Question #1 of 16

Question ID: 1875245

Which of the following securities is *most likely* to offer the lowest return for the investor?

A) A 3-year corporate bond. ✗

B) A 90-day government bill. ✓

C) An equity classified as "large cap." ✗

Explanation

Bonds are generally seen as having less risk than equities, so they are expected to offer lower returns than equities.

Government debt is seen as having lower risk than corporate debt and is, therefore, expected to offer lower returns. Additionally, shorter-term bonds tend to have less risk—and so, lower return—than longer-term bonds.

(Module 2.2, LOS 2.a)

Question #2 of 16

Question ID: 1875241

An investor purchases a 30-day US Treasury bill with a face value of $1,000 for $992. The annualized risk-free rate implied by this price (assuming a 365-day year) is *closest* to:

A) 9.81%. ✗

B) 10.27%. ✓

C) 10.18%. ✗

Explanation

The total return over the 30-day holding period is ($1,000 – $992) / $992 = 0.8065%. This then needs to be annualized: $1.008065^{365/30} - 1 = 10.27\%$.

The rate of 10.18% is incorrect as it uses the face value in the denominator, rather than the purchase price: ($1,000 – $992) / $1,000 = 0.80%. Annualized, this return is $1.008^{365/30} - 1 = 10.18\%$.

The rate of 9.81% is incorrect because it multiplies the holding period return by 365/30 rather than raising it to the power, eliminating the impact of compounding: 0.8065% × 365/30 = 9.81%.

(Module 2.1, LOS 2.a)

Question #3 of 16

Question ID: 1875238

Which of the following *most accurately* characterizes the typical return earned on traditional fixed-income securities?

A) A high proportion of the return earned from the price return, with a lower proportion from fixed coupons. ✗

B) Equal proportions of the return earned from fixed periodic coupons and price return. ✗

C) A high proportion of the return earned from fixed coupons, with a lower proportion from price return. ✓

Explanation

Fixed-income securities (i.e., bonds) typically derive most of their return from their capital distribution, referred to as coupon interest. Coupons are fixed for most bonds. While a bond's price may change in the market during the investor's holding period—which can lead to some price return—this is generally a much lower proportion of the total return of the bond.

(Module 2.1, LOS 2.a)

Question #4 of 16

Question ID: 1875246

Which of the following risks is *most accurately* classified as a systematic risk factor?

A) Business risk. ✗

B) Inflation risk. ✓

C) Credit risk. ✗

Explanation

Systematic risks, also known as macro risks, affect all investments to some degree and cannot be diversified away. Inflation risk, interest rate risk, and market risk are all examples of systematic risk factors. Business risk and credit risk are both examples of unsystematic or micro risks.

(Module 2.2, LOS 2.a)

Question #5 of 16

Question ID: 1875244

For developed markets, which of the following orders *most accurately* reflects the expected order of securities classes, from lowest expected return to highest expected return?

A) Government bonds, corporate bonds, large-capitalization equities. ✓

B) Large-capitalization equities, government bonds, small-capitalization equities. ✗

C) Corporate bonds, small-capitalization equities, large-capitalization equities. ✗

Explanation

Long-term expectations are that bonds generate lower returns than equities because bonds have lower risk.

Within fixed-income securities, government bonds are lower risk and lower return than corporate bonds.

Within equities, small-capitalization equities tend to demand a higher return than low-capitalization equities. The order for all four securities mentioned in the question should, therefore, be government bonds, corporate bonds, large-capitalization equities, and small-capitalization equities.

(Module 2.2, LOS 2.a)

Question #6 of 16

Question ID: 1875240

A financial instrument that has some of the risk and return characteristics of both equity and debt is *best* classified as a:

A) hybrid asset. ✓

B) derivative contract. ✗

C) non-interest-bearing deposit. ✗

Explanation

Hybrid financial assets, such as convertible bonds or preferred stock, offer an investment which has some characteristics of bonds (e.g., fixed capital distributions), and some characteristics of equity (e.g., the option to convert the bond or preferred stock into common stock at a later date). Non-interest-bearing deposits are classified as cash. Derivatives are financial instruments that derive their value from the performance of a specified underlying asset.

(Module 2.1, LOS 2.a)

Question #7 of 16

Question ID: 1875239

Cash is *most accurately* described as a financial asset that:

A) provides no return.

B) earns a capital distribution return in the form of interest.

C) increases in value in line with inflation.

Explanation

Cash, as we define it here, includes notes, coins, and non-interest-bearing deposits, which are assumed not to earn any form of return. Cash does not increase in value in line with inflation; its purchasing power decreases as prices increase.

(Module 2.1, LOS 2.a)

Question #8 of 16

Question ID: 1875237

When evaluating returns on equity investments, the largest proportion of total return *most likely* comes from:

A) the performance of an underlying reference asset to which the stock is linked.

B) fixed capital distributions mandated by the terms of the stock issuance.

C) price return driven by changes in the company's earnings potential.

Explanation

Equity returns largely come from movements in the stock price, due to factors affecting the company's earnings capability. While stocks can make capital distributions in the form of dividends, these are typically not fixed or mandated at the point of stock issuance. Derivatives, not equities, derive their total return from the performance of an underlying reference asset.

(Module 2.1, LOS 2.a)

Question #9 of 16

Question ID: 1875236

Total return is *most accurately* described as the:

A) annualized percentage increase in price of the financial asset. ✗

B) sum of capital appreciation return and capital distribution return. ✓

C) realized return an investor receives over the reporting period. ✗

Explanation

For financial assets, total return = capital appreciation return + capital distribution return. Capital appreciation return is the movement in price of the asset, and capital distribution return results from cash flows distributed, such as dividends or interest.

Capital distributions are realized returns, but capital appreciation returns could be realized or unrealized depending on whether the investor still holds the financial asset at the end of the reporting period.

The annualized percentage increase in price of financial assets is the capital appreciation return (also known as price return) over one year, but it does not include capital distribution return.

(Module 2.1, LOS 2.a)

Question #10 of 16

Question ID: 1875248

The risk that a debt issuer may not be able to meet debt payments as they fall due is *most accurately* described as:

A) interest rate risk. ✗

B) credit risk. ✓

C) business risk. ✗

Explanation

Credit risk is the risk that an entity cannot meet debt payments (such as interest or repayment of principal) when they fall due.

Interest rate risk is the risk that rising prices erode the real return of investors.

Business risk relates to the volatility of earnings of the issuer due to business conditions, such as reputation or supply chain disruptions.

(Module 2.2, LOS 2.a)

Question #11 of 16

Question ID: 1875247

Which of the following risks is *most accurately* classified as an unsystematic risk factor?

A) Interest rate risk.

B) Market risk.

C) Sector risk.

Explanation

Sector risk, the risk that a downturn to a specific industry causes investment losses, is an unsystematic risk factor. Unsystematic risks, also known as micro risks, can be reduced by diversifying investments within a portfolio. Interest rate risk and market risk are systematic risks—those that affect all investments to some degree.

(Module 2.2, LOS 2.a)

Question #12 of 16

Question ID: 1875243

When comparing the performance of an individual stock to a diversified market index, which of the following statements is *most accurate*?

A) Individual stock returns tend to have more volatility than index returns, resulting in lower geometric average returns for the individual stocks.

B) Indexes tend to have less volatility than individual stocks, resulting in an overstatement of multiperiod index returns when calculated using the arithmetic mean.

C) Arithmetic mean returns tend to understate multiperiod returns in individual stocks in comparison to index performance.

Explanation

Greater volatility in multiperiod returns reduces the average return when calculated using the geometric mean. Individual stocks tend to be more volatile than indexes, so they also tend to have lower geometric average returns than their comparative indexes.

Arithmetic means tend to overstate, not understate, multiperiod returns for individual stocks (those with more volatility) as they do not reflect the compound impact of volatility over time.

It is individual stocks, not index returns, for which returns are overstated when using arithmetic means, because individual stocks have more volatility.

(Module 2.1, LOS 2.a)

Question #13 of 16

Question ID: 1875250

A portfolio manager allocates 60% of a fund to an equity index and 40% to a fixed-income index. The equity index has an expected capital appreciation return of 7.0% and an expected capital distribution return of 2.0%. The fixed-income index has an expected capital appreciation return of 1.0% and an expected capital distribution return of 3.5%. The expected capital distribution return for the entire portfolio is *closest* to:

A) 2.60%. ✓

B) 4.60%. ✗

C) 2.75%. ✗

Explanation

The portfolio's capital distribution return is the weighted average of the distribution components: (0.60 × 2.0%) + (0.40 × 3.5%) = 1.20% + 1.40% = 2.60%.

The return of 2.75% is incorrect because it is the arithmetic mean of the two capital distribution returns, not adjusted for the security weights. The return of 4.60% is the capital appreciation return, not the capital distribution return. The capital appreciation return = (0.60 × 7.0%) + (0.40 × 1.0%) = 4.20% + 0.40% = 4.60%.

(Module 2.2, LOS 2.a)

Question #14 of 16

Question ID: 1875249

An investor allocates capital to a portfolio with 70% in equities and 30% in government bonds. If the expected total return on equities is 8.0% and the expected total return on government bonds is 4.5%, the expected total return of the portfolio is *closest* to:

A) 6.25%. ✗

B) 6.95%. ✓

C) 12.50%. ✗

Explanation

The expected total return of a portfolio is the weighted average of the returns of its constituent assets: (0.70 × 8.0%) + (0.30 × 4.5%) = 5.60% + 1.35% = 6.95%.

The return of 6.25% is incorrect because it calculates the arithmetic average of the two asset returns: (8.0% + 4.5%) / 2 = 6.25%

The return of 12.50% is incorrect because it simply sums the total returns of the two asset classes without multiplying them by their allocation weights.

(Module 2.2, LOS 2.a)

Question #15 of 16

Question ID: 1875251

When advising an investor who requires a steady stream of income, a portfolio manager should *most appropriately* recommend an asset allocation heavily weighted toward:

A) bonds. ✓

B) cash. ✗

C) small-cap equities. ✗

Explanation

Investors who require a steady stream of income need reliable capital distributions. This is a typical characteristic of fixed-income securities, which provide most of their return to investors in the form of periodic coupon payments.

Small-cap equities are higher risk, with no guarantee of dividends, with most of the return coming from price appreciation. Non-interest-bearing cash does not provide any return to the investor.

(Module 2.2, LOS 2.a)

Question #16 of 16

Question ID: 1875242

A US investor buys shares in a European company. Over the investor's holding period, the local currency return on the shares is 8.0%. During the same period, the euro depreciates against the US dollar by 3.0%. The investor's return in US dollars is *closest* to:

A) 5.47%. ✗

B) 4.76%. ✓

C) 11.24%. ✗

Explanation

Domestic return (in USD) = (1 + local currency return of foreign asset)(1 + return of the foreign exchange rate) – 1 = 1.08 × (1 – 0.03) – 1 = 4.76%.

The return of 11.24% is incorrect as it treats the 3.0% movement in exchange rates as an appreciation of the euro, not a depreciation.

The return of 5.47% is incorrect because it is the geometric mean of the two figures, ignoring negatives.

(Module 2.1, LOS 2.a)