Module 2.1 — Return Calculations and Instruments

Each trap below is a wrong answer option the exam is built to tempt you with. Know why it is wrong.

1 Adding the local return and the currency return

WHY IT'S WRONG
The currency change applies to your gain as well as your original investment. 12% - 4.336% = 7.664% ignores that cross effect.

DO THIS INSTEAD
$R_{DC} = (1 + R_{FC})(1 + R_{FX}) - 1 = (1.12)(0.95664) - 1 =$ **7.14%**.

2 Forgetting that currency affects the dividend too

WHY IT'S WRONG
Income earned in foreign currency must also be converted back home, usually at the ending exchange rate.

DO THIS INSTEAD
Convert (ending price + dividend) at the new rate. Currency affects both price and distribution returns.

3 Annualizing by multiplying

WHY IT'S WRONG
0.8522% × 365/90 = 3.456% ignores return earned on reinvested return.

DO THIS INSTEAD
Compound: $(1.008522)^{365/90} - 1 =$ **3.50%**.

4 Dividing by the ending price

WHY IT'S WRONG
Return is measured on the money you invested, which is the starting price.

DO THIS INSTEAD
$r = (P_1 - P_0 + \text{Income}) / \mathbf{P_0}$.

5 Calling equity dividends a "fixed" distribution

WHY IT'S WRONG
Dividends are discretionary. The board decides them each year; shareholders are owners, not lenders.

DO THIS INSTEAD
Equity = mostly price return + **variable** distributions.

6 Assuming all fixed-income securities pay fixed distributions

WHY IT'S WRONG
Floating-rate notes pay a coupon linked to prevailing interest rates.

DO THIS INSTEAD
"Fixed income" names the family. FRNs give **variable** distributions.

7 Thinking rising rates make coupon income negative

WHY IT'S WRONG
The issuer keeps paying the coupon. Only the market price of the bond falls.

DO THIS INSTEAD
Rates ↑: distribution return stays **positive**; price (capital appreciation) return turns **negative**.

8 Thinking longer bonds do better when rates rise

WHY IT'S WRONG
Longer bonds have more fixed cash flows over a longer time, so their prices fall more.

DO THIS INSTEAD
Rates ↑ → longer-dated bonds **underperform** shorter-dated bonds.

9 Reading "risk-free" as "no risk at all"

WHY IT'S WRONG
Short-term government bills are free of *credit* risk only. Inflation can still erode real returns.

DO THIS INSTEAD
Risk-free = no default risk. The US 30-day T-bill earned almost zero real return.

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10 Ranking volatile assets by arithmetic mean

WHY IT'S WRONG
Arithmetic means ignore compounding and overstate multiperiod performance (volatility drag).

DO THIS INSTEAD
Compare multi-year performance with the **geometric** mean. Stock 5% arithmetic but -4.81% geometric.

11 Subtracting compound returns to measure outperformance

WHY IT'S WRONG
12.26% - 11.23% = 1.03% ignores compounding; 1.03 / 11.23 = 9.17% is a percentage of a percentage.

DO THIS INSTEAD
(1.1226 / 1.1123) - 1 = **0.93%**.

Module 2.2 — Risk, Long-Term Returns and Asset Allocation

12 Believing diversification removes all risk

WHY IT'S WRONG
Systematic risk (inflation, interest rate, market) hits every investment together, however many you hold.

DO THIS INSTEAD
Diversification removes **unsystematic** (issuer, sector) risk only.

13 Calling inflation an issuer-specific (micro) risk

WHY IT'S WRONG
Inflation reduces real returns on all types of investments, even if the impact varies by issuer.

DO THIS INSTEAD
Inflation is a **macro (systematic)** risk.

14 Calling sector risk systematic

WHY IT'S WRONG
A downturn in one industry does not affect all investments; it can be diluted across sectors.

DO THIS INSTEAD
Sector / industry risk is **unsystematic**, like issuer risk (business, financial, credit).

15 Taking the curriculum's historical data as the rule

WHY IT'S WRONG
Large-caps beating small-caps and government bonds beating corporates was an artifact of the period studied.

DO THIS INSTEAD
Expect higher long-term returns from **small-caps** and **corporate bonds** (risk-return tradeoff).

16 Getting distracted by the coupon when ranking expected returns

WHY IT'S WRONG
Expected return is driven by risk, not by today's coupon size.

DO THIS INSTEAD
Look at **issuer** (corporate > government) and **maturity** (longer > shorter).

17 Picking the highest total return for an income-focused retiree

WHY IT'S WRONG
Most of a high-return portfolio's return comes from volatile price return. The client needs stable income.

DO THIS INSTEAD
Choose the allocation with substantial **fixed income** (Allocation C: 7.40%, income 3.95%).

The one rule behind most traps: whenever returns stack — over time, across currencies, or when comparing compound returns — work with (1 + r) and multiply or divide. Never simply add or subtract.

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