

CFA Investment Practice Exam (Sample)

Study Guide



Everything you need from our exam experts!

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Questions

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- 1. A document that states that a company is in favour of fair employment practices is most likely a:**
 - A. Policy document**
 - B. Process document**
 - C. Procedure document**
 - D. Compliance document**
- 2. What is one of the main goals of establishing policies in risk management?**
 - A. Minimise communication**
 - B. Protect systems and information**
 - C. Encourage risk-taking behaviour**
 - D. Reduce financial investments**
- 3. What is the legal contract that outlines the terms of a bond called?**
 - A. Covenants**
 - B. Indenture**
 - C. Collateral**
 - D. Affidavit**
- 4. In the investment industry, liquidity risk refers to what?**
 - A. The inability to sell without incurring a loss**
 - B. A lack of available financing**
 - C. Lower market demand for products**
 - D. The risk of market fluctuations**
- 5. When a company issues new shares to raise capital, it typically occurs during what type of offering?**
 - A. Initial public offering**
 - B. Private placement**
 - C. Seasoned offering**
 - D. Secondary offering**

- 6. What is a primary function of a stock market index?**
- A. Contains shares from all companies currently listed on the exchange**
 - B. Is an investment product structured to track the returns of a specific index**
 - C. Can be used by an investor to assess how a particular market performed during a given period**
 - D. Predicts future stock performance based on historical data**
- 7. The crowding out effect tends to lead to higher:**
- A. Tax revenues**
 - B. Interest rates**
 - C. Public spending**
 - D. Economic growth**
- 8. What is a primary role of a broker in financial markets?**
- A. To trade for their own accounts**
 - B. To provide services for settling trades**
 - C. To facilitate transactions between buyers and sellers**
 - D. To manage investment portfolios**
- 9. What is the primary aim of risk management in investment portfolios?**
- A. Maximize returns**
 - B. Minimize losses**
 - C. Ensure client satisfaction**
 - D. Comply with regulations**
- 10. Investment advisers have a responsibility to:**
- A. Protect their own interests**
 - B. Exercise independent judgment**
 - C. Sell high-fee products**
 - D. Conform to industry trends**

Answers

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- 1. A**
- 2. B**
- 3. B**
- 4. A**
- 5. C**
- 6. C**
- 7. B**
- 8. C**
- 9. B**
- 10. B**

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Explanations

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1. A document that states that a company is in favour of fair employment practices is most likely a:

- A. Policy document**
- B. Process document**
- C. Procedure document**
- D. Compliance document**

A document that asserts a company's commitment to fair employment practices is best categorized as a policy document. Policies typically outline an organization's principles and values, setting the framework for its stance on various issues, including employment practices. In this case, the policy document would explicitly state the company's dedication to fair treatment, non-discrimination, and equal opportunity, reflecting its ethical position and commitment to fair employment. Such documents are designed to guide employee conduct and inform stakeholders about the company's standards and practices. Other types of documents, such as process documents, focus on the specific methods or actions taken to achieve goals, while procedure documents outline detailed steps to follow in carrying out those processes. Compliance documents, on the other hand, are related to adherence to laws and regulations but do not necessarily articulate a company's broader values or commitments as a policy does. Therefore, the function and content of a policy document align precisely with the intent of promoting fair employment practices.

2. What is one of the main goals of establishing policies in risk management?

- A. Minimise communication**
- B. Protect systems and information**
- C. Encourage risk-taking behaviour**
- D. Reduce financial investments**

One of the main goals of establishing policies in risk management is to protect systems and information. Effective risk management policies are designed to mitigate potential threats that could harm an organization's assets, including its technology systems and the sensitive data they handle. By defining clear policies, organizations can set standards for how to identify, assess, and respond to risks, ensuring that people across the organization understand the importance of safeguarding both physical and digital resources. These policies often include procedures for monitoring and reporting risks, conducting regular reviews, and implementing controls to improve security. Overall, the emphasis on protection helps maintain operational integrity, compliance with regulations, and prevents financial losses arising from data breaches or system failures. In contrast, minimizing communication would likely hinder collaboration and the sharing of risk-related information rather than promoting a comprehensive understanding of risk across the organization. Encouraging risk-taking behavior contradicts the goal of risk management, which is to manage and mitigate risks rather than to embrace them. Reducing financial investments may not directly relate to risk management policies, as those policies are focused more on protecting assets rather than altering the level of investment.

3. What is the legal contract that outlines the terms of a bond called?

- A. Covenants**
- B. Indenture**
- C. Collateral**
- D. Affidavit**

The legal contract that outlines the terms of a bond is referred to as an indenture. This document establishes the specific terms under which the bond is issued, including the interest rate, maturity date, the rights of bondholders, and the obligations of the issuer. An indenture serves as a protective measure for both the issuer and the investor, ensuring that all parties have a clear understanding of their rights and responsibilities under the bond agreement. In addition to specifying the basic features of the bond, the indenture may also include covenants, which are clauses that impose certain conditions or restrictions on the issuer to protect bondholders' interests. It's important to recognize that while covenants are a component of the overall legal agreement, they do not constitute the entirety of the bond contract itself, which is the indenture. Collateral refers to an asset pledged by the borrower to secure a loan or bond, and while it may be referenced in an indenture, it does not describe the contract as a whole. An affidavit is a written statement confirmed by oath, used in legal proceedings, and does not pertain to bonds or their terms. Thus, the indenture is the comprehensive legal document that encompasses the entire framework for the bond, making it the correct answer.

4. In the investment industry, liquidity risk refers to what?

- A. The inability to sell without incurring a loss**
- B. A lack of available financing**
- C. Lower market demand for products**
- D. The risk of market fluctuations**

Liquidity risk is primarily defined as the potential difficulty an investor may face in selling an asset quickly without substantially affecting its price. When an investor encounters liquidity risk, they may not be able to find a buyer for the asset at its fair market value, which could lead to selling at a loss if they need to liquidate quickly. This concept centers on the relationship between market participants' willingness to buy and sell assets and the overall demand. If there are few buyers or a lack of active market participation, an investor might have to accept a lower price to facilitate the sale. Thus, the correct identification of liquidity risk involves recognizing the implications of selling under unfavorable conditions, which is captured well by the notion of "selling without incurring a loss." This reflects the essence of liquidity within the investment markets.

5. When a company issues new shares to raise capital, it typically occurs during what type of offering?

- A. Initial public offering**
- B. Private placement**
- C. Seasoned offering**
- D. Secondary offering**

When a company issues new shares to raise capital, it typically occurs during a seasoned offering. A seasoned offering refers to the issuance of additional shares by a company that is already publicly traded. This is distinct from an initial public offering (IPO), where the company is first offering shares to the public, and it encompasses existing public companies that are looking to raise further capital by issuing new shares. In a seasoned offering, the company has already established a presence in the market and is expanding its equity base, often to fund growth, pay down debt, or improve its financial position. This is a critical way for companies to access additional funds while providing depth to their existing shareholder base. The market's existing knowledge of the company's performance can facilitate this process, as investors may be more informed about the company's potential, aiding in the capital-raising effort. Although private placements and secondary offerings are also methods of issuing shares, they serve different purposes. A private placement involves selling securities to a select group of investors and typically does not require the same level of disclosure as public offerings. A secondary offering usually refers to the sale of existing shares that large shareholders, like company insiders or venture capitalists, sell, rather than the issuance of new shares to raise funds for the company itself.

6. What is a primary function of a stock market index?

- A. Contains shares from all companies currently listed on the exchange**
- B. Is an investment product structured to track the returns of a specific index**
- C. Can be used by an investor to assess how a particular market performed during a given period**
- D. Predicts future stock performance based on historical data**

A primary function of a stock market index is to provide a benchmark for evaluating the performance of a particular market or segment of the market over a specific time frame. By tracking a selected group of stocks, the index summarizes how a market is performing, enabling investors to compare the performance of individual investments against the overall market. This function aids investors in assessing market trends, risk, and potential opportunities. Analyzing performance is essential for investors who need to make informed decisions regarding their portfolios. Using an index as a reference point allows for a straightforward measurement of market movements, successes, and failures. For instance, if an investor wants to see how their stock is performing relative to the broader market, they can look at the movements of the relevant index to gain perspective on whether their investment is underperforming, outperforming, or aligned with market trends. This understanding is critical for strategic decision-making, as it can influence buy, hold, or sell decisions based on the overall health of the market as represented by the index.

7. The crowding out effect tends to lead to higher:

- A. Tax revenues**
- B. Interest rates**
- C. Public spending**
- D. Economic growth**

The crowding out effect is a concept in economics that occurs when government spending leads to a reduction in private sector investment. When the government increases its borrowing to finance additional spending, it competes for available funds in the financial markets. This increased demand for capital typically drives up interest rates, as lenders require higher returns to compensate for the increased risk associated with a larger government debt. As interest rates rise, borrowing costs for businesses and consumers also increase, which can discourage private investment in the economy. This means that while government spending may initially stimulate demand, the resulting higher interest rates may ultimately counteract those benefits by limiting private sector growth and spending. Therefore, the crowding out effect is closely associated with higher interest rates, making this the correct answer to the question. In this context, tax revenues, public spending, and economic growth do not necessarily rise in tandem with the crowding out effect; in fact, they can be adversely impacted by the increase in interest rates, as higher borrowing costs deter private investment and consumption.

8. What is a primary role of a broker in financial markets?

- A. To trade for their own accounts**
- B. To provide services for settling trades**
- C. To facilitate transactions between buyers and sellers**
- D. To manage investment portfolios**

The primary role of a broker in financial markets is to facilitate transactions between buyers and sellers. Brokers act as intermediaries, connecting individuals or institutions looking to buy or sell securities. They help streamline the trading process by providing access to the market and executing orders on behalf of their clients. This function is crucial in maintaining market liquidity and efficiency, as it allows buyers and sellers to find each other more easily, negotiate prices, and complete transactions without difficulty. In contrast, trading for their own accounts involves a different role typically associated with dealers or proprietary traders, who take positions in securities intending to profit from price changes. Providing services for settling trades is a function often managed by clearinghouses or custodians, which ensure that transactions are completed and recorded accurately. Managing investment portfolios pertains to investment advisors or portfolio managers, who construct and oversee a collection of assets on behalf of clients, a role distinct from that of brokers whose primary duty is to facilitate market transactions.

9. What is the primary aim of risk management in investment portfolios?

- A. Maximize returns**
- B. Minimize losses**
- C. Ensure client satisfaction**
- D. Comply with regulations**

The primary aim of risk management in investment portfolios is to minimize losses. This focus on minimizing losses is essential because investments inherently carry risks that can lead to financial detriment if not managed properly. Effective risk management strategies help investors identify, assess, and prioritize risks, enabling them to mitigate potential negative impacts on their portfolios. By concentrating on strategies such as diversification, hedging, and using stop-loss orders, risk management seeks to protect the portfolio against unforeseen market movements or adverse economic conditions. This proactive approach is crucial for maintaining the overall stability and longevity of an investment strategy, allowing investors to stay on track toward their long-term financial goals. While maximizing returns, ensuring client satisfaction, and complying with regulations are important aspects of investment management, they are not the primary focus of risk management. Rather, they can be seen as secondary objectives that arise as a result of effectively managing and minimizing risks associated with investments.

10. Investment advisers have a responsibility to:

- A. Protect their own interests**
- B. Exercise independent judgment**
- C. Sell high-fee products**
- D. Conform to industry trends**

Investment advisers bear a fiduciary duty to their clients, which fundamentally requires them to act in the clients' best interests. Exercising independent judgment is crucial in this role because it allows advisers to make decisions based on objective criteria and the specific needs and goals of their clients, rather than being influenced by external pressures or conflicts of interest. When advisers exercise independent judgment, they are better positioned to recommend suitable investments, appropriate asset allocations, and tailored strategies that align with the client's risk tolerance, investment horizon, and overall financial objectives. This independence also mitigates the risk of making recommendations driven by personal gain or prevailing industry trends that may not serve the client's best interests. Ultimately, exercising independent judgment aligns with the ethical and professional standards that govern the investment advisory profession, reinforcing the trust that clients place in their advisers.