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CHAPTER 2—THE ASSET ALLOCATION DECISION

TRUE/FALSE

1.	Experts suggest life insurance coverage should be seven to ten times an individual's annual salary.				
	ANS: T	TS: 1			
2.	Term life insurance p	vides both a death benefit and a savings plan.			
	ANS: F	TS: 1			
3.	Most experts recomm	nd a cash reserve of at least one year's worth of living expenses.			
	ANS: F	TS: 1			
4.	The spending phase of	curs when investors are relatively young.			
	ANS: F	TS: 1			
5.	The gifting phase is s	nilar to, and may be concurrent with, the spending phase.			
	ANS: T	TS: 1			
6.	Long-term, high-prio	y goals include some form of financial independence.			
	ANS: T	TS: 1			
7.	It is not a good idea t	get too specific when constructing your policy statement.			
	ANS: F	TS: 1			
8.	Asset allocation is the	process of dividing funds into different classes of assets.			
	ANS: T	TS: 1			
9.	The typical investor's	oals rarely change during his/her lifetime.			
	ANS: F	TS: 1			
10.	Individual security se	ction is far more important than the asset allocation decision.			
	ANS: F	TS: 1			
11.	Return is the only im	ortant consideration when establishing investment objectives.			
	ANS: F	TS: 1			
12.	In constructing the po	folio, the manager should maximize the investor's risk level.			



	ANS: F	PTS: 1
13.	Risk tolerance is exc	lusively a function of an individual's psychological makeup.
	ANS: F	PTS: 1
14.	An appropriate investigated preservation of	tment objective for a typical 25-year-old investor is a low-risk strategy, such as or current income.
	ANS: F	PTS: 1
15.	Investment planning	is complicated by the tax code.
	ANS: T	PTS: 1
16.	Average tax rate is de	efined as total tax payment divided by total income.
	ANS: T	PTS: 1
17.	The portfolio mixes	of institutional investors around the world are approximately the same.
	ANS: F	PTS: 1
18.	The ability to retire a	t a certain age is a typical example of a long-term, lower-priority goal.
	ANS: F	PTS: 1
19.	It is essential that bor portfolio.	th the client and the portfolio manager agree on an appropriate benchmark
	ANS: T	PTS: 1
20.	An example of a union a fiduciary or trustee	que need in an investment policy statement is related to the legal responsibilities of
	ANS: F	PTS: 1
21.	Equity allocations of	pension funds in Japan and Germany are similar to those in the United States.
	ANS: F	PTS: 1
22.	Investing 30 to 40 pe they match funds.	rcent of your retirement funds in the company you work for is reasonable when
	ANS: F	PTS: 1
23.	The majority of a per	nsion fund's return is explained by asset allocation.
	ANS: T	PTS: 1



MULTIPLE CHOICE

1.	The current outlay o a. Asset manageme b. Portfolio manag c. Minimizing risk d. Loss control. e. Insurance.	ent. ement.	to guard again	ist a pot	tentially large future loss is commonly known as
	ANS: E	PTS:	1	OBJ:	Multiple Choice
2.	In an investment pol a. risk and return b. risk c. return d. time horizon e. liquidity needs	icy state	ement the objec	tives of	f an investor are expressed in terms of
	ANS: A	PTS:	1	OBJ:	Multiple Choice
3.					ly-to-middle earning years attempt to accumulate lucation or down payment on a home.
	ANS: A	PTS:	1	OBJ:	Multiple Choice
4.	Which of the follow a. Discovery phase b. Accumulation pl c. Consolidation pl d. Spending phase e. Gifting phase	hase	ot a life cycle p	hase?	
	ANS: A	PTS:	1	OBJ:	Multiple Choice
5.	Which of the follow a. Develop a policy b. Study current fin c. Construct the po d. Monitor investor e. Sell all assets an	y statem nancial a ortfolio. r's needs	ent. and economic c s and market co estment proceed	onditiondition	S.
6.	The first step in the				•
٠.	a. Objective statem		pro 3000 10 ti		



	b. Policy statemenc. Financial statemd. Statement of casee. Statement of case	ent. sh needs.			
	ANS: B	PTS:	1	OBJ:	Multiple Choice
7.	a. Capital preservab. Capital appreciac. Current incomed. Total return	tion tion			investment objective?
	ANS: E	PTS:	1	OBJ:	Multiple Choice
8.	must be stated established before re a. Investment requ b. Investment cons c. Investment rew d. Investment obje e. Investment police	eturns obj irements straints ards ctives	jectives can be		nd risk. An investor's tolerance for risk must be
	ANS: D	PTS:	1	OBJ:	Multiple Choice
9.	is an appropriation. a. Capital preservate. Capital appreciate. Portfolio growth. Value additivity. Nominal preservate.	ation ation	ive for investo	rs who	want their portfolio to grow in real terms, i.e., exceed
	ANS: B	PTS:	1	OBJ:	Multiple Choice
10.		oproaches nes entials			n quickly and at a fair market price and often e investment life cycle.
	ANS: A	PTS:	1	OBJ:	Multiple Choice
11.	The policy statement can be measured. a. Milestone b. Benchmark c. Landmark d. Reference point	·	clude a aş	gainst v	which a portfolio's or portfolio manager's performance

	e. Market pair				
	ANS: B	PTS: 1	OBJ:	Multiple Choice	
12.		h returns varia h the risk asso h the relations	ciated with differen	ent assets.	
	ANS: E	PTS: 1	OBJ:	Multiple Choice	
13.	The asset allocation a. Cultural differed b. The objectives c. The types of as d. The risk associ e. All of the above	ences. stated in the issets that are a ated with diffe	nvestor's policy st ppropriate for the	atement. investor.	
	ANS: E	PTS: 1	OBJ:	Multiple Choice	
14.				on explains% of thurns for a particular fund	e variation in fund returns over time.
	ANS: E	PTS: 1	OBJ:	Multiple Choice	
15.	Once the portfolio a. Rebalanced. b. Recycled c. Reinvested d. Monitored. e. Manipulated.	is constructed	, it must be contin	uously	
	ANS: D	PTS: 1	OBJ:	Multiple Choice	
16.	d. Returns compa e. Tax exempt inv	ital gains are tax al gains are tax vestments are risons should vestors prefer	taxable. table. attractive to indiv be made on an equ tax exempt invest		lities.
	ANS: A	PTS: 1	OBJ:	Multiple Choice	
17.				sold for more than its bas herited by the heirs of th	sis (the value of the asset e original owner).



a. Realized capital

	b. Incomec. Portfoliod. Nominale. Real			
	ANS: A	PTS: 1	OBJ: Multiple Choice	
18.	a. Except for ta investment reb. The only wayc. After adjustingd. An asset allo	eturns. y to maintain purchasing for taxes, long-term cation decision for a tax to common stocks may me.	eax-deferred accounts, annual tax payments increase power over time is to invest in bonds. onds consistently outperform stocks. able portfolio that does not include a substantial make it difficult for the portfolio to maintain real	
	ANS: D	PTS: 1	OBJ: Multiple Choice	
19.	a. Helps investob. Create a stan	nstrument to judge risk d b		
	ANS: D	PTS: 1	OBJ: Multiple Choice	
20.	allocation strateg a. 100% stocks b. 100% cash c. 30% cash, 50	y would be		et
	ANS: C	PTS: 1	OBJ: Multiple Choice	
21.	strategy would be a. 100% stocks b. 100% cash c. 30% cash, 50	e		ocation
	ANS: D	PTS: 1	OBJ: Multiple Choice	
22.	For an investor w strategy would be a. 100% stocks	e	years and higher risk tolerance, an appropriate asset a	llocation



- b. 30% cash, 50% bonds, and 20% stocks c. 10% cash, 30% bonds, and 60% stocks d. 50% bonds and 50% stocks e. 100% bonds ANS: A PTS: 1 OBJ: Multiple Choice 23. For an investor with a time horizon of 15 years and moderate risk tolerance, an appropriate asset allocation strategy would be a. 100% stocks b. 40% cash and 60% stocks c. 30% cash, 50% bonds, and 20% stocks d. 50% bonds, and 50% stocks e. 20% bonds, and 80% stocks ANS: E PTS: 1 OBJ: Multiple Choice 24. For an investor with a time horizon of 4 years and higher risk tolerance, an appropriate asset allocation strategy would be a. 100% cash b. 30% cash, 50% bonds, and 20% stocks c. 20% cash, 40% bonds, and 40% stocks d. 10% cash, 40% bonds, and 50% stocks e. 100% bonds ANS: C PTS: 1 OBJ: Multiple Choice 25. For an investor with a time horizon of 5 years and moderate risk tolerance, an appropriate asset allocation strategy would be a. 100% cash b. 30% cash, 50% bonds, and 20% stocks c. 20% cash, 40% bonds, and 40% stocks d. 10% cash, 30% bonds, and 60% stocks e. 100% bonds ANS: B PTS: 1 OBJ: Multiple Choice 26. John is 55 years old has \$55,000 outstanding on a mortgage and no other debt. John typically saves \$5,000 in an IRA account and another \$10,000 in a company pension. John is most likely in the: a. Discovery phase b. Accumulation phase
- - c. Consolidation phase
 - d. Spending phase
 - e. Gifting phase

ANS: C PTS: 1 OBJ: Multiple Choice

- 27. Which of the following is not a typical portfolio constraint?
 - a. Liquidity needs
 - b. Risk tolerance
 - c. Time horizon
 - d. Tax concerns



e. Legal factors

ANS: B PTS: 1 OBJ: Multiple Choice

- 28. Which of the following strategies seeks to increase the portfolio value by reinvesting current income in addition to capital gains?
 - a. Capital appreciation
 - b. Capital preservation
 - c. Return preservation
 - d. Current income
 - e. Total return

ANS: D PTS: 1 OBJ: Multiple Choice

- 29. Research from the 1970s to the 1990s found that over 90 percent of a fund's returns over time is explained by:
 - a. Market timing
 - b. Stock selection
 - c. Manager selection
 - d. Asset allocation
 - e. All of the above

ANS: D PTS: 1 OBJ: Multiple Choice

Exhibit 2.1
USE THE TAX TABLE PROVIDED BELOW FOR THE FOLLOWING PROBLEM(S)

	If Taxable In	come	Then	The Tax is		
	Is Over	But Not Over		This Amount	Plus This %	Of The Excess Over
Single	\$0	\$7,150		0	10%	0
	\$7,150	\$29,050		715	15%	\$7,150
	\$29,050	\$70,350		\$4,000	25%	\$29,050
	\$70,350	\$146,750		\$14,325	28%	\$70,350
	\$146,750	\$319,100	1	\$35,717	33%	\$146,750
	\$319,100	-	1	\$92,592.50	35%	\$319,100
			•			
Married	\$0	\$14,300		0	10%	0
Filing	\$14,300	\$58,100		1430	15%	\$14,300
Jointly	\$58,100	\$117,250		\$8,000	25%	\$58,100
	\$117,250	\$178,650		\$22,787.50	28%	\$117,250
	\$178,650	\$319,100	1	\$39,979.50	33%	\$178,650
	\$319,100	-		\$86,328	35%	\$319,100

- 30. Refer to Exhibit 2.1. What is the marginal tax rate for a single individual with taxable income of \$85,000?
 - a. 15%
 - b. 25%
 - c. 28%
 - d. 33%
 - e. 35%

ANS: C

Marginal tax rate = 28%

PTS: 1 OBJ: Multiple Choice Problem

- 31. Refer to Exhibit 2.1. What is the tax liability for a single individual with taxable income of \$85,000?
 - a. \$23,800
 - b. \$18,427
 - c. \$24,958
 - d. \$16,867
 - e. \$19,650

ANS: B

\$14,325 + 0.28(\$85,000 - \$70,350) = \$18,427 (tax bill)

PTS: 1 OBJ: Multiple Choice Problem

- 32. Refer to Exhibit 2.1. What is the average tax for a single individual with taxable income of \$85,000?
 - a. 13.57%
 - b. 15.68%
 - c. 21.68%
 - d. 25.74%
 - e. 29.55%

ANS: C

18,427/85,000 = 21.68% (average tax rate)

PTS: 1 OBJ: Multiple Choice Problem

- 33. Refer to Exhibit 2.1. What is the tax liability for a married couple filing jointly with taxable income of \$125,000?
 - a. \$23,800
 - b. \$18,427
 - c. \$24,958
 - d. \$16,867
 - e. \$19,650

ANS: C

22,787.50 + 0.28(125,000 - 117,250) = 24,958

PTS: 1 OBJ: Multiple Choice Problem

- 34. What would the equivalent taxable yield be on an investment that offers a 6 percent tax exempt yield? Assume a marginal tax rate of 28%.
 - a. 0.125%
 - b. 7.20%
 - c. 6.48%
 - d. 8.33%
 - e. 32.14%

ANS: D

Equivalent taxable yield = .06/(1 - .28) = .06/.72 = 8.33%

PTS: 1 OBJ: Multiple Choice Problem

- 35. What would the after-tax yield be on an investment that offers a 6 percent fully taxable yield? Assume a marginal tax rate of 31%.
 - a. 2.79%
 - b. 6.48%
 - c. 4.14%
 - d. 7.20%
 - e. 12.50%

ANS: C

After-tax yield = Before-tax yield (1 - Tax Rate) = 6%(1 - .31) = 4.14%

PTS: 1 OBJ: Multiple Choice Problem

- 36. The future value of \$50,000 invested today, at the end of 10 years assuming an interest rate of 7.5% per year, with semiannual compounding, is
 - a. \$104,407.60
 - b. \$103,051.58
 - c. \$123,510.52
 - d. \$210,673.43
 - e. \$105,117.46

ANS: A

 $FV = 50,000(1 + .0375)^{20} = $104,407.60$

PTS: 1 OBJ: Multiple Choice Problem

- 37. Assume that you invest \$750 at the end of each quarter for the next 20 years in a mutual fund. The annual rate of interest that you expect to earn in this account is 5.25%. The amount in the account at the end of 20 years is
 - a. \$60,000.00
 - b. \$105,039.84
 - c. \$37,009.35
 - d. \$123,510.52
 - e. \$115,637.37

ANS: B

$$FV = 750 \left(\frac{(1 + .013125)^{80} - 1}{.013125} \right) = $105,039.84$$

PTS: 1 OBJ: Multiple Choice Problem

- 38. Assume that you invest \$1250 at the end of each of the next 15 years in a mutual fund. You currently have \$10,000 in the mutual fund. The annual rate of interest that you expect to earn in this account is 4.35%. The amount in the account at the end of 15 years is
 - a. \$58,940.30
 - b. \$28,750.00



c. \$37,009.35

d. \$44,630.81

e. \$25,690.50

ANS: D

FV =
$$1250 \left(\frac{(1+.0435)^{15}-1}{.0435} \right) + 10,000(1+.0435)^{15} = $44,630.81$$

PTS: 1 OBJ: Multiple Choice Problem

39. Someone in the 15 percent tax bracket can earn 8 percent annually on his investments in a tax-exempt IRA account. What will be the value of a \$10,000 investment after 5 years (assuming annual compounding)?

a. \$6,805

b. \$14,693

c. \$15,528

d. \$20,114

e. \$50,000

ANS: B

$$FV = 10,000(1 + .08)^5 = $14,693$$

PTS: 1 OBJ: Multiple Choice Problem

40. Suppose the 8 percent investment of the previous problem is taxable rather than tax-deferred. What will be the after-tax value of his \$10,000 investment after 5 years (assuming annual compounding)?

a. \$10,680

b. \$11,765

c. \$13,895

d. \$14,693

e. \$15,528

ANS: C

After-tax yield = Before-tax yield
$$(1 - \text{Tax rate})$$

= $8\% (1 - .15) = 6.8\%$

$$10,000(1+0.068)^5 = 13,895$$

PTS: 1 OBJ: Multiple Choice Problem

41. An individual in the 36% tax bracket invests \$5,000 in a tax-exempt IRA. If the investment earns 10% annually, what will be the value of the IRA after five years?

a. \$6,600

b. \$6,818

c. \$7,500

d. \$8,053

e. \$10,879

ANS: D

The total amount is not adjusted for taxes or inflation.

$$FV = \$5,000(1 + 0.10)^5 = \$8,052.55$$

PTS: 1 OBJ: Multiple Choice Problem

- 42. An individual in the 15% tax bracket has \$10,000 invested in a tax-exempt IRA account. If the individual earns 8% annually before taxes and inflation is 2.5% per year, what is the real value of the investment in 20 years?
 - a. \$23,211
 - b. \$28,467
 - c. \$29,178
 - d. \$37,276
 - e. \$46,610

ANS: B

The annual real return adjusted for inflation is computed as follows:

$$(1.08)/(1.025) -1 = 5.37\%$$
.

$$FV = \$10,000(1 + 0.0537)^{20} = \$28,466.86$$

PTS: 1 OBJ: Multiple Choice Problem

- 43. An individual in the 36% tax bracket has \$20,000 invested in a tax-exempt account. If the individual earns 10% annually before taxes and inflation is 3.0% per year, what is the real value of the investment in 10 years?
 - a. \$31,000
 - b. \$33,200
 - c. \$38,614
 - d. \$39,343
 - e. \$47,823

ANS: C

The annual real return adjusted for inflation is computed as follows:

$$(1.10)/(1.03) - 1 = 6.8\%$$
.

$$FV = $20,000(1 + 0.068)^{10} = $38,613.80$$

PTS: 1 OBJ: Multiple Choice Problem

- 44. You currently have \$150,000 in an IRA designated for retirement. If you save an additional \$100 at the end of every month and expect to earn an annual return of 12%, how much do you expect to have in the IRA in 10 years?
 - a. \$467,632
 - b. \$518,062
 - c. \$732,546
 - d. \$949,328
 - e. \$1,215,234

ANS: B

FV =
$$100 \left(\frac{(1+.01)^{120}-1}{.01} \right) + 150,000(1+.01)^{120} = $518,061.90$$

PTS: 1 OBJ: Multiple Choice Problem