

THE DALTON REVIEW®

**INVESTMENT
PLANNING
PRE-STUDY
MATERIALS**

REVIEW FOR THE CFP® CERTIFICATION EXAMINATION

Investment Planning Pre-Study Materials

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LESSON 1: FUNDAMENTALS OF INVESTMENTS

FORMS OF UNDERWRITING

Best Efforts

- The underwriter agrees to sell as much of the offering as possible.
- The risk of the issue not selling resides with the firm because any shares not sold to the public are returned to the company.

Firm Commitment

- The underwriter agrees to buy the entire issuance of stock from the company.
- The underwriter may buy the stock from the company for \$18 share and sell to the public at \$20 per share, thus making the spread.
- The risk that an issuance may not sell resides with the underwriter.

KEY DOCUMENTS

Prospectus

- Outlines the risks, management team, business operations, fees, and expenses.
- A prospectus must be issued by an investment company prior to selling shares to an investor.

Red Herring

- Preliminary prospectus issued before the SEC approval and is used to determine investor's interest in the security.

10K and 10Q

- A 10K is an annual report of financial statements filed with the SEC. The 10K is audited.
- A 10Q is a quarterly reported that is filed with the SEC. The 10Q is not audited.

Annual Report

- Contains a message from the Chairman of the Board on the progress in the past year and outlook for the coming year.
- The annual report is sent directly to shareholders.

LIQUIDITY VS. MARKETABILITY

- Liquidity is how quickly something can be turned into cash, with little to no price concession. Generally, short-term investment assets are considered liquid. Stocks, bonds, stock mutual funds, and stock bond funds are not considered liquid because an investor could suffer price concessions.
- Marketability exists when there is a ready-made market for something. Real estate is marketable, but not very liquid.

TYPES OF ORDERS

- Market Order
 - Timing and speed of execution are more important than price.
 - A market order is most appropriate for stocks that are not thinly traded.

- Limit Order
 - The price at which the trade is executed is more important than the timing.
 - A limit order is most appropriate for stocks that are extremely volatile and are not frequently traded.
- Stop Order
 - The price hits a certain level and turns to a market order.
 - A stop order to sell means that once the stop order price is reached, the stock is sold at that price or possibly less because it has become a market order.
 - The primary risk is that the investor may receive significantly less than anticipated if the market is moving too quickly.
- Stop-Limit or Stop-Loss Limit Order
 - The investor sets two prices:
 - The first price is the stop-loss price, once the price is reached the order turns to a market order.
 - The second price is the limit price. An investor will not sell below the second price.
 - The risk is that if the market moves quickly, the order may not fill and the investor will be left with the stock at a significantly lower price.
 - A stop-loss limit order is appropriate for investors with a significant gain built into the stock, but may not want to sell the stock during a period of significant volatility based on short-term news.

Example

Donna is considering buying Apple stock which closed at \$100 per share. Before the open the next day, the price increases to \$105 because of a favorable announcement regarding the number of iPods sold. Assume the following orders the next day:

- Donna enters a market order to buy - Donna may have bought the stock for \$105.
- Donna enters a limit order to buy at \$100 - Donna may have not bought the stock because the stock increased to \$105, but she was only willing to pay \$100.

Donna bought the stock for \$105. Two days later Apple announces a recall for 10 million iPods. What happens to her stock, assuming the stock falls to \$80 per share rapidly?

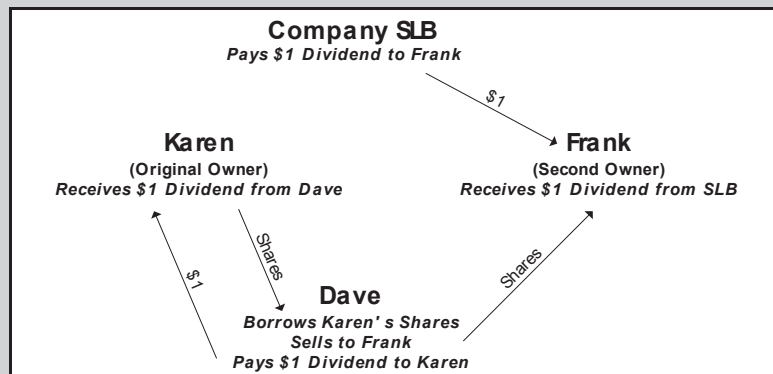
- Donna enters a stop order to sell at \$95 - Once the stock reaches \$95 per share, it turns into a market order. The risk is she may sell at a price significantly less than \$95 per share because the price is falling rapidly and her stop order turns to a market order.
- Donna enters a stop loss at \$95 with limit of \$90 - Donna's order turns to a market order at \$95 but she will not sell for anything less than \$90. The risk is that she may not sell between \$90-95, but will instead hold the stock at \$80.

SHORT-SELLING

- Selling first at a higher price, in the hopes of purchasing the stock back at a lower price.
- The goal is to sell high and buy low.
- An investor makes a profit when the asset's price decreases in value.
- Short selling is the opposite of taking a long position, where the investor anticipates making a profit when the price of the asset increases in value.
- Investor must have a margin account to protect against any price appreciation of the stock.
- There is no time limit on how long an investor can maintain the short position.
- Dividends paid by a corporation must be covered by the short seller.

Example

Karen buys 100 shares of SLB. Dave sells 100 shares of SLB short by borrowing Karen's shares and selling them to Frank. SLB is trading for \$50 a share and announces a \$1 per share dividend. When the stock price is adjusted to reflect payment of the dividend, the stock trades at \$49 and SLB pays \$1 dividend to Frank. Dave must pay \$1 to Karen since she would have received the dividend from SLB, had her shares not been borrowed and sold. Dave is not any economically worse off because his position increased by \$1 per share when the stock price adjusted to reflect the dividend, but by paying the dividend he is economically whole.

**MARGIN DEFINITION****Initial Margin**

- The initial margin reflects the amount of equity an investor must contribute to enter a margin transaction.
- Regulation T set the initial margin at 50% and was established by the Federal Reserve.
- The initial margin can be more restrictive based on the volatility of a stock.

Example

To purchase 100 shares of Starbucks trading at \$50 per share with an initial margin requirement of 75%, Joe must contribute $100 \times \$50 \times 0.75 = \$3,750$, and he will borrow $\$1,250$ ($100 \times \$50 \times 0.25$) from his broker.

- On the exam assume 50% margin requirement unless stated otherwise in the question.

Maintenance Margin

- The maintenance margin is the minimum amount of equity required before a margin call.

Margin Position

- Represents the current equity position of the investor.

Example

Joe bought Starbucks stock when it was at \$50 per share, using 75% initial margin. Within two minutes of Joe's purchase of Starbucks, the price fell to \$40 per share. What is Joe's new margin position?

$$\begin{aligned}\text{Margin Position} &= \text{Equity} \div \text{Fair Market Value} \\ \text{Margin Position} &= (\$40.00 - \$12.50) \div \$40.00 = 68.75\%\end{aligned}$$

$$\begin{aligned}\text{Equity} &= \text{Stock Price} - \text{Loan} \\ \text{Equity} &= \$40 - (\$50 \times 0.25)\end{aligned}$$

At What Price Does an Investor Receive a Margin Call Price?

- The formula below is used to determine the price that investor will receive a margin call.
- The formula below is NOT on your exam formula sheet.

$$\text{Margin Call} = \frac{\text{Loan}}{1 - \text{Maintenance Margin}}$$

Exam Tip

Memorize! Not on the exam formula sheet.

Example

Bob purchased 100 shares of Starbucks trading at \$50 per share with an initial margin requirement of 75% and a maintenance margin of 25%. At what price would Bob receive a margin call?

$$\begin{aligned}\text{Loan} &= \$50 \times (1 - .75) \\ \text{Loan} &= \$12.50 \text{ per share}\end{aligned}$$

$$\begin{aligned}\text{Price to Receive a Margin Call} &= \$12.50 \div (1 - 0.25) \\ \text{Price to Receive a Margin Call} &= \$16.67\end{aligned}$$

How Much Equity Must an Investor Contribute?

- When a stock price falls below the stock price at which an investor will receive a margin call, the investor will receive a margin call and must contribute equity to restore their equity position.
- For the purposes of the exam, an investor must restore their equity position to the maintenance margin.

Example

Bob purchased 100 shares of Starbucks trading at \$50 per share with an initial margin requirement of 75% and a maintenance margin of 35%. The price fell to \$15 per share. How much equity must Bob contribute?

| Required Equity | | Actual Equity | |
|------------------|---------------|----------------|---------------|
| Stock Price: | \$15.00 | Stock Price: | \$15.00 |
| Maint. Margin: | x 0.35 | Debt: | <\$12.50> |
| Required Equity: | <u>\$5.25</u> | Actual Equity: | <u>\$2.50</u> |

Bob must contribute the difference between Required Equity and Actual Equity.
 $\$5.25 - \$2.50 = \$2.75$ per share or \$275 in total

**Exam Question
Margin**

Lisa purchased 500 shares of XYZ stock trading at \$40 per share, with an initial margin requirement of 60% and a maintenance margin of 30%. At what price would Lisa receive a margin call?

- \$20.00
- \$22.86
- \$57.14
- \$80.00

Answer: B

$$\begin{aligned}
 \text{Price to receive a margin call} &= \frac{\text{Loan}}{1 - \text{MM}} \\
 &= \frac{\$40 \times (1 - 0.60)}{1 - 0.30} \\
 &= \frac{\$16}{0.70} \\
 &= \$22.86
 \end{aligned}$$

**Exam Question
Margin**

Laureen purchased 1,000 shares of CWC stock for \$80 per share with an initial margin requirement of 65% and a maintenance margin of 40%. Assume the stock price falls to \$30 per share, how much equity must Laureen contribute?

- a) \$2 per share
- b) \$8 per share
- c) \$10 per share
- d) \$12 per share

Answer: C

| Required Equity | | Actual Equity | |
|------------------|----------------|----------------|---------------|
| Stock Price: | \$30.00 | Stock Price: | \$30.00 |
| Maint. Margin: | x 0.40 | Debt: | <\$28.00> |
| Required Equity: | <u>\$12.00</u> | Actual Equity: | <u>\$2.00</u> |

$$\begin{aligned} \text{Debt} &= \$80 \times (1 - .65) \\ &= \$28 \text{ per share} \end{aligned}$$

Laureen must contribute \$10 per share. Required Equity - Actual Equity (\$12-\$2)

RESEARCH REPORTS

- Value Line.
 - Ranks stocks on a scale of 1 to 5 for timeliness and safety.
 - A ranking of 1 represents the highest rating for timeliness and safety (signal to buy).
 - A ranking of 5 represents their lowest ranking (signal to sell).
- Morningstar.
 - Ranks mutual funds using 1 to 5 stars.
 - 1 star represents the lowest ranking; 5 stars represents the highest ranking.

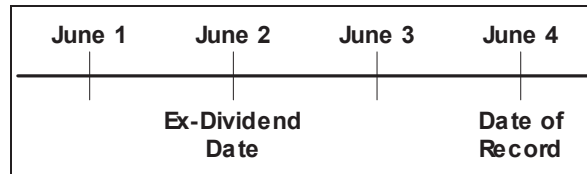
Exam Tip

Know that Value Line ranks stocks and Morningstar ranks mutual funds. Also know the rankings and whether they are a buy or sell signal.

DIVIDEND DATES

- Dividends are declared by the Board of Directors and are typically paid quarterly.
- There are two important dates to know regarding dividend payments:
 - Ex-Dividend Date
 - Date of Record

- Ex-Dividend Date
 - The date the stock trades without the dividend.
 - If you sell the stock on the ex-dividend date, then you will receive the dividend.
 - If you buy the stock on or after the ex-dividend date, then you will NOT receive the dividend.
 - The ex-dividend date is *two business days* before the date of record.



- Date of Record.
 - Date of record is the date on which you must be a registered shareholder in order to receive the dividend.
 - The date of record is *two business days* after the ex-dividend date.
 - An investor must actually purchase the stock three business days prior to the date of record in order to receive the dividend.

Exam Tip

To receive the dividend, an investor must purchase the stock before the ex-dividend date or 3 business days prior to the date of record.

Exam Question
Dividends

MSFT declared a dividend payable to shareholders on the record date of Wednesday, May 15th. Which is the last possible date an investor could purchase the stock and still receive the dividend?

- Stock purchased on May 13th.
- Stock purchased on May 12th.
- Stock purchased on May 11th.
- Stock purchased on May 10th.

Answer: D

The investor would have to purchase the stock on Friday, May 10th as the last possible date. Recall the ex-dividend date would be Monday, May 13th. An investor would have to purchase prior to the ex-dividend date to receive the dividend. Since the previous date would be Friday, May 10th, that is the last possible purchase date to actually receive the dividend.

DIVIDENDS & SPLITS

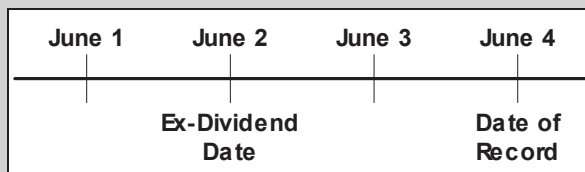
- Cash Dividends
 - Qualified dividends receive capital gains treatment.
 - A cash dividend is taxed upon receipt.

- Stock Dividends
 - Not taxable to the shareholder until the stock is sold.
- Stock Splits
 - Increases shares outstanding and reduces stock price.
 - A 2-for-1 split for an investor with 100 shares at \$50 per share.
 - o How many shares after the split?
Answer: $100 \text{ shares} \times 2 = 200$.
 - o How much is the stock after the split?
Answer: $\$50 \text{ per share} \div 2 = \25 per share .
 - A 3-for-2 split for an investor with 100 shares at \$60 per share.
 - o How many shares after the split?
Answer: $100 \text{ shares} \times 1.5 (3 \div 2) = 150 \text{ shares}$.
 - o How much is the stock after the split?
Answer: $\$60 \text{ per share} \div 1.5 (3 \div 2) = \40 .

Exam Question
Dividends

If June 4 is the date of record, when must Joe purchase the stock in order to receive the dividend?

- a) June 1.
- b) June 2.
- c) June 3.
- d) June 4.
- e) May 31.



Answer: A

Date of Record minus 3 days.

SECURITY REGULATIONS

- Securities Act of 1933
 - Regulates the issuance of new securities (Primary Market).
 - Requires new issues are accompanied with a prospectus before being purchased.
- Securities Act of 1934
 - Regulates the secondary market and trading of securities.
 - Created the SEC to enforce compliance with security regulations and laws.
- Investment Company Act of 1940
 - Authorized the SEC to regulate investment companies.
 - Three types of investment companies: Open, Closed, Unit Investment Trusts.

- Investment Advisers Act of 1940
 - Required investment advisors to register with the SEC or state.
- Securities Investors Protection Act of 1970
 - Established the SIPC to protect investors for losses resulting from brokerage firm failures.
 - Does not protect investors from incompetence or bad investment decisions.
- Insider Trading and Securities Fraud Enforcement Act of 1988
 - Defines an insider as anyone with information that is not available to the public.
 - Insiders cannot trade on that information.

Exam Tip

Make a flashcard of the security regulations with the characteristics outlined above.

MONEY MARKET SECURITIES

- Treasury Bills
 - Maturities of 4, 13, 26 and, 52 weeks.
 - Denominations of \$100.
- Commercial Paper
 - Short-term loans between corporations.
 - Maturities of 270 days or less and it does not have to register with the SEC.
 - Commercial paper has denominations of \$100,000 and are sold at a discount.
- Bankers Acceptance
 - Facilitates imports/exports.
 - Maturities of 9 months or less.
 - Can be held until maturity or traded.
- Eurodollars
 - Deposits in foreign banks that are denominated in US dollars.

Exam Tip

Make a flashcard of the terms and definitions for money market securities. Any questions on money market securities will be very definition oriented and surround the key terms outlined above.

INVESTMENT POLICY STATEMENT

- Establishes:
 - A client's objectives.
 - Limitations on investment manager.
- Used to measure investment manager's performance.
- The investment policy statement does NOT include investment selection.

| Investment Policy Statement | |
|-----------------------------|--|
| Objectives | Description |
| Return Requirements | The return requirement can be specific to a goal, such as retiring by age 55. |
| Risk Tolerance | Identifying and defining an investor’s risk tolerance is important so that the universe of investment alternatives can be narrowed. |
| Constraints | |
| Time Horizon | Time horizon is an important constraint that ties very closely to an investor’s risk tolerance. Time horizon helps determine which investment alternatives are appropriate and when the investor is going to need the asset. |
| Liquidity | Coincides with time horizon and the more liquidity that is needed, the lower the investment return and investment alternatives. |
| Taxes | Whether the investments are being held in a taxable, tax-deferred or tax-free account. |
| Laws & Regs | Could apply if the assets are held in a custodial account or trust. The unique laws and regulations surrounding the ownership or terms of a trust document. |
| Unique Circumstances | Anything unique to the client. |

Exam Tip

The IPS establishes “RR TLLU” --> Risk, Return, Taxes, Timeline, Liquidity, Legal, and Unique circumstances

Assessing a client’s risk tolerance is a critical step in developing the Investment Policy Statement. The primary goal is to understand an investor’s attitude toward risk so that an appropriate portfolio asset allocation can be developed. Although personal experience with an investor by the advisor will generally provide a useful qualitative assessment, most investment firms deploy a questionnaire based approach to develop a quantitative numerical score for investors. While useful if properly developed, many of these questionnaires are not sufficiently tested and compared to norms over a large number of investors. Administering multiple measures of risk tolerance can help to mitigate this problem. Engaging the client in a discussion about their values after first administering quantitative and qualitative risk tolerance measures improves the effectiveness of the discussion.

MARKET AVERAGES AND INDICES

- Dow Jones Industrial Average
 - A simple price-weighted average.

Example

Assume there are three stocks in our ABC average and their values are \$44, \$60, and \$100. Our price average would be $(\$44 + \$60 + \$100) \div 3 = \68 . Therefore, our price weighted average would be \$68.

- The DJIA does not incorporate market capitalization.
- S&P 500

- A value-weighted index - incorporates market capitalization of individual stocks into the average.
- Russell 2000
 - A value-weighted index of the *smallest* market capitalization stocks in the Russell 3000.
- Wilshire 5000
 - The broadest index that measures the performance of over 6,500 stocks. The Wilshire 5000 is also a value-weighted index.
- EAFE
 - A value-weighted index that tracks stocks in Europe, Australia, Asia, and the Far East.

Exam Tip

Be sure to know the difference between price-weighted average and value-weighted index.

BEHAVIORAL FINANCE

Behavioral Finance can be best understood by comparison with the four basic premises of Traditional Finance.

- Investors are Rational – Investor decisions are logical, centered on a clearly defined goal and free from the unsteady influences of emotion or irrationality, and take into account all available information.
- Markets are Efficient - At any given time, a stock’s share price in the market incorporates and reflects all relevant information about that stock. Stocks are deemed at all times to trade at their fair value on stock exchanges.
- The Mean-Variance Portfolio Theory Governs - Mean-Variance investors choose portfolios by viewing and evaluating mean returns and variance for their entire portfolios.
- Returns are Determined by Risk - The CAPM is the basic theory that links return and risk for all assets by combining a risk-free asset with risky assets from an efficient market.

Behavior Finance, on the other hand makes the following assumptions:

- Investors Are “Normal” - Normal investors have normal wants and desires, but may commit cognitive errors (through biases or otherwise). Normal investors may be misled by emotions while they are trying to achieve their wants.
- Markets Are Not Efficient - There can be deviations in price from fundamental value so that there are opportunities to buy at a discount or sell at a premium. As a result, markets can be tough to beat, but they are not efficient.
- The Behavioral Portfolio Theory Governs - Under this theory, investors segregate their money into various mental accounting layers. This mental process occurs when people “compartmentalize” certain goals to be accomplished in different categories based on risk rather than viewing their entire portfolio as a whole. This may result in having very different risk preferences for the same value depending on the goal or situation.
- Risk Alone Does Not Determine Returns - The Behavioral Asset Pricing Model determines the expected return of a stock using Beta, book to market ratios, market capitalization ratios, stock “momentum,” the investor’s likes or dislikes about the stock or company, social responsibility factors, status factors, and more.

What is the difference between a rational investor and a normal one? Normal investors are prone to making cognitive mistakes due to their beliefs or cognitive biases. The following is not an exhaustive list, but a list of the more commonly known biases or heuristics (mental short cuts or rules of thumb) that have been observed or linked to normal investors.

- Affect Heuristic - Deals with judging something, whether it is good or bad. Do they like or dislike some company based on non-financial issues.
- Anchoring - Attaching or anchoring one’s thoughts to a reference point even though there may be no logical relevance or is not pertinent to the issue in question. Anchoring is also known as conservatism or belief perseverance.

- Availability Heuristic - When a decision maker relies upon knowledge that is readily available in his or her memory, the cognitive heuristic known as “availability” is invoked. This may cause investors to overweight recent events or patterns while paying little attention to longer term trends.
- Bounded rationality - When individuals make decisions, their rationality is limited by the available information, the tractability of the decision problem, the cognitive limitations of their minds, and the time available to make the decision. Decision-makers in this view act as “satisficers”, seeking a satisfactory solution rather than an optimal one. One consequence of this concept is that having additional information does not lead to an improvement in decision making due to the inability of investors to consider significant amounts of information.
- Confirmation Bias - A commonly used and popular phrase is that “you do not get a second chance at a first impression.” People tend to filter information and focus on information supporting their opinions.
- Disposition Effect - The cognitive bias was “faulty framing” where normal investors do not mark their stocks to market prices. Investors create mental accounts when they purchase stocks and continue to mark their value to purchase prices even after market prices have changed.
- Familiarity Bias - Investors tend to overestimate/underestimate the risk of investments with which they are unfamiliar/familiar.
- Gambler’s Fallacy – Investors often have incorrect understanding of probabilities which can lead to faulty predictions. Investors may sell stock when it has been successful in consecutive trading sessions because they may not believe the stock is going to continue its upward trend.
- Herding - This cognitive bias is explained just by looking at the word. People tend to follow the masses or the “herd.”
- Hindsight Bias - Another potential bias for an investor. Hindsight is looking back after the fact is known and assuming they can predict the future as readily as they can explain the past.
- Illusion of Control Bias - The tendency for people to overestimate their ability to control events; for example, it occurs when someone feels a sense of control over outcomes that they demonstrably do not influence.
- Overconfidence Bias - Usually concerns an investor that listens mostly to himself or herself, overconfident investors mostly rely on their skills and capabilities to do their own homework or make their own decisions. This effect causes many investors to overstate their risk tolerance.
- Overreaction - A common emotion towards the receipt of news or information.
- Prospect Theory - Provides that people value gains and losses differently and will base their decisions on perceived gains rather than perceived losses. Investors are “loss averse” and have an asymmetric attitude to gains and losses, getting less utility from gaining, say, \$100 than they would lose if they lost \$100. This explains why investors may avoid higher risk investments even if they offer strong risk adjusted returns. It also explains why they over insure against risks through low deductibles.
- Similarity Heuristic - Used when a decision or judgment is made when an apparently similar situation occurs even though the situations may have very different outcomes.

Behavioral Finance does not abandon many of the concepts and use of scientific method from Traditional Finance. Advisors who study or educate themselves in Behavioral Finance may be able to improve their clients’ outcomes by providing prudent recommendations tailored to the goals of the client in a way that increases the chances that the clients will use the recommendations.

Example

Bryan, after extensive analysis, purchases a security that he believes will experience a 30% return over the next two years. After the first year, Bryan's investment increases by 12%. Bryan is so pleased with his return, he sells the investment after experiencing a 12% return.

Joe, after extensive research, believes a security will increase 25% over two years. Three months after making the investment, the investment decreases 50%. Joe continues to hold the investment in the hopes of the security returning to his original purchase price and breaking even.

- Herd mentality is the process of buying what and when others are buying and selling.
 - Herd mentality leads to:
 - o Buying high
 - o Selling low

Exam Question

You are interviewing James Smith, CFP® to manage your investments and provide financial guidance in other areas of your life. James states that his investment philosophy is as a contrarian; he buys securities that are losing favor and sells securities that are gaining favor. You review his previous track record, which is about equal with the market. His investments are typically in a security that has lost at least 10% from its most recent high. What type of bias is James exhibiting?

- a) Anchoring
- b) Herding
- c) Overconfidence
- d) Belief perseverance

Answer: A

He is subject to anchoring. His belief is a stock that falls 10% from its high is likely to return to that high. He is fixated on that high price.

- Other areas of behavioral finance include:
 - Naïve diversification, which is the process of investing in every option available to the investor.
 - This is common with 401(k) or other employer sponsored retirement plans.
 - A plan participant thinks they are adequately diversified if they invest an equal amount in all the funds.
 - Also known as 1/n diversification.
 - Representativeness is thinking that a good company is a good investment without regard to an analysis of the investment.
 - Familiarity causes investment in companies that are familiar, such as an employer.
 - Clearly this can cause devastating effects on a portfolio (e.g. Enron).

Exam Question

Kevin has subscribed to various investment magazines and data resources, which he religiously reads and analyzes. Kevin utilizes this analysis to make shifts in his high beta portfolio on a daily basis. Which behavioral finance bias is Kevin subject to?

- a) Hindsight bias
- b) Overconfidence
- c) Regret avoidance
- d) Herd mentality

Answer: B

This is a classic example of overconfidence. Kevin believes that his information is perfect, that his analysis is perfect, so he trades too often and has a very risky portfolio (high beta).

- Loss aversion suggests investors prefer avoiding losses more than experiencing gains.
 - An unwillingness to sell a losing investment, in the hopes it will turn around.
 - In other words, investors feel more pain from losses, than enjoying gains.

Exam Tip

Make a flashcard of all the behavioral finance terms and definitions.

LESSON 1 REVIEW QUESTIONS

1. Which of the following would you use to ascertain the chairman's perspective for progress completed and expected for the coming year?
 - a) 10K report.
 - b) Annual report.
 - c) 10Q report.
 - d) Quarterly report.

2. You own 1,000 shares of ePlace stock. You purchased these shares for \$25 per share on margin with a 50% initial margin requirement and a 25% maintenance margin requirement. ePlace has experienced some reversals in the pummeling that tech stocks have received recently. The price has dropped to \$13 per share. Will there be a margin call? If so, how much?
 - a) \$1,500.
 - b) \$2,750.
 - c) \$3,250.
 - d) No margin call required.

3. How do the *stock split* and the *stock dividend* impact the shareholders without bringing about any changes in the value of the company on the balance sheet?
 - a) The value of the stock split and value of the stock dividend are generally small enough that the impact on the balance sheet is minimal
 - b) The value of the stock split and the value of the stock dividend increase the number of shares but not the total value of those shares
 - c) The value of the stock split and the value of the stock dividend cause dilution, which keeps the value of the stock up, but without increasing the overall value on the balance sheet
 - d) The value of the stock split and the value of the stock dividend offset one another, thereby eliminating any change that might occur to the balance sheet of the company

4. Which of the following would serve as an analytical tool to provide information to a client regarding small-cap growth stocks?
 - a) Wilshire 5000.
 - b) S&P 500.
 - c) Russell 2000.
 - d) Dow Jones Small-Cap Average.

5. Which broad market index would be more appropriate to use when conducting comparisons between a large-cap, blue chip portfolio, and the securities market?
 - a) S&P 500.
 - b) DJIA.
 - c) Russell 5000.
 - d) Value Line 300.

6. Sydney buys a stock for \$50 using an initial margin of 75% and a maintenance margin of 40%. At what price will she receive a margin call?
 - a) \$13.12
 - b) \$20.83.
 - c) \$25.25.
 - d) \$66.67.

7. Which of the following statements is true regarding the Securities Investors Protection Act of 1970?
- a) The act protects investors from losses arising from bad investment decisions.
 - b) The act requires a prospectus to accompany all new issues.
 - c) The act protects investors from negligence on the part of an investment adviser.
 - d) The act protects investors from losses arising from brokerage firm failures.
8. Which of the following is not a value-weighted index?
- a) DJIA.
 - b) S&P 500.
 - c) Russell 2000.
 - d) Wilshire 5000.
9. Your best friend Alex came to your house party for the football game. During the game he starts telling you about his amazing portfolio performance. He tells you about several positions that experienced double digit returns in a matter of days. He says that he lost on a few but not very much. Impressed you decide to invest some money with him. What behavioral finance bias does your friend Alex portray?
- a) Overconfidence
 - b) Anchoring
 - c) Cognitive dissonance
 - d) Belief perseverance
10. An old Wall Street saying is “Cut your losses and let your profits run.” However, investors often do the opposite. It seems that people are reluctant to admit they made a mistake in purchasing a stock that subsequently performs poorly. This behavior is most consistent with:
- a) Anchoring.
 - b) Herd mentality.
 - c) Regret Avoidance
 - d) Representativeness.

ANSWERS TO LESSON 1 REVIEW QUESTIONS

1. Answer: B
The chairman's statement is included in the company's annual report.
2. Answer: B
Debt of \$12,500 and new portfolio value of \$13,000 requires a 25% or \$3,250 margin. With only \$500 [(\$13 - 12.50) x 1,000] remaining, there is a required call for \$2,750.
3. Answer: B
Only option B, which states that the value of the stock split and the value of the stock dividend increase the number of shares but not the value of those shares is correct. These options are sometimes used when a firm wishes to reward shareholders without expending cash that it prefers to use for other activities or opportunities.
4. Answer: C
Russell 2000 is a small-cap growth index. Wilshire 5000 is the largest index of all equity securities of all firms incorporated in the United States. The S&P 500 is a large-cap index, and there is no such thing as the Dow Jones Small-Cap Average.
5. Answer: A
The S&P 500, would be an ideal choice. The DJIA, is only 30 stocks - much too small for validity. The Russell is too broad, and there is no such thing as the Value Line 300.
6. Answer: B
 $(\$50 \times 0.25) \div (1 - 0.40) = \20.83
7. Answer: D
The act does not protect against bad investment decisions. The Securities Act of 1933 requires new issues are accompanied with a prospectus.
8. Answer: A
The DJIA is not a value-weighted index; it is price weighted.
9. Answer: C
Alex is, most likely, exaggerating his gains and minimizing or forgetting about his losses. He doesn't want the blow to his ego or pride associated with making bad decisions that lost money. This is an example of cognitive dissonance.
10. Answer: C
Regret avoidance (also known as the disposition effect) leads investors to take action or to refuse to act in hopes of minimizing any regret over their actions or inactions. In investments, it leads people to sell winners too soon and to hold on to losers too long.



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