CHAPTER 51

BASICS OF PORTFOLIO PLANNING AND CONSTRUCTION

1. (A) tax bracket.

Explanation

Tax concerns play an important role in investment planning. However, these constitute an investment constraint, not an investment objective (i.e. risk tolerance).

(Study Session 18, Module 51.1, LOS 51.d)

Related Material

SchweserNotes - Book 5

2. (B) liquidity.

Explanation

Liquidity constraints arise from an investor's need for spendable cash.

(Study Session 18, Module 51.1, LOS 51.e)

Related Material

SchweserNotes - Book 5

3. (C) risk tolerance.

Explanation

Risk tolerance and return requirements make up the investment objectives. Investment constraints include liquidity needs, time horizon, tax concerns, legal and regulatory factors, and unique circumstances.

(Study Session 18, Module 51.1, LOS 51.e)

Related Material

SchweserNotes - Book 5

4. (A) tax concerns.

Explanation

Of the five categories of investment constraints, the four matters listed are related to Pope's time horizon (years to retirement), liquidity needs (available cash), legal and regulatory factors (required copies of account statements to Pope's compliance officer), and unique needs and preferences (no investments in Lower Pannonia). None of these constraints address Pope's tax situation or the taxable status of the investment account.

(Study Session 18, Module 51.1, LOS 51.e)

Related Material

SchweserNotes - Book 5

5. (C) "What rate of investment return do you expect?"

Explanation

While the degree of risk tolerance will have an affect on expected returns, assessing the risk tolerance comes first, and the resulting set of feasible returns follows. The other questions address risk tolerance.

(Study Session 18, Module 51.1, LOS 51.d)

Related Material

SchweserNotes - Book 5

6. (B) the investment manager's compensation.

Explanation

Investment manager's compensation is not among the major components of a typical IPS. The major components include a description of the client; a statement of purpose; a statement of duties and responsibilities; procedures to update the IPS; investment objectives; investment constraints; investment guidelines; and benchmark for evaluation of performance.

(Study Session 18, Module 51.1, LOS 51.b)

Related Material

SchweserNotes - Book 5

7. (A) Level of inflation in the economy.

Explanation

The level of inflation in the economy should be considered in determining the return objective. Risk tolerance is a function of the investor's psychological makeup and the investor's personal factors such as age, family situation, existing wealth, insurance coverage, current cash reserves and income.

(Study Session 18, Module 51.1, LOS 51.d)

Related Material

SchweserNotes - Book 5

8. (A) Domestic bonds.

Explanation

An asset class should be specified by type of security (e.g., stocks, bonds, alternative assets, cash) and can then be further subdivided by region or industry classification. An asset class defined only as "emerging markets" or "consumer discretionary firms" should identify the type of securities (e.g., equities or debt).

(Study Session 18, Module 51.1, LOS 51.f)

Related Material

SchweserNotes - Book 5

9. (A) **Many individuals purchase lottery tickets.**

Explanation

Investors are risk averse. Given a choice between two assets with equal rates of return, the investor will always select the asset with the lowest level of risk. This means that there is a positive relationship between expected returns (ER) and expected risk and the risk return line (capital market line [CML] and security market line [SML]) is upward sweeping. However, investors can be risk averse in one area and not others, as evidenced by their purchase of lottery tickets.

(Study Session 18, Module 51.1, LOS 51.d)

Related Material

SchweserNotes - Book 5

10. (B) **emphasize bonds over stocks.**

Explanation

When determining an investor's risk tolerance, an advisor must consider both the investor's ability and willingness to bear risk. Even though the investor has a high willingness to bear risk, his ability to take risk (based on his financial situation) is low, and this should take precedence. A portfolio that emphasizes bonds over stocks has less investment risk and is the most appropriate choice.

For Further Reference:

(Study Session 18, Module 51.1, LOS 51.d)

CFA® Program Curriculum, Volume 6, page 8

Related Material

SchweserNotes - Book 5

11. (C) **identifies specific stocks the investor may wish to purchase.**

Explanation

The policy statement outlines broad objectives and constraints but does not get into the details of specific stocks for investment.

(Study Session 18, Module 51.1, LOS 51.a)

Related Material

SchweserNotes - Book 5

12. (C) **A broad market index is an inappropriate benchmark for a portfolio that uses negative screening to address the investor's ESG concerns.**

Explanation

If a portfolio's investment universe is constrained by negative screening, an appropriate benchmark is an index that excludes companies or industries that investors with ESG concerns commonly avoid.

Investors engaging in active ownership to pursue their ESG considerations may choose to vote their shares themselves or instruct an investment manager to vote the shares.

The effect of integrating ESG considerations on portfolio returns is uncertain. While limiting the universe of investment choices and incurring the costs involved in considering ESG factors may decrease returns, investing in companies with good corporate governance practices and avoiding those that face ESG-related risks may increase returns.

(Study Session 18, Module 51.1, LOS 51.h)

Related Material

SchweserNotes - Book 5

13. (C) **unwilling to invest in companies that sell weapons.**

Explanation

Issues involving taxes fall in the tax concerns category, and issues regarding regulation fall in the legal and regulatory factors category. Specific guidance from the investor on permitted businesses for investment is included in unique circumstances.

For Further Reference:

(Study Session 18, Module 51.1, LOS 51.e)

CFA® Program Curriculum, Volume 6, page 15

Related Material

SchweserNotes - Book 5

14. (B) **Investors concerned about time horizon are not likely to worry about liquidity.**

Explanation

Investors with a time horizon constraint may have little time for capital appreciation before they need the money. Need for money in the near term is a liquidity constraint. Time horizon and liquidity constraints often go hand in hand. Diversification often requires the sale of an investment and the purchase of another. Investment sales often trigger tax liability. Younger investors should take advantage of tax deferrals while they have time for the savings to compound, and while they are in their peak earning years. Many retirees have little income and face less tax liability on investment returns.

(Study Session 18, Module 51.1, LOS 51.e)

Related Material

SchweserNotes - Book 5

15. (C) **90%, 6%, 4%.**

Explanation

Several studies support the idea that approximately 90% of the variation in a single portfolio's returns can be explained by its target asset allocations, with security selection and tactical variations from the target (market timing) playing a much less significant role. In fact, for actively managed funds, actual portfolio returns are slightly less than those that would have been achieved if the manager strictly maintained the target allocation, thus illustrating the difficultly of improving returns through security selection or market timing.

(Study Session 18, Module 51.1, LOS 51.g)

Related Material

SchweserNotes - Book 5

16. (A) **approximate the investor's total investable universe as a group.**

Explanation

When taken together, the asset classes should approximate the investor's total investible universe. Properly defined and specified asset classes should each have a low return correlation to the other asset classes, and within each asset class should be assets that have similar expected risk and return.

(Study Session 18, Module 51.1, LOS 51.f)

Related Material

SchweserNotes - Book 5

17. (C) **based on a benchmark index or portfolio.**

Explanation

Relative return objectives are stated relative to specified benchmarks, such as LIBOR or the return on a stock index. Absolute return objectives are stated in terms of specific numerical outcomes, such as a 5% return. Risk objectives (either absolute or relative) may be stated in terms of probability, such as "no more than a 5% probability of a negative return."

(Study Session 18, Module 51.1, LOS 51.c)

Related Material

SchweserNotes - Book 5

18. (C) **allocates more than the targeted 10% to emerging market bonds because the** sector appears to be undervalued.

Explanation

Tactical asset allocation is deviating from a portfolio's strategic asset allocation because an asset class or sector is perceived to be mispriced in the short term. Establishing and updating target weights for asset classes based on the investor's objectives and constraints is strategic asset allocation.

(Study Session 18, Module 51.1, LOS 51.g)

Related Material

SchweserNotes - Book 5

19. (A) **How funds are spent after being withdrawn from the portfolio.**

Explanation

How funds are spent after withdrawal would not be a constraint of an IPS. (Study Session 18, Module 51.1, LOS 51.e)

Related Material

SchweserNotes - Book 5

20. (A) a core-satellite approach.

Explanation

With a core-satellite approach, a firm invests the majority of a portfolio passively and uses active strategies for the remaining portion. Strategic asset allocation refers to specifying the percentages of a portfolio's value to allocate to specific asset classes. Risk budgeting refers to allocating a portfolio's overall permitted risk among strategic asset allocation, tactical asset allocation, and security selection.

(Study Session 18, Module 51.1, LOS 51.g)

Related Material

SchweserNotes - Book 5

21. (C) spending needs allows for greater risk.

Explanation

Greater spending needs usually allow for lower risk because there is a definite need to ensure that the return may adequately fund the spending needs (a "fixed" cost).

(Study Session 18, Module 51.1, LOS 51.d)

Related Material

SchweserNotes - Book 5

22. (B) The SML uses beta, but the CML uses standard deviation as the risk measure.

Explanation

The SML and CML both intersect the vertical axis at the risk-free rate. The SML describes the risk/return tradeoff for individual securities or portfolios, whereas the CML describes the risk/return tradeoff of various combinations of the market portfolio and a riskless asset.

For Further Reference:

(Study Session 18, Module 51.1, LOS 51.0

CFA® Program Curriculum, Volume 5, page 520

CFA® Program Curriculum, Volume 5, page 541

Related Material

SchweserNotes - Book 5

23. (B) High correlation within asset classes and low correlation between asset classes.

Explanation

The portfolio diversification benefits from strategic asset allocation result from low correlations of returns between asset classes. Asset classes should consist of assets with similar characteristics and investment performance, which means correlations within an asset class are relatively high.

(Study Session 18, Module 51.1, LOS 51.0

Related Material

SchweserNotes - Book 5

24. (B) **Risk and return may be considered on a mutually exclusive basis.**

Explanation

Risk and return must always be considered together when expressing investment objectives. Return objectives may be expressed either in absolute terms (dollar amounts) or in percentages.

(Study Session 18, Module 51.1, LOS 51.c)

Related Material

SchweserNotes - Book 5

25. (C) **target return figure.**

Explanation

An IPS does not necessarily, or even typically, require a target return because future market movements are either difficult or impossible to predict with any degree of accuracy. At a minimum the IPS should contain a clear statement of client circumstances and constraints, and investment strategy consistent with these, and a benchmark portfolio or instrument against which to evaluate portfolio returns.

(Study Session 18, Module 51.1, LOS 51.b)

Related Material

SchweserNotes - Book 5

26. (A) **legal and regulatory.**

Explanation

Legal and regulatory constraints are those that apply to an investor by law.

(Study Session 18, Module 51.1, LOS 51.e)

Related Material

SchweserNotes - Book 5

27. (A) **Expressing investment goals in terms of risk is more appropriate than expressing goals in terms of return.**

Explanation

Expressing investment goals in terms of risk is not more appropriate than expressing goals in terms of return. The investment objectives should be stated in terms of both risk and return. Risk tolerance will likely help determine what level of expected return is feasible.

(Study Session 18, Module 51.1, LOS 51.c)

Related Material

SchweserNotes - Book 5

28. (B) **Procedures to update the IPS when circumstances change.**

Explanation

At a minimum an IPS should contain a clear statement of client circumstances and constraints, an investment strategy based on these, and some benchmark against which to evaluate the account performance. The investment must periodically update the IPS as circumstances change, but explicit procedures for these updates are not necessarily included in the IPS itself.

(Study Session 18, Module 51.1, LOS 51.a)

Related Material

SchweserNotes - Book 5

29. (C) **the client's investment objectives and constraints.**

Explanation

After defining the investable asset classes and constructing an efficient frontier of possible portfolios of these asset classes, the manager should choose the efficient portfolio that best suits the investor's objectives and constraints as specified in the IPS. The investor's strategic asset allocation can then be defined as the asset allocation of the chosen portfolio. Tactical asset allocation based on relative valuation of asset classes would require the manager to deviate from the strategic asset allocation. Risk budgeting refers to the practice of determining an overall risk limit for a portfolio and allocating that risk to strategic asset allocation, tactical asset allocation, and security selection decisions.

(Study Session 18, Module 51.1, LOS 51.g)

Related Material

SchweserNotes - Book 5

30. (C) **tactical asset allocation.**

Explanation

Tactical asset allocation refers to deviating from a portfolio's target asset allocation weights in the short term to take advantage of perceived opportunities in specific asset classes. Strategic asset allocation is determining the target asset allocation percentages for a portfolio. Rebalancing is periodically adjusting a portfolio back to its target asset allocation.

(Study Session 18, Module 51.1, LOS 51.g)

Related Material

SchweserNotes - Book 5

31. (B) **within an asset class should be relatively high.**

Explanation

Asset classes are defined such that correlations of returns within an asset class are relatively high. Low correlations of returns among asset classes increase the benefits of diversification across asset classes.

(Study Session 18, Module 51.1, LOS 51.f)

Related Material

SchweserNotes - Book 5

32. (A) Both of these items.

Explanation

Two of the major components of an IPS should be a statement of the responsibilities of the investment manager and the client, and a performance evaluation benchmark.

(Study Session 18, Module 51.1, LOS 51.b)

Related Material

SchweserNotes - Book 5

33. (B) Risk tolerance.

Explanation

The constraints are: liquidity needs, time horizon, taxes, legal and regulatory factors, and unique needs and preferences. Risk tolerance is included in the investment objectives of the policy statement, not in the constraints.

(Study Session 18, Module 51.1, LOS 51.e)

Related Material

SchweserNotes - Book 5