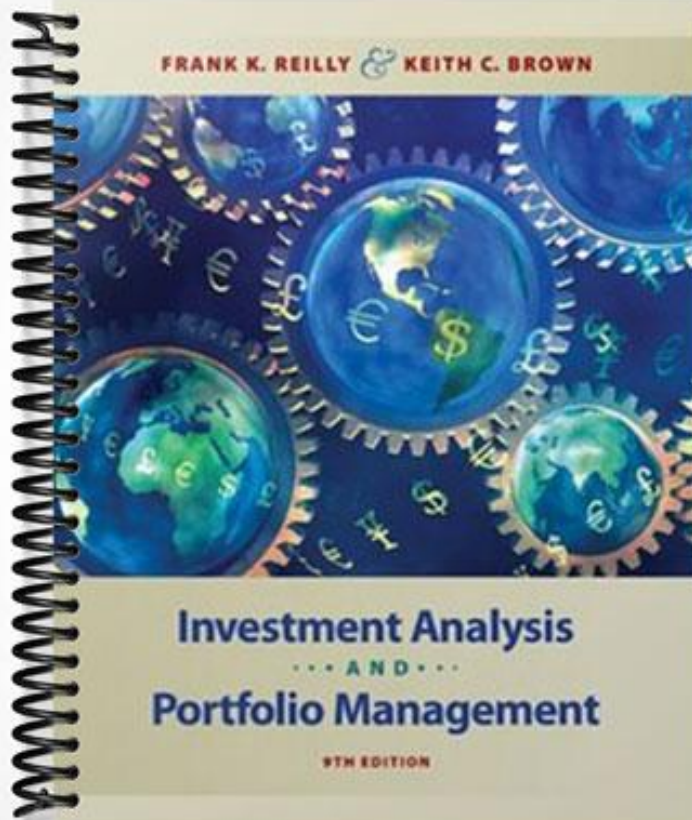


TEST BANK

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Investment Analysis ... AND ... Portfolio Management

9TH EDITION

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 PTS: 1
2. Term life insurance provides both a death benefit and a savings plan.
ANS: F PTS: 1
3. Most experts recommend a cash reserve of at least one year's worth of living expenses.
ANS: F PTS: 1
4. The spending phase occurs when investors are relatively young.
ANS: F PTS: 1
5. The gifting phase is similar to, and may be concurrent with, the spending phase.
ANS: T PTS: 1
6. Long-term, high-priority goals include some form of financial independence.
ANS: T PTS: 1
7. It is not a good idea to get too specific when constructing your policy statement.
ANS: F PTS: 1
8. Asset allocation is the process of dividing funds into different classes of assets.
ANS: T PTS: 1
9. The typical investor's goals rarely change during his/her lifetime.
ANS: F PTS: 1
10. Individual security selection is far more important than the asset allocation decision.
ANS: F PTS: 1
11. Return is the only important consideration when establishing investment objectives.
ANS: F PTS: 1
12. In constructing the portfolio, the manager should maximize the investor's risk level.

ANS: F PTS: 1

13. Risk tolerance is exclusively a function of an individual's psychological makeup.

ANS: F PTS: 1

14. An appropriate investment objective for a typical 25-year-old investor is a low-risk strategy, such as capital preservation 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 defined as total tax payment divided by total income.

ANS: T PTS: 1

17. The regular IRA, when compared to the Roth IRA, will consistently give an investor more after tax dollars at the end of an assumed 20-year time horizon.

ANS: F PTS: 1

18. The portfolio mixes of institutional investors around the world are approximately the same.

ANS: F PTS: 1

19. The ability to retire at a certain age is a typical example of a long-term, lower-priority goal.

ANS: F PTS: 1

20. It is essential that both the client and the portfolio manager agree on an appropriate benchmark portfolio.

ANS: T PTS: 1

21. An example of a unique need in an investment policy statement is related to the legal responsibilities of a fiduciary or trustee.

ANS: F PTS: 1

22. Equity allocations of pension funds in Japan and Germany are similar to those in the United States.

ANS: F PTS: 1

MULTIPLE CHOICE

1. The current outlay of money to guard against a potentially large future loss is commonly known as
- Asset management.
 - Portfolio management.

- c. Minimizing risk.
- d. Loss control.
- e. Insurance.

ANS: E PTS: 1

2. In an investment policy statement the objectives of an investor are expressed in terms of
- a. risk and return
 - b. risk
 - c. return
 - d. time horizon
 - e. liquidity needs

ANS: A PTS: 1

3. ____ phase is the stage when investors in their early-to-middle earning years attempt to accumulate assets to satisfy near-term needs, e.g., children's education or down payment on a home.
- a. Accumulation
 - b. Spending
 - c. Gifting
 - d. Consolidation
 - e. Divestiture

ANS: A PTS: 1

4. Which of the following is **not** a life cycle phase?
- a. Discovery phase
 - b. Accumulation phase
 - c. Consolidation phase
 - d. Spending phase
 - e. Gifting phase

ANS: A PTS: 1

5. Which of the following is **not** a step in the portfolio management process?
- a. Develop a policy statement.
 - b. Study current financial and economic conditions.
 - c. Construct the portfolio.
 - d. Monitor investor's needs and market conditions.
 - e. Sell all assets and reinvestment proceeds at least once a year.

ANS: E PTS: 1

6. The first step in the investment process is the development of a(n)
- a. Objective statement.
 - b. Policy statement.
 - c. Financial statement.
 - d. Statement of cash needs.
 - e. Statement of cash flows.

ANS: B PTS: 1

7. Which of the following is **not** considered to be an investment objective?
- a. Capital preservation

- b. Capital appreciation
- c. Current income
- d. Total return
- e. None of the above (that is, all are considered investment objectives)

ANS: E PTS: 1

8. ____ must be stated in terms of expected returns and risk. An investor's tolerance for risk must be established before returns objectives can be stated.
- a. Investment requirements
 - b. Investment constraints
 - c. Investment rewards
 - d. Investment objectives
 - e. Investment policy

ANS: D PTS: 1

9. ____ is an appropriate objective for investors who want their portfolio to grow in real terms, i.e., exceed the rate of inflation.
- a. Capital preservation
 - b. Capital appreciation
 - c. Portfolio growth
 - d. Value additivity
 - e. Nominal preservation

ANS: B PTS: 1

10. ____ refer(s) to the ability to convert assets to cash quickly and at a fair market price and often increase(s) as one approaches the later stages of the investment life cycle.
- a. Liquidity needs
 - b. Time horizons
 - c. Liquidation values
 - d. Liquidation essentials
 - e. Capital liquidations

ANS: A PTS: 1

11. The policy statement may include a ____ against which a portfolio's or portfolio manager's performance can be measured.
- a. Milestone
 - b. Benchmark
 - c. Landmark
 - d. Reference point
 - e. Market pair

ANS: B PTS: 1

12. Asset allocation is
- a. The process of dividing funds into asset classes.
 - b. Concerned with returns variability.
 - c. Concerned with the risk associated with different assets.
 - d. Concerned with the relationship among investments' returns.
 - e. All of the above.

ANS: E PTS: 1

13. The asset allocation decision must involve a consideration of
- Cultural differences.
 - The objectives stated in the investor's policy statement.
 - The types of assets that are appropriate for the investor.
 - The risk associated with different investments.
 - All of the above.

ANS: E PTS: 1

14. Research has shown that the asset allocation decision explains ____% of the variation in fund returns across all funds, and ____% of the variation in returns for a particular fund over time.
- 90 and 100.
 - 100 and 40.
 - 90 and 40.
 - 40 and 100.
 - 40 and 90.

ANS: E PTS: 1

15. Once the portfolio is constructed, it must be continuously
- Rebalanced.
 - Recycled
 - Reinvested
 - Monitored.
 - Manipulated.

ANS: D PTS: 1

16. Which of the following statements is **false**?
- Unrealized capital gains are taxable.
 - Realized capital gains are taxable.
 - Tax-exempt investments are attractive to individuals with high tax liabilities.
 - Returns comparisons should be made on an equivalent tax basis.
 - Tax exempt investors prefer tax exempt investments.

ANS: A PTS: 1

17. ____ gains are taxable and occur when an asset is sold for more than its basis (the value of the asset when it was purchased by the original owner, or inherited by the heirs of the original owner).
- Realized capital
 - Income
 - Portfolio
 - Nominal
 - Real

ANS: A PTS: 1

18. Which of the following statements is true?
- Except for tax-exempt investors and tax-deferred accounts, annual tax payments increase investment returns.
 - The only way to maintain purchasing power over time is to invest in bonds.

- c. After adjusting for taxes, long-term bonds consistently outperform stocks.
- d. An asset allocation decision for a taxable portfolio that does not include a substantial commitment to common stocks may make it difficult for the portfolio to maintain real value over time.
- e. None of the above

ANS: D PTS: 1

19. Important reasons for constructing a policy statement include:
- a. Helps investors decide on realistic investment goals
 - b. Create a standard by which to judge the performance of the portfolio manager
 - c. Develop an instrument to judge risk
 - d. Choices a and b
 - e. All of the above

ANS: D PTS: 1

20. For an investor with a time horizon of 6 to 10 years and lower risk tolerance, an appropriate asset allocation strategy would be
- a. 100% stocks
 - b. 100% cash
 - c. 30% cash, 50% bonds, and 20% stocks
 - d. 10% cash, 30% bonds, and 60% stocks
 - e. 100% bonds

ANS: C PTS: 1

21. For an investor with a time horizon of 6 to 10 years and higher risk tolerance, an appropriate asset allocation strategy would be
- a. 100% stocks
 - b. 100% cash
 - c. 30% cash, 50% bonds, and 20% stocks
 - d. 10% cash, 30% bonds, and 60% stocks
 - e. 100% bonds

ANS: D PTS: 1

22. John is 55 years old has \$55,000 outstanding on a mortgage and no other debt. John typically saves \$5,000 in a Roth 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

23. 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

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

ANS: D PTS: 1

25. A 25 year old individual with \$10,000 invested in a Roth IRA and an average risk tolerance should be concerned about:
- taxes, and should invest 70% in equities and 30% in bonds.
 - taxes, and should invest 30% in equities and 70% in bonds.
 - inflation, and should invest 70% in equities and 30% in bonds.
 - inflation, and should invest 30% in equities and 70% in bonds.
 - taxes and inflation.

ANS: C PTS: 1

NARRBEGIN: Exhibit 02-01

Exhibit 2-1

USE THE TAX TABLE PROVIDED BELOW TO ANSWER THE NEXT PROBLEM(S)

	If Taxable Income		Then	The Tax is		
	Is Over	But Not Over		This Amount	Plus This %	
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		\$35,717	33%	\$146,750
	\$319,100	-		\$92,592.50	35%	\$319,100
Married Filing Jointly	\$0	\$14,300		0	10%	0
	\$14,300	\$58,100		1430	15%	\$14,300
	\$58,100	\$117,250		\$8,000	25%	\$58,100
	\$117,250	\$178,650		\$22,787.50	28%	\$117,250
	\$178,650	\$319,100		\$39,979.50	33%	\$178,650
	\$319,100	-		\$86,328	35%	\$319,100

NARREND

26. Refer to Exhibit 2-1. What is the marginal tax rate for a single individual with taxable income of \$85,000?
- 15%
 - 25%

- c. 28%
- d. 33%
- e. 35%

ANS: C

Marginal tax rate = 28%

PTS: 1

OBJ: Multiple Choice Problems

NAR: Exhibit 02-01

27. 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 Problems

NAR: Exhibit 02-01

28. 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 Problems

NAR: Exhibit 02-01

29. 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 Problems

NAR: Exhibit 02-01

30. 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 Problems

31. 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%.
- 2.79%
 - 6.48%
 - 4.14%
 - 7.20%
 - 12.50%

ANS: C

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

PTS: 1 OBJ: Multiple Choice Problems

32. 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
- \$104,407.60
 - \$103,051.58
 - \$123,510.52
 - \$210,673.43
 - \$105,117.46

ANS: A

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

PTS: 1 OBJ: Multiple Choice Problems

33. 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 the this account is 5.25%. The amount in the account at the end of 20 years is
- \$60,000.00
 - \$105,039.84
 - \$37,009.35
 - \$123,510.52
 - \$115,637.37

ANS: B

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

PTS: 1 OBJ: Multiple Choice Problems

34. 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
- \$58,940.30
 - \$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 Problems

35. 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 Problems

36. Someone in the 15 percent tax bracket can earn 8 percent annually on his investments in a taxable IRA account. 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

$$\begin{aligned} \text{After-tax yield} &= \text{Before-tax yield} (1 - \text{Tax rate}) \\ &= 8\% (1 - .15) = 6.8\% \end{aligned}$$

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

PTS: 1 OBJ: Multiple Choice Problems

NARRBEGIN: Exhibit 02-02

Exhibit 2-2

USE THE FOLLOWING INFORMATION FOR THE NEXT PROBLEM(S)

As part of a retirement planning exercise, you are comparing a regular IRA with a Roth IRA. The regular IRA contribution is tax deductible. In both cases the contribution amount is \$3,000. Your time horizon is 30 years and you expect to earn 7% percent per year on both types of IRA accounts. Your current tax rate is 25% but you expect you tax rate at retirement to be 15%.

NARREND

37. Refer to Exhibit 2-2. Calculate the tax savings generated by the regular IRA at the time of investment.
- \$300
 - \$750
 - \$700
 - \$100
 - \$200

ANS: B

Tax savings on regular IRA = $(3000)(0.25) = \$750$.

PTS: 1

OBJ: Multiple Choice Problems

NAR: Exhibit 02-02

38. Refer to Exhibit 2-2. Calculate the future value, at the end of 25 years, of the tax savings.
- \$2,900.51
 - \$3,867.35
 - \$3,481.16
 - \$1,248.35
 - \$4,369.23

ANS: C

FV of tax savings = $\$750(1 + 0.0525)^{30} = \$3,481.16$

$0.07(1 - 0.25) = 0.0525$

PTS: 1

OBJ: Multiple Choice Problems

NAR: Exhibit 02-02

39. Refer to Exhibit 2-2. Calculate the total after tax future value, at the end of 25 years, of the regular IRA contribution and the tax savings.
- \$22,836.77
 - \$21,833.43
 - \$22,892.41
 - \$26,317.93
 - \$19,411.25

ANS: C

Pre tax FV of regular IRA contribution = $3000(1 + 0.07)^{30} = \$22,836.77$

After tax FV of regular IRA = $\$22,836.77(1 - 0.15) = \$19,411.25$

FV of tax savings = $750(1 + 0.0525)^{30} = \$3,481.16$

Total after tax = $\$22,892.41$

PTS: 1

OBJ: Multiple Choice Problems

NAR: Exhibit 02-02

40. Refer to Exhibit 2-2. Calculate the total after tax future value, at the end of 25 years, of the Roth IRA contribution.
- \$22,836.77
 - \$21,833.43
 - \$22,892.41
 - \$26,317.93
 - \$19,411.25

ANS: A

After tax FV of Roth IRA contribution = $3000(1 + 0.07)^{30} = \$22,836.77$

PTS: 1

OBJ: Multiple Choice Problems

NAR: Exhibit 02-02

41. An individual in the 36% tax bracket invests \$5,000 in a Roth IRA. If the investment earns 10% annually, what will be the value of the Roth IRA after five years?
- \$6,600
 - \$6,818
 - \$7,500
 - \$8,053
 - \$10,879

ANS: D

A Roth IRA is tax-exempt. Thus, the return is not adjusted for taxes.

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

PTS: 1

OBJ: Multiple Choice Problems

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?
- \$23,211
 - \$28,467
 - \$29,178
 - \$37,276
 - \$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 Problems

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?
- \$31,000
 - \$33,200
 - \$38,614
 - \$39,343
 - \$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 Problems