Investments Analysis and Management Canadian 3rd Edition Cleary Test Bank
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CHAPTER 1

Understanding Investments

MULTIPLE CHOICE

1. A Chartered Financial Analyst designation is a(an):
   a. OSC-approved and awarded designation.
   b. certification of a successful investing record.
   c. professional designation awarded for meeting recognized standards of conduct and competency.
   d. professional designation awarded by the brokerage industry.
   Answer: c Topic: Investments as a Profession Level of Difficulty: Easy
   Type: Factual

2. Gold, gems, art and real estate would be classified as:
   a. real assets.
   b. indirect assets.
   c. personal assets.
   d. financial assets.
   Answer: a Topic: The Nature of Investments Level of Difficulty: Easy
   Type: Factual

3. Another name for stockbrokers is:
   a. specialists.
   b. registered representatives.
   c. security analysts.
   d. portfolio managers.
   Answer: b Topic: Investments as a Profession Level of Difficulty: Moderate
   Type: Factual

4. A portfolio:
   a. is made of the asset holdings of an investor.
   b. cannot include real assets.
   c. is not evaluated after initially purchased.
   d. is unimportant in overall financial planning.
   Answer: a Topic: Structuring the Decision Process: Portfolio Management
   Level of Difficulty: Moderate Type: Factual

5. Underlying the evaluation of an investment is the trade-off between:
   a. expected return and actual return.
   b. low risk and high risk.
   c. actual return and high risk.
   d. expected return and risk.
   Answer: d Topic: The Expected Return-Risk Tradeoff
   Level of Difficulty: Moderate Type: Factual

6. Most investors exhibit risk averse behaviour which means:
   a. they will not assume more risk only unless they are compensated by higher expected returns.
   b. they will always invest in investments providing the lowest possible risk.

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c. they actively seek to maximize their risks.
d. they invest only in money market securities to avoid the risk inherent in the stock market.
Answer: a Topic: The Basis on Investment Decisions: Risk
Level of Difficulty: Moderate Type: Factual

7. The discipline of security analysis concerns as its primary criterion to provide a(n):
a. analysis of the overall securities market and its direction.
b. valuation and analysis of individual securities.
c. purchasing securities at the best price.
d. determination of the investor's required return.
Answer: b Topic: Structuring the Decision Process: Security Analysis
Level of Difficulty: Moderate Type: Factual

8. The ex ante risk-return trade-off as its basic principle suggests:
a. a higher expected return for investors who take on higher expected risk.
b. a lower expected return for investors who take on higher expected risk.
c. the same expected return for investors who take on higher expected risk.
d. the amount of expected return for investors is not directly related to the amount of expected risk.
Answer: a Topic: The Expected Return-Risk Tradeoff
Level of Difficulty: Easy Type: Factual

9. The expected return from an investment is:
a. contingent upon the historical return from that investment.
b. inversely related to the risk associated with that investment.
c. always equal to required return.
d. the anticipated return for some future period on that investment.
Answer: d Topic: The Expected Return-Risk Tradeoff
Level of Difficulty: Moderate Type: Factual

10. An emerging market is one that is characterized by:
a. the continual introduction of new products and technologies.
b. the issuance of financially engineered securities.
c. a high participation rate in Internet trading.
d. a low per capita economy.
Answer: d Topic: The Global Investments Arena: Emerging Markets
Level of Difficulty: Moderate Type: Factual

11. Global events have a significant impact on the Canadian economy because:
a. Canada derives a small percentage of its economic wealth from international trade.
b. Canada's economy has a relatively large proportion of commodity-based industries.
c. Canada's manufacturing base has increased substantially in the last two decades
d. almost all of the Government of Canada debt is held by domestic investors.
Answer: b Topic: The Global Investments Arena
Level of Difficulty: Moderate Type: Conceptual

12. Which of the following is *not* an institutional investor?
a. chartered banks
b. insurance companies
c. pension funds
d. high net worth investors

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Answer: d Topic: Institutional Investors
Level of Difficulty: Easy Type: Factual

13. Which of the following would be considered a risk-free investment by a Canadian investor?
    a. gold
    b. equity in a house
    c. high-grade corporate bonds
    d. Bank of Canada Treasury bills
    Answer: d Topic: The Expected Return-Risk Tradeoff
    Level of Difficulty: Easy Type: Factual

14. International investing:
    a. is only practical for institutional investors.
    b. increases the overall risk of a stock portfolio.
    c. always leads to higher returns than a domestic portfolio.
    d. can reduce risk due to increased diversification.
    Answer: d Topic: The Global Investments Arena
    Level of Difficulty: Moderate Type: Factual

15. Investment decision-making traditionally consists of two steps:
    a. investment banking and security analysis.
    b. buying and selling.
    c. risk and expected return.
    d. security analysis and portfolio management.
    Answer: d Topic: The Expected Return-Risk Tradeoff
    Level of Difficulty: Moderate Type: Factual

16. Which of the following groups of investments is incorrectly ordered from lowest to highest risk?
    a. government bonds, preferred stock, warrants
    b. T-bills, corporate bonds, options
    c. government bonds, financial futures, common stock
    d. T-bills, common stock, options.
    Answer: a Topic: The Expected Return-Risk Tradeoff
    Level of Difficulty: Difficult Type: Factual

17. Investors should be concerned with international investing for all of the following reasons except:
    a. Large amount of capital flows from abroad into domestic markets.
    b. Rates of return on foreign securities have often been larger than on domestic securities.
    c. Foreign companies are taking over many domestic industries, such as banking.
    d. Canadian companies derive a large percentage of their revenues from abroad.
    Answer: c Topic: The Global Investment Arena
    Level of Difficulty: Difficult Type: Factual

18. The __________ Act was implemented in 2002 in the U.S. in response to the collapse in public confidence surrounding the debacles of Enron and WorldCom.
    a. Canadian Business Incorporation
    b. Sarbanes-Oxley
    c. Sherman
    d. Trading with the Enemy
    Answer: b Topic: Corporate Governance: Sarbanes Oxley Act

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Level of Difficulty: Easy Type: Factual

19. Emerging markets are often characterized as:
    a. low risk, low return markets.
    b. low risk, high return markets.
    c. high risk, low return markets.
    d. high risk, high return markets.
    Answer: d Topic: The Global Investment Arena
    Level of Difficulty: Moderate Type: Factual

20. Markets that have prices adjusting quickly to new information to reflect the impact of that information on the security is known as:
    a. risk-free.
    b. liquid.
    c. self-fulfilling.
    d. efficient.
    Answer: d Topic: The Issue of Market Efficiency
    Level of Difficulty: Easy Type: Factual

21. Investment professionals whose jobs may depend on their performance relative to the market are the:
    a. registered representatives.
    b. security analysts.
    c. investment bankers.
    d. portfolio managers.
    Answer: d Topic: Investments as a Profession
    Level of Difficulty: Moderate Type: Factual

22. Institutional investors often avoid investing in spinoffs because:
    a. they often pay no dividends and may be too small.
    b. they tend to be too risky for most institutional investors.
    c. they generally have lower than average returns.
    d. they require too great a commitment of funds.
    Answer: a Topic: Institutional Investors
    Level of Difficulty: Difficult Type: Conceptual

23. Technically, investments include:
    a. only financial assets.
    b. only marketable assets.
    c. financial and real assets that are marketable or non-marketable.
    d. only financial and real assets that are marketable.
    Answer: c Topic: The Nature of Investments
    Level of Difficulty: Easy Type: Factual

24. Portfolio management is most concerned with:
    a. generating the highest expected return regardless of risk.
    b. the income tax planning for security returns.
    c. the retirement planning process.
    d. the selection, revision, and evaluation of a group of assets.
    Answer: d Topic: Structuring the Decision Process: Portfolio Management
    Level of Difficulty: Moderate Type: Conceptual

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25. In order to become licensed to sell securities in Canada, individuals must pass the following courses:
    1. CSC 3. IFIC
    2. CPH 4. CFA

    a. 1 and 2
    b. 1, 2, and 3
    c. 1 only
    d. 1 and 4

    Answer: a Topic: Investments as a Profession/CSI Appendix 1B
    Level of Difficulty: Moderate Type: Factual

TRUE-FALSE

1. A risk-averse investor will avoid all risk when investing.
   Answer: False Topic: The Basis of Investment Decisions
   Level of Difficulty: Easy Type: Factual

2. Investors always seek to maximize the return from their investments regardless of the risk of investing.
   Answer: False Topic: The Basis of Investment Decisions
   Level of Difficulty: Moderate Type: Factual

3. All investors should allocate the majority of their portfolio in T-bills to minimize the risk of the portfolio.
   Answer: False Topic: The Expected Return–Risk Trade-Off
   Level of Difficulty: Easy Type: Factual

4. The two major considerations in investing are timing and risk.
   Answer: False Topic: Understanding the Investment Decision Process
   Level of Difficulty: Easy Type: Factual

5. Common stock analysis is a two-step process of analyzing the industry and analyzing the individual company.
   Answer: False Topic: Structuring the Decision Process
   Level of Difficulty: Moderate Type: Factual

6. Investors that do not strongly believe in the Efficient Market Hypothesis tend to follow a passive investment strategy.
   Answer: False Topic: The Issue of Market Efficiency
   Level of Difficulty: Difficult Type: Factual

7. Financial planners must pass a standardized test and possess certain credentials.
   Answer: False Topic: Appendix 1A – The Chartered Financial Analyst Program
   Level of Difficulty: Easy Type: Factual

8. Risk is defined as the chance that the actual return on an investment will outperform the stock market in a given year.
   Answer: False Topic: The Basis of Investment Decisions
   Level of Difficulty: Moderate Type: Factual

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9. Institutional investors have gained in importance at the expense of individual investors.
Answer: True Topic: Institutional Investors
Level of Difficulty: Difficult Type: Factual

10. Financial planners, on average, earn much more than security analysts.
Answer: False Topic: Investments as a Profession
Level of Difficulty: Difficult Type: Factual

11. The minimum actual return necessary to induce investors to invest is known as the expected return.
Answer: False Topic: The Basis of Investment Decisions
Level of Difficulty: Easy Type: Factual

12. According to the Efficient Market Hypothesis, prices of securities reflect their underlying economic value.
Answer: True Topic: The Issue of Market Efficiency
Level of Difficulty: Moderate Type: Conceptual

13. Real assets include stocks, bonds and financial futures.
Answer: False Topic: The Nature of Investments
Level of Difficulty: Moderate Type: Factual

14. The CSI has the exclusive right to grant the Certified Financial Planner (CFP) designation in Canada.
Answer: False Topic: Appendix 1B – The Canadian Securities Institute (CSI)
Level of Difficulty: Easy Type: Factual

15. The CFA program is offered by the CFA Institute.
Answer: True Topic: Appendix 1A – The Chartered Financial Analyst Program
Level of Difficulty: Easy Type: Factual

SHORT ANSWER

1. Briefly explain the difference between expected returns and realized returns and between ex ante returns and ex post returns.
Answer: Expected returns are mean returns based on probability distributions dealing with the future. Realized returns are the returns that actually occurred in the past. Ex ante returns are in the future. Ex post returns are in the past.

2. What are some of the career opportunities in the investment industry?
Answer: Merger and acquisition specialist, security traders, salespeople, security analyst, portfolio manager, registered representative, and financial analyst.

3. What is the major difference separating the Chartered Financial Analyst from the other financial planners?
Answer: The CFA is oriented toward institutional portfolio management, whereas the others (Certified Financial Planner, Chartered Financial Consultant, and Personal Financial Specialist) are oriented toward personal financial planning.

4. Define risk in the context of investments.

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Answer: Risk is the chance that the actual return on an investment will deviate from its expected return.

5. Will risk-averse investors ever include commodity futures or options in their portfolios? Explain.
   Answer: They may include these items in their portfolios since risk-averse is not the same thing as risk avoidance. Risk-averse investors would expect a higher return from these assets as they are riskier than many other assets.

6. Explain why T-bills are not totally risk-free.
   Answer: T-bills are assumed free of default risk since the Canadian government has always paid its debts. But T-bills are still subject to interest rate and inflation risk since their prices may fluctuate if interest rates or inflation changes.

7. What are the components of security analysis and why does it take place before portfolio construction?
   Answer: The valuation of securities is a time-consuming and difficult task wherein the analyst is required to understand the various factors that affect the value of securities and to then be able to incorporate these factors into a valuation model. Once these factors on individual securities have been identified and valued, then the analyst can incorporate them into the construction of a portfolio, which will need to reflect the risk-return components of the individual securities.

8. A 25-year old college graduate is participating in an RRSP. His primary investment criterion is to minimize risk. What will this decision probably do to his ending retirement funds in 40 years? What types of investments would be in that RRSP that the graduate has chosen to provide minimum risk?
   Answer: If he minimizes risk, then he will also minimize return. His retirement fund will likely be much smaller than if he chose to take on additional risk over the long run. The types of investors would be money market instruments, such as T-bills, GIC, commercial paper, as well as very secure government bonds.

9. Considering the Efficient Market Hypothesis, how does new economic information affect securities' prices?
   Answer: The price adjusts quickly to new economic information.

CRITICAL THINKING/ESSAY

1. What are the steps required to value common stock?
   Answer: The investor must evaluate the overall economy, industry and individual company as all have an impact on the value of the stock to estimate the expected return and risk for the company. And while the investor is attempting to identify undervalued stocks, the efficiency of the stock markets must be considered to ascertain whether the observed market price of the stock is the same as the economic value.

2. According to the Efficient Market Hypothesis, stocks in the market are assumed to be fairly priced. Does this mean that security analysis is a waste of time?
   Answer: No, security analysis helps investors to identify the underlying economic strengths and weaknesses associated with the investment. Also, the possibility of a short-term market lag, and hence a potentially slow speed of adjustment of the price to that information, means that the more informed investor can take advantage of temporarily undervalued securities.

3. When it comes to decisions about the amount of trades taken by an investor explain why some investors and their brokers may want to take different approaches to trading decisions?

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Answer: Investors are generally looking for long-term returns and must consider the overall cost of trading. Investors may often do well with a buy-and-hold strategy attempting passive techniques that index the market. Brokers, on the other hand, make their living by commissions which means they have a vested interest in having customers trade more often and may be more predisposed towards active techniques which attempt to time the market or are based on a belief that they are able to pick better performing assets. Excessive trading in an investor's account is known as churning an account.

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