Private Wealth: Mock Exam 1 - Session 1 - Questions

Passage for Questions 1.1–1.4

TOPIC: ASSET ALLOCATION
TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS

Sarah Holt is a Senior Analyst with Quantum Economics Insights, a boutique consultancy that provides economic forecasting services to institutional investors. One of Holt's clients has asked her to produce a short-term forecast of equity market returns in Terrania and Verdentina, two countries with emerging markets that have become increasingly integrated into the global economy over the last three decades.

Holt's projections are based on several inputs, including those shown in Exhibit 1.

Exhibit 1
Holt's annualized forecasts of key metrics

	Terrania	Verdentina
Inflation	2.1%	1.8%
Population growth	1.6%	2.2%
Capital stock growth	1.1%	1.3%
Labor input growth	2.1%	2.4%
Total factor productivity growth	1.1%	1.0%

In the report that she prepares for her client, Holt notes that she does not anticipate that corporate earnings will change as a share of GDP in either country over the client's investment horizon. However, she is forecasting increases of 0.4% and 0.1% in the price-to-earnings ratios in Terrania and Verdentina, respectively.

After accounting for dividend yields, Holt forecasts annualized equity market returns of 9.8% in Terrania and 9.4% in Verdentina. She cautions her client that these expectations are based on several assumptions and that there are several factors that could impact the capital appreciation and/or dividend yield components of equity returns. Holt expresses particular concern about the volatility of the aggregate earnings multiple in both countries.

Holt also points to empirical evidence documenting that higher economic growth rates are not necessarily reliable indicators of higher equity returns.

Question 1.1

1 points

Determine, based on Holt's forecasts, which country is offering the highest dividend yield component of expected equity returns.

(You will be asked to show your calculations in the next question.)

A. Terrania

B. Verdentina

Question 1.2

4 points

Show your calculations for the previous question.

Answer:

Question 1.3

3 points

All else equal, a higher earnings multiple will *most likely* produce a:

A. lower dividend yield.

B. higher dividend yield.

Question 1.4

4 points

Discuss *two* reasons why higher rates of economic growth may not produce higher equity returns.

Note: Each reason should be given in a separate paragraph.

Answer:

Passage for Questions 2.1–2.4

TOPIC: ETHICAL AND PROFESSIONAL STANDARDS
TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS

Isabel Matto, CFA is an equity analyst specializing in the travel and leisure sector. She works for Lakeland and Company, a large and diversified financial services firm. Matto is a well-respected analyst with unparalleled access to executives at the companies that she covers and her recommendations have been known to affect stock prices and trading volumes.

A significant portion of Matto's time is spent serving Lakeland's larger clients, which include several mutual fund managers and other institutional clients. These clients may buy and sell millions of shares daily and pay more for a higher level of service from Lakeland. Matto also serves Lakeland's smaller clients, who are typically satisfied with Lakeland's standard level of service. When issuing a new report, Matto emails it to all clients simultaneously before following up with phone calls to larger clients to discuss her recommendations in greater detail.

One of the travel firms that Matto covers, Travelnet, has posted disappointing sales growth in recent quarters. After receiving unconfirmed but, in her opinion, credible information that the company will be replacing its CEO, Matto immediately orders that the release of a report that she has prepared on the company be delayed pending further investigation. Many of Lakeland's large institutional clients have significant holdings of Travelnet stock and the value of these positions could be significantly affected by a change at the top level of the company's management. None of Lakeland's smaller clients own this company's stock.

The majority of Lakeland's revenues are generated by its investment banking division and, unknown to anyone outside Lakeland, a significant portion of Matto's compensation is tied to the performance of this division. Since hiring Matto, Lakeland's underwriting of security offerings by travel and leisure companies has dramatically increased. Matto often accompanies the investment banking team on road shows that promote clients to prospective investors. Her role on such trips is to provide factual information in response to investor's questions. Of the 10 companies for which Matto has issued a buy recommendation, 8 have used Lakeland as the lead underwriter for the initial public offering. All investment banking relationships, including the nature of Matto's participation in any road shows, are disclosed in the notes that appear at the end of her research reports.

HotelFinder, which Matto has covered for several years and knows very well, has persistently underperformed its peers since completing a large acquisition that has failed

so far to generate the synergies that the company's managers had expected. Lakeland executives recently directed the firm's sales staff to reduce its excessive inventory of HotelFinder shares by aggressively selling these securities to clients. Matto, who discloses Lakeland's holdings of HotelFinder stock in her research reports, believes that the company has properly addressed the difficulties associated with its recent acquisition and issues a buy recommendation for the company's stock, which she believes to be attractively priced.

Question 2.1 3 points

Has Matto *most likely* violated the Standards by following up with larger clients after issuing recommendations?

A. No

B. Yes, by providing additional service to the larger clients

C. Yes, by giving larger clients a better opportunity to act on her recommendations

Question 2.2 3 points

By delaying the release of her report on Travelnet, has Matto *most likely* violated the Standards?

A. No

B. Yes, with respect to independence and objectivity

C. Yes, with respect to material non-public information

Question 2.3 3 points

Regarding her relationship with Lakeland's investment banking department, has Matto *most likely* violated the Standards?

A. No

B. Yes, with respect to disclosure of conflicts

C. Yes, with respect to additional compensation arrangements

Question 2.4

3 points

Which of the following statements *most likely* accurately characterizes the situation in which Matto issued a buy recommendation for HotelFinder at a time when her firm is liquidating its position in this stock?

A. Both Lakeland and Matto have violated the Standards

B. Lakeland has violated the Standards, but Matto has not

C. Neither Lakeland nor Matto have violated the Standards