

Test Alert!

to Accompany the 3rd Edition LEM

9/22/08

series **65**

The information included in this release, in addition to your other Kaplan Financial Education materials, is designed to assist you in preparing for concepts that your exam may include. We urge you to read it carefully and take time to review the sample questions and rationales.

Be sure to visit Kaplan Financial Education's Website at www.kaplanfinancial.com for the latest updates to this *Test Alert!*

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Introduction

The information in this TestAlert! is intended to update Kaplan Financial Education's Series 65 License Exam Manual, 3rd Edition, to match the newly published 4th edition. In addition to Take Note callouts, which highlight special or unusual information and amplify important points, you will also see Quick Quizzes, which will help ensure that you understand and retain the material covered in that particular section. Quick Quizzes are a quick interactive review of what you just read.

Changes to the LEM

Note Almost all references to NASD have been replaced with FINRA.

Page 6 Change the wording in the description of commercial paper to the following:

Any commercial paper that has a maturity at the time of issuance of no more than nine months (270 days), with the stipulation that the proceeds are to be used by the issuer to increase working capital and not for the purchase of fixed assets; there is no minimum denomination or rating requirement similar to that found in the Uniform Securities Act.

Page 13 Add the following text after the sentence “The term accredited investor applies only to private placements”:

The net worth requirement has not changed since the introduction of this rule in 1982, but, particularly due to increased real estate values, many seniors meet this definition. There is a current SEC proposal to raise the limits, but in the meanwhile a favorite phrase of the regulators is, “eligibility does not equal suitability.” Therefore, just because one meets the financial requirements of an accredited investor does not mean that suitability standards are ignored.

Page 34 Replace the final bullet dealing with contractual plans (which are now obsolete) with the following:

- Shares purchased through automatic reinvestment of dividends and capital gains distributions. Although no tax benefit accrues, the investor is able to enjoy compounding without expense.

Page 34 Add the following Test Topic Alert before Quick Quiz 1.10:

 **TEST TOPIC ALERT**

This rule may appear on your exam in a question asking if an investment adviser is permitted to reduce his fees because of commissions earned on the sale of mutual funds. Although negotiated commissions are allowable on other securities, because mutual funds are a continuous new issue sold based upon a stated offering price in the prospectus, reducing fees in this instance would be a prohibited practice.

Pages 37-40 Change the following information in the Unit Test 1 questions:

12. II. Change “bribery” to “a financial matter”

20. B. Change “NASD” to “FINRA”

Page 39 Replace Question 23 with the following:

23. It would be most correct to state that, as defined in the Securities Exchange Act of 1934, a securities information processor
- A. clears trades made on regulated stock exchanges
 - B. distributes information on trades or quotations for nonexempt securities
 - C. processes information provided by the SEC
 - D. secures the information necessary to process a trade

Pages 40–41 Change the following information in the answer key:

12. II. Change “bribery” to “a financial matter”; replace “not allowed” with “a cause for disqualification”
20. Change “NASD” to “FINRA”

Page 41 Replace the answer to Question 23 with the following:

23. **B** Securities information processors (SIPs) are regulated under the Securities Exchange Act of 1934. They include any person engaged in the business of collecting, processing, or preparing for distribution or publication information dealing with transactions in, or quotations for, any nonexempt security; or distributing or publishing (whether by means of a ticker tape, a communications network, a terminal display device, or otherwise), on a current and continuing basis, information with respect to such transactions or quotations.

Page 52 The snowbird exemption applies to all securities professionals, not just broker/dealers.

Page 53 Insert the following before the Test Topic Alert at the top of the page:

Another example that has recently been addressed by NASAA is broker/dealers and investment advisers using the Internet. A firm’s Website, considered advertising, can be seen everywhere. Does that mean the firm has a place of business in the state? Without getting too technical, there are several requirements to insure that the person is not deemed to be in the state.

- The communication clearly states that the person may only do business in this state if properly registered or exempt from registration.
- Any follow-up with prospects can only be made in compliance with state registration requirements.
- The site may only make available general information, not specific advice or recommendations.

Page 54 The Take Note at the top of page should read:

TAKE NOTE

In addition, at the time of registration of a broker/dealer, any partner, officer, or director of the broker/dealer who is active in the broker/dealer’s securities business, is automatically registered as an agent of the broker/dealer.

Page 56 Add the following first paragraph under “Exclusions from Definition of Agent for Administrative Personnel”:

In fact, if the broker/dealer they work for wishes to pay their employees, including this group, a year-end bonus based on company profits (not related to any individual’s sales efforts), it would be allowable.

Page 61 Add this Test Topic Alert to the end of the page:

TEST TOPIC ALERT

Please note that, unlike FINRA (NASD) registration requirements, fingerprints do not have to be submitted.

Page 66 After the example on the bottom of page 66, add this Test Topic Alert:

TEST TOPIC ALERT

When investors purchase shares of an open-end investment company (mutual fund), that is always an issuer transaction because the fund is continuously offering new shares. However, when the investment company sells shares out of its portfolio, that is a nonissuer transaction in the secondary markets.

Page 73 Add the following paragraphs to “Effective Date”:

Although the above rule applies to all methods of registration, as a practical matter, it would rarely apply other than in a security registered by qualification. Those registered by coordination are also, obviously, registered with the SEC and, therefore, are sold by the major investment banking houses. Unless the issue is a real “dog,” it will sell out rather quickly. Even those that are not popular are usually completely subscribed to in a week or two.

On the other hand, what if the issue, regardless of the method of registration, is in high demand? Is it possible to increase the number of shares in the offering without having to file a new registration statement? Yes! A registration statement may be amended after its effective date so as to increase the securities specified to be offered and sold, if two conditions are met:

- the public offering price; and
- the underwriters’ discounts and commissions are not changed from the respective amounts stated in the original registration statement.

The amendment becomes effective when the Administrator so orders. Every person filing such an amendment shall pay a late registration fee and a filing fee, calculated in the manner as the original quantity, levied against the additional securities proposed to be offered.

Page 74 Add this sentence to the paragraph just ahead of the Take Note:

This action may be taken with or without prior notice.

Page 78 Revise the second paragraph of “Administrator’s Powers.” The second paragraph should say:

Try to follow this next point because it is a bit tricky. The Administrator may, by rule or order, deny or revoke the registration exemption of “any security issued by any person organized and operated not for private profit but exclusively for religious, educational, benevolent, charitable, fraternal, social, athletic, or reformatory purposes, or as a chamber of commerce or trade or professional association” (your basic nonprofit exemption),

and “any investment contract issued in connection with an employees’ stock purchase, savings, pension, profit-sharing, or similar benefit plan.” Please note that we gave you a list of 10 exempt securities, but the Administrator can only deny exemption to the above two. On the other hand, with the exception of federal covered securities, the Administrator may deny any exempt transaction. That means that, for example, just because an agent had a trade with an insurance company, the Administrator has the power, if he feels it is justified, to consider that transaction nonexempt.

Page 79 Add the following Take Note before Quick Quiz 2.8:

TAKE NOTE

There are only two securities exemptions that the Administrator may revoke, while all exempt transactions, other than in federal covered securities, may be revoked.

Page 89 At the top of the page, add this sentence:

Unlike agents, investment advisers and their representatives are never permitted to share in the profits or losses in their client’s accounts.

Page 89 The Market Manipulation section should have Front Running replaced with Wash Sales as follows:

Securities legislation is designed to uphold the integrity of markets and transactions in securities. However, market integrity is violated when transactions misrepresent actual securities prices or market activity. The most common forms of market manipulation are matched purchases and its first cousin, wash sales.

Matched purchases occur when market participants agree to buy and sell securities among themselves to create the appearance of activity or trading in a security. Increased volume in a security can induce unsuspecting investors to purchase the security, thereby bidding up the price. As the price rises, those who initiated the matched purchases sell their securities at a profit.

A **wash sale** is an attempt to manipulate a security’s price by creating an apparent interest in the security that really does not exist. This is done when an investor buys through one brokerage account while simultaneously selling through another. No real change in ownership has occurred, but, to the marketplace, it appears that volume is increasing.

Page 90 Add the following bullet points at the top of the page:

- Accepting anything other than an indication of interest prior to the effective date of a security in registration
- Failing to know your customer’s goals, objectives, and financial capabilities
- Withholding shares of an IPO by the underwriter for the purpose of personal gain
- Offering “free lunch” seminars, especially for seniors, without explaining that the primary purpose of the seminar is to make sales, not educate

Page 98 Add after the Case Study:

Frequently, before a final determination of proceedings under the act, the Administrator will act summarily to suspend a registration. However, no formal order may be issued without the Administrator:

- giving appropriate prior notice to the affected persons;

- granting an opportunity for a hearing; and
- providing findings of fact and conclusions of law.

Page 99 Add the following text before the first Take Note:

TEST TOPIC ALERT

Because of a lack of uniformity in state criminal laws, a person can be convicted of a misdemeanor in one state and then move to a state where that same crime is a felony. If the person were to then apply for registration, the Administrator must consider the crime under the statutes of the state where it occurred, not his own.

Page 102 Add the following Test Topic Alert after the last paragraph:

TEST TOPIC ALERT

The USA provides that every cause of action under this statute survives the death of any person who might have been a plaintiff or defendant. Therefore, any bond required must provide that suit may be brought for the specified two-year period even though the person who is bonded dies before the expiration of that period.

Pages 105–111 Change the following information in Unit Test 2:

4. B. Change to “an individual who represents an issuer of a security exempt from the act”
5. III. Replace “various” with “registered”
8. IV. Change to: “An individual who is paid a commission to sell nonnegotiable certificates of deposit for ABC National Bank.”
24. III. Delete “front running” and replaced with “wash sales”
26. III. Add “instead of exercising them”
40. Replace “an asset management” with “a wrap fee” and add the word “client’s” before “portfolio”
 - Choice D – replaced “in advance” with “no later than completion”

Pages 113–118 Change the following information in the answers:

3. Add “or supervise those that do”
4. Change the third sentence to: “The law excludes from the definition of an agent, those individuals who represent an issuer in exempt transactions, selling exempt securities, and transactions with issuers’ employees when no commission is paid.”
8. Change the last sentence to read: “to sell these certificates”

- 16. Change “brokers” to “broker/dealers”
- 19. Delete sentence relating to oil, gas, and mining
- 24. Replace the first sentence with: “Wash sales, the practice of attempting to create the appearance of trading activity by entering offsetting buy and sell orders, is a form of market manipulation.”
- 40. Replace the second sentence with: “Any action that results in a transaction in which the firm or an affiliate acts in either a principal or agency capacity requires, prior to completion of the trade, written disclosure of that fact to the client and approval of the client.”
- 44. Add “without a prior hearing”

Page 119 Change the following in the answer to Question 2 of Quick Quiz 2.3:

Delete “effecting transactions”

Page 131 Delete the Take Note relating to the Merrill Lynch rule and replace with the following:

TAKE NOTE

For purposes of incidental, look at this example. The Maryland Securities Act sets that, “[a] lawyer, certified public accountant, engineer, or teacher whose performance of investment advisory services is solely incidental to the practice of the profession will be excluded from the definition of investment adviser. However the performance of such services is not solely incidental unless: 1) the investment advisory services rendered are connected with and reasonably related to the other professional services rendered; 2) the fee charged for the investment advisory services is based on the same factors as those used to determine the fee for other professional services, and 3) the lawyer, certified public accountant, engineer, or teacher does not hold out as an investment adviser.”

Page 133 Add the following before the Case Study:

TEST TOPIC ALERT

Because these exemptions all apply when the investment adviser does not have an office in the state, it is relevant to understand that an investment adviser or one of its representatives who advertises to the public, in any way, the availability of meeting with prospective clients in a hotel, seminar, or any other location in the state is considered to have an office in the state. However, an investment adviser representative who contacts clients in the state and notifies them that he will be passing through the state and will be available to meet with them in his hotel room is not considered to have an office in the state because the announcement is being made only to existing clients and not to the public.

Page 136 Add the following Take Note before Schedule I:

TAKE NOTE

Although there are no minimum educational requirements, the ADV Part II requires disclosure of the formal education after high school of each principal executive officer of the investment adviser or each person with similar status or performing similar functions as well as each member of the investment committee or group that determines general investment advice to be given to clients.

Page 147 Add the following sentence to the first bullet on the Brochure rule:

Part II contains information about the IA's management and advisory personnel, style of investing, fees, etc. It does not include information found in Part I such as the legal form of the entity, states in which registered, and number of employees.

Page 152 Add the following before the Take Note:

TEST TOPIC ALERT

Most investment advisers do not take custody and, therefore, are unable to accept direct delivery of customer securities or funds except under the limited conditions described in this section. However, broker/dealers are not constrained by this rule; they are only required to provide receipts anytime they accept customer assets.

Page 161 In Quick Quiz 3.14, question 1, choice III, delete the words "of the same asset class."

Page 162 Add the following Test Topic Alert before the Take Note:

TEST TOPIC ALERT

There are two additional points related to performance based compensation that you must know. First, the adviser must use net performance, that is, consider both gains and losses. Second, as with so many other rules, the Administrator has the power to authorize this type of fee even when the stated conditions are not met.

Page 167 Add after this bullet in the middle of the page referring to CPA:

- Recommending the same security to clients without regard to individual suitability; this is sometimes referred to as blanket recommendations
- Relying on oral discretionary authority for transactions in a customer's account beyond the first 10 business days after the date of the initial transaction

Pages 174–179 Change the following in Unit Test 3:

7. Replace "act" with "Investment Advisers Act of 1940"
8. Replace "act" with "Investment Advisers Act of 1940"

- 13. III. Replaced “registered” with “doing business”
- 23. Added “Changed the Act of 1940 to the Investment Advisers Act of 1940”

Pages 180–183 Change the following in the answers:

- 9. Delete the last sentence
- 18. Replace the rationale with: “Both state and federal law require that records be kept easily accessible for a period of no less than five years. What might have tricked you here is that these laws require that the records be kept in the principal office of the IA for the first two years.”
- 33. Change “either party” to “both parties”

Unit 3 Change the following information in the Quick Quizzes

- 3.5 Add a new first sentence: “ABC Advisers is a federal covered IA.”
- 3.11 Question 2: Remove the statement “with the exception stated above”
- 3.14 Question 1: Remove the words “of the same asset class”
- 3.12 Delete the end of the rationale beginning with the word “Nothing”
- 3.14 Delete the words “of the same type of asset,” and change “cover” to “covering”

Page 191 Change the wording on the bottom of the page to the following:

Historically, owning common stock has provided investors with returns in excess of the inflation rate. For this reason, most investors with a long term investment horizon have included common stock in their portfolios as a hedge against inflation. Of course, it must be mentioned that stock prices can decline, particularly over the short run.

Page 192 Change the Take Note to the following:

TAKE NOTE

The increase in the price of RST stock in the example above is an unrealized gain until the stock is sold; when it is sold, it becomes a realized gain. Capital gains are not taxed until they are realized. Under current tax law, most dividends are taxed at a rate not in excess of 15%.

Pages 192–193 Delete Quick Quiz 4.1, the section on Proxy Voting, and all references to statutory and cumulative voting procedures.

Page 194 Add the following after the Take Note:

In summation, why would you include common stock in a client's portfolio?

- Potential capital appreciation
- Income from dividends
- Hedge against inflation

In doing so, the client would be incurring the following risks:

- Market
- Business difficulties leading to possible reduction or elimination of the dividend and even bankruptcy leading to loss of principal

Page 199 Add the following after Quick Quiz 4.3:

Risks of owning preferred stock:

- As a fixed income security, there is no inflation protection
- As a fixed income security, when interest rates rise, the value of preferred shares declines
- As an equity security, there is the risk that dividends may be skipped
- As an equity security, in the event of a corporate liquidation or bankruptcy, all creditors have a prior claim against the assets.

In summation, why would you include preferred stock in a client's portfolio?

- Fixed income from dividends
- Prior claim ahead of common stock
- Convertible preferred sacrifices income in exchange for potential appreciation

In doing so, the client would be incurring the following risks:

- Possible loss of purchasing power
- Interest rate (money rate) risk
- Business difficulties leading to possible reduction or elimination of the dividend and even bankruptcy leading to loss of principal

Page 200 Change the first bullet under Emerging Markets to say gross domestic product (GDP) instead of gross national product (GNP).

Pages 202–203 Add the following after the Test Topic Alert at the bottom of the page:

In summation, why would you include REITs in a client's portfolio?

- The opportunity to invest in real estate without the degree of liquidity risk found in direct ownership
- A negative correlation to the general stock market (we'll talk more about correlation in Unit 10, but, for now, it means that real estate prices and the stock market frequently move in opposite directions)
- Reasonable income and/or potential capital appreciation

In doing so, the client would be incurring the following risks:

- Because the investor has no control, much of the risk in investing in REITs lies with the quality of the management
- Problem loans in the portfolio could cause income and/or capital to decrease
- Dividends are not considered qualified for purposes of the 15% maximum tax rate and are taxed at full ordinary income rates

Page 217 Add a fourth bullet to “Zero-Coupon Bonds”:

-
- This investment is particularly useful when there is a target goal, such as college education or a specified retirement fund.

Page 221 Add the following after “Commercial Paper”:

In summation, why would you place money market securities in a client’s portfolio?

- Highly liquid
- Very safe
- The best place to store money that will be needed soon

In doing so, the client would be incurring the following risks:

- Because of their many advantages, the rate of return is quite low so these are not suitable for long-term investors
- Fluctuating income; due to short-term maturities, principal is always being reinvested at a different rate

Page 265 Add the following information before Quick Quiz 5.9:

Straddles

When an investor is not sure which direction the market will move but has a strong opinion that there will be dynamic movement, a strategy that might be employed is the purchase of a straddle. This is the combining of a put and a call on the same stock with the same exercise price and expiration date. If the stock moves up, a profit is made on the call; if down, a profit is made on the put.

TEST TOPIC ALERT

Those who buy a straddle will profit from volatility while those who sell a straddle will profit if the market is stable because the options will expire unexercised.

Page 297 In the listing of ineligible investments, remove the comma between bond funds and UITs. The statement is meant to refer to municipal bond mutual funds and municipal bond UITs.

Page 302 Add the following Test Topic Alert after “Contributions”:

TEST TOPIC ALERT

Only earnings from self-employment count toward determining the maximum that may be contributed. For example, if a corporate employee had a part-time consulting job, only that income, not the corporate salary, could be included in the computation.

Page 307 Change Quick Quiz 7.3 to the following:

- The maximum annual employer contribution to a 403(b) for the 2008 plan is
- A. \$9,500
 - B. \$15,500
 - C. \$25,000
 - D. \$46,000

Page 313 Add the following paragraphs at the end of the first paragraph on 401(k) Plans:

There are maximum limits, and the amount withdrawn is not eligible for a rollover and, therefore, is taxable as ordinary income and possibly the 10% penalty. It differs from a 401(k) loan, which is not taxable as long as the repayment requirements of the IRS are met.

Somewhat different from the hardship withdrawal is the ability to borrow from the 401(k). This has the advantage of not being treated as a distribution so there is no tax. However, if certain IRS rules are not followed, it will be considered a premature distribution and taxed as such. The IRS maximum loan amount is the participant's vested share or \$50,000, whichever is the smaller. Other than if used for a home mortgage, the loan must be paid back on a regular schedule (usually through payroll deduction) in a period not to exceed 60 months.

Page 320 Change Question 10, choice D, to the following:

- D. A former corporate employee who decides to become self-employed may not rollover any distributions from a qualified corporate plan into a rollover IRA if he has created a Keogh Plan.

Page 322 For Question 10 answer, replace the first sentence of the rationale with the following:

Rollovers are permitted into an IRA regardless of any plans maintained.

Page 328 Add the following Test Topic Alert after Signature Cards:

TEST TOPIC ALERT

The exam will require you to know that there are only two signatures necessary on a new account form—that of the registered representative (agent) introducing the account, and of the principal accepting it, but not of the client. Although many firms do ask for a client's signature, that is the "real" world and not the "test" world.

Page 336 Add Take Note just ahead of the Test Topic Alert:

TAKE NOTE

It is not unusual for a client to grant another party with a durable power of attorney. The power is durable in that it survives the incompetence (but not death), of either party.

Pages 338–339 This text has been revised to the following because of tax law changes:

The minor's Social Security number appears on an UGMA/UTMA account, and the minor must file an annual income tax return and pay taxes on any income exceeding \$1,800 (2008) produced by the UGMA/UTMA at the parent's top marginal tax rate, regardless of the source of the gift, until the minor reaches age 19,

unless the individual is a full-time student, in which case, under 23 (commonly referred to as the kiddie tax). Lower amounts of annual unearned income are not subject to the kiddie tax. When the minor is no longer covered by the kiddie tax, the account will be taxed at the minor's tax rate. Although the minor is the account's beneficiary and is responsible for any and all taxes on the account, in most states it is the custodian's responsibility to see that the taxes are paid.

EXAMPLE

In 2008, the kiddie tax is expanded to include all children under age 19 and full-time students under age 23. (In 2007, only children under age 18 were subject to the tax.) The amount of investment income a child can earn in 2008 without being taxed at the parents' rate is \$900 (up from \$850 in 2007). Combined with the standard deduction of \$900 (up from \$850) for a child who is claimed as a dependent on the parents' return, the kiddie tax exemption rises to \$1,800, up from \$1,700 in 2007.

Page 343 Add Question 7 to Quick Quiz 8.6:

7. An investment adviser has been granted trading authority in writing. Which two of the following statements are correct about this discretionary account?
- I. This account will be under a higher level of scrutiny than nondiscretionary accounts.
 - II. In order for the adviser to exercise discretion, the account must have a minimum of \$750,000 under management, or the client must have net worth of at least \$1.5 million.
 - III. Having written authorization from the client shields the adviser against claims of excessive trading in the account.
 - IV. Once the discretionary authority has been granted, the client will still be able to make his own portfolio decisions if desired.
- A. I and II
 - B. I and IV
 - C. II and III
 - D. III and IV

Page 343 Add the following answer to Quick Quiz 8.6:

7. **B.** All regulatory bodies require a higher level of supervision over discretionary accounts. One of the concerns is that these accounts lend themselves to excessive activity or churning. Although it would be anticipated that most of the investment decisions would be made by the adviser, clients are still able to make their own buy and sell decisions if desired.

Page 356 Add the following after the first sentence under Partnerships:

Partnerships are easy to form and easy to dissolve, but are generally not suited for raising large sums of capital.

Page 357 Add the following Test Topic Alert before Client Personal Profile:

TEST TOPIC ALERT

You may be asked about tax documents for each of different forms of business organizations. Sole proprietors file their business information on a Schedule C. Members of LLCs and shareholders in S corporations receive a Form K-1 and C corporations report their income on a Form 1120.

Page 360 Add the following to Retirement:

As life expectancy has risen, the topic of decumulation has come into focus. How do we make sure that the money accumulated lasts long enough? One way to minimize longevity risk is through the purchase of variable annuities because payout is guaranteed for life.

Page 361 Add the following Test Topic Alert:

TEST TOPIC ALERT

In those cases where the estate does have liquid assets such as stocks and bonds, life insurance still may serve a valuable need in that these income producing assets will not have to be sold to cover the estate tax liability or other final expenses.

Page 362 Under Asset and Income Shifting, the kiddie tax now applies to all children under age 19 and full-time students under age 23:

Page 367 Add the following after Diversification:

Contrarian

A contrarian is an investment manager who takes positions opposite of that of other managers or in opposition to general market beliefs.

Page 387 Add the following to Inflation:

A term that may appear on your exam is *inflation inertia*. This is the concept that the rate of inflation does not immediately react to unexpected changes in economic conditions. Rather, it takes a pronounced change in the reality before there is an effect.

Page 388 Add the following before Quick Quiz 10.1:

Top Down Analysis

If we were to draw a picture of **top down analysis**, it would look like an inverted isosceles triangle—broad on top and narrow on the bottom. The analyst starts with the broadest measure of the overall economy and then successively narrows it down to finally select the company or companies that best fit the objectives.

Bottom Up Analysis

This is the direct opposite of top down. In this case, the triangle is standing on its base. This analyst starts with the narrowest indicator and then steadily broadens the search.

Page 395 Add the following to the entry on Eurobonds prior to the Take Note:

The most tested form of Eurobond is the eurodollar bond. These bonds are most commonly issued by an overseas company outside of the US as well as the issuer's home country. These bonds are not limited to European issuers, that's just where they originated. For example, if an Indian bank held dollar-denominated bonds issued by a Korean company, the term Eurodollar bond would still apply.

The primary reason for issuing these bonds is that they are free from the requirement to register with the SEC and generally carry lower interest rates than those issued here.

TEST TOPIC ALERT

One advantage to investors is that, because they are US dollar denominated, they bear no currency risk to US investors.

Page 406 Add the following to the Test Topic Alert:

The cash flow statement will also reflect money from operations, financing, and investing, but not accounting changes.

Page 414–415 Add the following index after NASDAQ Composite Index:

EAFE

The EAFE, sometimes referred to as the MSCI EAFE (it was developed by Morgan Stanley Capital International) is an index of foreign stocks. The index is market capitalization weighted. The EAFE acronym stands for Europe, Australasia, and Far East.

The index includes a selection of stocks from 21 developed countries outside of the US and Canada. The index has been calculated since the end of 1969, making it the oldest truly international stock index. It is probably the most common benchmark for foreign stock funds.

Page 415 Add the following on the list of Technical Market Theories:

Advance/Decline Theory

The number of issues closing up or down on a specific day reflects market breadth. The number of advances and declines can be a significant indication of the market's relative strength. When declines outnumber advances by a large amount, the market is bearish even if it closed higher. In bull markets, advances substantially outnumber declines. Technical analysts plot daily advances and declines on a graph to produce an advance/decline line that gives them an indication of market breadth trends.

Page 415–416 Add the following to the Efficient Market Hypothesis section:

Eugene F. Fama, coined the term in a 1965 Financial Analysts Journal article titled "Random Walks in Stock Market Prices":

In an efficient market, competition among the many intelligent participants leads to a situation where, at any point in time, actual prices of individual securities already reflect the effects of information based both on events that have already occurred and on events which, as of now, the market expects to take place in the future. In other words, in an efficient market at any point in time the actual price of a security will be a good estimate of its intrinsic value.

Page 416 Replace the first paragraph under Modern Portfolio Theory with the following:

Modern portfolio theory is an approach that attempts to quantify and control portfolio risk. It differs from traditional securities analysis in that it emphasizes determining the relationship between risk and reward in the total portfolio rather than analyzing specific securities. This is derived from the **capital asset pricing model (CAPM)**, which states that the pricing of a stock must take into account two types of risk: systematic and nonsystematic.

Page 420 Add the following under Total Return:

Total return includes the income from dividends or interest plus any capital appreciation over a given time period, usually one year.

Page 421 Add the following sentence to the end of Holding Period Return:

It is essentially the same as total return, but, whereas total return is usually computed on an annual basis, holding period return can be for any period.

Page 424 Add the following sentence to the top paragraph:

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

Page 424 Add the following after the first Take Note:

Dividend Models

Some analysts believe you can determine the value of a stock based upon current or anticipated dividends. The models work best with a company whose dividends are paid with regularity, so they are more popular with larger, well established organizations than small cap stocks. Two methods used are the dividend discount model and the dividend growth model

Dividend Discount Model

This model says that the value of a stock should be equal to the present value of all future dividends. There are several methods to use, such as assuming constant or variable dividends, but the concept is still the same. What does the investor expect to receive in the future and then discount that to the present value? You will not have to know the formula, but it is basically the annual dividend divided by the required rate of return. For example, if a stock pays a \$1.20 dividend and the required rate of return in the marketplace is 6%, the stock should be worth \$20 ($1.20/.06$)

Dividend Growth Model

This model assumes that the amount of the annual dividend will grow at a constant rate. Because projections of future growth can be hazy at best, this model is best used in conjunction with other forecasting tools. You will not have to know the formula, but it is basically the current dividend multiplied by $(1 + \text{the dividend growth})$ and then divided by the required rate of return. For example, if a stock pays a \$1.20 dividend that expected to grow at a 3% rate each year, with a required rate of return of 6%, the stock should be worth \$41.20. This is significantly higher than a stock whose dividends are expected to remain constant.

Page 429 Add the following Test Topic Alert after the second Take Note:

TEST TOPIC ALERT

Business risk is highest for investors whose portfolios contain stock in only one issuer or in lower rated bonds.

Page 430 Add the following example after Interest Rate Risk:

EXAMPLE

The longer the duration, the greater the interest rate risk.

Page 431 Add the following before Quick Quiz 10.7:

Reinvestment Risk

A variation of interest rate risk is reinvestment risk. There is reinvestment risk as to interest and reinvestment risk as to principal.

One receiving a periodic cash flow from an investment, such as interest on a debt security, may be unable to reinvest the income at the same rate as the security itself is paying. For example, if one purchased a bond with a 10% coupon and several years later comparable securities were only paying 7%, the investor would not be able to compound the investment at the original rate. Zero coupon bonds avoid this risk because there is nothing to reinvest.

This risk also occurs at maturity. If your fixed income client had been enjoying a 10% return on the above bond, when it matured, he was only able to reinvest the principal in a 7% security.

Currency or Exchange Rate Risk

Purchasers of foreign securities, whether through direct ownership or ADRs, face the uncertainty that the value of either that foreign currency or our domestic currency will fluctuate. As of the date of this publication, the past few years has seen the Euro increase greatly against the dollar. As a result, investors in stocks domiciled in those countries using the Euro have seen their investment grow, in many instances solely due to the exchange rate of the Euro.

Page 432 Add the following bullet:

- International Stocks—EAFE

Errata

Note Throughout the LEM, beginning with the Table of Contents on page iii, references to the Securities Acts Amendments of 1975 should be changed to Securities Amendments Act of 1975.

Page 23 Market Manipulation—Churning is listed in this group in such a fashion that it might be thought that it is considered a form of market manipulation. It is not. It is, however, a prohibited practice. The other three items on the list are forms of market manipulation.

Page 42 Delete the last sentence the rationale to Question 17. We have not yet given you the short list of items that are not securities. That comes in the next Unit.

Page 187 The text after **D.** should read “an investment advisor derives an economic” rather than “an investment advisor derives and economic.”

Page 351 Change the following heading:

Heading should be in the singular, Trust Account rather than Trusts Accounts.

Page 366 The example on the bottom of the page should say the following:

ABC would be attractive to investors because its intrinsic value is higher than its market value.

Page 390 Change the following in the second Take Note:

Last word should be plural, bonds rather than bond.

Page 399 Make the following corrections to the balance sheet:

On the balance sheet, the entry for the long-term liability (the 20-year convertible) should be \$50 million and the following entry for Total Liabilities (which has no total) is \$60 million.

Page 461 Under Glossary QTIP trust, the last line should read “also known as” rather than “also knows as.”

Appendix A The second item on the left column under Miscellaneous should be “change,” not “charge.”



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