According to the Capital Asset Pricing Model (CAPM), the expected rate of return of a portfolio with a beta of 1.0 is the market expected return.
- X **C)** Assuming assets are not perfectly positively correlated, the systematic risk of a portfolio decreases as more assets are added.
- X **D)** Adding the risk-free asset to a portfolio will reduce return and total risk.

Explanation

Diversification reduces *unsystematic*, or unique risk. With the risk-free asset and a portfolio of risky assets, the equation for the expected standard deviation is linear: w_{ASA} . A combination of the risk free asset and a portfolio always gives more return for a given level of risk. Risk tends to be reduced, but assuming that assets are not perfectly positively correlated, an investor can achieve the benefits of diversification by adding just one security (Markowitz). Studies have shown that approximately 18-30 stocks are needed for proper diversification. The main point is that the number of stocks required is small and is significantly less than all securities (and significantly less than 1,000 securities).

References

Question From: Topic Area 1 > Topic 10 > LO 2

Related Material:

- Key Concepts by LO
-

Question #23 of 50

Question ID: 438613

The market portfolio in Capital Market Theory is determined by:

- A)** the intersection of the efficient frontier and the investor's highest utility curve.
- B)** a line tangent to the efficient frontier, drawn from any point on the expected return axis.
- C)** a straight line drawn to any efficient portfolio.
- D)** a line tangent to the efficient frontier, drawn from the risk-free rate of return.

Explanation

The Capital Market Line is a straight line drawn from the risk-free rate of return (on the Y axis) through the market portfolio. The market portfolio is determined as where that straight line is exactly tangent to the efficient frontier.

References

Question From: Topic Area 1 > Topic 10 > LO 3

Related Material:

- Key Concepts by LO
-

Question #24 of 50

Question ID: 438579

Consider the expected returns and standard deviations for the following portfolios:

	<i>Portfolio 1</i>	<i>Portfolio 2</i>	<i>Portfolio 3</i>	<i>Portfolio 4</i>
Expected Return	10%	12%	11%	14%
Standard Deviation	14%	13%	12%	18%

Relative to the other portfolios, the portfolio that is not mean variance efficient is:

- A)** Portfolio 4.
- B)** Portfolio 2.
- C)** Portfolio 3.
- D)** Portfolio 1.

Explanation

Portfolio 1 is not efficient because it has a lower expected return and higher risk than both Portfolios 2 and 3.

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO

Question #25 of 50

Question ID: 438603

The slope of the capital market line (CML) is a measure of the level of:

- A)** risk over the level of excess return.
- B)** inflation over the level of expected return.
- C)** expected return over the level of inflation.
- D)** excess return per unit of risk.

Explanation

The slope of the CML indicates the excess return (expected return less the risk-free rate) per unit of risk.

References

Question From: Topic Area 1 > Topic 10 > LO 3

Related Material:

- Key Concepts by LO
-

Question #26 of 50

Question ID: 438573

Which of the following is *least likely* considered a source of systematic risk for bonds?

- A)** Default risk.
- B)** Purchasing power risk.
- C)** Interest rate risk.
- D)** Market risk.

Explanation

Default risk is based on company-specific or unsystematic risk.

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #27 of 50

Question ID: 438594

All of the following are assumptions of the capital asset pricing model **EXCEPT**:

- A)** investors can borrow and lend at the same risk-free rate.
- B)** each investor seeks to maximize the expected utility of wealth and gain of his/her

- ✓ **C)** the time horizons of investors are normally distributed.
- ✗ **D)** investors have the same expectations concerning returns.

Explanation

The CAPM assumes that investors all have the same horizon (as well as expectations). This means that the distribution of the horizons is not normal because normality implies a bell-shaped curve distribution, which would have a positive variance and, hence, dispersion.

References

Question From: Topic Area 1 > Topic 10 > LO 2

Related Material:

- Key Concepts by LO
-

Question #28 of 50

Question ID: 438595

Capital market theory is *least likely* to assume that:

- ✗ **A)** it is possible to buy or sell fractional shares of an investment.
- ✗ **B)** all investors have the same one-period time horizon.
- ✗ **C)** investors can lend any amount of money at the risk-free rate.
- ✓ **D)** all investors desire to be the same location on the efficient frontier.

Explanation

Capital market theory assumes that all investors want to be on the efficient frontier, but the exact location on the efficient frontier for each investor will depend on that investor's risk-return utility function.

References

Question From: Topic Area 1 > Topic 10 > LO 2

Related Material:

- Key Concepts by LO
-

Question #29 of 50

Question ID: 438587

Which of the following statements about a stock's beta is **TRUE**? A beta greater than one is:

- ✗ **A)** risky, while a beta less than one is risk-free.
- ✓ **B)** is riskier than the market, while a beta less than one is less risky than the market.
- ✗ **C)** overvalued, while a beta less than one is undervalued.
- ✗ **D)** undervalued, while a beta less than one is overvalued.

Explanation

Beta is a measure of the volatility of a stock. The overall market's beta is one. A stock with higher systematic risk than the market will have a beta greater than one, while a stock that has a lower systematic risk will have a beta less than one.

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #30 of 50

Question ID: 438617

A stock is expected to earn a return of 10%, which is 6% greater than the risk-free rate. If the expected return on the market is 12% and the beta of the stock is 0.75, the stock *most likely*:

- ✓ **A)** is properly valued.
- X **B)** will plot above the security market line.
- X **C)** is overvalued.
- X **D)** will plot below the security market line.

Explanation

The risk-free rate is $10\% - 6\% = 4\%$. Using the CAPM, the required return on the stock is $4\% + 0.75(12\% - 4\%) = 10\%$. Because the expected return on the stock is equal to its required return, the stock is properly valued according to the CAPM and will plot on the security market line. (*Tip:* You can immediately eliminate the responses "is overvalued" and "will plot below the security market line" because they mean the same thing.)

References

Question From: Topic Area 1 > Topic 10 > LO 4

Related Material:

- Key Concepts by LO
-

Question #31 of 50

Question ID: 438585

A security's systematic risk is proportional to:

- ✓ **A)** the covariance of its return with the return on the market portfolio.
- X **B)** the standard deviation of its return.
- X **C)** the variance of its return.
- X **D)** its diversifiable risk.

Explanation

The measure of systematic risk is beta, and beta is proportional to the covariance of a security's return with the return on the market portfolio.

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

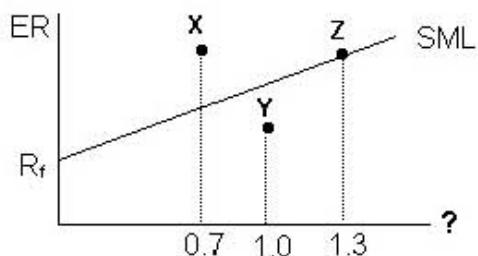
- Key Concepts by LO

Question #32 of 50

Question ID: 438619

In the graph of the Security Market Line (SML) below (not drawn to scale):

- The letters X, Y, and Z represent risky asset portfolios.
- The SML crosses the y-axis at 5%.
- The market premium is 7.5%.
- Portfolio Y and Z have the same expected return (holding period return).



Using the graph and the list of assumptions, determine which of the following statements is *most* accurate.

- X **A)** The expected return on Portfolio Z is greater than the required return.
X **B)** Portfolio X is overvalued.
✓ **C)** The required return on Portfolio X is 10.25%.
X **D)** The expected return on Portfolio Y is 15%.

Explanation

Remember that the SML graph plots systematic, or beta, risk versus expected return. Thus, the numbers on the x-axis represent beta. Using the Capital Asset Pricing Model (CAPM) equation, the required return for portfolio X = $R_f + (ER_M - R_f) \times Beta = 5.0\% + 0.7(7.5\%) = 10.25\%$.

Portfolio Y lies below the SML and is thus overvalued and the expected return must be less than the required return. Using the CAPM, required return for portfolio Y = $R_f + (ER_M - R_f) \times Beta = 5.0\% + 1.0(7.5\%) = 12.50\%$. (On the exam, you can quickly determine the required return for a portfolio or asset with a beta of 1.0 by adding the risk-free rate and the market premium.) Since the expected return on portfolio Y must be less than the required return, the expected return must be less than 12.50% and cannot be 15%. Since Portfolio Z is on the SML, it is fairly valued and its expected return equals its required return. Since Portfolio X lies above the SML, it is *undervalued*.

References

Question From: Topic Area 1 > Topic 10 > LO 4

Related Material:

- Key Concepts by LO

Questions #33-34 of 50

An analyst collected the following data for three possible investments.

Stock	Price Today	Forecasted Price*	Dividend	Beta
Alpha	25	31	2	1.6
Omega	105	110	1	1.2
Lambda	10	10.80	0	0.5

*Forecasted Price = expected price one year from today.

The expected return on the market is 12% and the risk-free rate is 4%.

Question #33 of 50

Question ID: 438583

According to the security market line (SML), which of the three securities is correctly priced?

- A)** Omega.
- B)** None of the securities are correctly priced.
- C)** Lambda.
- D)** Alpha.

Explanation

In the context of the SML, a security is underpriced if the required return is less than the holding period (or expected) return, is overpriced if the required return is greater than the holding period (or expected) return, and is correctly priced if the required return equals the holding period (or expected) return.

Here, the holding period (or expected) return is calculated as: (ending price - beginning price + any cash flows / dividends) / beginning price. The required return uses the equation of the SML: risk free rate + Beta × (expected market rate - risk free rate).

- For Alpha: $ER = (31 - 25 + 2) / 25 = 32\%$, $RR = 4 + 1.6 \times (12 - 4) = 16.8\%$. Stock is underpriced.
- For Omega: $ER = (110 - 105 + 1) / 105 = 5.7\%$, $RR = 4 + 1.2 \times (12 - 4) = 13.6\%$. Stock is overpriced.
- For Lambda, $ER = (10.8 - 10 + 0) / 10 = 8\%$, $RR = 4 + 0.5 \times (12 - 4) = 8\%$. Stock is correctly priced.

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO

Question #34 of 50

Question ID: 438584

Which of the three securities identified by Williams would plot on the capital market line(CML)?

- A)** Omega.
- B)** None of the securities would plot on the CML.
- C)** Lambda.
- D)** Alpha.

Explanation

By definition, all stocks and portfolios (other than the market portfolio) fall below the CML. (Only the market portfolio is efficient).

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #35 of 50

Question ID: 438600

According to the capital asset pricing model, a negative risk premium:

- A)** is an impossibility.
- B)** would only occur if the covariance of a security's return with the return on the market is zero.
- C)** would only occur if the covariance of a security's return with the return on the market is positive.
- D)** would only occur if the covariance of a security's return with the return on the market is negative.

Explanation

A negative risk premium would occur if the beta of the security was negative, which would occur if the covariance of a security's return with the return on the market is negative.

References

Question From: Topic Area 1 > Topic 10 > LO 2

Related Material:

- Key Concepts by LO
-

Question #36 of 50

Question ID: 438580

Jim Sheehan manages a diversified portfolio containing forty stocks. The portfolio beta is 1.05. Jim is considering adding the stock of ABC Inc. to the portfolio, and would fund the purchase with cash already in the portfolio. ABC Inc. has a beta of 1.20, and is currently not part of the portfolio. Which statement about the resulting portfolio is **TRUE**?

- A)** Both systematic risk and unsystematic risk would be unchanged.
- B)** Systematic risk would decrease, but the unsystematic risk would be unchanged.
- C)** Systematic risk would increase, but the unsystematic risk would be unchanged.
- D)** Both systematic risk and unsystematic risk would both increase.

Explanation

Since the portfolio is well diversified, the assumed level of unsystematic risk is zero. The addition of ABC Inc will increase the portfolio beta, and, hence, the level of systematic risk.

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO

Question #37 of 50

Question ID: 438616

The intercept and slope of the capital market line are:

- A)** R_F and $[E(R_M) - R_F] / \sigma_M$, respectively.
- B)** R_M and $[E(R_M) - R_P] / \sigma_M$, respectively.
- C)** R_M and $[E(R_P) - R_F] / \sigma_P$, respectively.
- D)** R_F and $[E(R_P) - R_F] / \sigma_M$, respectively.

Explanation

The CML is expressed by the following equation:

$$E(R_P) = R_F + \left[\frac{E(R_M) - R_F}{\sigma_M} \right] \sigma_P$$

The line begins at the vertical axis at R_F . With each increase in σ_P , the expected return increases by $[E(R_M) - R_F] / \sigma_M$.

References

Question From: Topic Area 1 > Topic 10 > LO 3

Related Material:

- Key Concepts by LO

Question #38 of 50

Question ID: 438602

Under the CAPM, which of the following can investors choose for their portfolios?

- I. The risk-free asset.
- II. The market portfolio.
- III. Assets that maximize return relative to asset-specific risk.
- IV. A portfolio (other than the market portfolio) on the efficient frontier of risky portfolios.

A) I, II and IV only.

B) II and III only.

C) I and II only.

D) I only.

Explanation

All investors will combine the market portfolio with the risk-free asset. Asset-specific risk is not important and is actually eliminated with the choice of the market portfolio.

References

Question From: Topic Area 1 > Topic 10 > LO 2

Related Material:

- Key Concepts by LO

Question #39 of 50

Question ID: 438576

Given the following data, what is the correlation coefficient between the two stocks and the Beta of stock A?

- standard deviation of returns of Stock A is 10.04%
- standard deviation of returns of Stock B is 2.05%
- standard deviation of the market is 3.01%
- covariance between the two stocks is 0.00109
- covariance between the market and stock A is 0.002

Correlation Coefficient Beta (stock A)

A) 0.6556 2.20

B) 0.5296 2.20

C) 0.6556 0.06

D) 0.5296 0.06

Explanation

correlation coefficient = $0.00109 / (0.0205)(0.1004) = 0.5296$.

beta of stock A = covariance between stock and the market / variance of the market

Beta = $0.002 / 0.0301^2 = 2.2$

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #40 of 50

Question ID: 438621

Charlie Smith holds two portfolios, Portfolio X and Portfolio Y. They are both liquid, well-diversified portfolios with approximately equal market values. He expects Portfolio X to return 13% and Portfolio Y to return 14% over the upcoming year. Because of an unexpected need for cash, Smith is forced to sell at least one of the portfolios. He uses the security market line to determine whether his portfolios are undervalued or overvalued. Portfolio X's beta is 0.9 and Portfolio Y's beta is 1.1. The expected return on the market is 12% and the risk-free rate is 5%. Smith should sell:

- A)** portfolio Y only.
- B)** portfolio X only.
- C)** both portfolios X and Y because they are both overvalued.
- D)** either portfolio X or Y because they are both properly valued.

Explanation

Portfolio X's required return is $0.05 + 0.9 \times (0.12 - 0.05) = 11.3\%$. It is expected to return 13%. The portfolio has an expected excess return of 1.7%.

Portfolio Y's required return is $0.05 + 1.1 \times (0.12 - 0.05) = 12.7\%$. It is expected to return 14%. The portfolio has an expected excess return of 1.3%.

Since both portfolios are undervalued, the investor should sell the portfolio that offers less excess return. Sell Portfolio Y because its excess return is less than that of Portfolio X.

References

Question From: Topic Area 1 > Topic 10 > LO 4

Related Material:

- Key Concepts by LO
-

Question #41 of 50

Question ID: 438586

The beta of stock D is -0.5. If the expected return of Stock D is 8%, and the risk-free rate of return is 5%, what is the expected return of the market?

- A)** +3.0%.
- B)** -4.0%.
- C)** -1.0%.
- D)** +3.5%.

Explanation

$RR_{Stock} = R_f + (R_{Market} - R_f) \times Beta_{Stock}$, where RR = required return, R = return, and R_f = risk-free rate

A bit of algebraic manipulation results in:

$$R_{Market} = [RR_{Stock} - R_f - (Beta_{Stock} \times R_f)] / Beta_{Stock} = [8 - 5 - (-0.5 \times 5)] / -0.5 = 0.5 / -0.5 = -1\%$$

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #42 of 50

Question ID: 438601

The assumption that returns are normally distributed means that investors:

- A)** have the same horizon.
- B)** only consider the mean and standard deviation of the returns.
- C)** are risk averse.
- D)** do not need to consider transactions costs.

Explanation

If a distribution is normally distributed, then it is completely described by the mean and standard deviation. Then, these are the only two parameters in the investors' utility functions.

References

Question From: Topic Area 1 > Topic 10 > LO 2

Related Material:

- Key Concepts by LO
-

Question #43 of 50

Question ID: 438590
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An analyst has developed the following data for two companies, PNS Manufacturing (PNS) and InCharge Travel (InCharge). PNS has an expected return of 15 percent and a standard deviation of 18 percent. InCharge has an expected return of 11 percent and a standard deviation of 17 percent. PNS's correlation with the market is 75 percent, while InCharge's correlation with the market is 85 percent. If the market standard deviation is 22 percent, which of the following are the betas for PNS and InCharge?

Beta of PNS Beta of InCharge

X A)	0.66	0.61
✓ B)	0.61	0.66
X C)	0.92	1.10
X D)	1.10	0.92

Explanation

$$\text{Beta}_i = (s_i/s_M) \cdot r_{i,M}$$

$$\text{Beta}_{PNS} = (0.18/0.22) \times 0.75 = 0.6136$$

$$\text{Beta}_{Incharge} = (0.17/0.22) \times 0.85 = 0.6568$$

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #44 of 50

Question ID: 438609

Portfolios that represent combinations of the risk-free asset and the market portfolio are plotted on the:

- X **A)** capital asset pricing line.
- ✓ **B)** capital market line.
- X **C)** characteristic line.
- X **D)** utility curve.

Explanation

The introduction of a risk-free asset changes the Markowitz efficient frontier into a straight line. This straight efficient frontier line is called the capital market line (CML). Investors at point R_f have 100 percent of their funds invested in the risk-free asset. Investors at point M have 100 percent of their funds invested in market portfolio M. Between R_f and M, investors hold both the risk-free asset and portfolio M. To the right of M, investors hold more than 100 percent of portfolio M. *All investors have to do to get the risk and return combination that suits them is to simply vary the proportion of their investment in the risky portfolio M and the risk-free asset.*

The term "characteristic line" refers to Beta, used to form the security market line (SML). Utility curves reflect individual preferences.

References

Question From: Topic Area 1 > Topic 10 > LO 3

Related Material:

- Key Concepts by LO

Question #45 of 50

Question ID: 438604

Which of the following is the vertical axis *intercept* for the Capital Market Line (CML)?

- A) Efficient frontier.
- B) Expected return on the market.
- C) Expected return on the portfolio.
- D) Risk-free rate.

Explanation

The CML originates on the vertical axis from the point of the risk-free rate.

References

Question From: Topic Area 1 > Topic 10 > LO 3

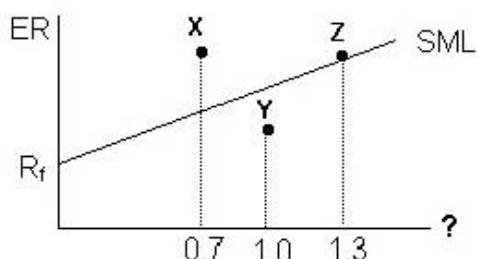
Related Material:

- Key Concepts by LO

Question #46 of 50

Question ID: 438618

Consider the following graph of the Security Market Line (SML). The letters X, Y, and Z represent risky asset portfolios. The SML crosses the y-axis at the point 0.07. The expected market return equals 13.0%. Note: The graph is **NOT** drawn to scale.



Using the graph above and the information provided, which of the following statements is *most* accurate?

- A) Portfolio X's required return is greater than the market expected return.

- ✓ **B)** The expected return (or holding period return) for Portfolio Z equals 14.8%.
- X **C)** The correct label for the x-axis is total risk.
- X **D)** Portfolio Y is undervalued.

Explanation

At first, it appears that we are not given the information needed to calculate the holding period, or expected return (beginning price, ending price, or annual dividend). However, we are given the information required to calculate the required return (CAPM) and since Portfolio Z is on the SML, we know that the required return (RR) equals the expected return (ER). So, $ER = RR = R_f + (ER_M - R_f) \times Beta = 7.0\% + (13.0\% - 7.0\%) \times 1.3 = 14.8\%$.

The SML plots beta (or *systematic risk*) versus expected return, the CML plots total risk (systematic plus unsystematic risk) versus expected return. Portfolio Y is overvalued - any portfolio located below the SML has an RR > ER and is thus overpriced. Since Portfolio X plots above the SML, it is undervalued and the statement should read, "Portfolio X's required return is *less* than the market expected return."

References

Question From: Topic Area 1 > Topic 10 > LO 4

Related Material:

- Key Concepts by LO
-

Question #47 of 50

Question ID: 438578

Beta is *least* accurately described as:

- X **A)** a measure of the sensitivity of a security's return to the market return.
- X **B)** the factor by which the market risk premium is multiplied in the Capital Asset Pricing Model.
- ✓ **C)** a standardized measure of the total risk of a security.
- X **D)** the covariance of a security's returns with the market return, divided by the variance of market returns.

Explanation

Beta is a standardized measure of the *systematic* risk of a security. $\beta = Cov_{r,mkt} / \sigma^2_{mkt}$. Beta is multiplied by the market risk premium in the CAPM: $E(R_i) = RFR + \beta[E(R_{mkt}) - RFR]$.

References

Question From: Topic Area 1 > Topic 10 > LO 1

Related Material:

- Key Concepts by LO
-

Question #48 of 50

Question ID: 438611

In the context of the CML, the market portfolio includes:

- A)** the risk-free asset.
- B)** 12-18 stocks needed to provide maximum diversification.
- C)** risky stocks and bonds only.
- D)** all existing risky assets.

Explanation

The market portfolio has to contain *all the stocks, bonds, and risky assets in existence*. Because this portfolio has all risky assets in it, it represents the ultimate or completely diversified portfolio.

References

Question From: Topic Area 1 > Topic 10 > LO 3

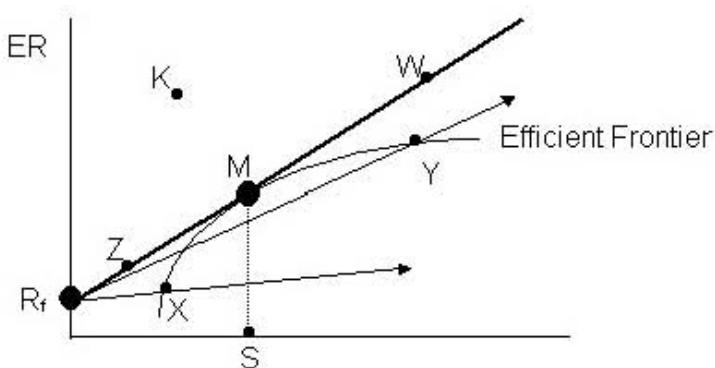
Related Material:

- Key Concepts by LO

Question #49 of 50

Question ID: 438606

Consider the following graph of the risk-free asset R_f and the efficient frontier. The letters K, W, X, Y, and Z represent risky portfolios. Portfolio M is the market portfolio. The lines R_fX and R_fY represent the combination of the risk-free asset and the risky portfolio.



Which of the following statements about the above graph is *least* accurate?

- A)** Portfolios W and Z are perfectly positively correlated with each other.
- B)** Investors on the capital market line to the right of M are leveraged and hold more than 100% of portfolio M.
- C)** Portfolio K is possible, but not the most efficient because it does not fall on the efficient frontier and is overvalued.
- D)** Point S represents the standard deviation of returns on the market portfolio.

Explanation

By definition, all stocks and portfolios other than M, the market portfolio, fall on or below the CML. Thus, K is not a possible portfolio on this graph. Overvaluation/undervaluation is usually expressed in relation to the security market line. The other statements are true.

References

Question From: Topic Area 1 > Topic 10 > LO 3

Related Material:

- Key Concepts by LO
-

Question #50 of 50

Question ID: 438608

A portfolio to the right of the market portfolio on the capital market line (CML) is created by:

- ✓ **A)** holding more than 100% of the risky asset.
- X **B)** fully diversifying.
- X **C)** holding both the risk-free asset and the market portfolio.
- X **D)** buying the risk-free asset.

Explanation

Portfolios that lie to the right of the market portfolio on the capital market line are created by borrowing funds to own more than 100% of the market portfolio (M).

Both the statement, "holding both the risk-free asset and the market portfolio" and "buying the risk-free asset" refer to portfolios that lie to the *left* of the market portfolio. Portfolios that lie to the left of point M are created by lending funds (or buying the risk free-asset). These investors own less than 100% of both the market portfolio and more than 100% of the risk-free asset. The portfolio at point R_f (intersection of the CML and the y-axis) is created by holding 100% of the risk-free asset. The statement, "fully diversifying" is incorrect because the market portfolio is fully diversified.

References

Question From: Topic Area 1 > Topic 10 > LO 3

Related Material:

- Key Concepts by LO

Topic 11: Applying the CAPM to Performance Measurement: Single-Index Performance Measurement Indicators

Question #1 of 32

Question ID: 438669

Jenny Rouse has been a portfolio manager for Theta Advisors for the last five years. The performance of her portfolio has had few returns below its benchmarks since its inception. Which of the following risk measures *best* measures Rouse's performance?

- A)** Range.
- B)** Sortino ratio.
- C)** Sharpe ratio.
- D)** Standard Deviation.

Explanation

The Sortino ratio examines the downside risk of returns. It is calculated as the portfolio return minus the minimum acceptable return (MAR) divided by a standard deviation that only uses returns below the MAR. It is similar to the target semivariance. Since Rouse's portfolio has had consistently higher returns, she should not be penalized for any variability on the upside. The range (the difference between the highest and lowest values), standard deviation, and Sharpe ratio (which uses the standard deviation in the denominator) examine all returns, whether they correspond to positive or negative alphas. The use of these measures would result in risk measurements that are unfairly high in Rouse's case.

References

Question From: Topic Area 1 > Topic 11 > LO 2

Related Material:

- Key Concepts by LO
-

Question #2 of 32

Question ID: 438661

Of the Sharpe, Treynor, and Jensen's Alpha measures, when measuring the risk/return performance of actively managed portfolios, which is the *most appropriate* to use?

- A)** Treynor measure.
- B)** All three measures are equally appropriate.
- C)** Sharpe ratio.
- D)** Jensen's Alpha.

Explanation

Jensen's Alpha measures the value added of an active portfolio strategy.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #3 of 32

Question ID: 438642

Which Sharpe ratio indicates that Fund One earned a return on investment that is greater than the risk taken by the fund?

- ✓ **A)** 1.5.
- X **B)** 1.0.
- X **C)** 0.
- X **D)** 0.5.

Explanation

A Sharpe ratio of 1 indicates the risk and return of the investment are proportional, while a lower ratio indicates greater risk was taken and a higher ratio indicates less risk was taken to generate the return on investment.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #4 of 32

Question ID: 438648

Which of the following measures used to evaluate the performance of a portfolio manager is (are) **NOT** subject to the assumptions of the capital asset pricing model (CAPM)?

- ✓ **A)** Sharpe measure.
- X **B)** Jensen's alpha.
- X **C)** Jensen's alpha and the Treynor measure.
- X **D)** Treynor measure.

Explanation

Both the Treynor measure and the Jensen's alpha assume that the CAPM is the underlying risk-adjustment model. The Sharpe measure on the other hand does not make this assumption. It uses total risk of a portfolio, unlike the Treynor measure and Jensen's alpha, which use the systematic (undiversifiable) risk as measured by beta to compute the risk-adjusted return of a portfolio.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Questions #5-6 of 32

The following information is available for the Trumark Fund:

- The Trumark Fund has an average annual return of 12 percent over the last five years.
- Trumark has a beta value of 1.35.
- Trumark has a standard deviation of returns of 16.80 percent.
- During the same time period, the average annual T-bill rate was 4.5 percent.
- During the same time period, the average annual return on the S&P 500 portfolio was 18 percent.

Question #5 of 32

Question ID: 438664

What is the Sharpe ratio for the Trumark Fund?

- A)** 0.80.
 B) 0.45.
 C) 5.56.
 D) 7.50.

Explanation

$$\text{Sharpe Ratio} = S_j = (\bar{R}_j - \bar{R}_F) / \sigma_j = (12 - 4.50) / 16.80 = 0.45$$

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO

Question #6 of 32

Question ID: 438665

What is the Treynor measure for Trumark Fund?

- A)** -0.04.
 B) 0.06.
 C) 0.80.
 D) 0.45.

Explanation

Treynor measure = $T_j = (\bar{R}_j - \bar{R}_F) / \beta_j = (.12 - .0450) / 1.35 = 0.0556$

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #7 of 32

Question ID: 438670

In the Sortino ratio, the excess return is divided by the:

- A)** standard deviation.
- B)** VAR.
- C)** maximum drawdown.
- D)** standard deviation using only the returns below a minimum level

Explanation

The Sortino ratio examines the downside risk of returns. It is calculated as the portfolio return minus the minimum acceptable return (MAR) divided by a standard deviation that only uses returns below the MAR. It is similar to the target semivariance. The other responses refer to other measures of risk-adjusted performance. The Sharpe ratio divides the excess return above the risk-free rate by the standard deviation. An example of a risk-adjusted return on invested capital (RAROC) measure would be to divide the portfolio's expected return by the VAR. The RoMAD (return over maximum drawdown) is the average portfolio return divided by the maximum drawdown. Drawdown refers to the percentage difference between the highest and lowest portfolio values during a period.

References

Question From: Topic Area 1 > Topic 11 > LO 2

Related Material:

- Key Concepts by LO
-

Question #8 of 32

Question ID: 438643

Over the previous year, the average and variance of a portfolio's returns was 0.18 and 0.09. The risk-free rate over the period was 0.03. The Sharpe ratio for the portfolio for the previous year is:

- A)** 1.5.
- B)** 0.5.
- C)** 0.6.
- D)** 3.0.

Explanation

The Sharpe ratio is the difference between the average of the portfolio's return minus the risk-free rate, $0.15 - 0.03 = 0.12$, divided by the standard deviation, which is the square root of the variance: $0.3 = 0.09^{0.5} = 0.3$. The Sharpe ratio is $0.12 / 0.3 = 0.4$.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #9 of 32

Question ID: 438646

Portfolios X and Y have had an equal average return over the most recent period. Compared to Portfolio Y, Portfolio X had higher total risk, but lower systematic risk. Given this information, which of the following statements is **TRUE**? Compared to Portfolio Y:

- ✓ **A)** Portfolio X has a lower Sharpe ratio and a higher Treynor ratio.
- X **B)** Portfolio X has both a lower Sharpe ratio and a lower Treynor ratio.
- X **C)** Portfolio X has a higher Sharpe ratio and a lower Treynor ratio.
- X **D)** Portfolio X has both a higher Sharpe and a higher Treynor ratio.

Explanation

The two portfolios will have the same numerator for both the Sharpe and the Treynor ratio. Thus, the denominator of the two measures will determine their relative sizes. The Sharpe measure has the standard deviation or total risk in the denominator, thus the value will be lower for X. Since X has lower systematic risk, its denominator in the Treynor measure will be lower and the overall measure will be higher for X.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #10 of 32

Question ID: 438638

The mean monthly return on U.S. Treasury bills (T-bills) is 0.42%. The mean monthly return for an index of small stocks is 4.56%, with a standard deviation of 3.56%. What is the Sharpe measure for the index of small stocks?

- ✓ **A)** 1.16.
- X **B)** 10.60.

C) 16.56.

D) 3.48.

Explanation

The Sharpe ratio measures excess return per unit of risk. $(4.56 - 0.42) / 3.56 = 1.16$.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #11 of 32

Question ID: 438662

The efficient market portfolio had a return of 12%. The risk-free rate was 6%. A portfolio has a beta of 1.2. If the portfolio return was 12%, which of the following is closest to the Treynor ratio for the portfolio?

A) 0.

B) 0.05.

C) 0.20.

D) 1.

Explanation

The Treynor ratio is the difference between the portfolio return and the risk-free rate divided by the beta: $0.05 = (0.12 - 0.06) / 1.2$.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #12 of 32

Question ID: 438644

Johnson Inc. manages a growth portfolio of equity securities that has had a mean monthly return of 1.4% and a standard deviation of returns of 10.8%. Smith Inc. manages a blended equity and fixed income portfolio that has had a mean monthly return of 1.2% and a standard deviation of returns of 6.8%. The mean monthly return on Treasury bills has been 0.3%. Based on the Sharpe ratio, the:

- A)** performance of the Smith portfolio is preferable to the performance of the Johnson portfolio.

- B)** performance of the Johnson portfolio is preferable to the performance of the Smith portfolio.
- C)** Johnson portfolio has greater excess return per unit of risk than the Smith portfolio.
- D)** shows that the Johnson and Smith portfolios have exhibited the same risk-adjusted performance.

Explanation

The Sharpe ratio for the Johnson portfolio is $(1.4 - 0.3)/10.8 = 0.1019$.

The Sharpe ratio for the Smith portfolio is $(1.2 - 0.3)/6.8 = 0.1324$.

The Smith portfolio has the higher Sharpe ratio, or greater excess return per unit of risk.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO

Question #13 of 32

Question ID: 438666

Annual Returns on ABC Mutual Fund									
1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
11.0%	12.5%	8.0%	9.0%	13.0%	7.0%	15.0%	2.0%	-16.5%	11.0%

If the risk-free rate was 4.0% during the period 1991-2000, what is the Sharpe ratio for ABC Mutual Fund for the period 1991-2000?

- A)** 0.52.
- B)** 1.12.
- C)** 0.68.
- D)** 0.35.

Explanation

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	
Annual return	11.0%	12.5%	8.0%	9.0%	13.0%	7.0%	15.0%	2.0%	-16.5%	11.0%	Mean = 7.2
X – mean	3.8	5.3	0.8	1.8	5.8	-0.2	7.8	-5.2	-23.7	3.8	
$(X - \text{mean})^2$	14.44	28.09	0.64	3.24	33.64	0.04	60.84	27.04	561.69	14.44	Sum = 744.10

Variance = $(X - \text{mean})^2 / (n - 1) = 744.10 / 9 = 82.68$

Standard deviation = $(82.68)^{1/2} = 9.1$

Sharpe Ratio = $(\text{mean return} - \text{risk-free rate}) / \text{standard deviation} = (7.2 - 4) / 9.1 = 0.35$

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #14 of 32

Question ID: 438652

A higher Sharpe ratio indicates:

- A)** lower volatility of returns.
- B)** a lower risk per unit of return.
- C)** greater diversification in the portfolio.
- D)** a higher excess return per unit of risk.

Explanation

The Sharpe ratio is excess return ($\text{return} - R_f$) per unit of risk (defined as the standard deviation of returns).

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Questions #15-16 of 32

The following performance data for an actively managed portfolio and the S&P 500 Index is reported:

	<i>Actively Managed Portfolio</i>	<i>S&P 500</i>
Return	50%	20%
Standard deviation	18%	15%
Beta	1.1	1.0
Risk-free rate = 6%.		

Question #15 of 32

Question ID: 438655

Determine the Sharpe measure, Treynor measure, and Jensen's alpha for the actively managed portfolio.

- ✓ **A)** Sharpe measure = 2.44; Treynor measure = 0.40; Alpha = 0.29.
- X **B)** Sharpe measure = 1.04; Treynor measure = 0.14; Alpha = 0.04.
- X **C)** Sharpe measure = 1.06; Treynor measure = 0.12; Alpha = 0.02.
- X **D)** Sharpe measure = 1.05; Treynor measure = 0.17; Alpha = 0.04.

Explanation

Sharpe measure for active portfolio = $(0.50 - 0.06)/0.18 = 2.44$

Treynor measure for active portfolio = $(0.50 - 0.06)/1.1 = 0.40$

Alpha for active portfolio = $0.50 - [0.06 + (0.20 - 0.06) \times 1.1] = 0.29$

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO

Question #16 of 32

Question ID: 438656

Based on the results from determining the Sharpe measure, Treynor measure, and Jensen's alpha for the actively managed portfolio, does the portfolio manager outperform or underperform the S&P 500 index?

- X **A)** Sharpe measure → underperform; Treynor measure → outperform; Alpha → outperform
- X **B)** Sharpe measure → underperform; Treynor measure → underperform; Alpha → underperform.
- X **C)** Sharpe measure → outperform; Treynor measure → underperform; Alpha → underperform.
- ✓ **D)** Sharpe measure → outperform; Treynor measure → outperform; Alpha → outperform.

Explanation

Sharpe measure for S&P portfolio = $(0.20 - 0.06)/0.15 = 0.93$

Treynor Measure for S&P portfolio = $(0.20 - 0.06)/1.0 = 0.14$

Alpha for S&P portfolio = 0

Hence, the portfolio manager outperforms based on all the three performance evaluation methods.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO

Question #17 of 32

Question ID: 438640

Which of the following statements regarding the Sharpe ratio is *most* accurate? The Sharpe ratio measures:

- A)** total return per unit of risk.
- B)** peakedness of a return distribution.
- C)** excess return per unit of risk.
- D)** dispersion relative to the mean.

Explanation

The Sharpe ratio measures excess return per unit of risk. Remember that the numerator of the Sharpe ratio is (portfolio return – risk free rate), hence the importance of *excess* return. Note that dispersion relative to the mean is the definition of the *coefficient of variation*, and the peakedness of a return distribution is measured by *kurtosis*.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #18 of 32

Question ID: 438649

A portfolio has a return of 14.2% and a Sharpe's measure of 3.52. If the risk-free rate is 4.7%, what is the standard deviation of returns?

- A)** 2.7%.
- B)** 3.1%.
- C)** 2.6%.
- D)** 3.9%.

Explanation

Standard Deviation of Returns = $(14.2\% - 4.7\%) / 3.52 = 2.6988$.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #19 of 32

Question ID: 438647

Portfolio A	0.25	0.12	0.04
Portfolio B	0.65	0.09	0.03
Portfolio C	0.45	0.11	0.02
Portfolio D	0.75	0.10	-0.02

The table represents risk-adjusted returns across all fund categories. Which of the following represents the best risk-adjusted return?

- A)** Portfolio A.
- B)** Portfolio D.
- C)** Portfolio B.
- D)** Portfolio C.

Explanation

The Sharpe measure should be used since all funds are considered. Portfolio D should be selected because it has the highest Sharpe measure.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #20 of 32

Question ID: 438668

The Sortino ratio is a measure of a portfolio's return above:

- A)** zero divided by the standard deviation.
- B)** a minimal acceptable return divided by downside deviation.
- C)** the market return divided by beta.
- D)** the market return divided by the standard deviation.

Explanation

The definition of the Sortino ratio is a predefined minimal acceptable return divided by downside deviation.

References

Question From: Topic Area 1 > Topic 11 > LO 2

Related Material:

- Key Concepts by LO
-

Question #21 of 32

Question ID: 438667

The Sortino ratio is most similar to the:

- A)** relative tracking error ratio.
- B)** Treynor ratio.
- C)** information ratio.
- D)** Sharpe ratio.

Explanation

The Sortino ratio is similar to the Sharpe ratio except for two changes. We replace the risk-free rate with a minimum acceptable return, denoted R_{\min} , and we replace the standard deviation with a type of semivariance.

References

Question From: Topic Area 1 > Topic 11 > LO 2

Related Material:

- Key Concepts by LO
-

Question #22 of 32

Question ID: 438653

Portfolio A earned an annual return of 15% with a standard deviation of 28%. If the mean return on Treasury bills (T-bills) is 4%, the Sharpe ratio for the portfolio is:

- A)** 1.87.
- B)** 0.39.
- C)** 2.54.
- D)** 0.54.

Explanation

$$(15 - 4) / 28 = 0.39$$

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #23 of 32

Question ID: 438641

The efficient market portfolio had a return of 14%. The risk-free rate was 5%. A portfolio has a beta of 0.8. If the portfolio return was 11%, then Jensen's alpha for the portfolio equals:

- A)** +8.000%.
- B)** -1.200%.
- C)** -0.375%.
- D)** +3.000%.

Explanation

Jensen's alpha = $-1.20\% = 11\% - [5\% + 0.8(14\% - 5\%)]$

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #24 of 32

Question ID: 438659

An analyst has generated the following information about risk/return performance using the Sharpe ratio and the Treynor measure:

	<i>Equity Fund</i>	<i>S&P 500</i>
Sharpe ratio	0.47	0.42
Treynor measure	0.31	0.34

Which of the following statements about the relative risk/return performance of the funds is **TRUE?** The:

- A)** Treynor measure shows the fund outperformed the S&P 500 on a systematic risk-adjusted basis.
- B)** Sharpe ratio shows the equity fund underperformed the S&P 500 on a systematic risk-adjusted basis.
- C)** Treynor measure shows the fund underperformed the S&P 500 on a total risk-adjusted basis.
- D)** Sharpe ratio shows the equity fund outperformed the S&P 500 on a total risk-adjusted basis.

Explanation

With either the Sharpe or Treynor methodology, a higher number means a higher risk-adjusted return. Since the Sharpe ratio is 0.05 higher, it outperformed the S&P 500. Note that the key difference between the Sharpe and Treynor measures is that the Sharpe ratio measures return per unit of *total* risk, while Treynor measures return per unit of *systematic* risk.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #25 of 32

Question ID: 438645

The Treynor and Sharpe ratios will:

- A)** give identical rankings when the assets have identical correlations with the market.
- B)** give identical rankings when the same minimum acceptable return is chosen for the calculations.
- C)** always provide identical rankings.
- D)** give identical rankings when the assets have identical standard deviations.

Explanation

The Treynor and Sharpe ratios will provide the same ranking for two assets that have identical correlations with the market. While Treynor uses beta to measure risk and Sharpe uses standard deviation, we can decompose the beta of a security into its correlation and standard deviation components such that equal correlations will yield identical calculations for the Sharpe and Treynor ratios.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #26 of 32

Question ID: 438660

An analyst has gathered the following information about the performance of an equity fund and the S&P 500 index over the same time period.

	Equity Fund	S&P 500
Return	-12%	-16%
Standard Deviation	15%	19%
Beta	1.18	1.00
Risk-free rate is 6.00%		

The difference between the Treynor measure for the equity fund and the Treynor measure for the S&P 500 is:

- A)** 0.15.
- B)** 0.07.

C) 0.17.

D) 0.21.

Explanation

The equity fund: $(-0.12 - 0.06)/1.18 = -0.15$

The S&P 500: $(-0.16 - 0.06)/1.00 = -0.22$

The equity fund is $(-0.15 - (-0.22)) = 0.07$ higher

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #27 of 32

Question ID: 438650

The Treynor measure is correctly defined as a measure of a fund's:

- A)** return earned compared to its unsystematic risk.
- B)** excess return earned compared to its total risk.
- C)** excess earned compared to its systematic risk.
- D)** return earned compared to its systematic risk.

Explanation

The Treynor measure is defined as a fund's excess return (fund's return minus the risk-free rate) divided by its systematic risk (beta).

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #28 of 32

Question ID: 438657

Jensen's alpha for a portfolio measures the:

- A)** fund's return in excess of the required rate of return given the unsystematic risk of the portfolio.
- B)** fund's return in excess of the required rate of return given the systematic risk of the portfolio.

C) difference between the fund's Sharpe ratio and Treynor measure.

D) difference between a fund's return and the market return.

Explanation

Jensen's alpha measures the return above the required rate of return based on the fund's systematic risk. Said differently, Jensen's alpha is the amount of return earned by the fund over and above the return predicted for the fund based on the capital asset pricing model, given the fund's systematic risk.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #29 of 32

Question ID: 438658

An analyst has gathered the following information about the performance of an equity fund and the S&P 500 index over the same time period.

	<i>Equity Fund</i>	<i>S&P 500</i>
Return	13%	10.5%
Standard Deviation	22%	20%
Beta	1.21	1.00

Risk-free rate is 5.25%

The Treynor measure for the equity fund is:

A) 0.048.

B) 0.570.

C) 0.064.

D) 0.071.

Explanation

$(0.13 - 0.0525)/1.21 = 0.064$.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO

Question #30 of 32

Question ID: 438637

For a given portfolio, the expected return is 12% with a standard deviation of 22%. The beta of the portfolio is 1.1. The expected return of the market is 10% with a standard deviation of 20%. The risk-free rate is 4%. The Sharpe measure of the portfolio is:

- A)** 0.36.
- B)** 7.27.
- C)** 20.00.
- D)** 0.10.

Explanation

The Sharpe Measure is the risk premium divided by the standard deviation, σ : Sharpe measure of portfolio "p" = $[E(R_p) - R_f]/\sigma_p = [12 - 4]/22 = 0.363$

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO
-

Question #31 of 32

Question ID: 438639

Portfolio A earned a return of 10.23% and had a standard deviation of returns of 6.22%. If the return over the same period on Treasury bills (T-bills) was 0.52% and the return to Treasury bonds (T-bonds) was 4.56%, what is the Sharpe ratio of the portfolio?

- A)** 0.91.
- B)** 1.56.
- C)** 7.71.
- D)** 0.56.

Explanation

Sharpe ratio = $(R_p - R_f) / \sigma_p$, where $(R_p - R_f)$ is the difference between the portfolio return and the risk free rate, and σ_p is the standard deviation of portfolio returns. Thus, the Sharpe ratio is: $(10.23 - 0.52) / 6.22 = 1.56$. Note, the T-bill rate is used for the risk free rate.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO

Question #32 of 32

Question ID: 438651

A portfolio of options had a return of 22% with a standard deviation of 20%. If the risk-free rate is 7.5%, what is the Sharpe ratio for the portfolio?

- A)** 0.147.
- B)** 0.725.
- C)** 0.267.
- D)** 0.568.

Explanation

Sharpe ratio = $(22\% - 7.50\%) / 20\% = 0.725$.

References

Question From: Topic Area 1 > Topic 11 > LO 1

Related Material:

- Key Concepts by LO

Topic 12: Arbitrage Pricing Theory and Multifactor Models of Risk and Return

Questions #1-2 of 10

Carrie Marcel, CFA, has long used the Capital Asset Pricing Model (CAPM) as an investment tool. Marcel has recently begun to appreciate the advantages of arbitrage pricing theory (APT). She used reliable techniques and data to create the following two-factor APT equation:

$$E(R_p) = 6.0\% + 12.0\%\beta_{p,\Delta GDP} - 3.0\%\beta_{p,\Delta INF}$$

Where ΔGDP is the change in GDP and ΔINF is the change in inflation. She then determines the sensitivities to the factors of three diversified portfolios that are available for investment as well as a benchmark index:

Portfolio	Sensitivity to ΔGDP	Sensitivity to ΔINF
Q	2.00	0.75
R	1.25	0.50
S	1.50	0.25
Benchmark Index	1.80	1.00

Marcel is investigating several strategies. She decides to determine how to create a portfolio from Q, R, and S that only has an exposure to ΔGDP . She also wishes to create a portfolio out of Q, R, and S that can replicate the benchmark. Marcel also believes that a hedge fund, which is composed of long and short positions, could be created with a portfolio that is equally weighted in Q, R, S and the benchmark index. The hedge fund would produce a return in excess of the risk-free return but would not have any risk.

Question #1 of 10

Question ID: 438629

Which of the following statements *least likely* describes characteristics of the APT and the CAPM?

- ✓ **A)** Both models require the ability to invest in the market portfolio.
- X **B)** Under the framework of CAPM, investors who are more risk averse should hold less of the market portfolio and more of the risk-free asset.
- X **C)** The APT is more flexible than the CAPM because it allows for multiple factors.
- X **D)** Both models assume firm-specific risk can be diversified away.

Explanation

The CAPM can be thought of as a subset of the APT, multifactor model. Therefore, fewer assumptions are needed for the APT model than the CAPM. Although it could be included as a factor, the APT does not require an investment in the market portfolio. APT can be thought of as a k factor model, while the CAPM is based on the risk-free asset and the market portfolio.

References

Question From: Topic Area 1 > Topic 12 > LO 5

Related Material:

- Key Concepts by LO

Question #2 of 10

Question ID: 438630

What is the APT expected return on a factor portfolio exposed only to ΔGDP ?

- A)** 18.0%.
- B)** 15.0%.
- C)** 12.0%.
- D)** 3.0%.

Explanation

A factor portfolio is a portfolio with a factor sensitivity of one to a particular factor and zero to all other factors. The expected return on a "factor 1" portfolio is $E(R_R) = 6.0\% + 12.0\% (1.00) - 3.0\%(0.00) = 18.0\%$.

References

Question From: Topic Area 1 > Topic 12 > LO 5

Related Material:

- Key Concepts by LO
-

Question #3 of 10

Question ID: 438632

The factor risk premium on factor j in the arbitrage pricing theory (APT) can be interpreted as the:

- A)** expected return investors require on a factor portfolio for factor j.
- B)** expected return on an arbitrage portfolio with j factors.
- C)** expected risk premium investors require on a factor portfolio for factor j.
- D)** sensitivity of the market portfolio to factor j.

Explanation

We can interpret the APT factor risk premiums similar to the way we interpret the market risk premium in the CAPM. Each factor price is the expected risk premium (extra expected return minus the risk-free rate) investors require for a portfolio with a sensitivity of one ($\beta_{p,j} = 1$) to that factor and a sensitivity of zero to all the other factors (a factor portfolio).

References

Question From: Topic Area 1 > Topic 12 > LO 5

Related Material:

- Key Concepts by LO
-

Question #4 of 10

Question ID: 438635

Which of the following is not an assumption of the arbitrage pricing theory (APT)?

- A)** Security returns are normally distributed.
- B)** No arbitrage opportunities exist.
- C)** The market contains enough stocks so that unsystematic risk can be diversified away.
- D)** Returns on assets can be described by a multi-factor process.

Explanation

APT does not require that security returns be normally distributed.

References

Question From: Topic Area 1 > Topic 12 > LO 5

Related Material:

- Key Concepts by LO
-

Question #5 of 10

Question ID: 438634

Which of the following statements regarding the arbitrage pricing theory (APT) as compared to the capital asset pricing model (CAPM) is *least* accurate? APT:

- A)** does not require that one of the risk factors is the market portfolio; unlike the CAPM.
- B)** is more flexible than CAPM in its application.
- C)** has fewer assumptions than CAPM.
- D)** is often times thought of as a special case of the CAPM.

Explanation

The CAPM is often times thought of as a special case of the APT since CAPM has only one factor, the market portfolio.

References

Question From: Topic Area 1 > Topic 12 > LO 5

Related Material:

- Key Concepts by LO
-

Question #6 of 10

Question ID: 438636

Which of the following is an assumption of the arbitrage pricing theory (APT)?

- A)** The process generating asset returns can be represented by a 5-factor model.
- B)** Security returns are normally distributed.
- C)** Assets are priced such that no arbitrage opportunities exist.
- D)** Investors have quadratic utility functions.

Explanation

APT implies that investors will undertake infinitely large positions (long and short) to exploit any perceived mispricing, causing asset prices to adjust immediately to their equilibrium values.

References

Question From: Topic Area 1 > Topic 12 > LO 5

Related Material:

- Key Concepts by LO
-

Questions #7-8 of 10

Marcie Deiner is an investment manager with G&G Investment Corporation. She works with a variety of clients who differ in terms of experience, risk aversion and wealth. Deiner recently attended a seminar on multifactor analysis. Among other things, the seminar taught how the assumptions concerning the Arbitrage Pricing Theory (APT) model are different from those of the Capital Asset Pricing Model (CAPM). One of the examples used in the seminar is below.

$$E(R_i) = R_f + f_1 B_{i,1} + f_2 B_{i,2} + f_3 B_{i,3} \text{ where: } f_1 = 3.0\%, f_2 = -40.0\%, \text{ and } f_3 = 50.0\%.$$

<i>Beta estimates for Growth and Value funds for a three factor model</i>			
	<i>Factor 1</i>	<i>Factor 2</i>	<i>Factor 3</i>
Betas for Growth	0.5	0.7	1.2
Betas for Value	0.2	1.8	0.6

Question #7 of 10

Question ID: 638283

For the model used as an example in the seminar, if the T-bill rate is 3.5%, what are the expected returns for the Growth and Value Funds?

E(R_{Growth})

E(R_{Value})

- | | |
|-------------------|--------|
| X A) 3.1% | -3.16% |
| X B) 93.0% | 106.1% |
| ✓ C) 37.0% | -37.9% |
| X D) 33.5% | -41.4% |

Explanation

$$E(R_{Growth}) = 0.035 + 0.03(0.5) - 0.4(0.7) + 0.5(1.2) = 0.035 + 0.015 - 0.28 + 0.6 = 0.37 \text{ or } 37.0\%$$

$$E(R_{Value}) = 0.035 + 0.03(0.2) - 0.4(1.8) + 0.5(0.6) = 0.035 + 0.006 - 0.72 + 0.30 = -0.379 \text{ or } -37.9\%$$

References

Question From: Topic Area 1 > Topic 12 > LO 5

Related Material:

- Key Concepts by LO

Question #8 of 10

Question ID: 438627

Which of the following is *least likely* an assumption of the APT model?

- X **A)** asset returns are explained by a factor model.
- X **B)** a large number of available assets for investment allow investors to eliminate non-systematic risk through diversification.
- X **C)** no arbitrage opportunities are available to investors because capital markets are perfectly competitive.
- ✓ **D)** asset returns are normally distributed.

Explanation

It is not necessary to assume that asset returns are normally distributed. The Arbitrage Pricing Theory (APT) Model allows for different characteristics of return distributions to be captured by the factors in the model. The APT model also does not require the existence of a market portfolio that is mean-variance efficient. These assumptions are necessary for the Capital Asset Pricing Model (CAPM). The APT has three less restrictive assumptions:

1. Asset returns are explained by a k factor model.

2. No arbitrage opportunities exist for investors, because capital markets are perfectly competitive.
3. Investors can eliminate non-systematic or firm-specific risk through diversification.

References

Question From: Topic Area 1 > Topic 12 > LO 5

Related Material:

- Key Concepts by LO
-

Question #9 of 10

Question ID: 438633

Given a three-factor arbitrage pricing theory (APT) model, what is the expected return on the Premium Dividend Yield Fund?

- The factor risk premiums to factors 1, 2 and 3 are 8%, 12% and 5%, respectively.
 - The fund has sensitivities to the factors 1, 2, and 3 of 2.0, 1.0 and 1.0, respectively.
 - The risk-free rate is 3.0%.
- ✓ **A)** 36.0%.
- X **B)** 50.0%.
- X **C)** 28.0%.
- X **D)** 33.0%.

Explanation

The expected return on the Premium Dividend Yield Fund is $3\% + (8.0\%)(2.0) + (12.0\%)(1.0) + (5.0\%)(1.0) = 36.0\%$.

References

Question From: Topic Area 1 > Topic 12 > LO 5

Related Material:

- Key Concepts by LO
-

Question #10 of 10

Question ID: 438631

An arbitrage pricing theory (APT) model has the following characteristics:

- The risk free rate is 3.8 percent.
- Factor risk premiums are:
 - A. (7 percent)
 - B. (4 percent)
 - C. (2 percent)

D. (10 percent)

Assume Silver Linings Fund has the following sensitivities to the factors:

- Sensitivity to A is 0.5.
- Sensitivity to B is 1.2.
- Sensitivity to C is 2.1.
- Sensitivity to D is 0.2.

The expected return on the Silver Linings Fund is:

- X **A)** 14.5 percent.
✓ **B)** 18.3 percent.
X **C)** 20.1 percent.
X **D)** 16.8 percent.

Explanation

$$E(R) = 3.8 + (0.5 * 7) + (1.2 * 4) + (2.1 * 2) + (0.2 * 10) = 18.3.$$

References

Question From: Topic Area 1 > Topic 12 > LO 5

Related Material:

- Key Concepts by LO

Topic 13: Principles for Effective Data Aggregation and Risk Reporting

Question #1 of 5

Question ID: 440348

Ponder Bank has experienced recent losses resulting from regional home loan concentration. While the national market has recovered, a few regions have suffered. Ponder bank is now undercapitalized because of the losses. The Basel Committee's principles for effective risk data aggregation and reporting can help prevent and deal with situations like what Ponder Bank is experiencing. Which one of the committee's principles most likely recommends that risk management reports include risk data, risk analysis, interpretation of risk, and qualitative explanations of risks?

- A)** Clarity and Usefulness.
- B)** Comprehensiveness.
- C)** Completeness.
- D)** Accuracy.

Explanation

According to the committee "risk management reports should communicate information in a clear and concise manner. Reports should be easy to understand yet comprehensive enough to facilitate informed decision-making. Reports should include meaningful information tailored to the needs of the recipients." Principle 9 (Clarity and Usefulness) requires that:

- Reports be tailored to the end user (e.g., the board, senior managers, and risk committee members) and should assist them with sound risk management and decision-making.
- Reports will include: risk data, risk analysis, interpretation of risks, and qualitative explanations of risks.

References

Question From: Topic Area 1 > Topic 13 > LO 5

Related Material:

- Key Concepts by LO

Question #2 of 5

Question ID: 444840

The Basel Committee Principles for effective risk data aggregation capabilities include:

- A)** accuracy and integrity, completeness, timeliness, and adaptability.
- B)** accuracy and integrity, completeness, competence, and diligence.
- C)** competence, diligence, and adaptability.
- D)** competence, diligence, and timeliness.

Explanation

The Principles of the Basel Committee for effective risk data aggregation capabilities include accuracy and integrity, completeness, timeliness and adaptability. Aggregated risk data should exhibit all of these features together, not in isolation.

References

Question From: Topic Area 1 > Topic 13 > LO 4

Related Material:

- Key Concepts by LO
-

Question #3 of 5

Question ID: 444839

Which of the following statements is least likely consistent with the Basel Committee's guidance and principles regarding effective risk data aggregation and risk reporting practices?

- A)** A single data model must be used for data classifications.
- B)** Risk managers and business managers are responsible for accurately managing and entering relevant data into their data infrastructure.
- C)** Banks should devote financial and human resources to data aggregation and reporting roles throughout a market cycle.
- D)** Data architecture should include information on metadata.

Explanation

Multiple data models can be used for data classification if a bank has healthy automated reconciliation measures in place.

References

Question From: Topic Area 1 > Topic 13 > LO 3

Related Material:

- Key Concepts by LO
-

Question #4 of 5

Question ID: 440347

The risk aggregation process includes breaking down, sorting, summarizing data and datasets. True or False

accrue to banks that have effective risk data aggregation and reporting systems in place. Which of the following statements least likely describes a benefit of effective risk data aggregation?

- A)** It is easier to see problems on the horizon when risks are viewed individually rather than as a whole.
- B)** The bank is better able to make strategic decisions, increase efficiency, reduce the chance of loss, and ultimately increase profitability.
- C)** Improved resolvability in the event of bank stress or failure.
- D)** Increase efficiency, reduce the chance of loss, and ultimately increase profitability.

Explanation

Several benefits accrue to banks that have effective risk data aggregation and reporting systems in place. These benefits include:

- An increased ability to anticipate problems. Aggregated data allows risk managers to understand risks holistically. It is easier to see problems on the horizon when risks are viewed as a whole rather than in isolation.
- In times of financial stress, effective risk data aggregation enhances a bank's ability to identify routes to return to financial health. For example, a bank may be better able to identify a suitable merger partner in order to restore the bank's financial viability.
- Improved resolvability in the event of bank stress or failure. Regulatory authorities should have access to aggregated risk data to resolve issues related to the health and viability of banks. This is especially important for global systemically important banks (G-SIBs).
- By strengthening a bank's risk function, the bank is better able to make strategic decisions, increase efficiency, reduce the chance of loss, and ultimately increase profitability.

References

Question From: Topic Area 1 > Topic 13 > LO 1

Related Material:

- Key Concepts by LO
-

Question #5 of 5

Question ID: 444838

Which of the following statements is least likely consistent with the Basel Committee's guidance and principles regarding data aggregation?

- A)** Data aggregation and risk reporting capabilities should be independently reviewed and validated.
- B)** Data aggregation and reporting decisions should be based on a bank's physical location and legal structure.

- C)** Time frames should be established to integrate data and risk reporting capabilities of acquired firms.
- D)** A bank's board of directors should be aware of its compliance with key governance principles set forth by the Basel Committee.

Explanation

Data aggregation and reporting decisions should be independent of a bank's physical location, geographical presence and legal structure.

References

Question From: Topic Area 1 > Topic 13 > LO 2

Related Material:

- Key Concepts by LO

Topic 14: GARP Code of Conduct

Question #1 of 7

Question ID: 438701

Charmaine Townsend, FRM, has been managing a growth portfolio for her clients using a screening process that identifies companies that have high earnings growth rates. Townsend has decided that, because she thinks the economy might turn volatile, she is going to adopt a value strategy using a screening process that identifies companies that have low price-earnings multiples. Townsend will violate the GARP Code of Conduct if she makes this change in her investment process without:

- A)** getting prompt written acknowledgment of the change from her clients within a reasonable time after the change was made.
- B)** notifying her supervisor before she makes the change.
- C)** promptly notifying her clients of the change.
- D)** getting written permission from her clients in advance of the change.

Explanation

GARP Members shall make full and fair disclosure of all matters that could reasonably be expected to impair independence and objectivity or interfere with respective duties to their employer, clients, and prospective clients.

References

Question From: Topic Area 1 > Topic 14 > LO 1

Related Material:

- Key Concepts by LO
-

Question #2 of 7

Question ID: 438700

Sue Johnson, FRM, has an elderly client with a very large asset base. The client intends to start divesting her fortune to various charities. Johnson is on the Board of a local charitable foundation. Johnson most appropriately:

- A)** can make this known to the charitable foundation so that they can solicit the client, since it is the client's wish to divest assets to charities in the future.
- B)** must not discuss anything regarding her client and her client's intentions with the charitable foundation without permission.
- C)** can discuss her client's situation with the charitable foundation as long as she informs other local charities of her client's intentions.
- D)** should solicit the client herself, along with other Board members, to obtain a larger contribution.

Explanation

To comply with Standard 3.1, Johnson must not discuss with her charitable foundation anything regarding her client and her client's intentions. It does not matter that her client intends to give money to charities in the near future.

References

Question From: Topic Area 1 > Topic 14 > LO 1

Related Material:

- Key Concepts by LO
-

Question #3 of 7

Question ID: 438703

Preservation of confidentiality applies to the information that an analyst learns from:

- A)** former clients and prospects only.
- B)** current clients and prospects only.
- C)** current clients and former clients only.
- D)** current clients, former clients, and prospects.

Explanation

According to Standard 3.1 and 3.2, confidentiality, a GARP Member shall not make use of confidential information for inappropriate purposes and unless having received prior consent shall maintain the confidentiality of their work, their employer, or client.

References

Question From: Topic Area 1 > Topic 14 > LO 1

Related Material:

- Key Concepts by LO
-

Question #4 of 7

Question ID: 438699

When an analyst makes an investment recommendation, which of the following statements must be disclosed to clients?

- A)** The analyst's father-in-law has a material ownership in the security.
- B)** All of these statements must be disclosed to clients.
- C)** An employee of the firm holds a directorship with the recommended company.
- D)** The firm is a market maker in the stock of the recommended company.

Explanation

GARP Members must make full and fair disclosure of all matters that could reasonably be expected to impair independence and objectivity or interfere with respective duties to their employer, clients, and prospective clients.

References

Question From: Topic Area 1 > Topic 14 > LO 1

Related Material:

- Key Concepts by LO
-

Question #5 of 7

Question ID: 438705

Which of the following statements is incorrect regarding GARP Code of Conduct violations?

- X **A)** Violations of the Code of Conduct may result in permanent removal from GARP membership.
- ✓ **B)** If the Code of Conduct and certain laws conflict, then the GARP Code of Conduct will take priority.
- X **C)** Violations of the Code of Conduct could lead to a revocation of the right to use the FRM designation.
- X **D)** Violations of the Code of Conduct may result in temporary suspension from GARP membership.

Explanation

All GARP Members are expected to act in accordance with the GARP Code of Conduct as well as any local laws and regulations that pertain to the risk management profession. If the Code and certain laws conflict, then laws and regulations will take priority.

References

Question From: Topic Area 1 > Topic 14 > LO 2

Related Material:

- Key Concepts by LO
-

Question #6 of 7

Question ID: 438704

Will Lambert, FRM, is a financial risk analyst for Offshore Investments. He is preparing a purchase recommendation on Burch Corporation. According to the GARP Code of Conduct, which of the following statements about disclosure of conflicts is most correct? Lambert would have to disclose that:

- X **A)** Offshore is an OTC market maker for Burch Corporation's stock.
- X **B)** he has a material beneficial ownership of Burch Corporation through a family trust.
- ✓ **C)** All of these choices require disclosure.
- X **D)** his wife owns 2,000 shares of Burch Corporation.

Explanation

According to Standard 2.2, GARP Members shall make full and fair disclosure of all matters that could reasonably be expected to impair independence and objectivity or interfere with respective duties to their employer, clients, and prospective clients.

References

Question From: Topic Area 1 > Topic 14 > LO 1

Related Material:

- Key Concepts by LO
-

Question #7 of 7

Question ID: 438702

The Investment Banking Department of MLB&J often receives material nonpublic information that could have considerable value to MLB&J's brokerage clients. To comply with the GARP Code of Conduct, MLB&J should most appropriately:

- A)** ensure that material nonpublic information is not disseminated beyond the firm's investment banking, brokerage, and research departments.
- B)** contact the firms involved and request that they make this information available to the public before MLB&J allows its clients to trade in these securities.
- C)** prohibit MLB&J analysts from making buy or sell recommendations on this information until ten business days after the receipt of this information.
- D)** restrict proprietary trading in the securities of companies about which the Investment Banking Department has access to material nonpublic information.

Explanation

According to Standard 1.3, GARP members must take reasonable precautions to ensure that Member's services are not used for improper, fraudulent or illegal purposes.

References

Question From: Topic Area 1 > Topic 14 > LO 1

Related Material:

- Key Concepts by LO