series 65 SECURITIES QuickSheet

KAPLAN FINANCIAL EDUCATION

FEDERAL SECURITIES REGULATION

Securities Act of 1933: Registration of securities (Paper Act).

Nonexempt new issues can only be sold once the prospectus is effective. Indications of interest, but no orders or money can be accepted during the time the issue is "in registration" (prior to the effective date).

If a mutual fund has been registered for more than five years, must a prospectus be delivered during a sale? Yes!

Securities Exchange Act of 1934: Registration of persons and exchanges (people and places) including securities information processors and transfer agents.

Margin requirements are determined by the Board of Governors of the Federal Reserve System (Reg. T) as provided in the Securities Exchange Act of 1934.

Defined investment discretion as: the ability to select one or more of the following for the client:

- Asset
- Amount
- Action

STATE REGULATION UNDER THE UNIFORM SECURITIES ACT (USA)

Under the USA, all professionals' registrations/ withdrawals take place at noon, 30 days after completed application.

All registrations of persons expire on the first **December 31** after registration with annual renewal after that. However, registration of securities is effective for **one year** from the registration date.

A successor firm to a broker-dealer (B/D) or investment adviser (IA) does not pay a fee until renewal date.

All professionals file a consent to service of process as a permanent part of their registration.

A *person* is not a minor, a dead person, or someone declared mentally incompetent.

If a B/D has an office in a state, it must register.

A B/D exercising discretion or maintaining custody of customer funds/securities may have to post a surety bond unless the B/D's net capital is in excess of SEC requirements.

An agent exercising discretion (can't have custody) may have to post a surety bond.

In lieu of a surety bond, the Administrator may accept deposits of cash or securities.

In order for a surety bond to meet the requirements of the Uniform Securities Act, it must provide that any customer who can prove a violation is entitled to collect against the bond.

Anytime a customer deposits securities with a B/D, a receipt for those certificates must be issued promptly.

The following are not securities: retirement plans (IRAs, Keoghs), non-variable insurance contracts (fixed annuity, term, whole life, modified endowment), collectibles, commodities (including precious metals like gold), condominiums used as a personal residence, and currencies.

The term *guaranteed* under the USA means guaranteed by someone other than the issuer as to principal, interest, or dividends, but not capital gains.

A security registered by *qualification* becomes effective only with an active review of registration.

The most common exempt transactions:

- Isolated nonissuer transactions
- Unsolicited orders
- Transaction with institutions
- Transactions between the issuer and underwriter
- Transactions by fiduciaries
- Private placements (10 or fewer offers to noninstitutional clients within 12 months)

Even if the security or the transaction is exempt, the agent of a B/D must be properly registered.

Under the USA, when an agent terminates association with a B/D, both the agent and the B/D must notify the Administrator.

Under the USA, when an IAR leaves an IA, notification depends on whether the IA is federal or state registered. If state registered, only the IA notifies the Administrator. If federal covered, only the IAR notifies the Administrator.

Any individual representing a B/D in any form of securities offer or sale must be registered.

Agents may **split commissions** with other agents of the same or affiliated B/Ds and don't have to inform clients of the split.

The **Snowbird rule** provides an exemption from registration for all securities professionals when dealing with vacationing clients. Subject to 30-day rule for change of residence.

Any written customer complaint must be promptly brought to the attention of the appropriate supervisor.

A registered agent may accept an unsolicited order for a nonexempt unregistered security because it is an exempt transaction. However, the Administrator retains the right to have clients acknowledge that the order was truly unsolicited.

Records may be kept on a computer disk that cannot be altered.

B/D records must be kept for three years and investment adviser records for five years.

Correspondence and Social Media

Electronic communications come under same scrutiny as "written." For social media, the content, not the method of delivery, is what is important. Firms must have strict controls over use of personal and office equipment. Training is essential.

Margin account agreements must be signed promptly ***after*** initial trade in the account.

- Credit and hypothecation—mandatory
- Loan consent—optional
- Risk disclosure document—prior to trading

Material changes to a B/D's registration must be reported promptly.

A B/D's website is considered advertising, and records must be kept for three years after the original site plan and three years after any subsequent changes to the design.

All conflicts of interest, such as recommending a company owned by your sister or underwriting an IPO of an affiliated company, must be disclosed.

Broker-dealer fees must be disclosed.

- A BD is permitted to make a reasonable charge for certain services, such as appraisals, account transfers, collection of dividends or interest, and safekeeping of client assets.

A civil suit under the terms of the USA must be filed within three years of the alleged infraction or two years from discovering the violation, whichever comes first. Under federal law, it is one year from discovery.

The right of rescission is the offer to return a customer's money, plus interest, less any income received from the investment when a sale has taken place in violation of the USA. Clients have 30 days to accept or reject the offer.

The USA gives each state Administrator jurisdiction over offers to buy or sell when the offers originate in, are directed to, or are accepted in the Administrator's state. A violation can lead to multiple Administrators bringing an action.

Under the USA, an offer is the attempt to make a sale. It is not a sale until the actual transaction takes place.

A gift of assessable stock is a sale, while a gift of nonassessable stock is not.

If a B/D (or anyone else) gives a security as a bonus with a purchase of anything (other stock, a car, a house), that bonus is considered a sale.

A stock split or stock dividend (even of stock other than that of the issuer) is NOT a sale if there is no cost involved.

Know the difference between a stop order, a cease and desist order, and summary action.

Stop Order

Used to "stop" registration of securities issues.

These orders may be appealed to the appropriate court within 60 days.

Cease and Desist

Used to halt activities of persons.

The Administrator may issue a cease and desist order, with or without a prior hearing. Failure to adhere to this order can lead to a court imposed injunction.

Summary Action

The Administrator may summarily suspend the registration of any person or security as long as within 15 days after the receipt of a written request, a hearing will be granted.

Maximum criminal penalty under USA is $5,000 fine and/or three-year imprisonment. Maximum penalty under federal law is $10,000 fine and/or five-year imprisonment.

FEDERAL AND STATE REGULATION OF INVESTMENT ADVISERS AND THEIR REPRESENTATIVES

AUM of $110 million or more—SEC registration as federal covered adviser; < $100 million AUM—state registration.

Federal-covered IA falling below $90 million must register with state(s).

If any advisory clients are **investment companies**, IA must be federally registered (SEC).

Lawyers, accountants, teachers, and engineers (**LATE**) are excluded from the definition of investment adviser as long as advice is incidental to the practice of the profession. Charging for the advice removes the exclusion.

The term *investment counsel* can only be used by an IA whose principal business consists of rendering investment advice and a substantial portion of his advisory business involves investment supervisory services.

IA exercising discretion needs $10,000 net worth or surety bond. (USA)

IA maintaining custody of customer funds/ securities needs $35,000 net worth or surety bond. (USA)

If a state-covered IA meets the bonding, net worth, or recordkeeping requirements of the IA's home state, it suffices for any other state in which the IA is registered. Federal-covered IAs meet SEC requirements only.

An ad offering free service must be totally free of any obligations.

Any literature describing performance of past recommendations must show all performance (good and bad) for a minimum of past 12 months.

No investment adviser ad may contain a testimonial and, if charts are used, a caveat relating to difficulties of use and limitations must be given.

Rule on use of third party research reports:

1. If it is distributed, attribution must be given.
2. If it is used as the basis for the IA's report, no mention is necessary.

An adviser may only divulge the name of current clients with their permission, a joint owner's permission, or under a court or IRS order.

Performance-based compensation is received only if the client is an investment company or a qualified investor meeting certain minimum net worth requirements or having a certain amount of assets under management with that adviser. If using joint assets, must be with spouse.

IA fees should be competitive under the USA.

IA fees would be considered unreasonable if the fee is projected to consistently be more than the expected return in the portfolio.

When an adviser buys the same security for a number of clients in one order, but at different prices, each client pays an "averaged" price.

Agency cross transaction: IA represents both sides and receives commissions from both sides.

No agency cross transaction may be effected in which the same investment adviser recommended the transaction to both any seller and any purchaser.

IA must disclose the nature of the relationship and receive prior consent.

It is unethical for an IA to direct clients to trade in securities in which the adviser has an undisclosed interest, causing the value of those securities to increase to the adviser's benefit.

Under the Uniform Securities Act, a solicitor for an investment advisory firm who is paid a fee for his services must register as an IAR.

An analyst's report is released on the IA's website today. Can she go on TV tonight and talk about the stock? Yes!

If a person is in the business of comparing the performance of one adviser against others for compensation, registration as an IA is required.

A stock certificate or money was inadvertently mailed to the IA by the client or the executing B/D. The IA should return the certificate or money to the sender promptly, but in any case, within three business days of receiving it, unless the IA is authorized to maintain custody. Third-party checks must be forwarded within three business days.

Prohibited practices include borrowing money or securities from a client, unless the client is a broker dealer, an affiliate of the investment adviser, or a financial institution engaged in the business of loaning funds (a mortgage broker does not qualify) or loaning money to a client unless the investment adviser is a financial institution engaged in the business of loaning funds or the client is an affiliate of the investment adviser.

Blanket recommendation of the same security to all clients is a prohibited practice.

Under state and federal law, a person is deemed to be in control of an investment adviser with an ownership level of at least 25%.

If an investment adviser has custody of funds, statements must be sent to clients quarterly, but change in location must be sent promptly.

If the IA's **brochure** (Form ADV Part 2A and Supplement, Part 2B) is not delivered at least 48 hours prior to entering into the contract, the client has five business days to terminate without penalty. (USA)

Both state- and federal-covered IAs must deliver brochure (ADV Part 2A and 2B) no later than commencement of agreement. Thereafter, they must provide an annual delivery of "summary of material changes" within 120 days of end of fiscal year with offer to provide brochure on request.

Company records, such as corporate charters or partnership agreements, must be maintained in the principal office of the investment adviser or broker-dealer and preserved until at least three years after termination of the enterprise.

Form ADV specifically requires information on how the adviser will be compensated. If fees are negotiable, the IA can charge different fees for different clients.

Form ADV-E is for the annual financial examination of an IA. It is *completed* by the IA and *submitted* by the independent accountant.

Under the safe harbor provisions of Section 28(e) of the Securities Exchange Act of 1934, investment advisers may accept compensation from broker-dealers in the form of research, customer related software, and seminar registration fees, but not travel and transportation reimbursement, rent, furniture, or noncustomer related software and computers.

Cybersecurity and Data Protection

- Firm and customer data must be protected.
- Identity theft red flags.
- Update software frequently.
- Report all breaches.
- Agent is frequently the first line of defense.

EQUITY

An investor in preferred stock would be most concerned about the issuer's ability to pay dividends.

American Depositary Receipts (ADRs) facilitate trading in foreign securities, but still have currency risk.

ADRs are issued by domestic branches of American banks.

Investors expecting the dollar to weaken would allocate more of their portfolio to ADRs.

Convertible preferred stock or bond investors sacrifice some income in exchange for potential appreciation.

Employee stock options are either nonqualified or incentive.

The dividend discount model is the method for valuing a stock by determining the PV of all future dividends to be paid on a given stock assuming a constant dividend rate.

The dividend growth model is the method for valuing a stock by determining the PV of all future dividends to be paid assuming that dividends will grow by a stated percentage.

Securities analysis: Fundamental analyst looks at the company's "books." Technical analyst charts price and volume over time.

FIXED INCOME

Tax Equivalent Yield (TEY) formula: Municipal bond coupon divided by (100% – investor's tax bracket).

Liquidation priority is secured bondholders, general creditors (including debentures), subordinated debentures, preferred stock, and common stock.

Current yield formula: Interest (bond) or annual dividend (stock) divided by current market price.

Bond selling at a discount always has higher yield than coupon. Bond selling at a premium always has a lower yield than coupon. The yield to maturity is lower than the yield to call on a bond selling at a discount.

Higher coupon bonds have a shorter duration and, therefore, less volatility. Zero coupon bonds have a duration equal to their maturity.

Convexity is the best way to measure a bond's sensitivity to changes in interest rates.

Discounted cash flow is used to value a fixed income security by taking the future cash flow (the interest payments plus the return of the principal) and discounting it to arrive at a present value.

Eurodollar bonds are issued outside of the United States and are dollar denominated. Therefore, they have no currency risk.

CASH AND CASH EQUIVALENTS

Commercial paper (CP) is traded at a discount in the money market.

Negotiable (jumbo) CDs are issued at face value and do not have a prepayment penalty.

The LIBOR is the world's most widely used benchmark for short-term interest rates.

When doing cash flow analysis on a mortgage-backed pass-through security, you would want to know the average maturities.

DDA stands for demand deposit account, usually a checking account at a bank.

POOLED INVESTMENTS

Three types of investment companies:

- Face-amount certificates
- Unit investment trusts
- Management companies

Closed-end funds trade on the secondary markets (NYSE, Nasdaq). Open-end (mutual) funds do not.

The price of a closed-end company is based on supply and demand, not NAV.

Most country funds are closed-end due to liquidity issues.

Net redemptions for a mutual fund can cause portfolio managers to alter their investment strategies with potential negative consequences to performance.

A "breakpoint sale" is a violation.

A money market fund's portfolio holdings would include CDs, Treasury bills, CP, and repurchase agreements.

REITs must distribute at least 90% of their income.

ETNs (ELNs) are actually debt instruments.

Leveraged and inverse funds are highly speculative.

INSURANCE-BASED PRODUCTS

Term insurance is pure protection and has no cash value. Premium increases upon renewal.

Whole life builds guaranteed cash value with policy loans.

Universal life has flexible premiums—insufficient payments could cause policy lapse.

Variable life has a separate account. Guaranteed minimum death benefit, cash value is not guaranteed. 75% of cash value can be borrowed after three years.

Variable life has exchange privilege to a new permanent plan of life insurance within first 24 months.

Capital needs analysis is used to determine coverage for future needs and ignores market volatility.

A fixed annuity is NOT a security, so a seminar dealing exclusively with them cannot result in securities fraud.

Variable annuities are generally not suited for short-term investing because of their surrender charges.

Variable annuities are a tax-deferred way to participate in the equities market.

Variable annuities typically carry higher expenses than mutual funds with the same objective.

Index annuities have a participation rate that is usually limited by a cap.

DERIVATIVE SECURITIES

Buying a call option is the best way to protect (hedge) a short stock position.

Buying a put option is the best way to protect (hedge) a long stock position.

Holders of *futures* and forward contracts have an obligation, while the holder (long position) of an *option* has none; it is only the seller (short position) of the option that is obligated to perform if exercised.

American style options may be exercised at anytime, European style only at expiration.

LEAPS are options with an expiration time that can run as long as 39 months. They—like all other options—do not pay interest or dividends.

Options, futures, and forward contracts are derivatives—their value is based on some underlying asset.

ALTERNATIVE INVESTMENTS

Limited partners in a DPP have limited liability; general partners have unlimited liability.

In a limited partnership program, the limited partner's loss is limited to their basis, which includes their initial contribution and funds committed for but not yet contributed.

A hedge fund is usually organized as a partnership, which is the issuer of the securities, with management investing alongside the investors.

Investment real estate

- Active rather than passive role
- Generally not correlated with stock market
- Potential inflation hedge
- High leverage increases risk and possible reward

Commodities

- Generally not correlated with stock market
- Potential inflation hedge
- Agricultural very popular
- Precious metals—largest spreads
  - Gold
  - Platinum
  - Silver

ECONOMIC FACTORS AND FINANCIAL REPORTING

Two government policies – Fiscal and Monetary

Fiscal – taxing and budget, Congress and President

Monetary – Federal Reserve Board

- Discount rate
- Reserve requirements
- Open-market operations
- NOT prime rate

An increase in help-wanted ads is a **leading** indicator.

Fundamental analysis uses financial statements to compute financial ratios, such as:

- price to earnings (P/E);
- price to book value;
- current ratio; and
- gross margin.

Business cycle

- Expansion
- Peak
- Contraction
- Trough

Yield curves

- Normal (positive)
- Inverted (negative)
- Yield spread

Top-down analysis: A top-down analyst attempts to profit by finding the best performing sectors of the economy and buying stocks in that sector with the expectation that those companies will do well.

Bottom-up analysis: A bottom-up analyst attempts to profit by identifying individual companies that will outperform others in the industry.

If the dollar weakens, exports increase and imports decrease; if the dollar strengthens, exports decrease and imports increase.

Trade deficit/negative balance of payments: more imports than exports, leads to weaker dollar.

Balance of payments

- Net exports – dollar stronger
- Net imports – dollar weaker

If a corporation has pending litigation against it or "off-book" debts, they will be revealed in footnotes to the financial statements or the annual report.

When a company redeems bonds at par, there is no change to net worth. If at a premium, net worth is reduced and if at a discount, net worth increases. In all cases, working capital is reduced.

Another term for **revenue** on the income statement is **sales**.

Compute cash flow from operations (CFO): Start with net income and add back all noncash charges such as depreciation.

A corporation whose securities are registered with the SEC is excused from filing a Form 8-K when a wholly owned subsidiary is relocated to a different state.

METHODS OF QUANTITATIVE ANALYSIS

To compute **future value**, we need the following:

- Current amount invested
- Expected earnings rate
- Time the money will be invested

To compute **present value**, we need the following:

- Future amount needed
- Expected earnings rate
- Time the money will be invested

The **Rule of 72** tells me that I can double my money by earning at a rate determined by dividing 72 by the number of years I have to go.

Internal rate of return (**IRR**) takes into consideration the time value of money.

IRR is not practical for common stock due to uneven cash flow and no maturity date and price.

The variable NOT needed to compute NPV (net present value) is the inflation rate.

Stock with beta of 1.0 mirrors the movement of the overall market; higher beta has greater movement, lower beta less movement.

To the extent that a stock or portfolio performs better than its beta would predict, it has positive alpha.

The least volatile portfolio is the one with the lowest standard deviation.

Correlation measures the movement of one security in relationship to the movement of another. Perfect correlation is at +1.0, perfect non-correlation is at –1.0, and a measurement of 0 indicates no correlation at all.

The most diversified portfolio is the one with some negative correlation.

TYPES OF RISK

Market risk, sometimes called **systematic risk**, is the risk that changes in the overall market will have an adverse effect on individual securities regardless of the company's circumstances and cannot be diversified away.

Interest rate risk is the risk of changes to the market value of interest sensitive securities, such as debt and preferred stock, when interest rates change. When rates go up, prices go down and vice versa. The longer the duration, the greater the risk.

Inflation (or **purchasing power**) **risk** is the risk that the value of the currency unit will fall so when principal is returned to the investor, its purchasing power will be decreased. Fixed income securities are most susceptible.

Unsystematic (or **nonsystematic**) **risk** is the risk specific to a particular security. The best example is business risk; it is based upon management decisions, competition, or product deficiencies, and it is independent of the general market. This risk can be diversified away.

Regulatory risk is the risk that changes to regulations (think EPA) can cause financial distress to corporate earnings.

Legislative risk is the risk that legal changes (think tax increases) can cause financial distress to corporate (and personal) earnings.

Political risk is the risk that political upheavals, such as a coup or nationalization of an industry will have a negative effect upon an investment.

Sovereign risk is the risk that a sovereign government will default on its obligations.

Liquidity risk is the risk that an investment cannot be turned into cash quickly without significantly lowering the price (think "short sale" of a home that is "underwater").

Currency risk is the risk that foreign exchange rate fluctuations will cause the value of an investment to change relative to the investor's home currency. ADRs, although in U.S. dollars, do have currency risk for U.S. investors.

Opportunity cost: The 90-day Treasury bill is currently yielding 6%. An investor decides to purchase a stock with an expected return of 11%. If that stock actually returns 2%, the opportunity cost is 4% (6% – 2%).

TYPE OF CLIENT

Joint accounts are joint tenants with right of survivorship (JTWROS), tenants in common (TIC), or tenants in the entirety.

Tenancy by the entirety is only for married couples and requires consent of both parties for transactions.

Individual accounts and joint accounts (other than TIC) may be opened with a TOD designation which avoids probate on the first to die.

Powers of attorney—must be in writing:

- Limited—trading only
- Full—trading and money
- Durable—effective upon incompetence
- All terminated upon death of principal on account

The grantor of the trust can also be the trustee and beneficiary.

A remainderman is the individual who will receive the principal of a trust when final distribution takes place.

Per stirpes is the term used to describe the way assets are distributed to descendents.

An IAR can be appointed trustee and handle the account, but must disclose the potential conflict of interest.

Dying without a will has the estate handled by an administrator in intestacy rather than an executor.

CLIENT PROFILE

A client with a negative net worth (too much debt) receiving a surprise inheritance should first pay off high interest (credit card) debt.

A family's balance sheet only contains assets and liabilities, not income and expenses.

If a liability is paid off, it disappears from the balance sheet.

Term life insurance has no cash value, so it is not an asset on your balance sheet.

Life insurance may serve a valuable need in that income producing assets will not have to be sold to cover the estate tax liability or other final expenses.

Clients with a need for cash in the near term should invest in money market instruments like T-bills.

First choice for preservation of capital is insured **bank CDs**.

Time horizon for someone 5, 10, or 20 years from retirement is life expectancy.

PORTFOLIO MANAGEMENT STYLES

Growth: Portfolio manager looks for stocks that trade at higher price-to-earnings and price-to-book ratios than value stocks. Earnings momentum is important. Growth is more volatile and requires higher risk tolerance.

Value: Portfolio manager looks for stocks that are cheaper and trading at lower P/E and price-to-book multiples. Focuses on the financial statements. Higher dividend yields found here.

Contrarian: Portfolio manager thinks majority is wrong, so does the opposite of what most investors are doing.

Rebalancing: Done periodically to bring a portfolio back to target allocation percentages.

Tangible assets: Placed in a portfolio to reduce inflation risk.

The **efficient market hypothesis** maintains that security prices adjust rapidly to new information with security prices fully reflecting all available information. In other words, markets are efficiently priced as a result.

Under **modern portfolio theory**, the **optimal** or **efficient** portfolio is one that has the most return for a given amount of risk.

When computing the Capital Market Line, one of the risk statistics you must know is standard deviation. You do not have to know the alpha or the beta.

Under weak **EMH**, technical analysis is no good; under semi-strong, neither technical or fundamental does any good; under strong, even insider information is known—the market is totally efficient.

The collection of efficient portfolios is called the *efficient set* or *efficient frontier*.

Dollar cost averaging: Investing a fixed dollar amount on a regular basis and purchasing at different prices.

TAX CONSIDERATIONS

The distributable net income (DNI) of a trust includes dividends, interest (including from tax-free municipal bonds), and rents, but does NOT include capital gains reinvested into the corpus of the trust.

The trustee must distribute all income every year under a simple trust; income may be retained under a complex trust and is reported on Form 1041.

A **generation-skipping trust** is a trust that continues more than one generation, skipping the children and going to the grandchildren.

Sole proprietors file their business information on a Schedule C. Limited partners, members of LLCs, and shareholders in S corporations receive a Schedule K-1, and C corporations report their income on a Form 1120. Business returns are due on March 15.

Taxation of gifted stock: Donee (recipient of the gift) acquires the stock at the donor's basis (e.g., stock purchased for $4,000 by uncle last year is worth $5,000 at the time of the gift to niece; she sells for $6,000 next month—long-term capital gain of $2,000).

Taxation of inherited stock: Beneficiary receives a "stepped-up" cost basis (e.g., stock purchased for $4,000 by uncle last year is worth $5,000 at time of death; niece who inherits sells for $6,000 next month—long-term capital gain of $1,000).

A child owns a life insurance policy on his mother so the proceeds are not part of her estate.

What would be included in husband's estate? IRA, securities, money market fund, but not life insurance with spouse as owner.

Estate taxes are due nine months after the date of death and are paid on Form 706.

TRADING SECURITIES

Margin accounts use leverage. Margin agreements signed promptly *after* initial transaction.

Initial margin—Reg. T

Maintenance call when equity falls

Mixed margin account includes both long and short positions

Positive margin—profits exceed interest cost.

When equity drops below 25%, maintenance margin call is sent to client under SRO rules. "House" calls are sent at higher level set by BD.

Market makers: Sell from their inventory at their asking price and buy for their inventory at their bid price.

The inside market is the highest bid and lowest ask among all market makers.

Market order: An order to be executed immediately at the best available price. A market order is the only order that guarantees execution.

Limit order: An order that instructs the broker-dealer to buy a specified security at or below a certain price (buy limit) or to sell a specified security at or above a certain price (sell limit).

Buy stop order: Used to "stop loss" by persons with a short position in a stock. Can accelerate the direction of a bull market.

Sell stop order: Used to "stop loss" by persons with a long position in a stock. Can accelerate the direction of a bear market.

A trade of 10,000 shares or more is known as a block trade.

PERFORMANCE MEASURES

Current return (yield) – annual dividend (or interest) divided by current market price

Total return – annual dividend (or interest) + appreciation (– depreciation) divided by original investment

Annualized return – total return on a 12-month basis

After-tax return – total return minus taxes

Expected return – combine different probable outcomes

Real rate of return adjusts for inflation as based on the CPI.

The inflation adjusted return of a **TIPS** (Treasury Inflation Protection Security) is always the coupon rate.

Total return is not related to the **variability** of a portfolio's returns.

The yield to maturity of a bond is actually the bond's **internal rate of return** and will be lower than the holding period return if coupons are reinvested at a rate higher than the YTM.

The **Sharpe ratio** is a measure of a stock's risk-adjusted return. It is computed by subtracting the risk-free rate (90-day Treasury bill) from the security's actual return and dividing that by the standard deviation.

The market capitalization of a stock is computed by multiplying the number of outstanding shares times the market value per share.

Market Capitalization

- Small cap—$300 million to $2 billion
- Mid cap—$2 to $10 billion
- Large cap—over $10 billion

Tracking **small cap** securities is generally done by measuring against the Russell 2000.

Tracking **mid cap** securities is generally done by measuring against the S&P 400.

Tracking **large cap** securities is generally done by measuring against the S&P 500.

RETIREMENT PLANS AND CUSTODIAL ACCOUNTS

No life insurance (term or whole life) is permitted in an IRA.

Generally inappropriate to include municipal bonds in an IRA.

May invest in real estate but cannot benefit participant or lineal family.

CEO cannot utilize the company's profit sharing plan for a short-term loan to the company.

Deferred compensation plan is nonqualified so can be discriminatory and has no mandatory funding. Frequently used to retain key people.

Critical factors in a defined benefit plan are the participant's age, annual earnings, years to retirement, but NOT gender.

The Roth IRA is the only individually funded plan permitted after age 70½ and has no required minimum distributions (RMDs).

Contributions to a Roth IRA are made with after-tax dollars, and distributions are tax free if proper conditions are met. Minors may be named as beneficiaries.

Permitted investment vehicles for 403(b) plans include mutual funds, stocks, bonds, and CDs (but not life insurance policies).

EGTRRA of 2001 allows for "catch-up" provisions for those 50 and older for retirement plans and also provided for rollovers to an IRA for participants in a government employee's **457** Plan.

A 401(k) is tested to see if it is "top-heavy." That means that a disproportionate amount of benefits or contributions go to **KEY**, not highly compensated, employees.

A safe harbor 401(k) is a plan that does not have to undergo annual top-heavy testing if all employees receive a minimum employer-sponsored contribution with immediate vesting.

The safe harbor provisions of Section 404(c) of ERISA say a fiduciary is not liable for losses to the plan resulting from the participant's selection of investments in the participant's own account. Provided the plan gives the participants at least three investment alternatives (a high-yield bond fund should not be one of the three), they can change their investments at least quarterly, and participants must be able to access their accounts either by phone or through the internet.

Fiduciaries must act under the Uniform Prudent Investor Act (UPIA). In satisfying this standard, the trustee must exercise reasonable care, skill, and caution. They may delegate portfolio management, but not amount and timing of distributions.

It is recommended, but not required, to have an Investment Policy Statement that spells out the following:

- Investment objectives and philosophy
- Methods of performance measurement
- Determination for meeting future cash flow needs
- Investment parameters to be followed by the portfolio managers
- But does NOT include
  - a copy of the Summary Plan Description (SPD) required by the Department of Labor (DOL), or
  - specific security selection

Beneficiary of an IRA may disclaim proceeds.

The maximum contribution to Section 529 is much higher than a Coverdell ESA and is set by the individual states.

ESA funds may be used at any level of education; Section 529 may be used only on post-secondary education.

ESA puts an income limitation on contributors while Section 529 does not.

U.S. Savings Bonds are not available as investment options in Section 529 Plans.

You can switch 529 Plans once each 12 months.

Custodial accounts

- UGMA—limited to securities and cash—transfer at majority
- UTMA—can hold almost any asset—transfer at 21 or later
- Minor's Social Security number on account
- One custodian—one minor

Health savings accounts

- Tax deductible contributions for medical expenses
- Individual, employer, or both may contribute
- Must have a high deductible health plan (HDHP)

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