Overview for Questions #1-3 of 84

Question ID: 1748951

TOPIC: ASSET ALLOCATION

TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS

Valerie Gordon is a medical scientist at a large pharmaceutical company. Aged 48, Gordon has saved toward her intended retirement at age 65 in a tax-deferred retirement account that is currently valued at USD 1 million. Exhibit 1 shows her current asset allocation.

Exhibit 1: Current Asset Allocation—Gordon

Asset Class	Weighting
Non-investment-grade bonds	20%
Investment-grade bonds	20%
Equity total return (capital gain) strategy	30%
Equity dividend income strategy	30%

Gordon recently inherited an additional USD 1 million from her aunt, which she plans to invest in a new taxable portfolio. Gordon meets with three potential wealth managers (Manager X, Manager Y, Manager Z) and advises them that she wants to invest in the same set of asset classes as her retirement account. The wealth managers also note the following:

- Gordon wants to maintain her current risk tolerance.
- The equity dividend income strategy focuses on high-dividend-paying stocks.
- The equity total return strategy focuses on growth companies that do not pay dividends.
- Gordon has an annual salary of $150,000 and pays a 40% tax rate.

Exhibit 2 shows each manager's recommended asset allocations.

Exhibit 2: Recommended Asset Allocations

Asset Class	Manager X	Manager Y	Manager Z

Non-investment-grade bonds	15%	0%	0%
Investment-grade bonds	25%	40%	30%
Equity total return (capital gain) strategy	30%	30%	70%
Equity dividend income strategy	30%	30%	0%
Totals	**100%**	**100%**	**100%**

The potential wealth managers each discuss the concept of tactical asset allocation with Gordon. She considers three statements made by the potential managers:

Statement 1:	Tactical asset allocation includes security selection.
Statement 2:	Tactical asset allocation attempts to take advantage of perceived short-term opportunities in the market.
Statement 3:	Tactical asset allocation seeks to maintain the investor's long-term targeted risk profile.

Based on an overall portfolio value of USD 2 million that is split between her tax-deferred retirement account and her taxable account, she wants to know the optimum allocation of assets to each account. She states that she has no constraints on transferring assets between accounts.

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Determine the *most* suitable asset allocation for Gordon, given the recommendations in Exhibit 2 (Manager X, Manager Y, or Manager Z). **Justify** your recommended allocation with *two* reasons.

Explanation

Scoring key: (4 points possible)

The allocation recommended by *Manager Z* is the most suitable allocation for Gordon in the new taxable portfolio.

Tax efficiency:

Manager Z optimizes tax efficiency by allocating a 70% weight to the equity total return strategy. This strategy focuses on capital gains, which are deferred until assets are eventually sold. This tax-deferred approach allows for gross compounding of these assets within the taxable account. The equity total return strategy focuses on companies that do not pay dividends, which avoids income taxes.

Manager Z allocates 30% to investment-grade bonds. This is the lowest allocation to income-producing assets (Managers X and Y allocate 40% to bonds). Reducing the allocation to bonds improves tax efficiency because coupon income is taxable.

Maintaining the client's risk profile:

In the taxable portfolio, we consider the net standard deviation of returns, whereas in the tax-deferred retirement account, we consider the gross standard deviation.

This means the increased allocation to equity (70% from 60%) still results in a comparable risk profile for the client on a net standard deviation basis. Put another way, in the taxable account, some of the standard deviation is shared with the tax authorities.

Higher expected returns:

Increasing the equity allocation from 60% to 70% also increases the expected return of the taxable portfolio.

2 points for the correct recommendation. 1 point for each valid justification.

(Module 5.2, LOS 5.c)

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Recommend the optimum allocation of assets to each of Gordon's accounts. **Justify** your recommendation with *two* reasons.

Explanation

Scoring key: (4 points possible)

Tax-deferred retirement account:

Allocate all the *income-producing assets to the tax-deferredaccount* to shield the income produced each year from tax:

- Non-investment-grade bonds
- Investment-grade bonds
- Equity dividend income strategy

Taxable account:

Allocate the *equity total return (capital gains) assets to the taxable account*. This is because equity benefits from tax deferral of capital gains until assets are sold. This approach optimizes tax efficiency.

2 points for choosing the correct allocation. 1 point for each valid reason.

(Module 5.2, LOS 5.c)

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Identify which of the statements made by the potential managers is correct (Statement 1, Statement 2, or Statement 3). **Justify** your choice with *one* reason.

For the other two statements that you believe are incorrect, **justify** your decision with *one* reason for each statement.

Place your responses in separate paragraphs.

Explanation