

**Sample of Pre-Study
Materials for
THE DALTON REVIEW®**

*Review
for the
CFP® Certification Examination*

THE DALTON REVIEW
BROUGHT TO YOU BY DALTON EDUCATION

Sample of Pre-Study Materials

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LESSON 1: FUNDAMENTALS OF INVESTMENTS

FORMS OF UNDERWRITING

Best Efforts

- The underwriter agrees to sell as much of the offering as possible.
- The risk of the issue not selling resides with the firm because any shares not sold to the public are returned to the company.

Firm Commitment

- The underwriter agrees to buy the entire issuance of stock from the company.
- The underwriter may buy the stock from the company for \$18 share and sell to the public at \$20 per share, thus making the spread.
- The risk that an issuance may not sell resides with the underwriter.

KEY DOCUMENTS

Prospectus

- Outlines the risks, management team, business operations, fees, and expenses.
- A prospectus must be issued by an investment company prior to selling shares to an investor.

Red Herring

- Preliminary prospectus issued before the SEC approval and is used to determine investor's interest in the security.

10K and 10Q

- A 10K is an annual report of financial statements filed with the SEC. The 10K is audited.
- A 10Q is a quarterly reported that is filed with the SEC. The 10Q is not audited.

Annual Report

- Contains a message from the Chairman of the Board on the progress in the past year and outlook for the coming year.
- The annual report is sent directly to shareholders.

LIQUIDITY VS. MARKETABILITY

- Liquidity is how quickly something can be turned into cash, with little to no price concession. Generally, short term investment assets are considered liquid. Stocks, bonds, stock mutual funds, and stock bond funds are not considered liquid because an investor could suffer price concessions.
- Marketability exists when there is a ready-made market for something. Real estate is marketable, but not very liquid.

TYPES OF ORDERS

- Market Order.
 - Timing and speed of execution are more important than price.
 - A market order is most appropriate for stocks that are not thinly traded.
- Limit Order.
 - The price at which the trade is executed is more important than the timing.
 - A limit order is most appropriate for stocks that are extremely volatile and are not frequently traded.
- Stop Order.
 - The price hits a certain level and turns to a market order.
 - A stop order to sell means that once the stop order price is reached, the stock is sold at that price or possibly less because it has become a market order.
 - The primary risk is that the investor may receive significantly less than anticipated if the market is moving too quickly.
- Stop-Limit or Stop-Loss Limit Order.
 - The investor sets two prices:
 - The first price is the stop-loss price, once the price is reached the order turns to a market order.
 - The second price is the limit price. An investor will not sell below the second price.
 - The risk is that if the market moves quickly, the order may not fill and the investor will be left with the stock at a significantly lower price.
 - A stop-loss limit order is appropriate for investors with a significant gain built into the stock, but may not want to sell the stock during a period of significant volatile based on short-term news.

Example

Donna is considering buying Apple stock which closed at \$100 per share. Before the open the next day, the price increases to \$105 because of a favorable announcement regarding the number of iPods sold. Assume the following orders the next day:

- Donna enters a market order to buy - Donna may have bought the stock for \$105.
- Donna enters a limit order to buy at \$100 - Donna may have not bought the stock because the stock increased to \$105, but she was only willing to pay \$100.

Donna bought the stock for \$105. Two days later Apple announces a recall for 10 million iPods. What happens to her stock, assuming the stock falls to \$80 per share rapidly?

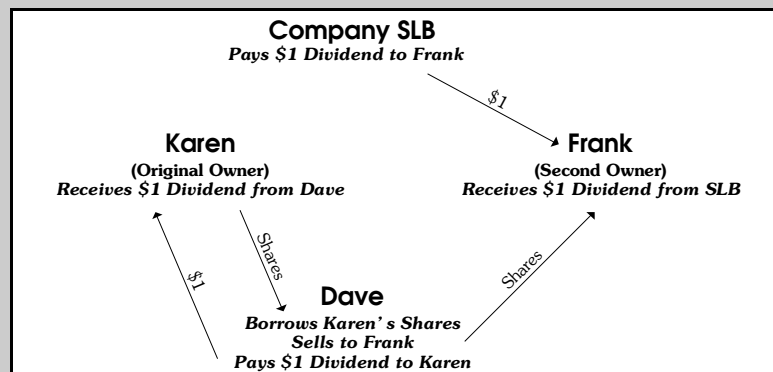
- Donna enters a stop order to sell at \$95 - Once the stock reaches \$95 per share, it turns into a market order. The risk is she may sell at a price significantly less than \$95 per share because the price is falling rapidly and her stop order turns to a market order.
- Donna enters a stop loss at \$95 with limit of \$90 - Donna's order turns to a market order at \$95 but she will not sell for anything less than \$90. The risk is that she may not sell between \$90-95, but will instead hold the stock at \$80.

SHORT-SELLING

- Selling first at a higher price, in the hopes of purchasing the stock back at a lower price.
- The goal is to sell high and buy low.
- An investor makes a profit when the asset's price decreases in value.
- Short selling is the opposite of taking a long position, where the investor anticipates making a profit when the price of the asset increases in value.
- Investor must have a margin account to protect against any price appreciation of the stock.
- There is no time limit on how long an investor can maintain the short position.
- Dividends paid by a corporation must be covered by the short seller.

Example

Karen buys 100 shares of SLB. Dave sells 100 shares of SLB short by borrowing Karen's shares and selling them to Frank. SLB is trading for \$50 a share and announces a \$1 per share dividend. When the stock price is adjusted to reflect payment of the dividend, the stock trades at \$49 and SLB pays \$1 dividend to Frank. Dave must pay the other \$1 dividend to Karen since there are two owners of the same shares of stock (Karen and Frank). Dave is not any economically worse off because his position increased by \$1 per share when the stock price adjusted to reflect the dividend, but by paying the dividend he is economically whole.



MARGIN DEFINITION

Initial Margin

- The initial margin reflects the amount of equity an investor must contribute to enter a margin transaction.
- Regulation T set the initial margin at 50% and was established by the Federal Reserve.
- The initial margin can be more restrictive based on the volatility of a stock.

Example

To purchase 100 shares of Starbucks trading at \$50 per share with an initial margin requirement of 75%, Joe must contribute $100 \times \$50 \times 0.75 = \$3,750$ and he will borrow \$1,250 ($100 \times \50×0.25) from his broker.

Maintenance Margin

- The maintenance margin is the minimum amount of equity required before a margin call.

Margin Position

- Represents the current equity position of the investor.

Example

Joe bought Starbucks stock when it was at \$50 per share, using 75% initial margin. Within two minutes of Joe's purchase of Starbucks, the price fell to \$40 per share. What is Joe's new margin position?

$$\begin{aligned}\text{Margin Position} &= \text{Equity} \div \text{Fair Market Value} \\ \text{Margin Position} &= (\$40.00 - \$12.50) \div \$40.00 = 68.75\%\end{aligned}$$

$$\begin{aligned}\text{Equity} &= \text{Stock Price} - \text{Loan} \\ \text{Equity} &= \$40 - (\$50 \times 0.25)\end{aligned}$$

At What Price Does an Investor Receive a Margin Call Price?

- The formula below is used to determine the price that investor will receive a margin call.
- The formula below is NOT on your exam formula sheet.

$$\text{Margin Call} = \frac{\text{Loan}}{1 - \text{Maintenance Margin}}$$

Exam Tip

Memorize! Not on the exam formula sheet.

Example

Bob purchased 100 shares of Starbucks trading at \$50 per share with an initial margin requirement of 75% and a maintenance margin of 25%. At what price would Bob receive a margin call?

$$\begin{aligned}\text{Loan} &= \$50 \times (1 - .75) \\ \text{Loan} &= \$12.50 \text{ per share}\end{aligned}$$

$$\begin{aligned}\text{Price to Receive a Margin Call} &= \$12.50 \div (1 - 0.25) \\ \text{Price to Receive a Margin Call} &= \$16.67\end{aligned}$$

How Much Equity Must an Investor Contribute?

- When a stock price falls below the stock price at which an investor will receive a margin call, the investor will receive a margin call and must contribute equity to restore their equity position.
- For the purposes of the exam, an investor must restore their equity position to the maintenance margin.

Example

Bob purchased 100 shares of Starbucks trading at \$50 per share with an initial margin requirement of 75% and a maintenance margin of 35%. The price fell to \$15 per share; how much equity must Bob contribute?

Required Equity		Actual Equity	
Stock Price:	\$15.00	Stock Price:	\$15.00
Maint. Margin:	$\times 0.35$	Debt:	$<\$12.50>$
Required Equity:	$\underline{\$5.25}$	Actual Equity:	$\underline{\$2.50}$

Bob must contribute the difference between Required Equity and Actual Equity $\$5.25 - \$2.50 = \$2.75$ per share or \$275 in total.

**Exam Question
Margin**

Lisa purchased 500 shares of XYZ stock trading at \$40 per share, with an initial margin requirement of 60% and a maintenance margin of 30%. At what price would Lisa receive a margin call?

- a) \$20.00
- b) \$22.86
- c) \$57.14
- d) \$80.00

Answer: B

$$\text{Price to receive a margin call} = \frac{\text{Loan}}{1 - MM}$$

$$= \frac{40 \times (1 - 0.60)}{1 - 0.30}$$

$$= \frac{16}{0.70}$$

$$= 22.86$$

**Exam Question
Margin**

Laureen purchased 1,000 shares of CWC stock for \$80 per share with an initial margin requirement of 65% and a maintenance margin of 40%. Assume the stock price falls to \$30 per share, how much equity must Laureen contribute?

- a) \$2 per share
- b) \$8 per share
- c) \$10 per share
- d) \$12 per share

Answer: C

Required Equity		Actual Equity	
Stock Price:	\$30.00	Stock Price:	\$30.00
Maint. Margin:	$\times 0.40$	Debt:	$<\$28.00>$
Required Equity:	\$12.00	Actual Equity:	\$2.00

$$\begin{aligned} \text{Debt} &= \$80 \times (1 - .65) \\ &= \$28 \text{ per share} \end{aligned}$$

Laureen must contribute \$10 per share. Required Equity - Actual Equity (\$12-\$2)

RESEARCH REPORTS

- Value Line.
 - Ranks stocks on a scale of 1 to 5 for timeliness and safety.
 - A ranking of 1 represents the highest rating for timeliness and safety (signal to buy).
 - A ranking of 5 represents their lowest ranking (signal to sell).
- Morningstar.
 - Ranks mutual funds using 1 to 5 stars.
 - 1 star represents the lowest ranking; 5 stars represents the highest ranking.

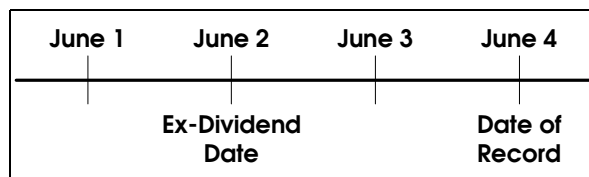
Exam Tip

Know that Value Line ranks stocks and Morningstar ranks mutual funds. Also know the rankings and whether they are a buy or sell signal.

DIVIDEND DATES

- Dividends are declared by the Board of Directors and are typically paid quarterly.
- There are two important dates to know regarding dividend payments:
 - Ex-Dividend Date.
 - Date of Record.
- Ex-Dividend Date.
 - The date the stock trades without the dividend.
 - If you sell the stock on the ex-dividend date, then you will receive the dividend.
 - If you buy the stock on or after the ex-dividend date, then you will NOT receive the dividend.

- The ex-dividend date is **two business days** before the date of record.



- Date of Record.
 - Date of record is the date on which you must be a registered shareholder in order to receive the dividend.
 - The date of record is **two business days** after the ex-dividend date.
 - An investor must actually purchase the stock three business days prior to the date of record in order to receive the dividend.

Exam Tip

To receive the dividend, an investor must purchase the stock before the ex-dividend date or 3 business days prior to the date of record.

Exam Question Dividends

MSFT declared a dividend payable to shareholders on the record date of Wednesday, May 15th. Which is the last possible date an investor could purchase the stock and still receive the dividend?

- Stock purchased on May 13th.
- Stock purchased on May 12th.
- Stock purchased on May 11th.
- Stock purchased on May 10th.

Answer: D

The investor would have to purchase the stock on Friday, May 10th as the last possible date. Recall the ex-dividend date would be Monday, May 13th. An investor would have to purchase prior to the ex-dividend date to receive the dividend. Since the next business date would be Friday, May 10th, that is the last possible purchase date to actually receive the dividend.

DIVIDENDS & SPLITS

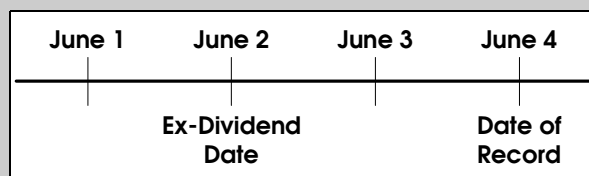
- Cash Dividends.
 - Qualified dividends receive capital gains treatment.
 - A cash dividend is taxed upon receipt.
- Stock Dividends.
 - Not taxable to the shareholder until the stock is sold.
- Stock Splits.
 - Increases shares outstanding and reduces stock price.
 - A 2-for-1 split for an investor with 100 shares at \$50 per share.
 - o How many shares after the split?

- Answer: $100 \text{ share} \times 2 = 200$.
- o How much is the stock after the split?
Answer: $\$50 \text{ per share} \div 2 = \25 per share .
 - A 3-for-2 split for an investor with 100 shares at \$60 per share.
 - o How many shares after the split?
Answer: $100 \text{ shares} \times 1.5 (3 \div 2) = 150 \text{ shares}$.
 - o How much is the stock after the split?
Answer: $\$60 \text{ per share} \div 1.5 (3 \div 2) = \40 .

Exam Question
Dividends

If June 4 is the date of record, when must Joe purchase the stock in order to receive the dividend?

- a) June 1.
- b) June 2.
- c) June 3.
- d) June 4.
- e) May 31.



Answer: A
Date of Record minus 3 days.

SECURITY REGULATIONS

- Securities Act of 1933.
 - Regulates the issuance of new securities (Primary Market).
 - Requires new issues are accompanied with a prospectus before being purchased.
- Securities Act of 1934.
 - Regulates the secondary market and trading of securities.
 - Created the SEC to enforce compliance with security regulations and laws.
- Investment Company Act of 1940.
 - Authorized the SEC to regulate investment companies.
 - Three types of investment companies: Open, Closed, Unit Investment Trusts.
- Investment Advisers Act of 1940.
 - This act required investment advisors to register with the SEC or state.
- Securities Investors Protection Act of 1970.
 - Established the SIPC to protect investors for losses resulting from brokerage firm failures.
 - This act does not protect investors from incompetence or bad investment decisions.
- Insider Trading and Securities Fraud Enforcement Act of 1988.
 - Defines an insider as anyone with information that is not available to the public.

- Insiders cannot trade on that information.

Exam Tip

Just make a flashcard of the above regulations with the characteristics outlined above.

MONEY MARKET SECURITIES

- Treasury Bills.
 - Maturities of 4, 13, and 26 weeks.
 - Denominations of \$1,000.
- Commercial Paper.
 - Short term loans between corporations.
 - Maturities of 270 days or less and it does not have to register with the SEC.
 - Commercial paper has denominations of \$100,000 and are sold at a discount.
- Bankers Acceptance.
 - Facilitates imports/exports.
 - Maturities of 9 months or less.
 - Can be held until maturity or traded.
- Eurodollars.
 - Deposits in foreign banks that are denominated in US Dollars.

Exam Tip

Just make a flashcard of the terms and definitions for money market securities. Any questions surrounding money market securities will be very definition oriented and surround the key terms outlined above.

INVESTMENT POLICY STATEMENT

- Establishes:
 - A client's objectives.
 - Limitations on investment manager.
- Used to measure investment manager's performance.
- The investment policy statement does NOT include investment selection.

Investment Policy Statement

Objectives	Description
Return Requirements	The return requirement can be specific to based upon a goal, such as retiring by by age 55.
Risk Tolerance	Identifying and defining an investor's risk tolerance is important so that the universe of investment alternatives can be narrowed.
Constraints	
Time Horizon	Time horizon is an important constraint that ties very closely to an investor's risk tolerance. Time horizon helps determine which investment alternatives are appropriate and when the investor is going to need the asset.
Liquidity	Coincides with time horizon and the more liquidity that is needed, the lower the investment return and investment alternatives.
Taxes	Whether the investments are being held in a taxable, tax-deferred or tax-free account.
Laws & Regs	Could be if the assets are held in a custodial account or trust. The unique laws and regulations surrounding the ownership or terms of a trust document.
Unique Circumstances	Anything unique to the client.

MARKET AVERAGES AND INDICES

- Dow Jones Industrial Average.
 - A simple price-weighted average.

Example

There are three stocks in our average and their values are \$44, \$60, and \$100. Our price average would be $(\$44 + \$60 + \$100) \div 3 = \68 . Therefore, our price weighted average would be \$68.

- The DJIA does not incorporate market capitalization.
- S&P 500.
 - A value-weighted index - incorporates market capitalization of individual stocks into the average.
- Russell 2000.
 - A value-weighted index of the **smallest** market capitalization stocks in the Russell 3000.
- Wilshire 5000.
 - The broadest index that measures the performance of over 6,500 stocks. The Wilshire 5000 is also a value-weighted index.
- EAFE.
 - A value-weighted index that tracks stocks in Europe, Australia, and the Far East.

Exam Tip

Be sure to know the difference between price-weighted average and value-weighted index.

LESSON 1 REVIEW QUESTIONS

1. Which of the following would one go to in order to ascertain the chairman's perspective for progress completed and expected for the coming year?
 - a) The 10K report.
 - b) The annual report.
 - c) The 10Q report.
 - d) The quarterly report.

2. You own 1,000 shares of ePlace stock. You purchased these shares for \$25 per share on margin with a 50% initial margin requirement and a 25% maintenance margin requirement. ePlace has experienced some reversals in the pummeling that tech stocks have received recently. The price has dropped to \$13 per share. Will there be a margin call? If so, how much?
 - a) \$1,500.
 - b) \$2,750.
 - c) \$3,250.
 - d) No margin call required.

3. How do the *stock split* and the *stock dividend* impact the shareholders but not bring about any changes in the value of the company on the balance sheet?
 - a) The value of the stock split and the stock dividend are generally small enough that the impact on the balance sheet is minimal
 - b) The value of the stock split and the stock dividend increase the number of shares but not the value of those shares
 - c) The value of the stock split and the stock dividend cause dilution, which keeps the value of the stock up, but without increasing the overall value on the balance sheet
 - d) The value of the stock split and the stock dividend offset one another, thereby eliminating any change that might occur to the balance sheet of the company

4. Which of the following would serve as an analytical tool if one wished to provide information to a client regarding small cap growth stocks?
 - a) Wilshire 5000.
 - b) S&P 500.
 - c) Russell 2000.
 - d) Dow Jones Small Cap Average.

5. Which broad market index would be more appropriate to use when conducting comparisons between a large-cap, blue chip portfolio, and the securities market?
 - a) S&P 500.
 - b) DJIA.
 - c) Russell 5000.
 - d) Value Line 300.

6. Sydney buys a stock for \$50 using an initial margin of 75% and a maintenance margin of 40%. At what price will she receive a margin call?
 - a) \$13.12
 - b) \$20.83.
 - c) \$25.25.
 - d) \$66.67.

7. Which of the following statements is true regarding the Securities Investors Protection Act of 1970?
- a) The act protects investors from losses arising from bad investment decisions.
 - b) The act requires a prospectus to accompany all new issues.
 - c) The act protects investors from negligence on the part of an investment advisor.
 - d) The act protects investors from losses arising from brokerage firm failures.
8. Which of the following is not a value-weighted index?
- a) DJIA.
 - b) S&P 500.
 - c) Russell 2000.
 - d) Welshire 5000.

ANSWERS TO LESSON 1 REVIEW QUESTIONS

1. Answer: B
The chairman's statement is included in the company's annual statement.
2. Answer: B
Debt of \$12,500 and new portfolio value of \$13,000 requires a 25% or \$3,250 margin. With \$500 $[(\$13 - 12.50) \times 1,000]$ still there, there is a required call for \$2,750 more.
3. Answer: B
Only option B, which states that the value of the stock split and the stock dividend increase the number of shares but not the value of those shares is correct. These options are sometimes used when a firm wishes to reward shareholders without expending cash that it wishes to use for other activities or opportunities.
4. Answer: C
Russell 2000 is a small cap growth index. Wilshire 5000 is the largest index of all equity securities of all firms incorporated in the United States. The S&P 500 is a large cap index, and there is no such thing as the Dow Jones Small Cap Average.
5. Answer: A
The S&P 500, A, would be an ideal choice. The DJIA, B, is only 30 stocks much too small for validity. The Russell is too broad and there is no such thing as the Value Line 300.
6. Answer: B
 $(\$50 \times 0.25) \div (1 - 0.40) = \20.83
7. Answer: D
The act does not protect against bad investment decisions. The Securities Act of 1933 requires new issues are accompanied with a prospectus.
8. Answer: A
The DJIA is not a value weighted index, it is price weighted.