

2012 Level III Mock Exam

The 2012 Level III Chartered Financial Analyst (CFA®) Mock Examination has 60 questions. To best simulate the exam day experience, candidates are advised to allocate an average of 18 minutes per item set (vignette and 6 multiple choice questions) for a total of 180 minutes (3 hours) for this session of the exam.

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Ashraf Omar Case Scenario

Ashraf Omar, CFA, recently joined the Sahara Manufacturing Company (Sahara) as its CFO. The company is planning an initial public offering (IPO). The proceeds of the IPO will be used to finance the purchase of plant and machinery. Omar was recruited on the basis of his extensive investment banking background, having successfully supervised ten IPOs over the last five years at Falcon Investment Bank (Falcon).

Sahara, a family-owned company, had a very good reputation until recently when an ongoing tax dispute became public. The dispute may lead the tax authority to impound plant assets. Furthermore, outdated plant equipment is causing production disruption and declining profit margins. The CEO is looking to retire because he is not able to manage the current challenges.

Omar creates a detailed plan to help manage the IPO process. He plans on using an extensive checklist and numerous templates he developed while at Falcon. Omar decides to employ the same external service providers he used at Falcon to handle the legal, accounting, and marketing aspects required for a successful IPO. He considers these external providers the best in the industry, and their fees are competitive. He will also work with his previous contacts at the regulatory authority during the approval process.

As part of the due diligence process, Omar discovers a letter from a credit rating agency indicating an imminent downgrade of Sahara to below investment grade. However, Omar recalls that a private placement document being used to pitch the debt issue to investors shows a pending investment-grade rating. He notes that the outstanding debt is being paid according to schedule. Omar also finds details regarding the successful defense of a wrongful dismissal suit by a former employee fired for theft. In addition, Omar learns Sahara had been penalized previously for harmful plant emissions and warned about any reoccurrence.

In the “Investment Risk” section of the draft prospectus, Omar includes Exhibit 1, shown below:

Exhibit 1
Investment Risks

Risk	Risk Details	Possible Business Impact
Management	Possibility Sahara will not find a suitable candidate to replace the retiring CEO in a timely fashion.	Any delay in finding a replacement could negatively impact Sahara’s ability to implement its strategy for improving investor returns.
Corporate Tax	Sahara is disputing underpayment of tax.	Sahara may be subject to additional tax payments, penalties, and fines.
Profitability	Sahara faces declining profit margins.	New equipment may not help improve profit margins.

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Knowing a third-party research firm can add value to the IPO marketing process by giving an independent opinion, Omar hires Miriam Halawi, CFA. She is a former colleague who started her own research firm two years ago. Halawi allows Omar to utilize her research report in all Sahara marketing material with proper acknowledgement. After extensive research, Halawi makes a “long-term buy” recommendation of Sahara. However, she qualifies the recommendation with a “high-risk” rating, knowing the IPO targets retail investors along with institutional investors. Omar invites Halawi to travel across the region with him to promote the IPO. Halawi agrees but only if she is paid a flat fee.

Omar works with the marketing specialists to create an advertisement, targeting retail investors, to be published in newspapers across the nation. Institutional investors will be invited to an investor briefing to kick off the offer period. The final copy reads, in part:

Invest in the Sahara Manufacturing Company to be assured of a good return. The Company offers the potential for long-term growth with reasonable levels of risk. Miriam Halawi, CFA, a third-party research analyst, affirms that Sahara Manufacturing Company is a “long-term buy”!

One week prior to the IPO, Sahara’s Board of Directors approves and implements an Employee Share Option Plan (ESOP). Existing staff members are allocated 10% of the upcoming IPO at a 25% discount to the IPO price. Omar acquires his allocation with the intention of selling his shares at a profit after trading commences. The details of the ESOP are highlighted in the IPO prospectus.

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1. How will Omar’s plan for the IPO *most likely* violate the CFA Institute Standards of Professional Conduct? Through his intended use of:
 - A. regulatory contacts.
 - B. checklists and templates.
 - C. external service providers.

Answer = B

“Guidance for Standards I–VII,” CFA Institute

2011 Modular Level III, Vol. 1, pp. 90–93

Study Session: 1-2-a

Demonstrate a thorough knowledge of the Code of Ethics and Standards of Professional Conduct by interpreting the Code and Standards in various situations involving issues of professional integrity.

B is correct because Omar most likely violated Standard IV (A) Loyalty in that the checklists and templates were created while Omar was employed by Falcon. Therefore, the checklists and templates are the intellectual property of Falcon, not Omar’s. If Omar wants to use the

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checklists and templates from his former employer, he must first seek their permission. Otherwise, he would need to develop his own based on his IPO experiences.

2. To avoid violating any of the Standards of Professional Conduct, Omar should *least likely* undertake further analysis of which issues uncovered during the IPO due diligence process?
- A. Plant emissions
 - B. Employee lawsuit
 - C. Letter from credit rating agency

Answer = B

“Guidance for Standards I–VII,” CFA Institute
2011 Modular Level III, Vol. 1, pp. 38–39, 107–108

Study Session: 1-2-a

Recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct.

B is correct because the employee theft issue concluded, so it is no longer a threat to the future operations of Sahara. However, any future plant emissions could subject the company to additional fines, or worse, closure. The debt private placement document is contradictory to the actual credit rating report of the debt issue, so further investigation is needed to determine why. As a CFA charterholder, Omar has the responsibility to not misrepresent any factual information on which investors will base their investment decisions (Standard I — Professionalism). To do so, he must be diligent in his investment analysis and recommendations as per Standard V (A) Diligence and Reasonable Basis. By promoting an IPO, Omar is effectively recommending Sahara shares to potential investors. Although potential investors in the IPO are not Omar’s clients, he maintains the responsibility to not misrepresent the investment characteristics of the company and/or offer by undertaking due diligence.

3. With regard to Exhibit 1, Omar *most likely* violates the Standards of Professional Conduct concerning the section on:
- A. profitability.
 - B. management.
 - C. corporate tax.

Answer = C

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“Guidance for Standards I–VII,” CFA Institute

2011 Modular Level III, Vol. 1, pp. 46–47

Study Session 1-2-a

Demonstrate a thorough knowledge of the Code of Ethics and Standards of Professional Conduct by interpreting the Code and Standards in various situations involving issues of professional integrity.

C is correct because Omar omitted the fact that the tax authorities have threatened to impound assets of the company that may cause the plant to shut down. This would be a material omission causing Omar to be in violation of Standard I (D) Misconduct. Members must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

4. In order to avoid violating the Standards of Professional Conduct, Halawi’s *most* appropriate action with regard to the regional marketing trip is to:
- A. act for the benefit of Sahara.
 - B. not attend any marketing trip.
 - C. disclose her total compensation.

Answer = C

“Guidance for Standards I–VII,” CFA Institute

2011 Modular Level III, Vol. 1, pp. 31–32, 65

Study Session: 1-2-a

Recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct.

C is correct because to avoid violating Standard I (B) Independence and Objectivity when undertaking issuer-paid research, members and candidates must fully disclose potential conflicts of interest, including the nature of their compensation, to avoid misleading investors. The standards do not forbid Halawi from participating in the regional marketing meetings as long as she discloses all potential and actual conflicts of interest, including her compensation package. Although CFA charterholders and candidates are required to put the interests of their clients before their own, in this case it is pertinent to determine whom the client actually is. At times, the client may be the investing public as a whole, in which case, the goals of independence and objectivity of research surpass the goal of loyalty to a single organization.

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5. With regard to the IPO advertisement, Omar is *least likely* in violation of which of the Standards of Professional Conduct?

- A. Plagiarism
- B. Misconduct
- C. Misrepresentation

Answer = A

“Guidance for Standards I–VII,” CFA Institute
2011 Modular Level III, Vol. 1, pp. 38–40, 46–47

Study Session: 1-2-a

Demonstrate a thorough knowledge of the Code of Ethics and Standards of Professional Conduct by interpreting the Code and Standards in various situations involving issues of professional integrity.

A is correct because Omar does not appear to copy from Halawi’s report. However, it does appear he omitted information (the high-risk rating) from Halawi’s report that would perhaps cause some investors to make a different investment decision if it had been included. Omar is in violation of Standard I (C) Misrepresentation. Members and candidates should exercise care and diligence when incorporating third-party information. Misrepresentations resulting from the use of the research of outside parties become the responsibility of the investment professional when it affects that professional’s business practice. Omar may also be in violation of Standard I (D) Misconduct if the omission was on purpose. Members and candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit that reflects adversely on their professional reputation, integrity, or competence.

6. Does Omar’s participation in the ESOP *most likely* violate any of the Standards of Professional Conduct?
- A. No
 - B. Yes, with regard to “Priority of Transactions”
 - C. Yes, with regard to “Conflicts of Stock Ownership”

Answer = A

“Guidance for Standards I–VII,” CFA Institute
2011 Modular Level III, Vol. 1, pp. 126, 131–132

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Study Session: 1-2-a

Demonstrate a thorough knowledge of the Code of Ethics and Standards of Professional Conduct by interpreting the Code and Standards in various situations involving issues of professional integrity.

A is correct because by participating in the ESOP program, Omar does not violate any standards because the ESOP program is fully disclosed in the IPO prospectus. When he sells his allocation, he will need to ensure he gives clients and the company priority in order to avoid any standards violation.

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Kim Tang Case Scenario

Kim Tang, CFA, is a consultant reviewing a hedge fund, CleanTech Research Fund. CleanTech invests in “clean technology” companies. CleanTech has adopted the CFA Institute Code of Ethics and Standards of Professional Conduct.

Tang examines the various forms of advertising used by CleanTech to attract new clients. In one of its advertising messages, CleanTech states, “We have a very experienced research team and are proud they all are CFA’s. Several of our managers serve as volunteers for CFA Institute. CFA Institute recognizes their expertise, and as a result, you can rely on our team for superior performance results.”

In reviewing CleanTech’s marketing brochure, Tang reads the following statements:

Statement 1: “The share prices of companies in the clean technology sector have increased recently due to the growing awareness of climate change issues and the rising cost of energy. It is our opinion that returns in this area will continue to be above average for several years. In fact, our proprietary investment analysis software has determined that investments in green transportation companies are likely to double in value in the next six months based on a multiple factor regression analysis. We will earn a 200% return over the next year on one of our solar power company investments based upon sales projections we prepared assuming last year’s generous tax incentives stay in place.”

Statement 2: “The CleanTech fund invests in publicly traded and highly liquid companies and is recommended only for investors who are able to assume a high level of risk. Last month we invested in EnergyAlgae, a “green energy” company that partnered with a global energy firm early last year to create oil from algae. EnergyAlgae’s market capitalization quadrupled shortly after the partnership was formed. Recently, EnergyAlgae also patented a waste plastic-to-oil process that produces oil at less than \$30 per barrel. One of the founders of CleanTech is on the board of EnergyAlgae, and his information on the company’s patent process led us to purchase additional stock in EnergyAlgae before the patent became widely publicized with the release of the company’s semi-annual financial report.”*

*Information supporting the statements made in this communication is available upon request.

When Tang asks CleanTech’s founders for supporting documents related to their investment in EnergyAlgae, she is told this information is based upon third-party research from Slar Brokerage (Slar), who maintains all necessary records. Tang completes a due diligence exercise on Slar and learns that Slar used, at a minimum, the following attributes to form the basis of the recommendation: the company’s past 3 years of operational and financial history; current stage of the industry’s business cycle; an annual research update; and a one-year earnings forecast.

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Tang also learns that the founders of CleanTech are majority shareholders of Slar, who underwrote the public offering of EnergyAlgae. Additionally, CleanTech's analysts inform Tang they did not need to look at the quality of Slar's research because one of their former colleagues recently left CleanTech and established the research department at the brokerage firm.

In researching EnergyAlgae, Tang finds that potential customers and suppliers of EnergyAlgae are highly skeptical of the claims made regarding the companies' respective products. She also contacts several energy companies and is unable to locate anyone who has even heard of EnergyAlgae. When Tang reviews CleanTech's trading activity in EnergyAlgae shares, she finds that CleanTech liquidated its position in EnergyAlgae soon after CleanTech's portfolio managers presented positive views on EnergyAlgae in a number of media interviews. In addition, many of CleanTech's employees also sold their shares in EnergyAlgae immediately after CleanTech sold its shares of the company. The share price of EnergyAlgae dropped dramatically after the stock sales made by CleanTech and its employees.

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7. CleanTech's advertising is *least likely* in violation of the CFA Institute Standards of Professional Conduct with respect to:
- A. use of the CFA designation.
 - B. expected performance results.
 - C. managers' volunteer activities.

Answer = C

"Guidance for Standards I–VII"

2012 Modular Level III, Vol. 1, pp. 144–147

Study Sessions: 1-2-a

Demonstrate a thorough knowledge of the Code of Ethics and Standards of Professional Conduct by interpreting the Code and Standards in various situations involving issues of professional integrity.

C is correct because disclosure of the managers' involvement with CFA Institute is not a violation of the Standards. Standard VII(A) prohibits members from disclosing and or soliciting confidential material gained prior to or during the examination and grading process with those outside the CFA examination development process. The disclosure in this case does not reveal any confidential information. The CFA designation must always be used as an adjective (i.e., "the entire research team is made up of CFA charterholders" rather than saying "they all are CFA's").

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8. In Statement 1, CleanTech management is *most likely* to have violated the CFA Institute Standards of Professional Conduct with regard to their comments on:
- A. investment analysis software.
 - B. clean technology sector returns.
 - C. solar power company investment.

Answer = C

“Guidance for Standards I–VII”

2012 Modular Level III, Vol. 1, pp. 38–39, 107–108, 116–118

Study Sessions: 1-2-a

Demonstrate a thorough knowledge of the Code of Ethics and Standards of Professional Conduct by interpreting the Code and Standards in various situations involving issues of professional integrity.

C is correct because the return claim is a violation of Standard V(B) Communication with Clients and Prospective Clients, which requires that opinion be separated from fact. In the case of complex analyses, analysts must clearly separate fact from statistical conjecture and should identify the known limitations of an analysis. In addition, Standard I(C) Misrepresentation prohibits members and candidates from guaranteeing clients any specific return on volatile investments.

9. In Statement 2, CleanTech *least likely* violated which of the following Standards of Professional Conduct?
- A. Suitability
 - B. Misrepresentation
 - C. Material Nonpublic Information

Answer = A

“Guidance for Standards I–VII”

2012 Modular Level III, Vol. 1, pp. 38–39, 49–51, 78–79

Study Sessions 1-2-a

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A is correct because Standard III(C) Suitability does not appear to have been violated because the fund is characterized as a high-risk investment and it is clearly stated that EnergyAlgae is also a high-risk investment. CleanTech's statement that the hedge fund benefited from the increase in share value for EnergyAlgae last year is a violation of Standard I(C) Misrepresentation because the fund had only recently invested in the stock so did not benefit from the large move in the stock's price. Standard II(A) Material Nonpublic Information has also been violated by the board member who shared material nonpublic information with the hedge fund and by the fund because it acted on the information.

10. To be in compliance with the CFA Institute Standards of Professional Conduct, CleanTech should most likely question the validity of Slar's research on EnergyAlgae for which of the following reasons?

- A. Earnings projections
- B. Annual research update
- C. Operational and financial analysis

Answer = B

"Guidance for Standards I–VII"

2012 Modular Level III, Vol. 1, pp. 108–109

Study Sessions 1-2-b

Recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct.

B is correct. A reasonable and diligent effort was not made when the analysis on EnergyAlgae was updated only on an annual basis because the information on the company could change materially in such a high-risk industry, a violation of Standard V(A) Diligence and Reasonable Basis. In addition, when the company reports financial results on a semi-annual basis, an annual update to research would not be timely.

11. Tang's *most* appropriate course of action concerning the relationship between CleanTech and Slar is to recommend that CleanTech:

- A. sever the relationship immediately.
- B. explain the ownership structure to all clients.
- C. communicate relevant information to all clients.

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Answer = C

“Guidance for Standards I–VII”

2012 Modular Level III, Vol. 1, pp. 27–29, 116–117, 123–126

Study Sessions: 1-2-b

Recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct.

C is correct because according to Standard I(B) Independence and Objectivity, full and fair disclosure of all matters that could reasonably be expected to impair independence and objectivity must be made to all clients. In this case, the controlling position in the broker held by the founders of CleanTech, as well as the fact that this firm has underwritten two stocks the hedge fund holds and whose recommendations the fund relied upon to make these investments, must be disclosed to all clients so they may be better able to judge motives and possible biases for themselves.

12. The EnergyAlgae trades are *least likely* to have violated the CFA Institute Standards of Professional Conduct with regard to:
- A. the order in which the shares were traded.
 - B. share price distortion due to positive media presentations.
 - C. the adverse and skeptical opinions of EnergyAlgae products.

Answer = A

“Guidance for Standards I–VII”

2012 Modular Level III, Vol. 1, pp. 59, 107–109

Study Session: 1-2-a

Demonstrate a thorough knowledge of the Code of Ethics and Standards of Professional Conduct by interpreting the Code and Standards in various situations involving issues of professional integrity.

A is correct because even though the hedge fund had priority in trading the stock ahead of employees, that does not alleviate the stock price manipulation that was engaged in by the fund and its employees, a violation of Standard II(B) Market Manipulation. In addition, there does not appear to be an adequate basis for recommending the stock (i.e., negative information on the company’s products from potential customers and suppliers), a violation of Standard V(A) Diligence and Reasonable Basis.

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Karin Larsson Case Scenario

Karin Larsson is a new employee in the risk management group at Baltic Investment Management, Inc. She is replacing Sten Reinfeldt, who has agreed to help her transition into her new role. Reinfeldt explains that risk governance refers to the process of setting risk management policies and standards for an organization, enabling firms to establish appropriate ranges for exposures and to emphasize individual risk factors within a centralized type of enterprise risk management.

Baltic manages proprietary investment strategies, which creates risk exposures for the firm. Larsson explains that these risks are both financial and nonfinancial in nature and proceeds to list several specific sources of risk:

Risk 1: Model Risk

Risk 2: Liquidity Risk

Risk 3: Settlement Risk

Baltic uses value at risk (VAR) as a probability-based measure of loss potential for its fixed income strategies. Reinfeldt states that the VAR for the fixed income strategy is SEK10 million over any 5-day time period with a probability of 5 percent. Larsson asks Reinfeldt to estimate the fixed income strategy's VAR at given levels of probability for specified time periods.

Baltic manages an equity strategy in addition to the fixed income strategy. The trading desks for each strategy are each granted risk budgets that consider the allocation of both capital and daily VAR. The correlation between the equity desk and the fixed income desk is low. Risk-budgeting data for both desks are provided in Exhibit 1.

Exhibit 1
Trading Desk Data
(SEK million)

	Equity Desk	Fixed Income Desk
Capital	200	100
Daily VAR	10	10
Monthly Profit	25	15

Reinfeldt comments that the risk management group has adopted stress testing to complement VAR analysis given some of its limitations. He lists several of the limitations of VAR for Larsson:

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- Limitation 1: VAR inaccurately measures risk exposure because it overestimates the magnitude and frequency of the worst returns.
- Limitation 2: VAR incompletely measures risk exposure because it does not incorporate positive results into its risk profile.
- Limitation 3: VAR incorrectly measures risk exposure because there are limited calculation methods and they often yield similar outcomes.

Larsson is concerned about credit exposure within the fixed income strategy and asks Reinfeldt how Baltic manages this risk. Reinfeldt responds, "There are a number of ways we manage credit risk. First, we utilize credit derivatives in order to transfer credit risk. Second, we mark-to-market our credit derivatives in order to post collateral whenever a credit derivative's value is positive to Baltic and negative to the swap counterparty."

13. Which element of Reinfeldt's initial statement to Larsson is *least likely* correct?

- A. Ranges for exposures
- B. Individual risk factors
- C. Risk management policies

Answer = B

"Risk Management," Don M. Chance, Kenneth Grant, and John Marsland
2012 Modular Level III, Vol. 5, pp. 213–217

Study Session: 14-34-a

Discuss the main features of the risk management process, risk governance, risk reduction, and an enterprise risk management system.

B is correct because risk management incorporates a centralized type of risk management called enterprise risk management (ERM). ERM's distinguishing feature is a firm-wide or across-enterprise perspective. The corporate governance structure is much broader than risk governance and encompasses the system of internal controls and procedures used to manage individual companies.

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14. Which risk listed by Reinfeldt is *most likely* a source of financial risk?

- A. Risk 1
- B. Risk 2
- C. Risk 3

Answer = B

“Risk Management,” Don M. Chance, Kenneth Grant, and John Marsland
2012 Modular Level III, Vol. 5, pp. 218–219

Study Session 14-34-d

Evaluate a company’s or a portfolio’s exposures to financial and nonfinancial risk factors.

B is correct because liquidity risk is considered to be a financial risk.

15. Given Reinfeldt’s estimate of VAR for the fixed income strategy, which of the following statements is *most likely* accurate? Over a 5-day period, there is a:

- A. 5% probability the portfolio will lose at least SEK10 million.
- B. 95% probability the portfolio will lose at least SEK10 million.
- C. 5% probability the portfolio will lose no more than SEK10 million.

Answer = A

“Risk Management,” Don M. Chance, Kenneth Grant, and John Marsland
2012 Modular Level III, Vol. 5, pp. 231–232

Study Session 14-34-e

Calculate and interpret value at risk (VAR), and explain its role in measuring overall and individual position market risk.

A is correct because VAR is a minimum. That is, there is a 5% chance that the portfolio will lose SEK10 million or more.

16. With regard to the fixed income and equity trading desks, based on Exhibit 1, which of the following statements is *most likely* accurate?

- A. The trading desks have the same risk budget.
- B. The combined daily VAR of the trading desks is less than SEK20 million.
- C. The fixed income desk generates better returns on its allocated capital given its VAR.

Answer = B

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“Risk Management,” Don M. Chance, Kenneth Grant, and John Marsland
2012 Modular Level III, Vol. 5, pp. 260–263

Study Session: 14-34-j

Demonstrate the use of risk budgeting, position limits, and other methods for managing market risk.

B is correct because the trading desks engage in activities that are weakly correlated; therefore, a diversification benefit is experienced, and it would be reasonable to expect that the combined VAR of the two desks will be less than the sum of the VARs of the individual desks (SEK20 million).

17. Which of the limitations of VAR analysis given by Reinfeldt is *most likely* correct?

- A. Limitation 1
- B. Limitation 2
- C. Limitation 3

Answer = B

“Risk Management,” Don M. Chance, Kenneth Grant, and John Marsland
2012 Modular Level III, Vol. 5, pp. 245–246

Study Session: 14-34-g

Discuss the advantages and limitations of VAR and its extensions, including cash flow at risk, earnings at risk, and tail value at risk.

B is correct because VAR fails to incorporate positive results into its risk profile and therefore arguably provides an incomplete picture of overall exposures.

18. Is Reinfeldt’s statement regarding credit derivatives *most likely* correct?

- A. Yes.
- B. No, he is incorrect about marking to market.
- C. No, he is incorrect about transferring credit risk.

Answer = B

“Risk Management,” Don M. Chance, Kenneth Grant, and John Marsland
2012 Modular Level III, Vol. 5, pp. 263–267

Study Session: 14-34-k

Demonstrate the use of exposure limits, marking to market, collateral, netting arrangements, credit standards, and credit derivatives to manage credit risk.

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B is correct because whenever the mark-to-market is positive to Baltic, the credit derivative counterparty, not Baltic, will post collateral. Baltic will only post collateral should the mark-to-market value be negative to Baltic/positive to the swap counterparty.

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Gregory Dodson Case Scenario

Gregory Dodson, CFA, is an investment consultant who advises individual and institutional clients on their equity portfolios. During a typical workweek, he is called upon to evaluate a variety of situations and provide expert advice. This week, he is meeting with three clients.

Dodson's first client meeting is with the Magnolia Foundation, a small not-for-profit organization. Magnolia currently uses three long-only portfolio managers for its equity investments. Details of those investments, including expected performance relative to Magnolia's equity benchmark, the S&P 500 Index, are provided below.

Exhibit 1
Magnolia Foundation Equity Portfolio Managers

	Investment Size (in millions)	Expected Alpha	Expected Tracking Error
Manager A	USD140	0%	0%
Manager B	USD40	1.5%	2.5%
Manager C	USD20	2.0%	4.0%

The Magnolia Foundation's goal for its total equity investment is expected alpha greater than 0.40% and expected tracking error less than 1.00%.

Dodson's second client meeting is with Sarah Tan, a wealthy individual who is actively involved in managing her investments. Tan wants to add a USD100 million allocation to U.S. midcap stocks, represented by the U.S. S&P 400 Midcap Index, to her long-term asset allocation. No investment has been made to meet this new allocation. Tan has not found any manager capable of generating positive alpha in U.S. midcap stocks. She has, however, identified a long-only portfolio manager of Canadian equities who she believes will produce positive alpha. This manager uses the S&P/TSX (Toronto Stock Exchange) Index as a benchmark. Tan wants to create a portable alpha strategy that will earn the alpha of the Canadian equity portfolio and meet the new benchmark allocation to U.S. midcap stocks. She asks Dodson for advice to establish this strategy. Tan provides some information about the security selection methods used by the Canadian equity portfolio manager. He uses a proprietary discounted cash flow model to analyze all stocks in the S&P/TSX Index, purchasing those with market prices most below the intrinsic value estimated by his model, regardless of their P/E ratios.

Dodson's third client meeting is with the chief investment officer (CIO) of the Susquehanna Industries' pension fund. The fund needs to establish a USD50 million portfolio that replicates the Russell 2000, an

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index of small-cap U.S. equities. The CIO's goal is to minimize trading costs. Dodson has been asked to suggest an investment approach that will meet this goal. The CIO also outlines his portfolio managers' sell discipline with respect to the pension fund's actively managed value and growth equity portfolios. Currently, the managers monitor the P/E (price-to-earnings) ratio of each stock held. A value stock is sold when its P/E ratio rises to its 10-year historical average. A growth stock is sold when its P/E ratio falls to its 10-year historical average.

19. The approach to portfolio construction used by the Magnolia Foundation is *best* described as:

- A. a core–satellite structure.
- B. a portable alpha strategy.
- C. using a completeness fund.

Answer = A

“Equity Portfolio Management,” Gary L. Gastineau, Andrew R. Olma, and Robert G. Zielinski
2012 Modular Level III, Vol. 4, pp. 257–260

Study Session: 11-27-r

Explain the core–satellite approach to portfolio construction, and discuss the advantages and disadvantages of adding a completeness fund to control overall risk exposures.

A is correct because a large portion of the portfolio is invested in a manager who is expected to match the portfolio's benchmark (zero alpha, zero tracking error), forming the core of the portfolio.

20. Do the Magnolia Foundation's current equity investments *most likely* meet its total equity investment return and risk goals?

- A. Yes.
- B. No, the expected alpha is too low.
- C. No, the expected tracking error is too high.

Answer = A

“Equity Portfolio Management,” Gary L. Gastineau, Andrew R. Olma, and Robert G. Zielinski
2012 Modular Level III, Vol. 4, pp. 253–260

Study Session 11-27-q

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Recommend and justify, in a risk–return framework, the optimal portfolio allocations to a group of investment managers.

A is correct because the expected alpha of the portfolio is:

$$\left(\frac{\$140}{\$200} \times 0\%\right) + \left(\frac{\$40}{\$200} \times 1.5\%\right) + \left(\frac{\$20}{\$200} \times 2.0\%\right) = 0.50\% , \text{ which is greater than } 0.40\% . \text{ The}$$

expected tracking error is:

$$\left[\left(\frac{\$140}{\$200} \times 0\%\right)^2 + \left(\frac{\$40}{\$200} \times 2.5\%\right)^2 + \left(\frac{\$20}{\$200} \times 4.0\%\right)^2 \right]^{\frac{1}{2}} = 0.64\% , \text{ which is less than}$$

1.00%.

21. Which of these futures positions combinations would *most likely* be included in Dodson’s advice to Tan regarding her intended portable alpha strategy?

- A. Long position in S&P/TSX futures and long position in S&P 400 futures
- B. Short position in S&P/TSX futures and long position in S&P 400 futures
- C. Long position in S&P/TSX futures and short position in S&P 400 futures

Answer = B

“Equity Portfolio Management,” Gary L. Gastineau, Andrew R. Olma, and Robert G. Zielinski
2012 Modular Level III, Vol. 4, pp. 261

Study Session 11-27-t

Explain alpha and beta separation as an approach to active management, and demonstrate the use of portable alpha.

B is correct because the portfolio needs to shed exposure to the return of the S&P/TSX Index and gain exposure to the return of the S&P 400 Index.

22. The style of the Canadian equities portfolio manager is *most likely*:

- A. value.
- B. growth.
- C. market-oriented.

Answer = C

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“Equity Portfolio Management,” Gary L. Gastineau, Andrew R. Olma, and Robert G. Zielinski
2012 Modular Level III, Vol. 4, pp. 222–227

Study Session: 11-27-i

Compare techniques for identifying investment styles, and characterize the style of an investor when given a description of the investor’s security-selection method, details on the investor’s security holdings, or the results of a returns-based style analysis.

C is correct because the portfolio manager is willing to buy both value and growth stocks (regardless of P/E ratio), focusing solely on whether the stock is trading below its intrinsic value. This is also known as a blend or core style—with reference to equity investing, an intermediate grouping for investment disciplines that cannot be clearly categorized as value or growth.

23. Given the manager’s goal, what approach should Dodson *most likely* recommend for the Susquehana Industries pension fund’s USD 50 million portfolio?
- A. Optimization
 - B. Full replication
 - C. Stratified sampling

Answer = C

“Equity Portfolio Management,” Gary L. Gastineau, Andrew R. Olma, and Robert G. Zielinski
2012 Modular Level III, Vol. 4, pp. 214–221

Study Session 11-27-f

Compare full replication, stratified sampling, and optimization as approaches to constructing an indexed portfolio, and recommend an approach when given a description of the investment vehicle and the index to be tracked.

C is correct because the portfolio contains small-cap stocks, which indicates an approach other than full replication, and the desire to minimize transaction costs indicates stratified sampling rather than optimization.

24. The Susquehana Industries’ pension fund value and growth portfolio managers follow a sell discipline that is *best* described as:
- A. rule driven.
 - B. substitution strategy.
 - C. deteriorating fundamentals.

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Answer = A

“Equity Portfolio Management,” Gary L. Gastineau, Andrew R. Olma, and Robert G. Zielinski
2012 Modular Level III, Vol. 4, pp. 249–250

Study Session 11-27-o

Compare the sell disciplines of active investors.

A is correct because valuation-level sell disciplines are rule driven.

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Rogers Case Scenario

Ted Rogers is the director of a research team that analyzes traditional and nontraditional sources of energy for investment purposes. For traditional energy sources, a number of high-frequency historical data series are available. For nontraditional energy sources, the data are generally quarterly and tend to hide a great deal of the volatility that Rogers knows to exist because appraised values are used instead of market values. To supplement the quarterly data, Rogers' team uses an index of the top 30 firms in new and experimental technologies called the NEXT Index. While not all of the firms in the NEXT are energy firms, the index is available as a weekly series. However, the NEXT does change its composite mix of firms frequently as firms in the index fail or are sold to larger firms that are not in the index.

To determine the correlation matrix within the different energy sectors, Rogers' team relies on a weighted average of correlations derived from multifactor models and historical correlations. Although the combined experience within the team favors emphasizing the correlations derived from the multifactor models, historical correlations are given a greater weight within the weighted average calculations to lower the future expected performance estimates of different investment models being considered. This practice of purposefully understating the expected future performance of these investment models is viewed as a safety measure by the team and as a way to manage client expectations.

In a recent meeting, the team discussed how using the last two years of historical data for oil-related industries generated relationships between factors that had not existed in the past. One member of the team, Steve Phillips, stated:

The relationships reflect the fact that hurricane activity in the last two years has impacted oil concerns worldwide. There is no reason to believe that such relationships will continue in the future.

Most of the team agreed with Phillips but conceded that a number of clients specifically requested analysis of the previous two years of data with an expectation that new trends were emerging within the industry. The team decided to add more variables to the analysis in order to show that the relationships the team believed to be significant actually outweighed the importance of these recently found relationships. After adding several additional variables, the team found the model did not improve in predictive ability, but the recently found relationships were indeed no longer significant.

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25. The data available for non-traditional energy sources are *best* described as data with:

- A. smoothing.
- B. a time-period bias.
- C. a survivorship bias.

Answer = A

“Capital Market Expectations,” John P. Calverley, Alan M. Meder, Brian D. Singer, and Renato Staub

2012 Modular Level III, Vol. 3, pp. 15–16

Study Session 6-18-b

Discuss, in relation to capital market expectations, the limitations of economic data, data measurement errors and biases, the limitations of historical estimates, *ex post* risk as a biased measure of *ex ante* risk, biases in analysts’ methods, the failure to account for conditioning information, the misinterpretation of correlations, psychological traps, and model uncertainty.

A is correct. Data for alternative investments without liquid public markets tend to overly smooth return variations because they are often appraisal-based rather than transaction-based. This smoothing underestimates risk and the magnitudes of correlation values.

26. The NEXT Index data most likely reflect:

- A. survivorship bias.
- B. transcription errors.
- C. volatility clustering.

Answer = A

“Capital Market Expectations,” John P. Calverley, Alan M. Meder, Brian D. Singer, and Renato Staub

2012 Modular Level III, Vol. 3, p. 15

Study Session 6-18-b

Discuss, in relation to capital market expectations, the limitations of economic data, data measurement errors and biases, the limitations of historical estimates, *ex post* risk as a biased measure of *ex ante* risk, biases in analysts’ methods, the failure to account for conditioning information, the misinterpretation of correlations, psychological traps, and model uncertainty.

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A is correct. Survivorship bias is when a data series only reflects companies that exist at a given moment in time and not companies that may have left prior to the given moment in time (i.e., only the surviving firms are in the data). The NEXT Index has survivorship bias as evidenced by the frequent change in its component firms because of failure and acquisition by larger non-index firms.

27. The approach taken by Rogers' team to calculate the correlation matrix is best described as which type of estimator?

- A. Historical
- B. Shrinkage
- C. Time-series

Answer = B

"Capital Market Expectations," John P. Calverley, Alan M. Meder, Brian D. Singer, and Renato Staub

2012 Modular Level III, Vol. 3, p. 27

Study Session 6-18-b

Discuss, in relation to capital market expectations, the limitations of economic data, data measurement errors and biases, the limitations of historical estimates, *ex post* risk as a biased measure of *ex ante* risk, biases in analysts' methods, the failure to account for conditioning information, the misinterpretation of correlations, psychological traps, and model uncertainty.

B is correct. To determine the correlation matrix within the different energy sectors, Rogers' team relies on a weighted average of correlations derived from multifactor models and historical correlations. A shrinkage estimator is a weighted average of correlation (or covariance) matrices created from at least two different correlation (or covariance) matrices generated from different sources.

28. Which of the following psychological traps best describes the Rogers team's decision to give historical correlation more weight in the correlation matrix?

- A. Prudence trap
- B. Anchoring trap
- C. Overconfidence trap

Answer = A

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"Capital Market Expectations," John P. Calverley, Alan M. Meder, Brian D. Singer, and Renato Staub

2012 Modular Level III, Vol. 3, pp. 22–23

Study Session 6-18-b

Discuss, in relation to capital market expectations, the limitations of economic data, data measurement errors and biases, the limitations of historical estimates, *ex post* risk as a biased measure of *ex ante* risk, biases in analysts' methods, the failure to account for conditioning information, the misinterpretation of correlations, psychological traps, and model uncertainty.

A is correct. Rogers' team views giving more weight to the historical correlations as a safety measure and as a way to manage client expectations. The prudence trap is a tendency to be overly cautious in forecasts because of potentially damaging results from being incorrect.

29. Which of the following types of biases best describes Steve Phillips' statement about oil-related industry data?

- A. Data mining
- B. Time-period
- C. Survivorship

Answer = B

"Capital Market Expectations," John P. Calverley, Alan M. Meder, Brian D. Singer, and Renato Staub

2012 Modular Level III, Vol. 3, p. 19

Study Session 6-18-b

Discuss, in relation to capital market expectations, the limitations of economic data, data measurement errors and biases, the limitations of historical estimates, *ex post* risk as a biased measure of *ex ante* risk, biases in analysts' methods, the failure to account for conditioning information, the misinterpretation of correlations, psychological traps, and model uncertainty.

B is correct. Phillips believes the impact of hurricane activity will not necessarily continue in the future. A time-period bias occurs when particular relationships or sensitivities only occur during a particular period of time.

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30. The decision to add variables to the oil-related industry analysis will most likely lead to:

- A. an appraisal bias.
- B. a data-mining bias.
- C. a regime-switching bias.

Answer = B

“Capital Market Expectations,” John P. Calverley, Alan M. Meder, Brian D. Singer, and Renato Staub

2012 Modular Level III, Vol. 3, p. 19

Study Session 6-18-b

Discuss, in relation to capital market expectations, the limitations of economic data, data measurement errors and biases, the limitations of historical estimates, *ex post* risk as a biased measure of *ex ante* risk, biases in analysts’ methods, the failure to account for conditioning information, the misinterpretation of correlations, psychological traps, and model uncertainty.

B is correct. A data-mining bias occurs when variables are added to an analysis without any predictive merit (i.e., there is no causal relationship for adding the variables). In this case, the variables are not added to enhance prediction but to thwart the predictive relationship between other variables.

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Berg Case Scenario

Alpha Consultants is working with the German-based Berg Pension Fund to select a fixed income firm to manage a EUR100 million global bond portfolio. Delta Managers is the third and final presenter to Berg's investment committee. After going through its investment philosophy and process, Delta addresses several questions.

Alpha expresses concern about the use of leverage in the portfolio. Delta indicates that by employing 100% leverage, it can generate incremental returns. Delta provides the committee with the portfolio's characteristics in Exhibit 1.

Exhibit 1
Portfolio Characteristics

	Assets	Liabilities
Portfolio (EUR millions)	200	100
Duration	6.00	1.00
Expected Return (%)	5.50	
Interest Rate on Borrowed Funds (%)		4.75

Berg's committee is concerned that the duration of the portfolio is inappropriate given its view that rates might rise and asks how Delta can use the futures market to manage the interest rate risk of the portfolio. The committee in fact states that it would like a target duration of 4.

Exhibit 2
Futures Market Data

Futures Contract Price	EUR100,000
Conversion Factor	1.15
Duration of Cheapest to Deliver Bond	5.2
Market Price of Cheapest to Deliver Bond	EUR98,000

Delta then makes the following statement to the committee:

International interest rates are not perfectly correlated. In fact, since this is a global bond portfolio, 60 percent of the portfolio is from German issuers and has average duration of 7 and the remainder is from U.K. issuers with average duration of 4.5, both before any hedging activities to meet the committee's duration target. Historically, the country beta of the U.K. (i.e., for German rates relative to U.K. rates) is estimated to be 0.55.

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Berg's committee then asks Delta to make a recommendation as to whether the portfolio should be hedged back to the euro, its domestic currency. Delta responds that currently short interest rates are 2.50% in the U.K. and 3.25% in Germany, and Delta's currency strategists forecast that the euro will depreciate by 0.35%.

Berg's committee then asks whether a global portfolio would benefit from the inclusion of emerging market debt. Delta responds that returns can be attractive in emerging markets during certain periods but that the following risks of this asset class must be understood:

- Risk 1: Returns are frequently characterized by substantial positive skewness.
- Risk 2: If a default of sovereign debt occurs, recovery against sovereign states can be very difficult.
- Risk 3: The frequency of default and ratings transition is significantly higher than that of developed market corporate bonds with similar ratings.

At the conclusion of the presentation, Alpha and Berg's committee convene to discuss which of the three managers who presented should be selected for the €100 million mandate. Alpha advises Berg that the following criteria are important when evaluating fixed income portfolio managers:

- Criterion 1: Style analysis will enable us to understand the active risks the manager has taken relative to the benchmark and which biases have consistently added to performance.
- Criterion 2: Decomposing the portfolio's historical returns will show whether the manager's skills will allow him to consistently outperform over time.
- Criterion 3: We could select two of the three managers who presented if our analysis shows that the correlation between their alphas is low.

31. Based on Exhibit 1, the duration of the equity in the leveraged portfolio is *closest* to:

- A. 5.00.
- B. 5.50.
- C. 11.00.

Answer = C

"Fixed-Income Portfolio Management – Part II," H. Gifford Fong and Larry D. Guin
2012 Modular Level III, Vol. 4, pp. 107–109
Study Session 10-25-a

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Evaluate the effect of leverage on portfolio duration and investment returns.

C is correct. Delta plans to leverage the EUR100 million portfolio by 100% by borrowing an additional EUR100 million.

$$D_E = \frac{D_A A - D_L L}{E}$$

$$D_E = \frac{6.00(200) - 1.00(100)}{100} = 11.00.$$

32. Based on Exhibits 1 and 2, the number of futures contracts Delta needs to sell in order to achieve the Berg committee's target duration is closest to:
- A. 682.
 - B. 784.
 - C. 902.

Answer = C

"Fixed-Income Portfolio Management – Part II," H. Gifford Fong and Larry D. Guin

2012 Modular Level III, Vol. 4, pp. 114–118

Study Session 10-25-d

Demonstrate the advantages of using futures instead of cash market instruments to alter portfolio risk.

C is correct. To hedge against rising rates, Delta needs to reduce duration by selling the following number of bund futures contracts:

$$\left(\frac{(D_T - D_I) \times P_I}{D_{CTD} P_{CTD}} \right) \times \text{Conversion factor for the CTD bond},$$

where D_T = target duration for the portfolio; D_I = initial duration for the portfolio; P_I = initial market value of the portfolio; D_{CTD} = the duration of the cheapest-to-deliver bond; P_{CTD} = the price of the cheapest-to-deliver bond.

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$$\left(\frac{(4.00 - 6.00) \times 200,000,000}{5.2 \times 98,000} \right) \times 1.15 = \frac{-400,000,000}{509,600} \times 1.15 = -902.669$$

33. Based on Delta's statement, the contribution to the portfolio's overall duration from U.K. bonds is closest to:

- A. 0.99.
- B. 1.49.
- C. 1.54.

Answer = A

"Fixed-Income Portfolio Management – Part II," H. Gifford Fong and Larry D. Guin

2012 Modular Level III, Vol. 4, pp. 131–132

Study Session 10-25-i

Evaluate 1) the change in value for a foreign bond when domestic interest rates change and 2) the bond's contribution to duration in a domestic portfolio given the duration of the foreign bond and the country beta.

A is correct because the duration of the U.K. bonds is 4.5 and the country beta is estimated to be 0.55 relative to Germany. The duration contribution to a German domestic portfolio is $4.50 \times 0.55 = 2.475$. Because a portfolio's duration is a weighted average of the duration of the bonds in the portfolio, the contribution to the portfolio's duration is equal to the adjusted U.K. bond duration of 2.475 multiplied by its weight in the portfolio: $2.475 \times 0.40 = 0.99$.

34. Based on Delta's expectations regarding currencies and assuming interest rate parity holds, should they most likely recommend hedging the portfolio's GBP exposure using forward contracts?

- A. Yes.
- B. No, because the euro is expected to depreciate by more than 0.35%.
- C. No, because the euro is expected to appreciate by more than 0.35%.

Answer = A

"Fixed-Income Portfolio Management – Part II," H. Gifford Fong and Larry D. Guin

2012 Modular Level III, Vol. 4, pp. 132–137

Study Session 10-25-j

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Recommend and justify whether to hedge or not hedge currency risk in an international bond investment.

A is correct because using interest rate parity, the euro is expected to depreciate by $3.25\% - 2.50\% = 0.75\%$. Delta's strategists believe that the euro will only depreciate by 0.35%. Based on expected returns alone, Delta should hedge the currency risk using a forward contract and lock in a 0.75% gain in GBP.

35. Delta is least likely correct with respect to which risk regarding investing in emerging market debt?

- A. Risk 1
- B. Risk 2
- C. Risk 3

Answer = A

"Fixed-Income Portfolio Management – Part II," H. Gifford Fong and Larry D. Guin

2012 Modular Level III, Vol. 4, pp. 139–141, 146

Study Session 10-25-I

Discuss the advantages and risks of investing in emerging market debt.

A is correct because this statement is incorrect; emerging market debt returns are characterized by significant **negative** skewness.

36. Which of the criteria outlined by Alpha is least accurate with respect to the selection of a fixed income manager?

- A. Criterion 1
- B. Criterion 2
- C. Criterion 3

Answer = B

"Fixed-Income Portfolio Management – Part II," H. Gifford Fong and Larry D. Guin

2012 Modular Level III, Vol. 4, pp. 141–145

Study Session 10-25-m

Discuss the criteria for selecting a fixed-income manager.

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B is correct because decomposing the portfolio's historical returns is used to see if a manager has skill in security selection. Over long periods of time when fund fees and expenses are factored in, the realized alpha of fixed income managers has averaged very close to zero with little evidence of persistence.

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Kamiko Watanabe Case Scenario

Kamiko Watanabe, CFA, is a portfolio advisor at Wakasa Bay Securities. She specializes in the use of derivatives to alter and manage the exposures of Japanese equity and fixed income portfolios. She has meetings today with two clients, Isao Sato and Reiko Kondo.

Sato is the manager of the Tsushima Manufacturing pension fund, which has a target asset allocation of 60% equity and 40% bonds. The fund has separate equity and fixed income portfolios, whose characteristics are provided in Exhibits 1 and 2. Sato expects equity values to increase in the coming two years and, in order to avoid substantial transaction costs now and in two years, would like to use derivatives to temporarily rebalance the portfolio. He wants to maintain the current beta of the equity portfolio and the current duration of the bond portfolio.

**Exhibit 1: Tsushima Pension Fund
Equity Portfolio Characteristics**

Current market value	JPY27.5 billion
Benchmark	Nikkei 225 Index
Current beta	1.15

**Exhibit 2: Tsushima Pension Fund
Bond Portfolio Characteristics**

Current market value	JPY27.5 billion
Benchmark	Nikko Bond Performance Index composite
Current duration	4.75

In order to rebalance the pension fund to its target allocations to equity and bonds, Watanabe recommends using Nikkei 225 Index futures contracts, which have a beta of 1.05 and a current contract price of JPY1,525,000, and Nikko Bond Performance Index futures, which have a duration of 6.90 and a current contract price of JPY4,830,000. She assumes the cash position has duration of 0.25.

Sato wants to know if other derivatives could be used to rebalance the portfolio. In response, Watanabe describes the characteristics of a pair of swaps that, together, would accomplish the same rebalancing as the proposed futures contracts strategy.

Kondo manages a fixed income portfolio for the Akito Trust. The portfolio's market value is JPY640 million, and its duration is 6.40. Kondo believes interest rates will rise and asks Watanabe to explain how to use a swap to decrease the portfolio's duration to 3.50. Watanabe proposes a strategy that uses a pay-fixed position in a 3-year interest rate swap with semi-annual payments.

Kondo decides he wants to use a 4-year swap to manage the portfolio's duration. After some calculations, Watanabe tells him a pay-fixed position in a 4-year interest rate swap with a duration of –

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2.875 would require a notional principal of JPY683 million (rounded to the nearest million yen) to achieve his goals.

Kondo asks Watanabe whether it would be possible to cancel the swap prior to its maturity. Watanabe responds with three statements:

- Statement 1: During the life of the swap, you could enter into a new pay-floating swap with the same terms as the original swap except it would have a maturity equal to the remaining maturity of the original swap. However, the fixed rate you receive might be lower than the fixed rate you're paying on the original swap.
- Statement 2: You could purchase a payer swaption with the same terms as the original swap. This would protect you from falling fixed swap rates but at the cost of the premium you would pay to the swaption counterparty.
- Statement 3: If you purchase a swaption from the same counterparty as the original swap, it is common to require the payments of the two swaps be netted or cash settled if the swaption is exercised.

37. The number of Nikko Bond Performance Index futures Sato must sell to rebalance the Tsushima pension fund to its target allocation is *closest* to:

- A. 149.
- B. 743.
- C. 1,594.

Answer = B

"Risk Management Applications of Forward and Futures Strategies," Don M. Chance
2012 Modular Level III, Vol. 5, pp. 364–366

Study Session 15-36-d

Demonstrate the use of equity and bond futures to adjust the allocation of a portfolio between equity and debt.

B is correct because the total value of the portfolio is JPY55.0 billion and the 40% target allocation to bonds would be JPY22.0 billion, but the current allocation is JPY27.5 or JPY5.5 billion more. In order to correct this, the equivalent of JPY5.5 billion in bonds with a duration of 4.75 must be sold using bond futures and then converted to equity exposure with a 1.15 beta using stock futures. The number of bond futures contracts to be sold (shorted) is

$$N_{bf} = \frac{(MDUR_T - MDUR_B)}{MDUR_f} \times \left(\frac{B}{f_B} \right), \text{ where } MDUR_T \text{ is the target modified duration (0.25 for}$$

cash), $MDUR_B$ is the current bond portfolio duration (4.75), $MDUR_f$ is the modified duration of the futures contract (6.90), B is the value of the bonds being converted to cash (JPY5.5 billion),

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and f_B is the price of one bond futures contract (JPY4,830,000). Therefore, the number of contracts is $N_{bf} = \frac{(0.25 - 4.75)}{6.90} \times \left(\frac{5,500,000,000}{4,830,000} \right) = -742.64$ or sell 743 bond contracts.

38. The number of Nikkei 225 Index futures Sato must buy to rebalance the Tsushima pension fund to its target allocation is *closest* to:

- A. 3,293.
- B. 3,950.
- C. 4,148.

Answer = B

“Risk Management Applications of Forward and Futures Strategies,” Don M. Chance
2012 Modular Level III, Vol. 5, pp. 364–366

Study Session 15-36-d

Demonstrate the use of equity and bond futures to adjust the allocation of a portfolio between equity and debt.

B is correct because the total value of the portfolio is JPY55.0 billion and the 60% target allocation to equity would be JPY33.0 billion, but the current allocation is JPY27.5 or JPY5.5 billion less. In order to correct this, the equivalent of JPY5.5 billion in bonds with a duration of 4.75 must be sold using bond futures (converted to synthetic cash) and then converted to equity exposure with a 1.15 beta using stock futures. The number of equity futures contracts to be

bought is $N_{sf} = \frac{(\beta_T - \beta_S)}{\beta_f} \times \left(\frac{S}{f_S} \right)$, where β_T is the target beta (1.15), β_S is the beta of the

synthetic cash position (0), β_f is the beta of the futures contract (1.05), S is the value of the stock being created from the synthetic cash position (JPY5.5 billion), and f_S is the price of one equity futures contract (JPY1,525,000). Therefore, the number of contracts is:

$$N_{sf} = \frac{(1.15 - 0.00)}{1.05} \times \left(\frac{5,500,000,000}{1,525,000} \right) = 3,950.04.$$

39. Which of these is *most likely* to be a characteristic of one of the two swaps Watanabe describes to Sato?

- A. Receive LIBOR.
- B. Pay return on Nikkei 225 Index.
- C. Receive return on Nikko Bond Performance Index.

Answer = A

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“Risk Management Applications of Swap Strategies,” Don M. Chance
2012 Modular Level III, Vol. 5, pp. 507–510

Study Session 15-38-g

Explain how equity swaps can be used to diversify a concentrated equity portfolio, provide international diversification to a domestic portfolio, and alter portfolio allocations to stocks and bonds.

A is correct because one of the swaps would be pay Nikko Bond Performance Index return and receive LIBOR.

40. The duration of the swap in Watanabe’s first proposal to Kondo is closest to:

- A. –1.75.
- B. –2.00.
- C. –2.75.

Answer = B

“Risk Management Applications of Swap Strategies,” Don M. Chance
2012 Modular Level III, Vol. 5, pp. 483–486

Study Session 15-38-b

Calculate and interpret the duration of an interest rate swap.

B is correct because a pay-fixed (receive-floating) position in an interest rate swap is similar to issuing a fixed-rate bond and buying a floating-rate bond with the proceeds. The duration of the fixed-rate bond is approximately 75% of the maturity, and the swap is short this duration. The duration of the floating-rate bond is approximately half its repricing frequency, and the swap is long this duration. Therefore, the duration of the 3-year swap with semi-annual payments is $(0.5 \times 0.5) - (0.75 \times 3) = -2.00$.

41. Is the notional principal of the swap Watanabe recommends to Kondo *most likely* correct?

- A. Yes.
- B. No, it is too low.
- C. No, it is too high.

Answer = C

“Risk Management Applications of Swap Strategies,” Don M. Chance
2012 Modular Level III, Vol. 5, pp. 486–488

Study Session 15-38-d

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Determine the notional principal value needed on an interest rate swap to achieve a desired level of duration in a fixed income portfolio.

C is correct because the notional principal needed is $NP = B \times \left(\frac{MDUR_T - MDUR_B}{MDUR_S} \right)$, where

B is the value of the fixed income portfolio and $MDUR$ is the duration of T = target, B = current portfolio, and S = swap. Therefore, the correct notional principal is

$$NP = 640 \times \left(\frac{3.50 - 6.40}{-2.875} \right) = 645.57, \text{ or JPY646 million rounded to the nearest million yen.}$$

Watanabe recommends a notional principal of JPY683 million, which is too high.

42. Which of Watanabe's three statements to Kondo is *least likely* correct?

- A. Statement 1
- B. Statement 2
- C. Statement 3

Answer = B

"Risk Management Applications of Swap Strategies," Don M. Chance
2012 Modular Level III, Vol. 5, pp. 512–513, 516–520

Study Session 15-38-h

Demonstrate the use of an interest rate swaption 1) to change the payment pattern of an anticipated future loan and 2) to terminate a swap.

B is correct because the original swap is pay-fixed, implying that the offsetting swap would be pay-floating. A receiver swaption provides its owner with the right to enter a pay-floating (receive-fixed) in a swap at the exercise fixed rate, whereas a payer swaption provides the right to enter the swap in a pay-fixed position.

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Manuel Silva Case Scenario

Manuel Silva is a principal at Raintree Partners, a financial advisory firm, and a specialist in providing advice on risk management and trading strategies using derivatives. Raintree's clients include high-net-worth individuals, corporations, banks, hedge funds, and other financial market participants.

One of Silva's clients, Iria Sampras, is meeting with Silva to discuss the use of options in her portfolio. Silva has collected information on S&P 500 Index options, which is shown in Exhibit 1.

Exhibit 1
Options Data for S&P 500 Stock Index
Options Expire in Six Months. Multiplier \$100

Exercise Price	Call Price	Put Price
\$1,100	\$95.85	\$42.60
\$1,125	\$80.50	\$48.00
\$1,150	\$64.70	\$60.00

At the beginning of the meeting Sampras states: "My investment in Eagle Corporation stock has increased considerably in value, and I would like suggestions on options strategies I can use to protect my gains." Silva responds: "There are two strategies that you may wish to consider: covered calls or protective puts. Covered calls provide a way to protect your gains in Eagle Corporation stock. Adding a short call to your long position in Eagle stock will provide protection against losses on the stock position, but it will also limit upside gains. A protective put also provides downside protection, but it retains upside potential. Unlike covered calls, protective puts require an upfront premium payment."

At the end of the meeting Sampras asks Silva to provide a written analysis of the following option strategies:

Strategy A: A butterfly spread strategy using the options information provided in Exhibit 1.

Strategy B: A straddle strategy using options in Exhibit 1 with an exercise price of \$1,125.

Strategy C: A collar strategy using options information in Exhibit 1.

On 16 March 2010, First Citizen Bank (FCB) approached Silva for advice on a loan commitment. At that time, FCB had committed to lend \$100 million in 30 days (on 15 April 2010), with interest and principal due on 12 October 2010, or 180 days from the date of the loan. The interest rate on the loan was 180-day LIBOR + 50 bps, and FCB was concerned about interest rates declining between March and April.

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Silva advised FCB to purchase a \$100 million interest rate put on 180-day LIBOR with an exercise rate of 5.75% and expiring on 15 April 2010. The put premium was \$25,000. LIBOR rates on 16 March 2010, and 15 April 2010, were 6% and 4%, respectively. The option was exercised on 15 April 2010, and the payoff was received on 12 October 2010. FCB has asked for a written evaluation of the success of the strategy.

On 15 October 2011, another client, Short Hills Corporation (SHC), indicates it expects to take out a \$25 million dollar loan on 15 December 2011. The loan rate is 90-day LIBOR + 100 basis points. Interest and principal will be paid on 14 March 2012, 90 days after the loan is made on 15 December 2011. SHC is concerned about rising interest rates and has approached Silva for recommendations on addressing this issue. On Silva's advice, SHC purchases a \$25 million interest rate call on 90-day LIBOR with an exercise rate of 3.5%. The option premium is \$45,000, and it expires in 61 days, on 15 December 2011. If the option is exercised on 15 December 2011, the payoff will be received on 14 March 2012. SHC has asked Silva to provide a report on possible outcomes relative to potential interest rate scenarios.

43. Is Silva's response to Sampras regarding reducing exposure to Eagle Corporation stock *most likely* correct?

- A. Yes.
- B. No, he is incorrect about covered calls.
- C. No, he is incorrect about protective puts.

Answer = B

"Risk Management Applications of Option Strategies," Don M. Chance

2012 Modular Level III, Vol. 5, pp. 405–413

Study Session 15-37-a

Compare the use of covered calls and protective puts to manage risk exposure to individual securities.

B is correct. Silva is incorrect about covered calls. Covered calls do not provide protection against downside losses. They do limit upside gains.

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44. Based on the information in Exhibit 1, the maximum profit per contract for Strategy A is *closest* to:

- A. \$2,545.
- B. \$5,855.
- C. \$9,015.

Answer = A

“Risk Management Applications of Option Strategies,” Don M. Chance
2012 Modular Level III, Vol. 5, pp. 419–422

Study Session 15-37-b

Calculate and interpret the value at expiration, profit, maximum profit, maximum loss, breakeven underlying price at expiration, and general shape of the graph for the major option strategies (bull spread, bear spread, butterfly spread, collar, straddle, box spread).

A is correct. In the butterfly spread, using calls you go long the 1100 and 1150 strikes and short 2 of the 1125 strike. The maximum profit is when the index is at 1125. The maximum profit per contract = Profit on long 1100 + Profit on 2 short 1125 + Profit on long 1150 = $(1125 - 1100) - 95.85 + (2 \times 80.50) - 64.70 = 25.45$. The profit per contract = $25.45 \times 100 = \$2,545$.

45. Based on the information presented in Exhibit 1, the maximum loss per contract for Strategy B is *closest* to:

- A. \$10,350.
- B. \$12,850.
- C. \$20,900.

Answer = B

“Risk Management Applications of Option Strategies,” Don M. Chance
2012 Modular Level III, Vol. 5, pp. 427–429

Study Session 15-37-b

Calculate and interpret the value at expiration, profit, maximum profit, maximum loss, breakeven underlying price at expiration, and general shape of the graph for the major option strategies (bull spread, bear spread, butterfly spread, collar, straddle, box spread).

B is correct. The straddle consists of a long call and a long put at a strike price of 1125. The maximum loss occurs when the index is at 1125, when the call and put are at the money. The

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maximum loss = Call premium + Put premium = 80.50 + 48.00 = 128.50. Per contract the loss is $100 \times 128.50 = \$12,850$.

46. The expected volatility of the S&P 500 Index, relative to market expectations, is *least* likely to be a factor in the decision to implement:
- A. strategy A.
 - B. strategy B.
 - C. strategy C.

Answer = C

“Risk Management Applications of Option Strategies,” Don M. Chance
2012 Modular Level III, Vol. 5, pp. 419–429

Study Session 15-37-b

Calculate and interpret the value at expiration, profit, maximum profit, maximum loss, breakeven underlying price at expiration, and general shape of the graph for the major option strategies (bull spread, bear spread, butterfly spread, collar, straddle, box spread).

C is correct. Strategy C is a collar, which is a directional strategy; that is, its performance is dependent on the direction of the movement of the underlying (in this instance, the S&P 500 Index). The performance of strategy A (butterfly spread) and strategy B (straddle) are based on the expected volatility (relative to the rest of the market) of the S&P 500 Index.

47. Based on Silva’s advice, the effective annual interest rate for First Citizen Bank’s loan is *closest* to:
- A. 4.56%.
 - B. 5.75%.
 - C. 6.38%.

Answer = C

“Risk Management Applications of Option Strategies,” Don M. Chance
2012 Modular Level III, Vol. 5, pp. 439–444

Study Session 15-37-c

Calculate the effective annual rate for a given interest rate outcome when a borrower (lender) manages the risk of an anticipated loan using an interest rate call (put) option.

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C is correct. The effective annual rate is calculated as follows:

$$\text{Future value of put premium on April 15} = 25,000 \left[1 + (.06 + .005) \left(\frac{30}{360} \right) \right] = \$25,135.42$$

$$\text{Effective loan outlay} = 100,000,000 + 25,135.42 = \$100,025,135.42$$

$$\text{Loan interest} = 100,000,000 \left[(0.04 + .005) \left(\frac{180}{360} \right) \right] = \$2,250,000$$

$$\text{Put payoff} = 100,000,000 [\text{Max}(0, 0.0575 - 0.04) \left(\frac{180}{360} \right)] = \$875,000$$

$$\text{Effective interest} = 2,250,000 + 875,000 = \$3,125,000$$

$$\text{Effective annualized loan rate} = \left[\frac{100,000,000 + 3,125,000}{100,025,135} \right]^{\frac{365}{180}} - 1 = 0.0638$$

48. Assuming Silva's advice is followed and LIBOR rates are 5% and 6% on 15 October 2011, and 15 December 2011, respectively, the effective annual interest rate on Short Hills Corporation's loan is *closest* to:

- A. 3.50%.
- B. 4.64%.
- C. 5.42%.

Answer = C

"Risk Management Applications of Option Strategies," Don M. Chance

2012 Modular Level III, Vol. 5, pp. 433–439

Study Session 15-37-c

Calculate the effective annual rate for a given interest rate outcome when a borrower (lender) manages the risk of an anticipated loan using an interest rate call (put) option.

C is correct. The effective annual rate is calculated as follows:

$$\text{Future value of call premium on December 15} = 45,000 \left[1 + (0.05 + 0.01) \left(\frac{61}{360} \right) \right] = \$45,457.50$$

$$\text{Effective loan proceeds} = 25,000,000 - 45,457.50 = \$24,954,542.50$$

$$\text{Loan interest} = 25,000,000 \left[(0.06 + 0.01) \left(\frac{90}{360} \right) \right] = \$437,500$$

$$\text{Call payoff} = 25,000,000 [\text{Max}(0, 0.06 - 0.035) \left(\frac{90}{360} \right)] = \$156,250$$

$$\text{Effective interest} = 437,500 - 156,250 = \$281,250$$

$$\text{Effective annualized loan rate} = \left[\frac{25,000,000 + 281,250}{24,954,542} \right]^{\frac{365}{90}} - 1 = 0.0542$$

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Midwest Case Scenario

Erik Smith, CFA, is director of Investments for Midwest Industries' pension fund. He is meeting with James Brown, ASA, his actuary, and Paul Jones, CFA, an investment consultant, to discuss changes to the fund's management and asset allocation.

Brown makes the following statement regarding Midwest's pension plan:

Discounting the projected benefit cash flows using a market-based discount rate of 6.2%, the present value of Midwest's pension fund is \$1 billion. The fund's duration is 12, and the plan assets currently cover 100% of this liability. Because the objective is primarily to meet these liabilities and we are using market rates as the discount rate, we should select a bond market index as the benchmark.

Jones offers his opinion on the appropriate investment strategy for the pension fund: "I believe that an immunization strategy that meets multiple liabilities is the best strategy. For multiple liability immunization, the necessary and sufficient conditions are: 1) the duration of the portfolio must equal the duration of the weighted average liabilities, and 2) the distribution of durations of individual portfolio assets must have a wider range than the distribution of the liabilities. As such, this strategy will not require us to rebalance the portfolio if interest rates change."

Smith expresses some concerns regarding immunization as a strategy and states:

Even if immunization minimizes risk, it assumes that the yield curve shifts in a parallel fashion, which is not what I have observed in the market. In addition, the ability to earn some incremental return to offset additional benefit requirements is not possible.

Jones then comments on portfolio holdings:

The current portfolio contains 40% in mortgage-backed securities (MBS), which present certain risks when immunizing a portfolio. These securities have a market value that is below their purchase price, and I am reluctant to recommend a sale in which we have to recognize a loss.

The discussion progresses to implementation of an investment strategy. Brown presents several alternative portfolios that may be used to implement this strategy and states:

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Although we are currently fully funded, I am concerned that future service benefits are not covered unless we make additional contributions. We should evaluate the alternative portfolios below to determine which one best address this concern while covering the liability's market-related exposures.

- Portfolio A: The fixed income assets will closely mimic the liabilities with regard to both expected return as well as variability. This is a low-risk strategy to meet our objectives.
- Portfolio B: Hedges uncompensated liability risks, such as interest rate risk with derivatives. This frees up capital to invest in higher returning assets, such as equities as well as bonds.
- Portfolio C: A traditional mix of securities with 60% in equities and the remainder in medium duration bonds but not fully hedging interest rate risk.

Smith is not completely convinced about the portfolio choices and offers the following alternative:

I believe cash flow matching is a superior strategy. This strategy will allow funds to be available when each liability is due and will require less cash to fund liabilities. A conservative interest rate assumption for cash must be made throughout the life of the plan.

-
49. Based on Midwest's stated objective, has Brown recommended the *most* appropriate benchmark?
- A. Yes
 - B. No, because the liability itself is the benchmark
 - C. No, because the benchmark should contain a broader universe of asset classes

Answer = B

"Fixed-Income Portfolio Management – Part I," H. Gifford Fong and Larry D. Guin
2012 Modular Level III, Vol. 4, pp. 8–10, 25–26

Study Session 9-23-a

Compare, with respect to investment objectives, the use of liabilities as a benchmark and the use of a bond index as a benchmark.

B is correct because the investor with liabilities will measure success by whether the portfolio generates the funds necessary to pay out the cash outflows associated with the liabilities, in this

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case a defined benefit pension plan. Meeting the liability is the investment objective; as such, it also becomes the benchmark for the portfolio.

50. Jones' investment strategy statement is *least likely correct* with respect to:

- A. matching durations.
- B. the distribution of durations.
- C. rebalancing the portfolio under certain conditions.

Answer = C

"Fixed-Income Portfolio Management – Part I," H. Gifford Fong and Larry D. Guin
2012 Modular Level III, Vol. 4, pp. 26–29, 41–42

Study Session 9-23-f; k

Formulate a bond immunization strategy to ensure funding of a predetermined liability, and evaluate the strategy under various interest rate scenarios.

Compare immunization strategies for a single liability, multiple liabilities, and general cash flows.

C is correct because the portfolio **does** need to be rebalanced. As interest rates fluctuate or as time elapses, the portfolio duration will also change; thus, the portfolio must be rebalanced to adjust duration to the desired level.

51. Smith's concerns regarding immunization as a strategy are *best* addressed by:

- A. decreasing the dispersion of cash flows around the horizon date.
- B. matching assets to liabilities using functional duration and targeting a cushion spread.
- C. increasing the dispersion of cash flows around the horizon date and targeting a cushion spread.

Answer = B

"Fixed-Income Portfolio Management – Part I," H. Gifford Fong and Larry D. Guin
2012 Modular Level III, Vol. 4, pp. 36, 38–39, 43–44

Study Session 9-23-i

Discuss the extensions that have been made to classical immunization theory, including the introduction of contingent immunization.

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B is correct because applying functional duration or key rate durations allows durations along the yield curve to match those of the liabilities. A nonparallel shift in the yield curve will affect assets and liabilities in an offsetting manner. In addition, the portfolio could allow for active management to generate additional returns—for an incremental difference between the minimum acceptable return and the higher possible immunized rate—which is referred to as the cushion spread.

52. The risk specific to MBS that Jones is *most likely* concerned about is?

- A. cap risk.
- B. interest rate risk.
- C. contingent claim risk.

Answer = C

“Fixed-Income Portfolio Management – Part I,” H. Gifford Fong and Larry D. Guin
2012 Modular Level III, Vol. 4, pp. 38

Study Session 9-23-j

Explain the risks associated with managing a portfolio against a liability structure, including interest rate risk, contingent claim risk, and cap risk.

C is correct because when such assets as mortgage-backed securities have a contingent claim provision, explicit or implicit, there is an associated risk. As rates fall, the security might have coupons halted and principal repaid. This results in reinvestment risk and also limits any potential upside that would be generated by a noncallable security.

53. Based on Brown’s concerns regarding future benefits, which portfolio is the *most* appropriate?

- A. Portfolio A
- B. Portfolio B
- C. Portfolio C

Answer = B

“Fixed-Income Portfolio Management – Part I,” H. Gifford Fong and Larry D. Guin
2012 Modular Level III, Vol. 4, pp. 38–41, 43–44

Study Session 9-23-l

Compare risk minimization with return maximization in immunized portfolios.

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“Linking Pension Liabilities to Assets,” Aaron Meder and Renato Staub

2012 Modular Level III, Vol. 2, pp. 499

Study Session 5-16-c

Compare pension portfolios built from a traditional asset-only perspective to portfolios designed relative to liabilities, and discuss why corporations may choose not to implement fully the liability mimicking portfolio.

B is correct because Portfolio B is the optimal strategy. Interest rate swaps are used to mimic the term structure exposure of the liability, freeing up capital to invest in “higher returning” assets, such as equities [Vol. 2, p. 499]. In this liability relative approach, investments are in long-duration bonds, a small allocation to equities, and interest rate derivatives to hedge the liability. Although interest rate risk is hedged with derivatives, Portfolio B allows for additional expected return by including equities to meet future benefits. [Vol. 4, p. 43]

54. Is Smith’s assertion about cash flow matching *most likely* correct?

- A. Yes.
- B. No, he is incorrect regarding cash balances.
- C. No, he is incorrect regarding the interest rate assumption.

Answer = B

“Fixed-Income Portfolio Management – Part I,” H. Gifford Fong and Larry D. Guin

2012 Modular Level III, Vol. 4, pp. 44–47

Study Session 9-23-m

Demonstrate the use of cash flow matching to fund a fixed set of future liabilities, and compare the advantages and disadvantages of cash flow matching to those of immunization strategies.

B is correct because cash flow matching will require a relatively conservative rate of return assumption for short-term cash and cash balances may be occasionally substantial. By contrast, an immunized portfolio is essentially fully invested at the remaining horizon duration. Funds from a cash flow–matched portfolio must be available when each liability is due.

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Anton Case Scenario

Beatriz Anton, CFA, is the chief compliance officer at Long Pond Advisors, an asset management firm catering to institutional investors. Long Pond is not currently GIPS compliant, but Anton would like to market the firm as being compliant as soon as possible. To assist Anton in achieving compliance, she hires Ana Basco, CFA, from Nantucket Advisors to provide guidance on achieving compliance.

At their initial meeting to discuss a framework for the implementation of GIPS standards, Anton asks Basco what she believes the fundamentals of GIPS compliance encompass. Basco responds, "A good starting point is input data because the Standards rely on the integrity of input data to accurately calculate results. Portfolios must be valued in accordance with the definition of fair value, not cost or book values. In fact, fair value supersedes market value. Transactions are reflected in the portfolio at settlement when the exchange of cash, securities, and paperwork involved in a transaction is completed. Accrual accounting is used for fixed income securities and all other assets that accrue interest income; dividend-paying equities accrue dividends on the ex-dividend date."

Basco then asks Anton about Long Pond's policies for return calculation methodologies. Anton responds that she has recently implemented the following policies:

- Policy 1: Total return is calculated for portfolios using time-weighted rates of return computed by geometrically linking the periodic returns. Both realized and unrealized gains and losses are used in the calculation.
- Policy 2: Large- and mid-cap equity portfolios are revalued on the date when capital equal to 10 percent or more of current market value is contributed or withdrawn. Small-cap and fixed income portfolios use a 5 percent threshold.
- Policy 3: Cash and cash equivalents are excluded in total return calculations. Custody fees are not considered direct transaction costs. Returns are calculated after deduction of trading expenses.

Their conversation turns to the construction of composites and composite return calculations. Anton tells Basco,

Long Pond calculates composite returns by asset-weighting the individual portfolio returns using beginning-of-period values. For periods beginning 1 January 2010, we calculate composite returns by asset weighting the individual portfolio returns quarterly. All actual, fee-paying, discretionary portfolios are included in at least one composite. Non-fee-paying discretionary portfolios are also included in a composite, and appropriate disclosures are provided. Client portfolios that restrict the purchase of certain securities are excluded if this restriction hinders

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the portfolio manager's ability to execute the investment strategy. We consider a hierarchical structure of criteria for composite definition that promotes primary and secondary strategy characteristics, such as asset classes, style, benchmarks, and risk/return characteristics. The composites are not always defined according to each level of the hierarchy.

Anton then provides Basco a recent presentation to a prospective client for Long Pond's mid-capitalization composite. Details of this presentation are found in Exhibit 1.

Exhibit 1 – Mid-Capitalization Equity Composite
Benchmark: Russell Midcap Index

Column >	1	2	3	4	5	6	7
	Gross-of-Fees Return (%)	Net-of-Fees Return (%)	Benchmark Return (%)	Number of Portfolios	Internal Dispersion (%)	Total Assets (\$m)	
Year						Composite	Firm
2007	4.4	3.4	3.6	5	3.1	125	1,000
2008	2.7	1.7	6.2	8	4.0	220	1,150
2009	-1.5	-2.5	-4.3	7	1.9	345	910
2010	8.3	7.3	11.1	11	2.6	430	1,020
1Q11	6.6	5.6	-2.9	13	4.1	600	1,100

Notes:

1. Long Pond is an independent investment firm founded in May 1998 and has a single office in Seattle, WA. The firm manages portfolios in various equity, fixed income, and real estate strategies.
2. The composite has an inception date of 31 December 1999. A complete list and description of firm composites is available upon request.
3. The composite includes all fee-paying discretionary, nontaxable portfolios that follow a mid-cap strategy. The composite does not include any non-fee-paying portfolios.
4. First Quarter 2011 (1Q11) data are not annualized.
5. Valuations are computed and performance reported in US\$.
6. Internal dispersion is calculated using the equal-weighted standard deviation of all portfolios that were included in the composite for the entire year.
7. Gross-of-fees performance returns are presented before management and custodial fees but after all trading expenses. The management fee schedule is as follows: 1.00% on first US\$25M; 0.60% thereafter. Net-of-fees performance returns are calculated by deducting the management fee of 0.25% from the monthly gross composite return.

Anton concludes by describing Long Pond's real estate valuation practices to Basco:

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Long Pond uses fair value to calculate returns on real estate assets, although for periods before 1 January 2011, we used market values. With effect from January 2011, we value real estate holdings annually and have an external expert value our real estate every 36 months. We calculate income returns and capital returns separately using geometrically linked time-weighted rates of return and composite returns by asset-weighting the individual portfolio returns at least quarterly.

55. In her statement regarding input data, Basco is *least likely* correct with respect to:

- A. fair value.
- B. accrual accounting.
- C. settlement date accounting.

Answer = C

“Global Investment Performance Standards,” Phillip Lawton
2012 Modular Level III, Vol. 6, pp. 280–281
Study Session 18-43-d

Explain the requirements and recommendations of the GIPS standards with respect to input data, including accounting policies related to valuation and performance measurement.

C is correct because the GIPS standards require that firms use trade-date accounting for the purpose of performance measurement for periods beginning 1 January 2005 (I.1.A.5). The principle behind requiring trade-date accounting is to ensure that no significant lag occurs between a trade’s execution and its reflection in the portfolio’s performance.

56. Which policy regarding return calculation methodology is *least likely* compliant with GIPS standards?

- A. Policy 1
- B. Policy 2
- C. Policy 3

Answer = C

“Global Investment Performance Standards,” Phillip Lawton
2012 Modular Level III, Vol. 6, pp. 283–284, 289–290

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Study Session 18-43-e

Discuss the requirements of the GIPS standards with respect to return calculation methodologies, including the treatment of external cash flows, cash and cash equivalents, and expenses and fees.

C is correct because a GIPS requirement is that returns from cash and cash equivalents held in portfolios must be included in total return calculations (I.2.A.3). A primary purpose of performance measurement is to enable prospective clients and, by extension, their consultants to appraise an investment management firm's results. Within the constraints established by a client's investment policy statement (IPS), active managers often have discretion to decide what portion of a portfolio's assets to hold in cash or cash equivalents.

57. With regard to Long Pond's procedures for composites, which of the following should *most likely* be modified in order to be compliant with GIPS standards? Composite:

- A. definition.
- B. construction.
- C. return calculations.

Answer = C

"Global Investment Performance Standards," Phillip Lawton
2012 Modular Level III, Vol. 6, pp. 293, 296–301

Study Session 18-43-f, g, h

Explain the requirements and recommendations of the GIPS standards with respect to composite return calculations, including methods for asset-weighting portfolio returns.

Explain the meaning of "discretionary" in the context of composite construction and, given a description of the relevant facts, determine whether a portfolio is likely to be considered discretionary.

Explain the role of investment mandates, objectives, or strategies in the construction of composites.

C is correct. The GIPS standards specify the required frequency of asset weighting. Provision I.2.A.7 states that for periods beginning on or after 1 January 2010, composite returns must be calculated by asset weighting the individual portfolio returns at least monthly. Provision I.2.B.2 recommends that the same be done for earlier periods.

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58. Based on Exhibit 1 and the notes following the table, Long Pond is *least likely* in compliance with GIPS standards with regard to the:

- A. length of performance record.
- B. measure of internal dispersion.
- C. presentation of 1Q11 performance.

Answer = A

“Global Investment Performance Standards,” Phillip Lawton
2012 Modular Level III, Vol. 6, pp. 307–321

Study Session 18-43-l, v

Explain the requirements and recommendations of the GIPS standards with respect to presentation and reporting, including the required timeframe of compliant performance periods, annual returns, composite assets, and benchmarks.

Identify and explain errors and omissions in given performance presentations, including real estate, private equity, and wrap fee/separately managed account (SMA) performance presentations.

A is correct because Long Pond is required by GIPS standards to present five years of performance because the composite has been in existence for that period. The mid-cap composite was started on 31 December 1999; therefore, performance for 2006 must be presented. After presenting five years of performance, the firm should present additional annual performance up to 10 years.

59. Regarding the disclosures contained in Exhibit 1, GIPS standards would *most likely*:

- A. require Columns 3 and 7 and recommend Column 6.
- B. require Columns 2 and 5 and recommend Column 1.
- C. require Column 6 and recommend Columns 4 and 7.

Answer = B

“Global Investment Performance Standards,” Phillip Lawton
2012 Modular Level III, Vol. 6, pp. 312, 314–321, 378–382

Study Session 18-43-k

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Explain the requirements and recommendations of the GIPS standards with respect to disclosure, including fees, the use of leverage and derivatives, conformity with laws and regulations that conflict with the GIPS standards, and noncompliant performance periods.

B is correct because the presentation of firm assets (or percentage of firm assets represented by the composite) is required. Firms are required to present either net-of-fees performance or gross-of-fees performance. If one or the other is presented, then it is recommended that the remaining also be presented. For example, if net-of-fees performance is disclosed, then it is recommended that gross-of-fees performance also be disclosed.

60. In order for the real estate composite to be GIPS compliant, at a minimum, which of Long Pond's practices would *most likely* need to be modified?

- A. Frequency of valuations
- B. Rate-of-return calculations
- C. The use of fair and market values

Answer = A

"Global Investment Performance Standards," Phillip Lawton

2012 Modular Level III, Vol. 6, pp. 322–329

Study Session 18-43-p

Explain the provisions of the GIPS standards for real estate and private equity.

A is correct because Provision I.6.A.4 states that for periods prior to 1 January 2012, real estate investments must have an external valuation at least once every 36 months. For periods beginning on or after 1 January 2012, real estate investments must have an external valuation at least once every 12 months unless client agreements stipulate otherwise; in that case, they must have an external valuation at least every 36 months (or more frequently if required by the client agreement).

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