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Financial

CFA Level I Chartered Financial Analyst Level III

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QUESTION: 1

HAS FOUR PARTS FOR A TOTAL OF 32 MINUTES

Ernie Marks, 62, is the owner of a regional construction company. Marks started the company when he was 20 years old, after receiving his grandfather's old pickup truck as a birthday gift. Through conservative management and judicious use of bank debt, Marks was able to build the company to over 150 employees. The company is debt-free and generates all required operating funds from internal operations. Marks' wife, Ellie, does not work and they have two children. Their daughter Allison, 28, suffers from a debilitating illness and requires constant attention. Their son Ernie Jr., 26, is in good health and graduated in the top 5% of his class at a prestigious New England liberal arts university. Marks wants to retire at 65 and wants Ernie Jr. to succeed him in running the company, but all efforts to train his son for succession have failed. Marks has just sold the company to a national construction concern for cash. The after-tax proceeds from the sale plus the Marks' current investment portfolio total $5 million. The only requirement of the sale agreement is that Marks remain at the firm until he reaches 65, at which time he will retire and have no further obligations to the company. Marks is seeking financial advice from Christopher Weber, CFA. In their first meeting, Marks makes the following statements:

• "Ellie and I owe nothing on the home in which we have lived for the past 30 years and we do not plan to move. The new owners of the company will pay me $150,000 next year, and that amount will grow at the general rate of inflation until I retire. They will provide medical benefits for Ellie and me for life, but I will not participate in their retirement plan."

• "I would prefer that the portfolio not lose more than 2% of its value in any one year. Since my bank account is earning only 1.5%, however, I realize that my portfolio may require some risk exposure."

• "Ellie and I estimate our personal living expenses will be $100,000 in the coming year, and I agree with you that they will probably grow at the general rate of inflation of 2% per year thereafter. My accountant indicates I will have a 33% average tax rate."

• "We have decided that Ellie can no longer care for Allison as in the past. Had Ellie not helped care for Allison over the past year, we estimate the total cost would have been $100,000, and there would have been no associated tax breaks. Given that a large portion of this cost was medical, I would expect the cost of her care to increase at a rate of approximately 5% annually. It is our intention to provide for Allison's care as long as she lives."

• "Ernie Jr.'s 'free spirit' has essentially made him unemployable, so I want to provide him with a stipend of $50,000 per year with the first $50,000 paid in the coming year. I would also like the stipend to increase annually at the general rate of inflation. When Ellie and I have both passed away, the stipend will stop and Ernie Jr. is to receive a lump-sum payment equal to 50% of our estate. The remainder of the estate will go to charities that I will designate later."

A. Formulate the Marks' risk objective. Calculate the after-tax nominal rate of return that is required to meet all expenses for the coming year. Show your calculations.

Answer Question 1-A in the template provided.

Template for Question 1-A

Investment Policy Statement for the Marks	
Risk Objective	
Return Objective	

B. Construct the constraints portion of an investment policy statement for the Marks. Justify each response with one reason. Answer Question 1-B in the template provided.

Template for Question 1-B

Time Horizon	
Liquidity	
Legal/ Regulatory	
Tax	
Unique Circumstances	

A recent analysis of market expectations has crossed Knight's desk, and she has formulated alternatives for allocating the assets from the sale proceeds.
B. T-bill rates are 2%, and the characteristics of four alternative portfolio allocations are provided in the following table.
C. Calculate Roy's Safety-First ratio for the above portfolios and explain the information provided by the ratio.
D. Recommend and justify one of the portfolios in the table.

Asset Classes	Portfolios			
A	B	C	D	
U.S stocks	50%	40%	20%	30%
Non-U.S. stocks	25%	20%	10%	0%
U.S. corporate bonds	10%	20%	30%	35%
Cash and equivalents	5%	10%	20%	10%
Real estate (REITs)	0%	5%	10%	10%
U.S. Treasurybills	10%	5%	10%	15%
After-tax income yield	2.0%	2.85%	4.30%	3.90%
Expected Sharpe ratio	0.46	0.60	0.75	0.88
After-tax expected return	8%	7.2%	6.3%	5.2%

QUESTION: 2

HAS TWO PARTS FOR A TOTAL OF 30 MINUTES Universal Insurance Company is an insurance mega-store selling life, property, and casualty insurance policies in all fifty states. The life insurance subsidiary sells products under the UniLife label, and the property and casualty subsidiary sells policies under the Un1PC label. UniLife's total assets are approximately $10 billion, which results in a surplus of $1 billion. As with most life insurance companies, UniLife's asset portfolio is segmented to cover the products sold and to achieve surplus growth to expand business. The segmentation of portfolio assets is a direct result of the increased competition in the life insurance industry and represents an attempt by UniLife to maintain an acceptable spread over their crediting rate of 5% and to more effectively price its products. Total expenses associated with business operations average 2% of assets. UniLife segments its asset base into three main asset classes: short-term/cash-like, long-term fixed-income, and equity instruments. The continued low interest rate environment, as well as improvement in equity markets, has strengthened the quality of UniLife's asset base. The following are statements made during a recent conversation by UniLife 's management regarding the portfolio segments:

• "The main purpose of the short-term portfolio is to meet the liquidity requirements of our life insurance and annuity products. Hence, we expect this segment to be invested in assets exceeding or equivalent in safety to 90-day high-grade corporate commercial instruments. The improvement in overall quality of corporate paper has been encouraging."

• "The purpose of our long-term, fixed-income portfolio is to generate sufficient total returns that not only cover the crediting rate, but add to our net interest margin. Investment grade corporate (i.e., rated at least Al) with maturities ranging from 10—20 years are representative assets for this portfolio segment. Again, the improvement of corporate issues is encouraging."

• "The stock portfolio segment exists to provide longer-term growth in company surplus in the hopes of not only improving our financial condition, but also to better meet competitive pricing objectives. The majority of state regulations allow for ample investments in mid- to large-cap domestic equities, but only a small proportion (less than 5%) in international securities. Hence, the equity portfolio should generate returns exceeding the appropriate mid-to-large cap equity indexes such as the S&P MidCap or S&P 500 indexes. The equity market trend has also been positive."

A. Construct the risk and return objectives portion of an investment policy statement for UniLife's portfolio segments. Answer Question 2-A in the template provided.

Template for Question Part 2-A

Investment Policy Statement for UniLife Portfolio Segments	
Objectives	**Return Objectives** Short-term portfolio: Long-term bond portfolio: Stock portfolio:
	Risk Tolerance Short-term portfolio: Long-term bond portfolio: Stock portfolio:
	Risk Tolerance Short-term portfolio: Long-term bond portfolio: Stock portfolio:

B. Construct the constraints portion of the investment policy statement for UniLife. Address the time horizon, liquidity, legal/regulatory, tax, and unique circumstances constraints. Address the time horizon and liquidity constraints for each of UniLife's portfolio segments.

Answer Question 2-B in the template provided.

Template for Question 2-B

Template for Question 2-B

Constraints	**Time Horizon** Short-term portfolio: Long-term portfolio: Stock portfolio:
	Liquidity Short-term portfolio: Long-term portfolio: Stock portfolio:
	Legal/regulatory:
	Taxes:
	Unique considerations:

QUESTION: 3

HAS ONE PART FOR A TOTAL OF 9 MINUTES Bernard Parker, CFA, is a portfolio manager at Net Worth Enhancers. Recently, Parker attended a conference on the outlook for investments over the next decade. During the conference, he heard the following comments:

• "Pension plan participants currently have 90% of their investments in traditional asset classes. Our portfolio management firm has had difficulty getting investors to consider the non-traditional investments that are available through newly introduced exchange traded funds."

• “Despite the recent increase in the CBOE volatility index (VIX) and increasing credit spreads, I have not increased the expected risk premium for stock investments beyond the 4.5% 1 forecasted earlier this year.”
• “The recent bubble in technology stock prices resulted in stock valuations not justifiable by even the most optimistic fundamental analysis. However, it was difficult to exploit the stocks’ mispricing because individual investors kept bidding up prices based on their perceptions of the trading of other investors.” Identify the behavioral concept that is best described in each statement. Briefly describe each concept.
Answer Question 3 in the template provided.
Template for Question 3

Comment	Identify the behavioral concept		Briefly describe the behavioral concept
“Pension plan participants currently have 90% of their investments in traditional asset classes. Our portfolio management firm has had difficulty getting investors to consider the non-traditional investments that are available through newly introduced exchange traded funds.”			
“Despite the recent increase in the CBOE volatility index (VIX) and increasing credit spreads, I have not increased the expected risk premium for stock investments beyond the 4.5% 1 forecasted earlier this year.”			
“The recent bubble in technology stock prices resulted in stock valuations not justifiable by even the most optimistic fundamental analysis. However, it was difficult to exploit the stocks’ mispricing because individual investors kept bidding up prices as they expected the trend to continue.”			

QUESTION: 4
HAS ONE PART FOR A TOTAL OF 12 MINUTES Margaret Knight, CFA, is convinced that reporting portfolio performance according to the Global Investment Performance Standards (GIPS®) will provide her firm a competitive edge in the marketplace. After reading the latest information on the Standards, Knight formulates the following statements as a
• guide for how she will approach implementation of GIPS at her firm.
• “All composites will have the same beginning and ending annual dates. We will apply accrual accounting to all interest generated by the bonds in our portfolios. Until 2010 we will calculate time-weighted portfolio returns that approximate the effect of daily cash flows. All discretionary, fee-paying portfolios will be included in at least one composite and composites will be defined according to investment strategy andlor objectives.”

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and many others.. See complete list Here