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Answer Key: Yield Curves and Capital Gains: 12th Grade Advanced Finance Quiz

Analyze tax-loss harvesting and geometric mean returns across 10 rigorous scenarios evaluating sophisticated asset allocation strategies.

1. An investor in the 37% marginal tax bracket realizes a \$50,000 short-term capital gain. To mitigate the tax liability via tax-loss harvesting, which action provides the most immediate fiscal efficiency?

Answer: B) Selling a short-term asset held for 8 months at a \$50,000 loss.

Short-term capital gains are taxed as ordinary income. Offsetting them with short-term losses first is more efficient than using long-term losses, as it directly reduces income taxed at the highest marginal rate (37% vs the lower long-term capital gains rate).

2. A strategy involving the simultaneous purchase of a put option and a lead-in stock to protect against downside risk while maintaining upside potential is known as a _____.

Answer: A) Protective Put

A protective put acts as an insurance policy for an equity position, allowing the investor to hedge against significant losses while retaining the ability to profit if the stock price rises.

3. According to the Modern Portfolio Theory (MPT), an investor can eliminate all systematic risk through the process of hyper-diversification across global equity markets.

Answer: B) False

Diversification reduces unsystematic (idiosyncratic) risk. Systematic risk, also known as market risk, is inherent to the entire market and cannot be eliminated through diversification.

4. Evaluate the impact of a 'backwardated' futures market on a commodity-heavy investment portfolio. What is the primary benefit to the investor?

Answer: B) Positive roll yield as the futures price converges upward toward the spot price.

In backwardation, the futures price is lower than the current spot price. As the contract approaches expiration, the price tends to rise toward the spot price, creating a positive roll yield for long positions.

5. The _____ rule prevents an investor from claiming a loss on a security if they purchase a 'substantially identical' security within 30 days before or after the sale.

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Answer: B) Wash-Sale

The IRS Wash-Sale Rule (under Section 1091) disallows the tax deduction of a loss if the investor buys the same or a very similar security within the 61-day window surrounding the sale.

6. A Treasury Inflation-Protected Security (TIPS) adjusts its principal based on the Consumer Price Index (CPI), meaning the interest payment (coupon) remains constant in dollar terms but increases in purchasing power.

Answer: B) False

While the coupon rate is fixed, it is applied to the adjusted principal. Therefore, as the principal increases with inflation (CPI), the actual dollar amount of the interest payment also increases.

7. Which scenario best describes the 'Sequence of Returns Risk' for a retiree beginning withdrawals in a bear market?

Answer: C) Early losses combined with withdrawals deplete the principal too quickly to recover during later bull markets.

Sequence risk is the danger that the timing of withdrawals from a retirement account will coincide with a market downturn, forcing the liquidation of assets at low prices and permanently reducing the portfolio's longevity.

8. The ratio used to measure the risk-adjusted return of an investment by subtracting the risk-free rate from the total return and dividing by the standard deviation is the _____ Ratio.

Answer: C) Sharpe

The Sharpe Ratio is a fundamental metric in finance for evaluating how much excess return an investor receives for the extra volatility (risk) endured for holding a risky asset.

9. If the Federal Reserve implements an expansionary monetary policy during a period of high stagflation, what is the most likely outcome for a holder of long-duration corporate bonds?

Answer: B) The real value of the bonds will decrease as inflation expectations rise, despite lower nominal rates.

Expansionary policy in a stagflationary environment often fuels inflation. Since long-duration bonds are highly sensitive to inflation eroding future cash flows, their real (inflation-adjusted) value typically declines.

10. In a 'Roth Conversion Ladder' strategy, an individual converts Traditional IRA funds to a Roth IRA to access the principal penalty-free after a five-year waiting period, regardless of age.

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Answer: A) True

This is a sophisticated early-retirement maneuver. Each converted amount has its own five-year clock; once that clock expires, the converted principal can be withdrawn penalty-free before age 59.5.