

## 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

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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 Furthermore, outdated plant equipment is causing production disruption and declining profit margins.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**

| <b>Risk</b>   | <b>Risk Details</b>  | <b>Possible Business Impact</b>   |
|---------------|--|---|
| 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.
  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
  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.

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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.
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
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"

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## Kim Tang Case Scenario

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

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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
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.
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.

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## Karin Larsson Case Scenario

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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."

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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
14. Which risk listed by Reinfeldt is *most likely* a source of financial risk?
- A. Risk 1
  - B. Risk 2
  - C. Risk 3
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.

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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.
17. Which of the limitations of VAR analysis given by Reinfeldt is *most likely* correct?
- A. Limitation 1
  - B. Limitation 2
  - C. Limitation 3
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.

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## Gregory Dodson Case Scenario

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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<br>(in millions) | Expected<br>Alpha | Expected<br>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.

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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.
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.
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
22. The style of the Canadian equities portfolio manager is *most likely*:
- A. value.
  - B. growth.
  - C. market-oriented.
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

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24. The Susquehanna 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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## Rogers Case Scenario

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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.
26. The NEXT Index data most likely reflect:
- A. survivorship bias.
  - B. transcription errors.
  - C. volatility clustering.
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
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
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
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.

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## Berg Case Scenario

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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**

|                                     | <b>Assets</b> | <b>Liabilities</b> |
|-------------------------------------|---------------|--------------------|
| 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.

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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.

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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.
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.
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%.
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
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

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## Kamiko Watanabe Case Scenario

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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<br>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.
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.
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.

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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.
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.
42. Which of Watanabe's three statements to Kondo is *least likely* correct?
- A. Statement 1
  - B. Statement 2
  - C. Statement 3

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## Manuel Silva Case Scenario

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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.
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.
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.

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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.
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%.
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%.

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## Midwest Case Scenario

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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

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.

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.

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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.

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

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

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.

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## Anton Case Scenario

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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<br>Return<br>(%) | Net-of-Fees<br>Return<br>(%) | Benchmark<br>Return (%) | Number of<br>Portfolios | Internal<br>Dispersion<br>(%) | 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.

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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.
56. Which policy regarding return calculation methodology is *least likely* compliant with GIPS standards?
- A. Policy 1
  - B. Policy 2
  - C. Policy 3
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.
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.
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.

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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

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