Fundamentals of Financial Planning
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Suggested Answers for Questions & Problems
The Institute of Financial Planners of Hong Kong

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Chapter 1

Multiple Choice Questions

1. D
2. C
3. D
4. B

Chapter 2

Multiple Choice Questions

1. B
2. A
Chapter 5

Multiple Choice Questions

1. C
2. D
3. D
4. B
5. C

Problems

1. Personal financial planning is a comprehensive process which evaluates all aspects of a client's financial needs including consumption, taxation, insurance, investment, retirement, and estate planning in an integrated six-step approach in order to achieve the client's financial goals. The six steps include (1) establishing client-planner relationships; (2) gathering client data and determining goals; (3) analyzing the client's financial status; (4) developing and presenting the financial plan; (5) implementing the plan; and (6) monitoring the financial plan.

2. Personal financial planning mainly involves achieving the overall financial objectives of individuals. Wealth management is a closely related concept to personal financial planning and is defined as the practice of comprehensive financial planning with an emphasis on conducting and implementing investment management for clients. However, recently, there has also been an increasing emphasis on estate planning implementation for wealth management clients. So the term wealth management is used when the financial planning service involves large investment portfolios and estate planning, usually for high net-worth clients. Owing to the similarity of financial planning and wealth management, professionals engaging in these businesses normally use these two terms interchangeably.

One may argue that commercial banks and private banks have a stronger presence in wealth management early on while independent financial advisors (IFAs) in general are credited for their contribution in developing the financial planning industry. However, while such a historical development may describe the picture in the United States, the financial planning and wealth management industries have taken different paths of development in Europe and Asia.

3. Countries like the United States and Australia have a longer history in financial planning. Financial planning appears to be a young concept in Hong Kong, Mainland China, and India. There are two major characteristics we can observe in the financial planning industry of a country in order to identify the level of sophistication and the maturity of its financial planning profession.

First, in a young and less mature financial planning market, clients are generally older. The required services for an older clientele normally focus on investment management, retirement planning, and estate planning. The
percentage of younger clients is much higher for a younger market. The services needed for such a market include consumption planning, insurance protection, and short- and medium-term investment planning.

Second, in a more mature financial planning market, consumers are generally better educated in terms of financial planning. Consequently, they are more receptive to paying a fee for getting comprehensive financial advisory services. This willingness of consumers to pay for financial planning advisory services would allow independent financial planning firms and fee-based financial planners to exist and to compete against product manufacturers and commission-based financial services professionals. The coexistence of fee-based and commission-based financial planners is a critical element in cultivating comprehensive financial planning services. In a less mature market, commission-based financial planners would dominate the industry.

4. As financial planners need to devise comprehensive and integrated financial planning services for their clients, they need to have all-round knowledge of the financial, psychological, and physical well-being of clients, of various financial analyses (e.g., cash flow analysis, financial statement analysis, and actuarial analysis), and of macroeconomic and microeconomic conditions. If financial planners do not have comprehensive knowledge in these different areas, they will not be able to cope with the high diversity of the client base, the great variety of the financial objectives of the clients, and the continuous change in economic conditions.

Financial planning is a profession which operates through personal selling. Therefore, besides possessing adequate knowledge of financial planning, financial planners must also have excellent communication and interpersonal skills. Basic communication skills are adequate to inform the consumer public about financial planning services. However, basic communication skills are not sufficient to convince the consumer public to rely on financial planners to provide financial planning services for them: Financial planners need better communication skills to be able to provide multipurpose financial services.

Public acceptance and trust are essential for all professions, including the financial planning profession. How then does the financial planner build up public acceptance and trust? The only way is to provide the best services for the best interests of the consumer public. The next question is, how does the financial planner measure the quality of his or her services? Because a financial planner of good standing is able to attract clients and hence business, service quality can be measured by the number of products bought and the amount of capital entrusted. Therefore, a good reputation is the most valuable intangible asset of a financial planner. How does the financial planner develop and maintain a good relationship with clients? One way is by conforming to an ethical financial planning practice.

The key to successful financial planning is a combination of three major ingredients. They are (1) strong interpersonal skills; (2) strong financial planning knowledge; and (3) professional and ethical behavior. Combining these three ingredients, we will be able to produce a strong reputation for the financial planning practice, leading to a trusting relationship with clients and finally a successful financial planning business.
5. To obtain the CFP\textsuperscript{CM} designation, financial planners have to fulfill the four “E” certification requirements imposed by the US Financial Planning and Standards Board: education, examination, experience, and ethics. The certification process is important for a profession as it ensures the general public that all the holders of the CFP\textsuperscript{CM} designation are equipped with a minimum level of competence and training to provide adequate financial planning services. These four “E” requirements set the standard that the financial planners are competent, qualified, experienced, and ethical professionals.
Chapter 6

Multiple Choice Questions

1. A
2. C
3. B
4. C
5. D

Problems

1. The major planning areas are consumption, insurance, tax, short/medium term investment, retirement, and estate planning.

2. The seven principles are integrity, objectivity, competence, fairness, confidentiality, professionalism, and diligence.

3. The ETHICS-PLUS decision-making model was developed by the ICAC. There are two parts in the model. The first part explains the six-step ETHICS process:

   i. Establish the relevant facts and identify the ethical issues involved
   ii. Take stock of all stakeholders or parties involved
   iii. Have an objective assessment for each stakeholder’s position
   iv. Identify viable alternatives and their effects on the stakeholders
   v. Compare and evaluate the likely consequences of each alternative with reference to the standards expected (PLUS factors below)
   vi. Select the most appropriate course of action

   The second part lists the four-factor PLUS standards:

   i. Professional/Trade-related/Company code of conduct
   ii. Legal requirement; e.g., whether there are any breaches of the laws such as the Prevention of Bribery Ordinance, the Securities and Futures Ordinance
   iii. Uncompromising self value; e.g., honesty, fairness, trustworthiness
   iv. Sunshine test; i.e., whether the issue can be discussed openly and the decision disclosed without misgivings

4. Clients rely on the services provided by professionals. Clients may not have the knowledge or time to check on the performance of the professionals. Therefore, professionals have the fiduciary obligation to secure the trust and reliance of their clients. Bayles (1989) argues that there are seven fundamental responsibilities of professionals toward their clients:

   i. Honesty
   ii. Truthfulness
   iii. Competence
   iv. Diligence
5. The four essential elements in cultivating *guanxi*—trust, favor, dependence, and adaptation—often lead to insider-based decision making (Wong 1998). The entire process of developing *guanxi* involves such practices as giving face and exchange of benefits, favors, and information. The mutual relationship developed creates reciprocal obligations that are almost impossible to refuse (Wong and Chan 1999; Yi and Ellis 2000). It appears that an inappropriate application of these *guanxi* elements would be in conflict with the strict compliance of ethical principles.

More specifically, financial planners practicing principles that are directly in conflict with the *guanxi* culture (e.g., the principles of fairness, confidentiality, and diligence) will face an uphill battle in China. After all, *guanxi* implies favoritism, having an inside scope, and privilege. Consequently, it will be very difficult for a financial planner to be fair if certain clients demand favoritism; to keep information confidential if senior executives and influential clients demand to know confidential inside information; and to practice due diligence if it is acceptable for society to allow certain higher level individuals to enjoy privileges and not follow certain rules.

6. It is common for any profession to have principles and rules for practitioners so that they can provide services of the highest quality. Such principles and rules are known as practice standards. Practice standards in financial planning are designed to guide financial planners and financial services firms in conducting their financial services in the best interests of society. In countries where financial planning is still a relatively new concept, these practice standards are still under development. In such cases, professional organizations and financial services firms may establish a best practices manual, which is based on their own experience and research, to provide some guidelines for financial planning professionals to follow. However, the standards that they develop may not be universally accepted by the industry, but serve as an important road map to reach that goal.

Just following a set of legal requirements would not be enough to formulate best practices; ethical principles must also be taken into account. While different professional bodies may have different practice standards peculiar to their profession, all follow similar ethical guidelines. Well-developed financial planning practice standards are evolved from centuries of general and professional-specific practices believed to be the best way to conduct financial planning and wealth management.

There are two opposing schools of thought regarding the formulation of best practices. The first is based on theoretical and academic studies. The second, championed by pragmatists in financial service firms, emphasizes the practical aspects—how best to implement something in the most efficient manner. Consequently, best practices guides of different institutions and professional bodies vary quite a lot, reflecting these opposing schools of thought. Judging from the fact that the US Financial Planning Standards Board just published its first set of practice standards in 2004, a country would take years, if not decades, to formulate its own practice standards.
Following best practices may not lead to immediate financial gains for financial planners. On the contrary, it may mean incurring more costs. Some financial planners may truly believe that following best practices is worthy of the cost and effort. Others may consider it as just a requirement to stay in business. Either way, it is important that financial planning bodies should take the time to formulate practice standards that would enhance the reputation of the financial planning profession as a whole.
Chapter 7

Multiple Choice Questions

1. A
2. C
3. A
4. C

Problems

1. Financial planners employ financial ratios to help analyze the financial status of clients. The interpretation of ratios is based on both cross-sectional and time-series analyses. Financial ratios are simple mathematical expressions of the financial relationship between the items on the various financial statements of clients. Financial ratios can be used to measure and reflect profitability of assets, liquidity position, debt repaying ability, risk preferences, living patterns, and values of clients. Therefore, financial ratio analysis enables financial planners to have a better understanding of their clients’ current financial position so that they can select better financial planning strategies to devise better plans for their clients.

2. The permanent-income hypothesis states that an individual’s current consumption level is determined by the expected income in the future. In order to receive the highest lifelong overall satisfaction level through consumption, an individual tends to engage in a stable or slowly increasing consumption pattern, even though his income may be unstable through life. In other words, there is a tendency in human behavior to adjust and smooth consumption based on lifelong expected income.

The implication for financial planners is that they should advise their clients to smooth their consumption patterns regardless of how much they earn in a particular year. Thus, clients should spend less and save more when their income is high. However, when income is low, they should withdraw money from their savings to maintain a stable consumption. In short, consumption smoothing provides a better overall satisfaction for individuals than the behavior of correlating periodical income with consumption.

If an individual’s current consumption level is determined by future expected income, then there is an implicit tendency to spend or use all the money earned through our life, unless there is a desire to make bequests. Of course, making a bequest can be regarded as a form of consumption. Thus, the following equation can be written:

\[ \text{Total lifelong income} = \text{Total consumption} + \text{Bequest} \]

To provide a simple model that can be used by financial planners in estimating the appropriate consumption level, we can use the following equation:

\[ \text{Present value of annuity (annual income)} = \text{Present value of annuity} \]
(annual consumption) 
+ Present value (bequest)

By using this method, we can easily estimate the ideal annual consumption for clients. Of course, if the client has no bequests to make, they can spend all the money on themselves. This naive model has obvious problems. For example, irregular major consumption items such as home purchase, education, and even funeral expenses, are not taken into account. However, these problems can be easily solved by partitioning the lifelong consumption period into subperiods of equal consumption using the irregular major expenses as the break points. In addition, consumption is based on the per-capita assumption. If the number of members in the household varies through time, adjustments should be made to the combined household consumption to reflect the fact that some members like children may spend more or less than a regular adult, depending on the life-cycle stage they are in.

3. One way of reducing or splitting assessable income is by setting up a family trust, in a discretionary trust format or a unit trust format. A family trust is a more effective income-splitting technique because of its flexibility. The trustee of the family trust collects the income and profits of all the family members. The income and profits are then divided among the family members in such a way that the total tax payable is a minimum. There are two major types of trusts: unit trust and discretionary trust. The beneficial ownership of the estate under a unit trust is divided into a number of units and the unit holders (beneficiaries) own the units rather than the estate. While the trustee of a unit trust does not possess the discretionary power to distribute the estate, the trustee of a discretionary trust assigns the estate distribution to the beneficiaries. As family trusts are so widely used, many taxing authorities have imposed additional taxation rules restricting its practice for income splitting.

4. A simple way to estimate the insurance needs of the client is by using the rules of thumb approach. This approach is based on some subjective industry wisdom that the life insurance coverage should be a multiple of the annual income of the client. For instance, for whole life insurance, it is believed that 6–8 times the gross annual income should be sufficient. For term life insurance, a higher multiple such as 10–15 times the current annual income should be more appropriate.

On top of this, it is also believed that an emergency cash fund of at least 3–6 months of income should be available at all times. Of course, rules of thumb vary from country to country and from client to client, depending on many factors such as tax rates, lifestyles, asset levels, and the sense of security of the clients. One must be very careful in applying these rules to clients. Financial planners should always remember that life insurance should not be used as a lifelong financial protection for the surviving spouse and family members. As long as there is enough financial protection for them to survive the emotional period of grief and loss and learn to be independent financially, the insurance coverage is deemed to be appropriate.

The needs approach is a better approach than the rules of thumb approach as it is more scientific. Using the needs approach, financial planners are required to come up with an estimate of the insurance coverage by predicting the lump-sum cash needed upon death to cover funeral expenses, liabilities, and more importantly, ongoing consumption needs of the surviving spouse.
and family. This approach requires an assumption of how much the surviving
members really “need” for every year and for how long. Need can be a very
abstract and subjective term. A lot of people think that they need a lot of stuff.
However, what they really need may not be essential to their daily lives. In
other words, what they think they need is actually what they want or desire.

Therefore, while the needs approach is more scientific in that it tries to
estimate the consumption needs of surviving members and relate these to
insurance coverage, the key issues of how much is necessary and for how
long they should be protected are still “open” questions that financial planners
will have to answer. Once these issues are resolved, hopefully with the
support and understanding of the client, the calculation of the consumption
amount and the estimation of the major expenses for the period become a
mere exercise of time value of money calculation.

5. The permanent-income hypothesis can help to provide a useful consumption
strategy for clients through consumption smoothing. The permanent-income
hypothesis can also be used to estimate the amount of life insurance
protection. The relevant equation is

Total lifelong income = Total consumption + Bequest

We can estimate the ideal annual consumption level for clients simply by
assuming that clients would spend all their lifelong income on consumption.
In this case, the total consumption would be determined by the income
earned. Therefore, life insurance coverage should be related to lifelong
income. To cater to the surviving family’s needs, we can reduce the
consumption level by the amount spent by the insured. After estimating the
total consumption needs of the family in terms of present value, the financial
planner can use that amount as the basis for the life insurance needed for the
family. In theory, the calculation must be repeated annually—the reason
being that, as the total lifelong consumption reduces through time, so does
the insurance coverage. In practice, it is quite difficult to reduce the insurance
coverage from year to year. Thus using a combination of term life and whole
life insurance to create a matching pattern of the upward and downward
trends in insurance needs in various life stages is an effective strategy to
match cyclical insurance needs in a client’s life cycle. In fact, there exist some
life insurance products that provide a decreasing life insurance coverage
through time. Such a decreasing term life insurance policy is a very useful
tool in dealing with the declining insurance needs in the later stages of a
client’s life cycle.

However, there are certain limitations of relating insurance needs to
consumption smoothing. One of the major assumptions for consumption
smoothing is that total lifelong income is a good indicator of the total
consumption of an individual. There are cases where this assumption may
not be valid. First, this assumption does not allow for the extensive use of
debt with the intention of defaulting or using an insurance policy to cover the
debt of the deceased. In this case, consumption can far exceed the income
earned. Second, this assumption may not be valid as well if the income level
of the client is too low or too high. We can divide clients into three major
categories according to their incomes: (1) low income; (2) middle income; and
(3) high income.

Individuals in the low-income group may not have enough money to buy
proper insurance coverage. The high-income group may earn too much
money for us to use the assumption that total income should be equal to total consumption, so the needs approach may be more suitable than the consumption smoothing approach. We can assume that the total lifelong income serves as a good benchmark of the total consumption for clients in the middle-income group. Thus, in order to estimate the insurance needs of clients, we can use the consumption smoothing approach with the total income as a constraint to estimate the ideal consumption level first, and then determine the proper insurance coverage.
Chapter 8

Multiple Choice Questions

1. A
2. D
3. A
4. C
5. B

Problems

1. Real estate is an irremovable asset. Its marketability and price level are restricted by its location. Real estate is also an illiquid asset. The purchase and sale transactions of real estate take a relatively longer time to proceed (as compared to other investments such as securities and derivatives). Although real estate investment can bring in large sales proceeds for the investor, it takes time for the investors to get it. Therefore, if investors are in quick need of cash, real estate investment is not a good choice. In some circumstances, the seller of the real estate may be pressured to lower the selling price to enhance the marketability and to speed up the selling process.

2. When making recommendations for an appropriate investment instrument, financial planners have to bear in mind that the main purpose of education investment is to provide sufficient funds for education expenses rather than gaining profits. Security and liquidity are the main concerns. The investment strategies for an education plan can be of short-term or long-term horizon. When clients commence the education plan late, they may have to employ more short-term investment strategies. If they start early, they can employ long-term investment strategies. The tools for long-term education investment planning include personal savings, fixed coupon bonds, life insurance products, bonds (government or corporate), and mutual funds. Clients can earn regular interest from bond investments. When they are in need of large amounts of capital, they can sell the bonds and enjoy the sales proceeds. In addition to coupon bonds that pay interest regularly, there are also zero-coupon bonds which pay no interest but allow the investor to buy at a deep discount. For instance, the US EE Series savings bond adopts a user-friendly approach to help individuals to save money for education purposes. The individuals who are interested in this kind of bonds can buy the bonds through the banks. The price of the bond is always half of the par value of the bond. The time to maturity for different interest rates is shown on the back of the savings bond certificate so the buyers can check when they can collect the money. If the bond money is used to pay for the education expenses of the buyer or the children of the buyer, the interest income earned from the bond is tax-free.

Treasury bills and government bonds are generally risk-free, highly marketable, and highly liquid. There is guaranteed of periodic interest income and redeemable value upon maturity. Unlike treasury bills and government bonds, corporate bonds are more risky.
3. Under a defined benefit plan the employers agree to provide the retired employees a specified payment at the retirement date. Depending on the terms of the defined benefit plan, the specified payment may be a fixed amount or may be varied to adjust for the increased cost of living due to inflation. Conservative employees usually prefer the defined benefit plan because of the certainty of receiving a one-off payment at their retirement dates.

In the United States, firms using the defined benefit plan as their chosen pension scheme have to follow one of two vesting schedules: the five-year rule or the three-to-seven-year rule. Being vested means that a worker has completed sufficient years of service and is entitled to receive accrued benefits under the plan. When an employee becomes fully vested, the employee is eligible to receive the accrued benefit, even if he or she leaves the company before retirement age. Under the five-year rule, employees become fully vested after five years of service. There is no partial vesting under this rule. However, there is partial vesting according to the number of years of service under the three-to-seven-year rule. For three years of service, 20% of the pension right can be vested. Subsequently, for each additional year of service, there is a further 20% increase in vesting (40% for four years of service; 60% for five years of service; 80% for six years of service; 100% for seven years of service). Consequently, the employees become fully vested after seven years of service.

4. Vesting is a term which defines the right of the employees to receive retirement benefits when they change jobs and leave their employers prior to retirement. The pension right is vested if the employees retain the right to receive pension benefits from their former employers prior to retirement and nonvested if the employees lose the right to do so.

Owing to the different costs and benefits of vesting for employers and employees, employers prefer pension rights to be nonvested while employees prefer pension rights to be vested. Defined contribution and profit sharing plans usually offer immediate vesting once employees participate in these plans. If employers are not willing to make pension plans provide immediate vesting, they may offer pension plans with deferred vesting.

By deferred vesting, it means that the time for the pension right to become vested is deferred. In the first few years of service, the pension right is nonvested. After the employees have remained in service for a number of years, the pension right becomes fully vested. When the pension right becomes fully vested, the employees can receive the pension benefits from their former employers even if they change jobs prior to retirement.

There are several benefits of deferred vesting particularly for the employers. In order to get the pension benefits, the employees have to work for a given period. Therefore, the deferred vesting pension plan helps retain employees in the firms for a given period and hence reduce the turnover of staff. In addition, if the employees change jobs before the pension right becomes fully vested, the employers can save the costs of pension plans for the early leavers. Although deferred vesting is beneficial for the employers as it reduces cost and staff turnover, earlier vesting is preferred by the employees. Firms which offer plans with earlier vesting are able to attract staff.
5. A will is a legally enforceable declaration and instruction of the estate owner on the estate when the estate owner dies. A will only becomes effective upon the death of the testator. A will is an essential instrument of estate planning. A will helps achieve and fulfill the wishes of the deceased and to enforce them legally.

There are three types of will: a formal will under the administration of an attorney, a written will, and an oral will. The formal will under the administration of an attorney is the most powerful as the procedure to formulate the will is formally drafted and witnessed by the attorney and signed by the testator. A written will is prepared and signed by the testator without the involvement of an attorney. As a written will is not drafted and witnessed by an attorney, it may not necessarily be valid legally. If the estate owner has not made a formal will, and is in critical medical condition rendering him incapable of writing, the only choice left is an oral will. However, to make an oral will legally enforceable, the oral statement should be witnessed by at least two bystanders. The witnesses must be over the age of 18 and cannot be the recipients of the estate. As a valid will is so important, financial planners should advise clients to make a formal will.

To allow amendments to be made to the will, financial planners may recommend that clients include codicils in the will. The inclusion of the codicil clause enables the testator to make changes in the will without drafting a new one. The testator should also include a residuary clause in the will. A residuary clause provides for the distribution of the remainder of the estate after all other specific bequests have been made.

Although financial planners cannot help clients formulate their wills, they can offer assistance in providing necessary information, suggestions, and explanations.
Chapter 10

Multiple Choice Questions

1. A
2. D
3. D
4. D
6. B

Problems

1. The life-cycle model is very useful in providing some generalizations of clients’ needs in financial planning. However, there are certain assumptions and limitations that financial planners have to consider when using life-cycle analysis for their clients.

   The consumption and savings behaviors are dependent on the culture of a people. Thus, a financial planner should not adopt the financial planning strategies concerning consumption and savings level for clients strictly from evidence documented for another country without understanding the potential cultural effects.

   Börsch-Supan and Lusardi (2003) suggest that different cohorts (i.e. different generations) demonstrate different savings behaviors. These cohort effects are due to different generations being subject to different economic conditions and potentially different pensions and tax systems, so financial planners should be careful in comparing consumption and savings behaviors of consumers in the same age category but from different generations. Thus, empirical research using data from different cohorts to generalize the consumption and savings patterns through various life stages for a given clientele could be subject to bias.

2. Personal profiling is defined as the process of employing both quantitative and qualitative assessment methods to obtain an accurate analysis of the nonfinancial background of an individual in order to facilitate the construction of an optimal financial plan.

   Personal profiling is an important conceptual framework and can be very useful in life-cycle analysis, establishing client-planner relationship (step 1 of the financial planning process), establishing goals for clients (step 2), analyzing financial status (step 3), monitoring the financial plan (step 6), and understanding the concept of total life planning. Personal profiling is useful in implementing total life planning as it considers the client’s personality, family values, cultural values, lifestyle preferences, physical and psychological health, and experiences of major life events.

3. Risk profiling is defined as the process of determining the risk tolerance level of an individual using effective tools through a utility-based method or
psychometric method. The methods may involve asking respondents a set of risk profiling questions with statement choices to choose from.

4. Psychometric surveys employ life events and investment gambles involving various risk tolerance levels in order to assess the clients’ risk tolerance level. Some of the questions asked are indirect in order to assess their risk appetite in making nonfinancial decisions. All psychometric surveys have a number of questions with a score attached to each answer. By summing the scores of all the questions, clients receive a rating representing their risk tolerance level. Depending on the available choices of portfolio provided by the financial planner or wealth manager, the risk tolerance scores of the client are matched with a table consisting of three to seven ranges of scores, each corresponded with a recommended asset allocation mix.

5. Roszkowski, Davey, and Grable (2005) explained how to construct reliable and stable risk tolerance questionnaires, and how to choose and use rigorous psychometric assessments. There are two reasons for inconsistent ratings: invalidity and unreliability of the questionnaire. Therefore, if the risk tolerance level of clients is to be measured effectively, it is important to construct a valid and reliable risk tolerance questionnaire.

Validity is a measure of how successful the questionnaire is in assessing outcomes. It is similar to the accuracy of hitting the right target. Since the definition of accuracy varies, a so-called valid questionnaire can generate slightly different outcomes. As long as the risk tolerance ratings are within a certain boundary, it is regarded as a valid questionnaire. Since the same or similar client may get a slightly different assessment outcome with the same instrument every time, the questionnaire may not be reliable even though it is valid.

Reliability is a measure of how persistent an outcome is generated by the questionnaire. In other words, a reliable questionnaire must produce a very similar rating score for various clients of similar risk tolerance. Note that reliability does not necessarily imply accuracy (validity). A reliable questionnaire may be persistently wrong, i.e., it keeps generating the same “wrong” answer.

Roszkowski, Davey, and Grable (2005) recommended the following to improve the effectiveness of risk tolerance questionnaires:

1. The questionnaire should contain at least 25 valid and reliable questions.
2. The questionnaire should be tested for overall validity (accuracy).
3. The questionnaire should be tested for overall reliability (consistency).
4. The questionnaire should be able to detect the true risk tolerance level of clients, and clients of similar risk tolerance level should receive similar ratings every time they are being evaluated.
Chapter 11

Multiple Choice Questions

1. B
2. C
3. B
4. D
5. D

Problems

1. By active listening, the listeners show their respect and appreciation to the speakers. It can be frustrating if clients perceive that their financial planners are not really listening to them. Clients are most likely to feel this way when the financial planners are passive listeners. There is nothing that destroys rapport faster than having clients believe that their financial planners do not care about what they say.

During the interview, financial planners need to be good active listeners. Asking questions and taking notes are essential but not sufficient for an effective financial planning interview. Whenever appropriate, financial planners should also provide short comments from time to time.

Whenever financial planners are not sure about the information, they should repeat the answer for confirmation. Financial planners should also bear in mind that they should not disturb their clients by abruptly raising questions or making conclusions when the clients are talking.

Being an active listener results in the following benefits:
   1. Enables accurate exchange of information. This is critical for you to serve the client properly.
   2. Reduces misunderstandings. This helps increase client satisfaction with your services.
   3. Increases rapport. When clients feel you understand them, it creates greater rapport and trust.
   4. Differentiates you from others. Since most people are poor listeners, good listening skills will make you stand above the crowd.

2. Relationship-oriented clients are not interested in numbers at all. They have stronger psychological needs and their behaviors are more easily affected by their emotions. In dealing with relationship-oriented clients, financial planners must try to understand their feelings and address their emotional needs. As relationship-oriented clients can sometimes be irrational, financial planners should be more sensitive to their life goals and be more forgiving if their requests are not logical. Once their psychological needs are satisfied, this client type will generally become very loyal customers. Relationship-oriented clients are usually less critical about their investment returns. Thus, it is actually easier to maintain a long-term relationship with relationship-oriented clients. Financial planners should have a strong emotional quotient (EQ) and excellent communication skills to deal with this client type. Relationship-
oriented clients don’t generally ask too many technical questions or care about numbers; they value human relationships more. The ability of the financial planners to explain how their financial goals can be related to their life goals is critical to make the relationship-oriented clients satisfied. If the financial planners can do this, they will be able to earn total trust from their clients, leading to a successful and long-lasting relationship.
Chapter 12

Multiple Choice Questions
1. D
2. B
3. A
4. D
5. D

Problems
1. The financial planning pyramid can be used to prioritize clients’ financial planning needs by the different financial planning areas. This financial planning pyramid is very similar to Maslow’s hierarchy of needs (1968) in which the needs of individuals are arranged in order of urgency. The financial planning pyramid is a logical theoretical framework. In real life, clients at different life stages may have different priorities and the order described in the framework may not always apply to every client.

In addition, while the logic is to move from the bottom to the top of the pyramid, we are not suggesting that the financial planner should deal with one area at a time this way. Multitasking and simultaneous executions should be considered if possible. There is no reason why a planner cannot help the client to work on his consumption planning while taking care of his insurance needs at the same time. The planning order as indicated by the financial planning pyramid is just to remind the financial planner of the relative immediacy of different financial needs. The financial planning pyramid is a useful guide for the financial planner in meeting the more basic financial needs of the clients before moving on to a higher level of financial goals.
Chapter 13

Multiple Choice Questions

1. D
2. D
3. B
4. D
5. D
6. B
7. A
Chapter 14

Multiple Choice Questions

1. A
2. C
3. D
4. A
5. B

Problems

1. Two commonly used methods for aggregation are arithmetic return (based on the sum of returns in each period) and geometric return (based on the product of return in each period). Of course, the best way to compute returns for most clients is to use the holding period return, which reflects the actual profit for the investment period:

\[
HPR = \frac{\text{Ending price} - \text{Beginning price} + \text{Cash dividend}}{\text{Beginning price}}
\]

Using the arithmetic return approach to aggregate single-period returns to form a longer-period performance measure can lead to a wrong conclusion. The reason is that the arithmetic method implicitly assumes periodical (in this case, annual) liquidation and immediate reinvestment in the same asset. However, this is an inappropriate assumption if the client intends to hold the asset for 2 years. Then there is no reason to count money at the end of each year and restart the clock the next year for the purpose of calculating return. In fact, there are other price patterns for which the arithmetic method can lead to a nontrivial error. The conclusion is that the geometric method is always accurate. Unfortunately, the arithmetic method is simple to use and some planners would be tempted to use it to generate returns for different clients.

2. Challenge 1

There exists a difference between what the traditional portfolio theory implies and what most investment professionals and financial planners practice in terms of asset allocation. In reality, the concept of market efficiency is a matter of degree instead of choosing between the two extreme cases: perfectly efficient or totally inefficient. For investment professionals who believe that the existing market indices are not a good proxy of the true market portfolio, or that they possess superior stock selection and timing skills in the world of inefficient markets, active investment strategies selecting undervalued securities or funds are a better deal than passive strategies through indexing. Following this logic, many investment professionals would not promote the usage of index funds but invest in objective-specific mutual funds or individual securities in the hope of beating the market by identifying undervalued assets and by active timing. In other words, few planners would actually practice two-fund separation and recommend their clients to buy equity index funds only. Thus the majority of the investment industry promotes the idea of using active funds (nonindexed portfolios) for investment.
Of course, there are some others who prefer to use index funds for each asset class but pursue an asset allocation strategy based on regional market movements. In this case, a mix of passive and active strategies is employed. Within the asset class, a passive strategy (indexing) is followed. However, active timing and selection strategies are used to decide the weightings of the asset classes.

**Challenge 2**
Another challenge related to practicing asset allocation strategies is the occasional flat efficient frontier (for risky assets). The risk-return trade-off makes it difficult to justify investing in high-risk portfolios, as the small increase in return does not nearly compensate for the much higher risk involved. There is no easy solution to this challenge. The financial planner should examine carefully if the same risk-return combinations would persist in the future and advise their clients about the small risk premium accordingly.

**Challenge 3**
The third challenge is the human capital of the clients. Human capital is related to the investment choice of the clients. Human capital is the discounted present value of future labor income, which is analogous to the price of financial assets. There are two major functions, hedging effect and cushion effect, of human capital in asset allocation.

The hedging function of human capital means that the clients can use the labor income to hedge against the risk in financial investment and vice versa. For instance, if there is a high income risk (high uncertainty about future income due to high unemployment rate or high corporate bankruptcy rate) in the labor market, financial planners should suggest that clients hold a smaller proportion of risky assets in the portfolio.

Human capital can provide a cushion effect for investment income. If there is a high variability in the financial market, the investments are subject to market volatility. Sometimes, the investments may result in a loss. Then the cushion effect of human capital may come to play a role by allowing the labor supply flexibility to be used to offset the shock to financial investments. Financial planners may suggest that clients work more to make up for the losses in the financial market. Therefore, financial planners have to take the nature of the job and the labor supply flexibility of clients into consideration when making investment suggestions.
Chapter 15

Multiple Choice Questions

1. C  
2. D  
3. A  
4. B  
5. B

Problems

1. Timing of Implementation
   Since there are so many goals and objectives to achieve, financial planners may categorize the goals and objectives in terms of immediacy. The action plan is executed according to the immediacy of the objectives. The recommendations which are easily affected by the timeliness of the transactions should be implemented first and those for which timing is not important can be executed later.

Communication with Clients
   After the action plan is formulated, financial planners should explain the procedures and strategies of each step to achieve the objectives and discuss with the clients if any amendments are needed. In addition, financial planners can ask if the clients have any other requests that the financial planners can fulfill. Finally, although the financial plan has been accepted, financial planners should continue to keep in contact with their clients.

Coordination with other Professionals
   When financial planners need to implement the strategies as documented in the financial plan, these strategies may be related to some area of expertise in which the financial planners may not be that competent. Although professional financial planners have all-round knowledge in many areas including accounting, tax matters, finance, investment, and insurance, it is unrealistic to assume that the financial planners possess more specialized know-how than the experts who hold educational and professional qualifications and working experience in these areas. Therefore, when financial planners need to implement strategies in areas where they are not professionally competent, they are allowed to seek help from qualified experts.