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Question 1

Question Type: MultipleChoice

Callie has a new client who wants to begin investing in mutual funds with the $5,000 she has pulled out of her savings account. The client has indicated she wants to set this money aside in a separate account so that her baby girl, now 2 years old, can have the "wedding of her dreams" when she grows up. Based on the information the client has provided, Callie believes the client would benefit most by purchasing shares of a certain fund that offers Class A, Class B, and Class C shares.

Given these facts, Callie's client is probably best off purchasing the shares of which class?

Options:

A- Class A

B- Class B

C- Class C

D- None of that above. Based on the facts, Callie's client would be better off buying a Treasury STRIP that matures in 20 to 30 years.

Answer:

B

Explanation:

If Callie's client wants to have enough money for her 2-year-old daughter to have the wedding of her dreams and a suitable fund has been selected, Callie would probably be best off purchasing Class B shares of that fund. Class B shares have a deferred sales charge, but this sales charge goes away after so many years, and since Callie's investment horizon is long -term, she should never have to pay this fee. If she buys the Class A shares, she will have to pay a front -end load when she buys the shares, thus reducing the total amount that she has invested. Class C shares tend to charge higher 12b-1 fees than Class A or Class B shares, which will reduce the annual return on Callie's client's investment. With Class B shares and a long-term investment, Callie can effectively avoid the ''loads.'' A Treasury STRIP investment will not return enough to provide Callie's little girl with ''the wedding of her dreams.''

Question 2

Question Type: **MultipleChoice**

Ms. Mix always assures her clients that she will be calling them with quarterly recommendations for rebalancing their portfolios if there are any changes that she feels are appropriate. This has worked out well for her pocketbook since she has always been able to tweak each of her clients' investment portfolios a little each quarter by recommending that they redeem their shares in one fund that hasn't performed as well in the last quarter and use the proceeds to invest in another that has. Her clients feel cared for since she is in such regular contact with them.

Is Ms. Mix violating any securities regulations with this policy of hers?

Options:

A- No. Ms. Mix is merely providing good service to her customers.

B- Yes. Mutual funds are not designed to be short-term investments.

C- It depends. There is no violation as long as her clients' portfolios are increasing in value.

D- Yes. Any recommendation that benefits a registered representative is deemed to be in violation of FINRA's rules regarding fair dealing.

Answer:

B

Explanation:

Yes. Mutual funds are not designed to be short-term investments, and Ms. Mix should not be calling her customers quarterly with rebalancing recommendations. Even if one fund has outperformed another in a particular quarter, there is no guarantee that this will happen in the next quarter. This violation falls under FINRA's rules regarding the trading of mutual fund shares, even if the trading results in an increase in the clients' portfolio values. Ms. Mix can certainly call her clients each quarter to see if they have any questions or concerns or to say hello; her clients will still feel cared for. It is not a violation for a registered representative to make a recommendation that benefits her as well as her clients as long as the recommendation is made to benefit the client first and foremost.

Question 3

Question Type: **MultipleChoice**

Mr. Schaker hasn't been seeing a lot of clients these days with the recent market downturn-which means he hasn't been generating any commissions, and commissions are his bread and butter. So, Mr. Schaker does some Googling on his computer and notes that a prominent family of load funds has just introduced a new global fund. Scribbling the name and contact information of the fund family on his notepad, he begins calling his existing clients and promoting the new fund, encouraging his clients to redeem some shares in their existing funds to invest in this fund.

Has Mr. Schaker violated any securities laws?

Options:

A- No. In FINRA's rules regarding fair dealing with customers, the SRO clearly states that "This does not mean that legitimate sales efforts in the securities business are to be discouraged. . . "

B- Yes. Mr. Schaker is recommending the fund to his existing clients to benefit himself, not them.

C- No. Research indicates that new funds tend to offer abnormally high returns for the first 12 months of their existence, so Mr. Schaker is doing his clients a favor even if he himself stands to profit.

D- D. Yes. A registered representative should always refrain from recommending shares of a load fund; trades involving load funds should always be "unsolicited."

Answer:

B

Explanation:

Yes. Mr. Schaker has violated securities laws in recommending a fund that he doesn't even seem to have researched very well to his existing clients, some of whom may not be suitable candidates for a global fund, which invests in foreign as well as domestic securities. Although FINRA's rules do indicate that it is not trying to stymie legitimate sales efforts, Mr. Schaker's actions do not fall within this category. There is no research that indicates new funds tend to offer abnormally high funds for the first 12 months of their existence, and if Mr. Schaker would have implied that, he could be up on criminal fraud charges. There is no law, however, that prohibits a registered representative from recommending a load fund to a client, as long as there is a legitimate reason for doing so.

Question 4

Question Type: MultipleChoice

Mr. Cross wanders into your office with a $35,000 check that he has received from his recently-deceased wife's insurance company and wants you to advise him how to invest it, since that is your job, as he puts it.

You ask him to fill out a standard investor profile questionnaire, but he refuses to do so. You offer to fill it out for him, based on his answers to your verbal questions, but he still refuses and calls you a "nibby-nose." Based on this, you can:

Options:

A- allocate the $35,000 any way you choose since you have an uncooperative client.

B- advise him to invest the money in a money market mutual fund instead of holding it as cash.

C- advise him to invest the money in an S&P 500 Index fund.

D- The advice provided in either Choice B or Choice C would be appropriate.

Answer:

B

Explanation:

If you cannot get any personal information from a client, you cannot legitimately recommend (or execute) an asset allocation for him. You can advise him to invest the money in a money market mutual fund instead of holding it as cash since this will provide him with a small return on his money. You cannot advise him to invest the money in an S&P 500 Index fund, which would subject him to more risk.

This would be considered an unsuitable recommendation and is in violation of securities' laws.

Question 5

Question Type: **MultipleChoice**

In 2008, Mr. Conservative bought a 1-year Treasury bill that was yielding 1.63%. The average annual rate of inflation in 2008 was 3.85%. In this case:

Options:

A- Mr. Conservative earned a nominal return of +3.85% on his T-bill investment.

B- Mr. Conservative earned a real return of -2.22% on his investment.

C- Mr. Conservative earned a real return of +1.63% on his investment.

D- Mr. Conservative earned a nominal return of +2.22% on his investment.

Answer:

B

Explanation:

If Mr. Conservative bought a 1-year Treasury bill in 2008 that was yielding 1.63%, and the average annual rate of inflation in 2008 was 3.85%, Mr. Conservative earned a real return of -2.22 % on his investment. In other words, he lost 2.22% in purchasing power since the dollars he received when the bill matured were worth less than the dollars he paid to buy the bill. Real return = nominal return - inflation rate = 1.63% - 3.85% = -2.22%.

Question 6

Question Type: **MultipleChoice**

Clem Shyster is a registered representative with a family of mutual funds. A married couple in their 50s sought his advice about how they should best invest an $80,000 profit that they had received when they sold a rental property they owned for a number of years. Their investment profile indicated to Clem that their main investment objective was capital appreciation and that they were willing to accept moderate levels of risk. Clem advised them to invest $10,000 in eight different growth funds, each of which had a 7% front-end load.

Has Clem violated any securities laws with his recommendation?

Options:

A- No. Growth funds invest in stocks that are selected to provide the capital appreciation that Clem's clients need, and an investment in eight such funds will provide them with maximum risk diversification.

B- Yes. Although growth funds provide some amount of capital appreciation, Clem should have recommended that they spread their money among eight different aggressive growth funds instead, to achieve even greater capital appreciation.

C- Yes. Clem should have advised them to invest in funds that had a deferred sales charge instead of a front-end load.

D- Yes. There is a lot of overlap of the individual stocks in which growth funds invest, so recommending that they spread their funds among eight different growth funds has not provided them with significantly more diversification, and it has cost them more to do so, which will benefit Clem.

Answer:

D

Explanation:

Yes, Clem has violated securities laws with his recommendation that his clients spread their money among eight different load, growth funds because there is a lot of overlap in the individual stocks in which these funds invest, so this strategy has not provided them with significantly more diversification; it has just cost them more, which will benefit Clem since he gets to pocket part of that load fee himself. He has made an unsuitable recommendation and has not upheld NASD's rules involving fair dealing with customers.

Question 7

Question Type: **MultipleChoice**

Andy and Annie Raggedy own their own graphics art business that they operate out of their home and, happily, generate enough income to meet their current needs. The couple is planning on having children in the not too distant future, however, and they want to start putting money aside for their children's college education and also want to start saving for retirement more aggressively.

Options:

A- Which of the following describes one of their primary investment objectives? tax-exempt income

B- preservation of capital

C- current income

D- capital appreciation

Answer:

D

Explanation:

Since Mr. and Mrs. Raggedy's stated goals are to save for their future children's college education and to save for retirement, one of primary investment objectives is capital appreciation. That is, they will want to invest their monies in assets that will grow at a sufficient rate for them to be able to meet these targets. They have enough income to meet their current needs, so Choices A and C are not primary objectives, and although we'd all like to preserve capital, we need to take some risk in order to get the returns we require.

Question 8

Question Type: MultipleChoice

Which of the following would be the most suitable investment for a client who has retired and needs some current income to augment her social security check?

Options:

A- growth fund

B- variable life policy

C- money market fund

D- U.S. government bond fund

Answer:

D

Explanation:

Of the choices provided, the most suitable investment for a client who has retired and needs some current income to augment her social security check would be a U.S. government bond fund. The growth fund is mostly invested in stocks that provide their return in the form of capital appreciation, not dividend income. The variable life policy would not offer her the current income she needs and may even have a surrender charge. Furthermore, these policies are insurance, not investments. A money market fund is good for capital preservation and some of her funds should be invested in a money market fund to meet this objective, but it will not provide her with current income. A U.S. government bond fund is less risky than other bond funds--although its value will fluctuate with interest rate changes-and will provide her with the supplemental income she requires.

Question 9

Question Type: **MultipleChoice**

Marshall's employer offers a 403(b) plan, and Marshall must decide into which of several mutual fund alternatives the contributions will be invested.

Regardless of other factors, which of the following would clearly not be a good choice?

Options:

A- a municipal bond fund

B- a fund that invests in stocks that are expected to experience high growth

C- a fund that invests almost exclusively in high-tech stocks

D- a fund that invests in both foreign and domestic stocks

Answer:

A

Explanation:

A municipal bond fund is clearly not a good investment choice for a 403(b) plan. Earnings in a 403(b) plan grow tax-deferred, so Marshall would not be receiving the tax-free income benefits offered by a municipal bond fund. All he would be receiving is a lower return on his investment.

Question 10

Question Type: MultipleChoice

Your nephew has asked you to help him formulate a financial plan for his family. Scott is 27 years old and has been employed as an associate with a law firm for two years. Sarah, his wife, is 26 years old and works in the human resources department of a large corporation. The couple is childless now, but they plan to begin a family in a few years. Together, they have accumulated $10,000 in a savings account and recently inherited $40,000 cash. They expect to be able to start saving at least $5,000 annually since their incomes more than meet their current needs. They each have employer-provided health insurance and retirement plans. Both have excellent upward mobility potential in their careers. They currently pay taxes at the marginal rate of 15%. Scott tells you that although they regularly read some of the more popular financial investment magazines, neither feels particularly knowledgeable about the world of investments.

Based on this information, which of the following statements is true?

Options:

A- A greater than average percentage of their money should be invested in money market mutual funds to meet their needs for liquidity.

B- A greater than average percentage of their money should be invested in municipal bonds to minimize their currently high tax bill.

C- Although some money should be allocated to bond funds for diversification purposes, bond funds should be underweighted in favor of stock funds.

D- Purchasing power risk is not an issue in their situation.

Answer:

C

Explanation:

Given that Scott and Sarah already have a nice nest egg started at their relatively young ages and are expecting to be able to contribute more to it, with no obvious need for current income, some of their money should be allocated to bond funds for diversification purposes, but bond funds should be underweighted in favor of stock funds. Purchasing power risk is an issue for them, and bond funds do not provide the inflation hedge that stock funds do. At the current time, municipal bond funds should not be selected since they pay taxes at a low marginal tax rate. This allocation may need to be changed down the road a bit as their tax rate (and other circumstances) change. Only a minimal amount of money should be allocated to a money market fund since the couple has no need for current income, and money market funds offer low returns.

Question 11

Question Type: **MultipleChoice**

Brian is single and 32 years old. He is employed as a buyer for a large sporting goods retail chain and participates in an employer-matched 401(k) plan. He remembers hearing about the benefits of passively managed portfolios in a college investments course he took. Therefore, he is directing 100% of his 401(k) monies into an S&P 500 Index fund. He has also been investing all of his discretionary income into a regular account with the same S&P 500 Index fund. Brian's goal is to retire no later than his 55th birthday.

Is this the best investment strategy for him?

Options:

A- Yes. He is investing in a diversified portfolio of stocks that is passively managed, so he isn't having to pay big management fees.

B- Yes. Because index funds are passively managed, they don't have as high a turnover rate, and lower turnover rates result in lower tax bills for the investor. Brian gets diversification and a lower tax bill.

C- No. The S&P 500 Index consists only of large, domestic stocks, so Brian isn't as diversified as he could be, and his investments may not grow fast enough for him to retire on his 55th birthday.

D- Both A and B are reasons that Brian's strategy is the best strategy for him.

Answer:

C

Explanation:

No, investing all of his retirement savings and all his discretionary income into the same S&P 500 Index fund is not the best strategy for Brian because the S&P 500 Index consists only of large domestic stocks, so Brian isn't as diversified as he could be, and his investments may not grow fast enough for him to retire on his 55th birthday. Although the S&P 500 Index fund is passively managed, which results in lower management fees and lower tax bills, Brian could spread his money among other index funds that offer these same benefits as well. For example, he could invest in a small cap index fund, a mid-cap index fund, and even a foreign stock index fund, such as an EAFE Index fund. This would give him even more diversification potential, and since the stocks in which these funds invest are a bit riskier, the funds offer a higher expected return, which should advance him toward his retirement goal more quickly. Brian's investment horizon is sufficiently long for him to be able to handle the risk. Furthermore, investing all of one's money in a single fund-even a single S&P 500 Index fund-isn't the best strategy, especially if one has a lot of money to invest as Brian does. Not all S&P 500 Index funds perform equally well.

Question 12

Question Type: MultipleChoice

Liz is a new client of yours. She is 36 years old, single, and has been working and earning a nice salary since her graduation from high school. She has been contributing the maximum allowed to a TSA plan through her employer, and you have no reason to doubt that she will meet her stated goal to retire when she is 58. She also has a good health care plan through her employer and is in excellent health. She has been depositing her non-retirement savings in a money market fund and is not pleased at the pathetic return she has been earning on her current balance of $140,000. Liz has been reading some articles on the web and understands she could allocate her funds to receive a higher return. She's willing to take on a moderate level of risk, but needs your help. She informs you that she does plan to use $40,000 of her current savings as a down payment for a condo and that her investment goals are to have money available for travel and for unexpected expenses and periodic purchases such as new cars and new furniture as the needs arise. She pays taxes at the highest marginal tax rate for individual tax payers.

Based on these facts, which of the following asset allocations would best meet her needs?

i. Money market fund: 30%; investment-grade corporate bonds: 20%; blue-chip stocks: 20%; high-yield bonds: 10%; small cap stocks: 10%; foreign stocks: 10%

ii. Money market fund: 10%; investment-grade municipal bonds: 5%; blue-chip stocks: 25%; high-yield bonds: 25%; small cap stocks: 10%; foreign stocks: 25%

iii. Money market fund: 10%; investment-grade municipal bonds: 25%; growth stocks: 40%; small cap stocks: 15%; foreign stocks: 10%

Options:

A- I

B- II

C- III

D- Either II or III would be suitable recommendations.

Answer:

C

Explanation:

The portfolio described in Selection III would be the best choice for Liz. She has little need for liquidity, so the allocation to a money market fund is only 10%. Another 40% of the allocation is in investment-grade municipal bonds and blue-chip stocks, with only 25% allocated to the riskier asset classes of foreign stocks and small caps. This meets her stated willingness to take on only a moderate level of risk. The large percentage that is allocated to municipal bonds is intended to provide her with federal tax-free interest income since she is in such a high marginal tax bracket -income that she can use for traveling and for those unexpected and periodic expenses, perhaps. The 45% allocation to growth stocks and small caps will also serve as a tax shield since these categories of stocks pay little, if any, dividends that would be taxed. Liz will only have to pay tax on capital gains when she chooses to sell these assets. The portfolio described in Selection I has far too much invested in a lower-yielding money market fund for someone who doesn't need much liquidity. Portfolio II has 60% invested in high risk securities-junk bonds, small caps, and foreign stocks-with a full 50% invested in junk bonds and foreign stocks. This would be an inappropriate allocation for an investor who is willing to accept only a moderate level of risk.