



Subject: PTSA

Chapter: Unit-2

Category: Practice Questions

1. Marie Gascon is so pleased with the services provided by her financial adviser that she suggests to her brother Jacques that he should also consult the adviser. Jacques thinks it is a good idea. Jacques, a self-employed computer consultant also based in Paris, is 40 years old and divorced with four children, aged between 12 and 16. The financial adviser notes the following aspects of Jacques' situation:
- Jacques' consultancy earnings average €40,000 per annum but are quite volatile.
 - Jacques is required to pay €10,000 per year to his ex-wife and children.
 - Jacques has a mortgage on his apartment of €100,000 and €10,000 of savings.
 - Jacques has a good knowledge of financial matters and expects that equity markets will deliver very high returns over the long term.
 - In the risk tolerance questionnaire, Jacques strongly disagrees with the statements "I am more comfortable putting my money in a bank account than in the stock market" and "When I think of the word 'risk', the term 'loss' comes to mind immediately."
 - Jacques expects that most of his savings will be required to support his children at university.

Based only on the information given, which statement is correct?

- A. Jacques has a low ability to take risk but a high willingness to take risk.
 B. Jacques has a high ability to take risk but a low willingness to take risk.
 C. Jacques has a high ability to take risk and a high willingness to take risk.

2. A European charity has an asset allocation at the beginning of the year consisting of the asset classes and weights shown in table below:

Exhibit 11 Asset Allocation of a European Charity (beginning of year)

Asset Class	Policy Weight	Corridor (+/-)	Upper Limit	Lower Limit
European equities	30.0%	2.0%	32.0%	28.0%
International equities	15.0%	2.0%	17.0%	13.0%
European government bonds	20.0%	2.0%	22.0%	18.0%
Corporate bonds	20.0%	2.0%	22.0%	18.0%
Cash and money market instruments	15.0%	2.0%	17.0%	13.0%
Total	100.0%			

As table of Exhibit 11 above reveals, the charity has a policy that the asset class weights cannot deviate from the policy weights by more than 2% (the corridor). The resulting upper and lower limits for the asset class weights are shown in the rightmost columns of the table. There are two reasons

for asset class actual weights to deviate from policy weights: by deliberate choice (tactical asset allocation or market timing) and as a result of divergence of the returns of the different asset classes (drift). In this example, the asset class weights start the year exactly in line with policy weights. After half a year, the investment portfolio is as shown in Exhibit 12 table below:

Asset Class	Policy Weight	Corridor (+/-)	Upper Limit	Lower Limit	Period Return	Ending Weight
European equities	30.0%	2.0%	32.0%	28.0%	15.0%	32.4%
International equities	15.0%	2.0%	17.0%	13.0%	10.0%	15.5%
European government bonds	20.0%	2.0%	22.0%	18.0%	0.5%	18.9%
Corporate bonds	20.0%	2.0%	22.0%	18.0%	1.5%	19.1%
Cash and money market instruments	15.0%	2.0%	17.0%	13.0%	1.0%	14.2%
Total	100.0%				6.6%	100.0%

a. Discuss the returns of the portfolio and comment on the main asset weight changes.

The investment committee decides against reducing European equities back to policy weight and adding to the fixed income and cash investments toward policy weights. Although this rebalancing would be prudent, the committee decides to engage in tactical asset allocation based on the view that this market will continue to be strong over the course of the year. It decides to just bring European equities back to within its bandwidth (a 32% portfolio weight) and add the proceeds to cash. Exhibit 13 shows the outcome after another half year.

Exhibit 13 Asset Allocation for a European Charity (an additional six months later)

Asset Class	Policy Weight	Starting Weight	Corridor (+/-)	Upper Limit	Lower Limit	Period Return	Ending Weight
European equities	30.0%	32.0%	2.0%	32.0%	28.0%	-9.0%	29.7%
International equities	15.0%	15.5%	2.0%	17.0%	13.0%	-6.0%	14.9%
European government bonds	20.0%	18.9%	2.0%	22.0%	18.0%	4.0%	20.0%
Corporate bonds	20.0%	19.1%	2.0%	22.0%	18.0%	4.0%	20.2%
Cash and money market instruments	15.0%	14.6%	2.0%	17.0%	13.0%	2.0%	15.2%
Total	100.0%					-2.0%	100.0%

The prior decision not to rebalance to policy weights did not have a positive result. Contrary to the investment committee's expectations, both European and international equities performed poorly while bonds recovered. The return of the portfolio was -2.0%.

- b. How much of this return can be attributed to tactical asset allocation?
3. Which of the following is best characterized as a relative risk objective?
 - A. Value at risk for the fund will not exceed US\$3 million.
 - B. The fund will not underperform the DAX by more than 250 basis points.
 - C. The fund will not lose more than €2.5 million in the coming 12- month period.
4. In preparing an investment policy statement, which of the following is most difficult to quantify?
 - A. Time horizon.
 - B. Ability to accept risk.
 - C. Willingness to accept risk.

5. After interviewing a client in order to prepare a written investment policy statement (IPS), you have established the following:

- The client has earnings that vary dramatically between £30,000 and £70,000 (pre- tax) depending on weather patterns in Britain.
- In three of the previous five years, the after- tax income of the client has been less than £20,000.
- The client's mother is dependent on her son (the client) for approximately £9,000 per year support.
- The client's own subsistence needs are approximately £12,000 per year.
- The client has more than 10 years' experience trading investments including commodity futures, stock options, and selling stock short.
- The client's responses to a standard risk assessment questionnaire suggest he has above average risk tolerance.

The client is best described as having a:

- A. low ability to take risk, but a high willingness to take risk.
- B. high ability to take risk, but a low willingness to take risk.
- C. high ability to take risk and a high willingness to take risk.

6. After interviewing a client in order to prepare a written investment policy statement (IPS), you have established the following:

The client has earnings that have exceeded €120,000 (pre- tax) each year for the past five years. She has no dependents.

The client's subsistence needs are approximately €45,000 per year.

The client states that she feels uncomfortable with her lack of understanding of securities markets.

All of the client's current savings are invested in short- term securities guaranteed by an agency of her national government.

The client's responses to a standard risk assessment questionnaire suggest she has low risk tolerance.

The client is best described as having a:

- A. low ability to take risk, but a high willingness to take risk.
- B. high ability to take risk, but a low willingness to take risk.
- C. high ability to take risk and a high willingness to take risk.

7. A client who is a 34 - year old widow with two healthy young children (aged 5 and 7) has asked you to help her form an investment policy statement. She has been employed as an administrative assistant in a bureau of her national government for the previous 12 years. She has two primary financial goals—her

retirement and providing for the college education of her children. This client's time horizon is best described as being:

- A. long term.
- B. short term.
- C. medium term.

8. Tactical asset allocation is best described as:

- A. attempts to exploit arbitrage possibilities among asset classes.
- B. the decision to deliberately deviate from the policy portfolio.
- C. selecting asset classes with the desired exposures to sources of systematic risk in an investment portfolio.

9. Toby is a professional who has been approached by a client to form a portfolio for them. Before giving the project to Toby, the client wants to know Toby's approach. Assuming you are Toby, list down the steps you will follow in managing a portfolio. Also, briefly explain the top down and bottom up approach for asset allocation.

10. You are a portfolio manager at an asset management company. You are being given a choice: to manage an open-end or a closed-end fund. Considering and listing the advantages and disadvantages of both, discuss which fund you would choose.