Testbank

to accompany

Financial planning
2nd updated edition

by

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WILEY

Chapter 1: Personal financial planning

Multiple-choice questions

1. A close reading of chapter 1 provides which of the following lessons for investors:

   *a. be aware of market cycles
   b. do not diversify unless there are no other options available
   c. both a and b
   d. none of the above

Correct answer: a
Feedback: Being aware of market cycles is one of the lessons from chapter 1. The chapter also advocates the benefits arising from diversification as a sound investment principle.
Learning objective 1.1 ~ describe the concept of personal financial planning.

2. Generally accepted finance principles would support which of the following statements?

   *a. 'high return generally equals high risk'
   b. 'high return generally equals low risk'
   c. 'high risk is generally inversely related to high return'
   d. none of the above

Correct answer: a
Feedback: The risk-return trade-off is positive with a higher investment return generally only being possible when the investor is (financially) exposed to relatively higher risk levels.
Learning objective 1.1 ~ describe the concept of personal financial planning.

3. The term personal financial planning generally implies:

   *a. the achievement of a financial outcome within a specified time period
   b. successfully gaining a job promotion
   c. winning the lottery within a specified time period
   d. both a and b

Correct answer: a
Feedback: Personal financial planning generally implies the achievement of a financial outcome within a specified time period. The other factors listed, although personal in nature, would not be expected to form part of the personal financial planning process.
Learning objective 1.1 ~ describe the concept of personal financial planning.

4. The value of the expected shortfall the working population will have in building an adequate retirement benefit is termed the:

    a. Retirement Standard (RS)
    *b. Retirement Savings Gap (RSG)
    c. Target Retirement Benefit (TRB)
    d. none of the above

Correct answer: b
Feedback: The Retirement Savings Gap is the term given to the expected shortfall in total retirement benefits as compared to expected accumulated retirement benefits.
Learning objective 1.2 ~ explain why personal financial planning has gained in importance over the past few years.

5. In Australia, it is expected that by about 2050 there will be approximately:

    *a. 2.7 people in working age groups for each retired person
    b. 3.5 people in working age groups for each retired person
    c. 5.0 people in working age groups for each retired person
    d. 4 males in working age groups and 2.5 females in working age groups for each retired person

Correct answer: a
Feedback: Statistical research in Australia provides evidence that by about 2050 there will be approximately 2.7 people in working age groups for each retired person.
Learning objective 1.2 ~ explain why personal financial planning has gained in importance over the past few years.

6. Superannuation guarantee contributions in Australia are levied on:

    a. employers and the self-employed
    *b. employers
    c. employees
    d. both b and c

Correct answer: b
Feedback: Superannuation guarantee contributions in Australia are only levied on employers with payment amounts based on the remuneration of eligible employees.
Learning objective 1.2 ~ explain why personal financial planning has gained in importance over the past few years.

7. To adequately meet required income needs in retirement it is generally accepted that people will need approximately what percentage of their pre-retirement income?

 a. more than 90 per cent
 *b. 60 to 70 per cent
 c. 40 to 50 per cent
 d. less than 40 per cent

Correct answer: b
Feedback: Although people are unique and have different income needs it is generally expected that approximately 60 to 70 per cent of pre-retirement income will be needed in retirement.
Learning objective 1.2 ~ explain why personal financial planning has gained in importance over the past few years.

8. Market volatility as a component of interest-rate risk:

 a. affects the amount of interest payments received on a fixed-interest investment
 b. affects the value of a fixed-interest investment at its maturity date
 *c. affects the value of a fixed-interest investment sold before its maturity date
 d. both a and b

Correct answer: c
Feedback: Market volatility affects the value of a fixed-interest investment sold before its maturity date. Any increase in market interest rates will have an inverse relationship on the value of the fixed-interest investment resulting in a decrease in its relative value.
Learning objective 1.5 ~ define various types of risk.

9. The currency risk effects from holding an investment valued in an overseas currency will result in:

 a. a rise in the Australian dollar value of the investment if the Australian dollar falls relative to the overseas currency
 b. a rise in the Australian dollar value of the investment if the Australian dollar rises relative to the overseas currency
 c. a fall in the Australian dollar value of the investment if the Australian dollar rises relative to the overseas currency
 *d. both a and c

Correct answer: d
Feedback: A rise / fall in the Australian dollar value of the investment will result if the Australian dollar falls / rises relative to the overseas currency – this is the basis of currency risk
Learning objective 1.5 ~ define various types of risk.

10. Given an understanding of interest-rate risk, an existing fixed-interest investor in bonds would be affected in which of the following way(s) if the market interest rates on bonds were to rise from 8% to 10%?

    a. interest receipts from the bonds would rise and the market price of the bond would also rise
    b. interest receipts from the bonds would fall and the market price of the bond would also fall
    c. interest receipts from the bonds would be unaffected and the market price of the bond would rise
    *d. interest receipts from the bonds would be unaffected and the market price of the bond would fall

Correct answer: d
Feedback: The investor's interest receipts are fixed for the duration of the bond whereas an increase in market interest rates would result in a decrease in the market price of the bonds as these would become a less desirable investment to other investors (as they would now be providing a relatively lower return [8%] than new bond issues [10%]).
Learning objective 1.5 ~ define various types of risk.

11. The highest credit rating from those indicated below would be:

    a. CCC
    *b. AAA
    c. A
    d. BBB

Correct answer: b
Feedback: The highest credit rating indicated would be AAA. Ratings agencies consider funds rated from AAA to BBB to be 'investment grade'.
Learning objective 1.5 ~ define various types of risk.

12. The lowest level of business activity occurs during which of the following phases in the business cycle?

    a. boom or expansion phase
    *b. recession phase
    c. recovery phase
    d. contraction phase

Correct answer: b
Feedback: The lowest level of business activity occurs during the recession phase and economic growth may even be negative during this time.
Learning objective 1.6 ~ describe the general features of the economic environment.

13. Stimulating or contracting the economy via changes in interest rates is an example of the government's use of:

    a. fiscal policy
    b. industrial relations policy
    *c. monetary policy
    d. welfare policy

Correct answer: c
Feedback: Government intervention using interest rates is an example of monetary policy.
Learning objective 1.6 ~ describe the general features of the economic environment.

14. Monetary policy, administered by the RBA, is concerned with control over interest rates and the amount of money in circulation and is used to:

    a. stimulate the economy by increasing interest rates
    b. stimulate the economy by decreasing interest rates
    c. slow the economy by increasing interest rates
    *d. both b and c

Correct answer: d
Feedback: A reduction in interest rates tends to encourage spending and borrowing by consumers to increase activity throughout the economy. Also, an increase in interest rates tends to restrict borrowing and spending and is designed to slow down the growth in the economy.
Learning objective 1.6 ~ describe the general features of the economic environment.

15. A managed fund investing in subprime mortgages will be holding assets of:

    a. low quality with a low possibility of default by borrowers
    *b. low quality with a high possibility of default by borrowers
    c. high quality with a low possibility of default by borrowers
    d. high quality with a high possibility of default by borrowers

Correct answer: b
Feedback: Assets held by the fund will be of low quality with a high possibility of default by borrowers reflecting the risk-return trade-off.
Learning objective 1.6 ~ describe the general features of the economic environment.

16. The global financial crisis:

    a. was brought about by US investment banks disguising the true risk characteristics of the collateralised debt obligations they were selling
    b. was made worse by the uncertainty within global markets as to the level of credit risk posed by financial institutions leading to governments having to guarantee bank deposits
    c. resulted in Governments offering stimulus packages to attempt to prevent economies from slipping into recession
    *d. all of the above

Correct answer: d
Feedback: All of the issues raised above were relevant to the recent global financial crisis.
Learning objective 1.7 ~ outline the origin of the global financial crisis and describe its impact on Australia.

17. The 'know your client rule':

    a. provides that a licensee must monitor and supervise the activities of representatives to ensure they are complying with the law
    *b. provides that before a financial planner is able to give specific advice on an investment, the Corporations Act requires the planner to make every effort to understand the client's investment objectives, financial situation and particular needs
    c. applies to both wholesale and retail clients
    d. is contained within the Financial Services Guide

Correct answer: b
Feedback: Before a financial planner is able to give specific advice on an investment, the Corporations Act requires the planner to make every effort to understand the client's investment objectives, financial situation and particular needs.
Learning objective 1.9 ~ outline the regulatory framework that applies to financial planning in Australia.

18. Items which are regarded as financial products include:

    *a. a security (e.g. a share in a body corporate or a debenture of a body corporate)
    b. health insurance, funeral bonds and reinsurance
    c. exempt public sector superannuation schemes within the meaning of the Superannuation Industry (Supervision) Act 1993
    d. all of the above

Correct answer: a
Feedback: The term 'financial product' is defined in general terms in s. 763A of the Corporations Act. Each limb of the general definition is then further examined in ss. 763B to 763D. Section 764A provides a list of things which are financial products and s. 765A provides a list of specific things that are not financial products.
Learning objective 1.9 ~ outline the regulatory framework that applies to financial planning in Australia.

19. A financial service is defined by the Corporations Act to be provided in the circumstances where people:

    a. give financial advice in relation to financial products
    b. give legal advice in relation to financial products
    c. make a market in a financial product
    *d. both a and c

Correct answer: d
Feedback: A financial service is a statement of opinion, a recommendation, or a report on either of these that is intended to influence a person in making decisions relating to a particular financial product or class of products, or could reasonably be regarded as being intended to have such an influence. However it does not extend to the provision of legal advice in relation to financial products.
Learning objective 1.9 ~ outline the regulatory framework that applies to financial planning in Australia.

20. The role of ASIC is to:

a. draft legislation governing the financial planning industry
b. monitor competition policy within the financial services sector
*c. ensure compliance by practitioners with legal requirements governing the financial planning industry
d. establish and monitor compliance of the prudential regulations that govern the operations of financial institutions within Australia

Correct answer: c
Feedback: It is the role of ASIC to ensure compliance by practitioners with the legal requirements governing the financial planning industry. However this responsibility does not extend to drafting legislation (which is undertaken by Treasury), monitoring competition policy (which is undertaken by the ACCC) or establishing and monitoring the compliance of the operations of financial institutions (which is undertaken by APRA).
Learning objective 1.9 ~ outline the regulatory framework that applies to financial planning in Australia.

Short answer questions

21. After reading chapter 1 you have learned of some of the issues that investors need to consider. Many of these lessons are learned by investors but not often applied. Outline five lessons that you have gained from your reading of chapter 1. You may illustrate the lesson by use of an example where appropriate.

You may select your five lessons from the section of “The lessons for investors and financial planners” and provide an outline of the lesson and illustrate with an example where appropriate.

The lessons include an awareness of:
- market cycles — shares, property and interest rates all experience cycles of high and low returns
- the risks accompanying high returns — recall the adage ‘high return equals high risk’
- the benefits of diversification — the benefits of spreading investments over asset classes to reduce risk and obtain more reliable returns
- the underlying portfolio of investment products — a fixed interest return may not be what it seems; an investor needs to know how money is being invested as a product may have a different set of risks than is immediately obvious, even though it may be ‘guaranteed’
- scams — they appear quite frequently and the ASIC website’s ‘FIDO’ provides updates
- the need to review investments based on economic and legislative changes — changes in the rules and regulations occur frequently and may affect a person’s tax position or eligibility for age pension. Economic changes may indicate a time to re-allocate an investment mix; for example, rising interest rates may mean it is time to move some funds from shares to fixed interest investments.

Learning objective 1.1 ~ describe the concept of personal financial planning.

22. Explain in your own words the relationship between personal financial planning and the 'life cycle' theory of consumption and saving.

Personal financial planning is said to be derived from the 'life cycle' theory of consumption and saving. This theory examines an individual's income and expenditure patterns over their lifetime. It recognises that during different periods of a person's lifecycle, their income is likely to fluctuate markedly, however expenditure (consumption) patterns remain relatively constant. The principal differences in income patterns arise from the source of such income (family members, salary, and investment).

By undertaking appropriate financial planning, the individual should be able to determine periods in advance where there is likely to be an income shortfall and thus plan as to how such shortfall will be met (for example; from external financing, savings, selling assets etc.).

Learning objective 1.2 ~ explain why personal financial planning has gained in importance over the past few years.

23. What are some of the principal factors that have contributed towards many developed countries including Australia, facing a rapidly ageing population?

Demographic trends world-wide show an ageing population in developed countries with the principal factors comprising: falling birth and death rates and lower levels of immigration. In addition, the significant global population increases during the period 1945 to 1960 (the so called 'baby boomers') are now reaching an age group in their late 50's to early 70's where they are approaching or are in their retirement phase. The factor of falling death rates has greatly been influenced by significant improvements in dietary habits and developments in medical science and technology such as the ready availability of vaccines for most life-threatening diseases.

Learning objective 1.2 ~ explain why personal financial planning has gained in importance over the past few years.

24. Comment on whether you consider the current government superannuation contribution requirements to be adequate in order to provide for a suitable retirement income for the Australian population.

The current compulsory superannuation contribution requirements are only directed towards those people who are employees, within specified age brackets and are earning a reasonable level of income. As a result, there are significant 'gaps' in the population who are not covered at all by such provisions. These groups include; the self-employed, part-time workers and those continuing to work beyond the 'normal' retirement age. Each of these categories of people will not have a suitable retirement income unless they provide for themselves via superannuation contributions etc. It would be expected that for a significant component of these categories such provision is unlikely.

In addition, research undertaken by various business and financial organisations have doubted the sufficiency of the current superannuation guarantee employer contribution level to provide an adequate retirement income. Such research has shown that superannuation contributions may need to be increased by at least 30 to 50% from their current levels in order to provide for an annual retirement income approximating at least 60% of a person's pre-retirement income.

Learning objective 1.2 ~ explain why personal financial planning has gained in importance over the past few years.

25. Differentiate the roles of the financial counsellor and the financial planner.

The financial counsellor typically provides a free, confidential and independent service often accessed via local government for people experiencing financial hardship. This contrasts with the role of the financial planner whose services are charged out at professional rates and are available to the public at large (at least those who can afford these professional service fees) from commercial organisations who may or may not be totally independent.

The service areas provided by the financial counsellor are often more short-term in nature and include advice and advocacy on areas such as unpaid bills, dealing with creditors and household budgeting whilst the financial planner typically deals more with longer-term issues such as the investment of surplus savings into the various asset classes or with investment vehicles / strategies such as the use of superannuation to accumulate for expected retirement needs.

Learning objective 1.3 ~ recognise the role played by financial counsellors in the financial environment.

26. List and explain the various types of investment risk.

Mismatch risk: this is the mismatching of a person's objectives, investments and time frame.

Inflation risk: this is the risk that the purchasing power of a person's money will be eroded by increases in the cost of living.

Interest-rate risk: this risk may be considered in two ways:

- Reinvestment risk: when fixed investments mature, an investor needs to consider the interest rates available at the time of reinvestment.
- Market volatility: fixed-interest investments usually have a set interest rate for the duration of the term. Movements in interest rates during the term of a fixed-interest investment will affect its current value – the relationship between interest rate fluctuations and prices are inverse – hence the sale of fixed-interest investments prior to maturity where there has been a movement in interest rates since the purchase date will realise a gain / loss on sale.

Market risk: all markets have ups and downs. Some are more volatile than others and it is important to be aware of the time frame of the investment in order to be able to ride out the bumps in the performance.

Market timing risk: some people believe that they can time when to get into the market and when to get out of the market. In practice, this is very difficult to achieve and in many cases some market timers end up being worse off.

Lack of diversification risk: the main benefit of diversification of investments is to reduce the overall risk of your investment portfolio. Although one market segment has a lower than expected return, other market segments may perform higher than expected. The key to successful long-term investing with a lower level of risk is to ensure that your investment portfolio is diversified across a range of asset classes.

Currency risk: this risk applies if you hold investments valued in overseas currencies. A rise in the Australian dollar relative to the currency of the country in which you hold some investments will see a fall in the value of your investments.

Liquidity risk: it is always important to have access to cash for emergency purposes. We can never foresee when we may need the cash, but it is very important to have either cash in the bank available at call or a credit facility which can provide cash at very short notice. Redeeming investments to meet such a need may mean paying an exit fee or selling an investment when market prices are low.

Credit risk: credit risk applies to investments such as term deposits, debentures, mortgage loans and bonds. It is the risk that the company to which you have lent money will become insolvent and will be unable to meet interest payments or repay your funds. You can guard against this to some degree by seeking information about the company's credit rating, past performance and ownership, which should give an indication of the quality of the organisation.

Legislative risk: the recognition that changes in government legislation is likely to impact on the value of specific / all investments is an important issue to recognise – recent examples have been the ongoing changes to the superannuation laws, changes in tax rate thresholds for individuals and changes to the rules affecting the availability of government benefits and allowances.

Gearing risk: this risk arises whenever borrowings are accessed for investment purposes. It includes risks arising from fluctuations in interest rates affecting debt repayment requirements and fluctuations in the values of underlying assets acquired as a result of the borrowings, particularly when borrowings are secured.

Learning objective 1.5 ~ define various types of risk.

27. Reno has a goal of purchasing a new speedboat valued at approximately $14,000 financed from the returns generated on his investments over the next 12 months. He currently has approximately $150,000 available for investment and wishes to select any one of the following alternative investments in order to realise his goal:

Details	**Expected Income return (% p.a.)**	**Expected Capital return (% p.a.)**
1 year unsecured note	**10**	**0**
1 bedroom rental property	**4**	**8**
Shares in Australian bank	**3**	**12**

Ignore the effects of taxation in your calculations.

(a) Calculate the expected amount of income and capital generated by each investment over the next 12 months.

(b) Rank the investments in the order of their total return (expressed as a dollar amount) from the highest to the lowest.

(c) Briefly outline the main risks attached to each investment from the various types of risk discussed in this chapter.

(d) What issues would be relevant and what specific benefits could Reno achieve if he sought to diversify his investments using the alternative investments provided?

(a)

Details	Expected Income ($)	Expected Capital ($)
1 year unsecured note	15,000	0
1 bedroom rental property	6,000	12,000
Shares in Australian bank	4,500	18,000

(b)

Details	Total Relative Return ($)	Rank
Shares in Australian bank	22,500	1
1 bedroom rental property	18,000	2
1 year unsecured note	15,000	3

(c) 1 year unsecured note: The main risks attached to this form of investment include; inflation risk, interest-rate risk and credit risk.

1 bedroom rental property: The main risks attached to this form of investment include; mismatch risk, market risk, diversification risk and liquidity risk.

Shares in Australian bank: The main risks attached to this form of investment include; market risk and market-timing risk.

(d) If Reno sought to diversify his investments using the alternative investments provided he would have to determine the minimum investment amount required for each investment, particularly in relation to the rental property which is likely to use most of his available investment capital ($150,000). In relation to the rental property, there is also likely to be significant transaction costs involved in the acquisition and sale of the investment which is likely to have significant impact on any net realised returns from this investment.

By diversifying his investments beyond merely one of the alternatives, Reno has the ability to reduce the overall risk exposure of his portfolio without significantly impacting on the expected returns from his investments. Given the difficulty that he may face in combining the rental property with the other investments due to the expected limited capital that may be available after the property purchase, a combination of 50% of each of the unsecured note and the Australian bank shares would produce an expected return of $18,750 (50% [$15,000] + 50% [$22,500]) with significantly less risk exposure than that arising from the individual investments.

Learning objective 1.5 ~ define various types of risk.

28. Briefly outline the ways in which governments seek to constrain or stimulate the domestic economy.

The main mechanisms used by government to constrain or stimulate the domestic economy are via fiscal or monetary policy. Ultimately their goal is to seek to grow the economy at a sustainable rate without experiencing significant fluctuations (up to down or down to up) in the business cycle within short periods of time. Fiscal policy arises from the use of taxation and government spending policies to increase or reduce the funds available to the population, which will have a resultant impact on economic growth. The policies introduced may be broadly-based, designed to impact across the whole population, or may be selective, whereby specific target groups are identified. Monetary policy initiatives by government involve the manipulation of interest rates to control the amount of money in circulation as a means of either stimulating or slowing down the economy. A decrease in interest rates will tend to encourage spending and borrowing activities which are of a stimulatory nature to the economy. An increase in interest rates however, will likely have the effect of restricting borrowing and spending patterns thus having the impact of slowing economic growth.

Governments must also be aware of the influence of the global economy and the roles of foreign governments when seeking to minimise the excesses of local market cycles, particularly for relatively small economies such as Australia.

Learning objective 1.6 ~ describe the general features of the economic environment.

29. Explain how the global financial crisis started and its impact upon Australia.

Students should discuss issues including the following when referring to the global financial crisis:

- poor lending standards by US banking and financial institutions
- loans of all credit ratings were parcelled into collateralised debt obligations (CDO's) in the hope that diversification would hide the bad loans amongst the good and the CDO's were sold world-wide (but not extensively in Australia)
- suspect performance of rating agencies by rating securities higher than otherwise
- a severe shock in the US real estate market that had been unanticipated
- some financial institutions were forced to close e.g. AIG, Lehman Brothers whilst others were bailed out by governments at great cost and many others became afraid to deal with other institutions because of concerns of heightened credit risk.
- Nations were forced to guarantee bank liabilities and stimulate their economies to avoid recession.
- Australia fared better than most because of limited exposure to CDO's and extensive government stimulus measures.

Learning objective 1.7 ~ outline the origin of the global financial crisis and describe its impact on Australia.

30. Explain the role of the ASIC.

It is the role of ASIC to ensure compliance by practitioners with legal requirements governing the financial planning industry. It is also important to note that ASIC does not draft legislation — this is Treasury's role. ASIC's role is to implement the legislation that is approved through the parliament. ASIC is the watchdog for consumer protection laws in financial products and services. Its powers relate to the client:

- receiving financial advice
- putting money into investments, superannuation, life insurance or general insurance, or depositing money with a bank, building society or credit union.
- however, ASIC's powers do not extend to protecting the client in the following situations: borrowing money, which is governed by state or territory departments of fair trading or the Australian Competition and Consumer Commission
- having concerns about the actual level of fees, that is in the case where the client has been clearly told about them and has been charged only what the contract provides for
- buying health insurance
- the merging of banks or closure of their branches.

In meeting the challenge of implementing the legislative changes introduced by the Financial Services Reform Act 2001 (FSRA), ASIC has developed policy and guidance in consultation with industry members and industry bodies to assist the advisory services industry apply the legislative provisions to their individual circumstances (refer to the ASIC website, asic.gov.au)

Learning objective 1.9 ~ outline the regulatory framework that applies to financial planning in Australia.