

2011 Level III Mock Exam

The 2011 Level III Chartered Financial Analyst® 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.

Questions	Topic	Minutes
1-6	Ethical and Professional Standards	18
7-12	Ethical and Professional Standards	18
13-18	Risk Management	18
19-24	Equity Portfolio Management	18
25-30	Performance Attribution	18
31-36	Fixed Income Portfolio Management	18
37-42	Risk Management Application of Derivatives	18
43-48	Risk Management Application of Derivatives	18
49-54	Portfolio Management of Global Bonds	18
55-60	GIPS	18
	Total:	180

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Vision 2020 Case Scenario

Vision 2020 Capital Partners (V2020) has operated for the last ten years originating and brokering corporate finance deals through private placements in emerging and frontier markets. Due to the global financial crisis, investment banking deals have declined and V2020 has struggled to generate enough fees to sustain its business. The board of directors of V2020, (“the board”) made up of corporate finance experts, has identified opportunities to generate a new revenue stream.

One such opportunity is the creation of a division to manage an Emerging and Frontier Market Balanced Fund (“the Fund”). The board has had several inquiries from clients asking for such a product. The board feels the Fund is an ideal business line to meet client demand, and create monthly asset management fees. The board thinks the Fund should also be required to act as a buyer of last resort for all its corporate finance client’s private placements. It believes this arrangement would act as a major incentive for private businesses to use their corporate finance services, thereby increasing revenues from their primary business activity.

Since none of the V2020 board members or senior managers are experienced in asset management, the board hires Lauren Akinyi, CFA, an independent consultant who works with various clients in the asset management industry. She is asked to undertake a study on an appropriate structure for the Fund to meet both corporate finance and Fund client needs. She is also asked to help V2020 set up policies and procedures for the new Fund to make certain that all capital market regulations have been followed. The board informs her that the policies and procedures should also ensure compliance with the CFA® Asset Manager Code of Professional Conduct.

Akinyi subsequently makes the following recommendations in a report to the Board concerning compliance with the CFA Asset Manager Code:

Recommendation 1: V2020 should abide by the following principles of conduct:

- Principle 1: act with skill, competence and diligence;
- Principle 2: act with independence and objectivity; and
- Principle 3: respond to all client inquiries.

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Recommendation 2: To take advantage of their vast business experience, the board of directors should implement new policies. Specifically, the board should:

- Policy 1: Take an active daily role in managing the Fund's assets;
- Policy 2: Designate an existing employee as a compliance officer; and
- Policy 3: Disclose any conflicts of interest arising from their business interests.

Recommendation 3: To avoid any conflicts of interest between the investment banking business and the new fund management business, a separate wholly owned subsidiary should be created to undertake the fund management business. The Fund would then provide a 100% guarantee to buy the private placements of the corporate finance clients without having to disclose to all clients the relationship between the two entities.

Recommendation 4: To ensure timely and efficient trades in each of the markets the Fund invests in, only one stockbroker in each market should be utilized. The board should also consider buying an equity stake in each of the appointed brokers as an added profit opportunity.

After the Fund completes its first year of operations, V2020 receives a letter from its regulator. The notification imposes fines for poor disclosures to its Fund clients and mandates the replacement of the senior fund manager as a condition for the renewal of V2020's asset management license. The board challenges the ruling stating the Fund made the necessary full disclosures. Not wanting to incur expensive legal fees or waste precious time, the board, without admitting or denying fault, settles out of court paying a fine. Subsequently, the senior fund manager is terminated but receives a multi-million dollar bonus upon leaving. After the replacement of the senior fund manager, the license is renewed for a further year. The regulatory body however gives a warning that if the Fund has any future violations their license will be permanently revoked. Subsequently, the Fund discloses to its clients that the regulator has renewed its license for one year after the termination of the senior fund manager, a condition of the renewal. They also disclose the settlement out of court and the fine paid.

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1. Given the board's intended purpose for starting the Fund, which of the following principles of conduct under the Asset Manager Code of Professional Conduct is *least likely* violated?
 - A. Act for the benefit of clients.
 - B. Uphold the rules governing capital markets.
 - C. Act in a professional and ethical manner at all times.

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2. Which of the principles in Akinyi's Recommendation 1 is *least likely* sufficient to meet the principles of the Asset Manager Code?
- A. Principle 1.
 - B. Principle 2.
 - C. Principle 3.
3. Which of Akinyi's policies in Recommendation 2 would *least likely* comply with the Asset Manager's Code if implemented?
- A. Policy 1.
 - B. Policy 2.
 - C. Policy 3.
4. Which of the following would be *most* effective to prevent any violation of the Asset Manager Code as reflected in Akinyi's Recommendation 3?
- A. "The Fund" only retains a minority shareholding in V2020.
 - B. "The Fund" not participate in any of V2020's private placements.
 - C. Disclose to all clients the relationship between V2020 and "the Fund".
5. If Recommendation 4 were to be implemented, which aspect of the Asset Manager Code would *most likely* be violated?
- A. Fair dealing.
 - B. Best execution.
 - C. Priority of Transactions.
6. Does the Fund's disclosure to its clients regarding the renewal of the license *most likely* comply with the Asset Manager Code?
- A. No.
 - B. Yes, the disclosure included the termination of the fund manager.
 - C. Yes, the disclosure included the out of court settlement and payment of fine.

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Rayne Brothers Case Scenario

Erin Mutini, CFA, a South African resident, is an employee of Oakwood Asset Management (OAM), an asset management company based in South Africa. OAM manages and sells its branded mutual funds and unit trusts through agents across Africa. Mutini was recently sent to Uganda to oversee OAM's new agency agreement with Rayne Brokers (Rayne), a licensed Ugandan stock brokerage company with a strong retail customer base.

Part of Mutini's oversight role is to establish policies and procedures to ensure the Ugandan sales force represents OAM in a professional manner. As a condition of its agency agreement, OAM requires all of Rayne's sales agents to adhere to South African financial regulations, generally considered to be stricter than those in Uganda. OAM also requires all of its sales agents to abide by the CFA Code of Ethics and Standards of Professional Conduct. OAM's lawyer has indicated South African laws are stricter than the CFA Code and Standards.

To inform the Rayne sales agents of their responsibilities under the OAM agency agreement, Mutini holds a meeting with them to discuss the financial regulations of South Africa and the CFA Code and Standards. To conclude the meeting, Mutini describes OAM's annual competition amongst its sales agents where the winner is determined by the value of products sold (assets under management), fees generated, and the number of new clients brought in. The competition prize is an all expense paid two-week holiday for two to Mauritius. Mutini advises the staff they should concentrate their sales efforts on OAM's front-end load funds since they earn the highest fees. She adds staff should not disclose this competition to clients.

Mutini next meets with Rayne supervisors to specifically discuss their roles in upholding the CFA Standards. She informs them they are responsible for the prevention of any violations of laws, rules, regulations or the Code and Standards by the staff directly under their supervision. To make their job easier, instead of focusing equally on all of the requirements Mutini suggests the supervisors should concentrate on:

- Communicating compliance policies and procedures to all covered staff;
- Undertaking periodic reviews to ensure procedures are followed; and
- Enforcing investment related policies.

Later that day, Mutini scrutinizes Rayne's marketing material with Rayne's most successful sales agent, Tom Okello, another CFA Charterholder. They are preparing for a sales meeting to introduce OAM products to a potential client. Mutini notices Rayne's responsibility to uphold the CFA Code and Standards is not mentioned anywhere in the marketing material. Neither does the material mention that

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some of Rayne's employees are CFA Charterholders. Mutini notices Okello does not use the CFA designation on his business card. When Mutini asks him why, he responds, "If I use it, people will think I have a duty to Rayne's clients. I don't have a duty to clients, as stockbrokers in Uganda are not required to uphold a fiduciary duty. I don't want to mislead our clients by using the CFA designation."

During the sales meeting with the potential client, Okello makes the following statements:

Statement 1: "Before making an investment for any of our mutual funds or unit trusts, Rayne follows an extensive due diligence process and research analysis. We will only invest in the company if that investment meets the investment criteria that I have outlined to you."

Statement 2: "Every six months you will be mailed an itemized investment statement with cash flows so that you can see if your portfolio is meeting your investment objectives. In addition, you can obtain other information about our firm and investment process from our website, which is updated on a regular basis to ensure the integrity of the site as well as offer confidentiality and security to our clients. For your security, we do not post client statements on the website."

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7. According to the CFA Code and Standards, if there is a conflict, Mutini should *most likely* adhere to:
- A. Uganda's laws and regulations.
 - B. South Africa's laws and regulations.
 - C. the CFA Code of Ethics and Standards of Professional Conduct.
8. By participating in OAM's annual competition, Rayne employees *least likely* violate which of the following CFA Standards?
- A. Misrepresentation.
 - B. Independence and Objectivity.
 - C. Additional Compensation Arrangements.
9. In her meeting with Rayne supervisors, Mutini is *least likely* correct with regard to:
- A. communicating with staff.
 - B. undertaking periodic reviews.
 - C. enforcing investment related policies.

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10. Given Okello's comment regarding his reason for not using the CFA designation, he will *most likely* violate which of the following CFA Standards?

- A. Duties to Clients.
- B. Misrepresentation.
- C. Reference to CFA Designation.

11. What CFA Standard did Okello *most likely* violate in his Statement 1?

- A. Suitability.
- B. Misrepresentation.
- C. Diligence and Reasonable Basis.

12. Does Okello's Statement 2 *most likely* meet the recommended procedures for compliance with the CFA Standards?

- A. Yes.
- B. No, with regard to investment statements.
- C. No, with regard to the company's website.

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James Stam Case Scenario

James Stam is a currency management consultant at Horizon, a Canadian asset management firm. Stam consults with portfolio managers within the firm as well as external clients.

In September, Amanda Lee, a Canadian equity portfolio manager at Horizon, approached Stam for advice about a £5,000,000 position in a U.K. stock she had just purchased in her portfolio. She believed the stock would outperform similar Canadian stocks over the next three months; however, she was concerned that the British pound (£) would weaken relative to the Canadian dollar (C\$) during that period. Stam recommended that Lee hedge 100% of the position's pound exposure.

Lee immediately executed the hedge by entering into enough December futures contracts to sell £5,000,000 for Canadian dollars at a futures exchange rate of C\$1.75/£. At the time, the spot exchange rate was C\$1.80/£.

One month later, the U.K. stock is valued at £5,200,000, the spot exchange rate is C\$1.70/£ and the futures rate is C\$1.65/£. Lee asks Stam to calculate the net profit or loss on the hedged stock position. Before Stam begins his analysis, he makes the following statement to Lee:

"The return on a hedged stock will differ from the stock return achieved in foreign currency for the following reasons: foreign exchange transaction costs, stock price volatility, and the interest rate differential."

Aaron Sykes is a Canadian bond portfolio manager at Horizon who wants to add a Mexican peso-denominated bond to his portfolio. Sykes' objective is to implement a currency hedge to minimize the Mexican bond's exposure to exchange rate changes. He consults with Stam, who notes that the foreign currency values of Mexican peso-denominated bonds react systematically to exchange rate movements and that the covariance between bond returns and movement in the peso's value is positive. Stam analyzes the position to determine an appropriate Mexican peso hedge ratio for Sykes.

The international equity portfolio manager at Horizon, Blain DuPont, believes the Canadian dollar will appreciate over the next two years against all of the six foreign currency exposures within his portfolio. DuPont approaches Stam for advice on hedging these exposures. Stam recommends directly hedging the major currency exposures (euro, pound, and yen) and cross-hedging the remaining three minor currency exposures using the euro, pound, or yen. The hedging currency will be the one with the closest correlation with the minor currency. Stam provides the following three facts in support of this hedge structure:

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- Fact 1. Currency futures and forward contracts are actively traded only for major currencies.
- Fact 2. In portfolios with assets in many currencies, the residual risk of each currency is partly diversified away.
- Fact 3. Changes in the exchange rates for major currencies are often closely related to changes in other currencies.

Stam recommends that DuPont implement the hedges with short-term futures contracts with a maturity of 3 months or less. He justifies the use of short-term futures contracts by stating:

“Short-term futures contracts are preferable to long-term futures contracts because they offer greater liquidity and lower transaction costs.”

A pension plan client of Horizon approaches Stam for advice on hedging foreign currency exposures within the plan’s asset mix. Stam considers three factors before recommending a strategic benchmark hedge ratio to the client:

- Factor 1. Asset types held by the plan.
- Factor 2. Forecasted short-term changes in exchange rates.
- Factor 3. Transaction and interest differential costs of hedging.

13. The net profit or loss on Lee’s hedged UK stock position is *closest to*:

- A. C\$660,000.
- B. C\$340,000.
- C. C\$500,000.

14. In his statement to Lee, Stam is *most likely* correct with respect to:

- A. stock price volatility.
- B. interest rate differential.
- C. foreign exchange transaction costs.

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15. The *most* appropriate recommendation that Stam should make to Sykes is that the hedge ratio be:
- A. equal to 1.
 - B. less than 1.
 - C. greater than 1.
16. Which of the three facts that Stam provides to DuPont *least likely* supports his recommended hedge structure?
- A. Fact 1.
 - B. Fact 2.
 - C. Fact 3.
17. Are the reasons Stam provides to DuPont justifying the use of 3 month futures to implement the hedging strategy *most likely* correct?
- A. Yes.
 - B. No, with respect to liquidity.
 - C. No, with respect to transaction costs.
18. With regard to the strategic benchmark hedge ratio, which of the three factors that Stam considers is *least* appropriate?
- A. Factor 1
 - B. Factor 2
 - C. Factor 3

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Goldsboro Partners Case Scenario

Goldsboro Partners, an investment management firm, intends to offer more products invested in equities traded on the Singapore Exchange (SGX).

Goldsboro is developing the Goldsboro Singapore Index (GSI); a proprietary index of Singapore equities comprised of five stocks traded on the SGX with the largest market capitalization. Goldsboro must decide how to structure the GSI. Information about the prices and market caps of these firms is found in Exhibit 1.

Exhibit 1
Five Largest Singapore Firms: Selected Information in US\$

Firm	Price @1/1/2009	Price @1/1/2010	Change in Price	Market Cap @1/1/2009 (billions)	Market Cap @1/1/2010 (billions)	Change in Market Cap
SingTel	2.35	2.53	+7.7%	48.5	52.5	+8.2%
Wilmar	5.77	6.80	+17.9%	32.7	41.2	+26.0%
DBS Group	11.62	13.28	+14.3%	26.6	30.1	+13.2%
Jardine Matheson	23.94	26.71	+11.6%	25.3	27.6	+9.1%
UOB	12.73	14.07	+10.5%	23.9	26.8	+12.1%
Total	56.41	63.39		157.0	178.2	

Goldsboro has four large, institutional clients who indicated that they might invest a total of US\$240 million in a fund indexed to the GSI. These clients are very cost sensitive.

Goldsboro already offers two mutual funds that consist of stocks that are part of the Straits Times Index (STI), a value-weighted index of the 30 largest firms traded on the SGX. Exhibit 2 provides information about these two funds (GB1 and GB2), the STI index, and all stocks traded on the SGX.

Exhibit 2
Comparison of Goldsboro's 2 Funds, the STI, and the SGX

	Fund GB1	Fund GB2	STI	SGX
Number of stocks	12	12	30	612
Average market cap	\$12.4 billion	\$13.2 billion	\$13.7 billion	\$2.7 billion
Dividend yield	1.5%	2.1%	1.6%	0.8%
P/E	21.7	16.8	21.4	24.7
P/B	2.6	2.1	2.7	2.9
Projected EPS growth rate	11.0%	8.4%	11.2%	13.7%

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Goldsboro also offers three independently-managed funds, GB-STI-1, GB-STI-2, and GB-STI-3. The three funds are benchmarked against the STI index. For the year 2009, Jason Briggs, a client whose Singapore benchmark is the MSCI Singapore Free Index, pursued a core-satellite approach by investing in these three funds, earning a return of 12.4%. Information about these three funds, their returns, and Briggs' investments is found in Exhibit 3.

Exhibit 3
Briggs' Investments in Goldsboro's STI-benchmarked Funds

	GB-STI-1	GB-STI-2	GB-STI-3
Fund expected alpha	5%	2%	0%
Fund expected tracking risk	9%	5%	0%
Briggs' investment	\$20 million	\$20 million	\$10 million
Return during 2009	15%	10%	12%

In 2009, the return on the MSCI Singapore Free Index was 11.7% and the return on the STI Index was 12.0%.

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19. Based on Exhibit 1, for the year 2009, assuming no stock splits or stock dividends for the stock components and no rebalancing, which of these index structures would have *most likely* resulted in the largest return for the GSI?
- A. A price-weighted index.
 - B. A value-weighted index.
 - C. An equal-weighted index.
20. Goldsboro's *best* choice for the GSI index portfolio structure is:
- A. a mutual fund.
 - B. a pooled account.
 - C. an exchange-traded fund.
21. According to the information provided in Exhibit 2, Fund GB1 is *best* characterized as having what equity style?
- A. Value.
 - B. Growth.
 - C. Market oriented.

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22. Goldsboro's Fund GB2 would appeal to an investor who is *most* closely focused on:
- A. relative strength.
 - B. earnings momentum.
 - C. price relative to intrinsic value.
23. The characterization of Briggs' investment as following a core-satellite approach is *most likely*:
- A. correct.
 - B. incorrect, because too little of the portfolio was passively invested.
 - C. incorrect, because the funds invested in are benchmarked against the wrong index.
24. During 2009, the "misfit" active return earned by Brigg's investments was *closest to*:
- A. 0.3%.
 - B. 0.4%.
 - C. 0.7%.

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Brian O'Reilly Case Scenario

Brian O'Reilly is a capital markets consultant for the Tennessee Teachers' Retirement System (TTRS). O'Reilly is meeting with the TTRS board to present his capital market expectations for the next year. Board member Kay Durden asks O'Reilly about the possibility that data measurement biases exist in historical data. O'Reilly responds:

"Some benchmark indexes suffer from survivorship bias. For example the returns of failed or merged companies are dropped from the data series resulting in an upward bias to reported returns. This may result in an overly-optimistic expectation with respect to future index returns. Another bias results from the use of appraisal data in the absence of market transaction data. Appraisal values tend to be less volatile than market determined values for identical assets. The result is that calculated correlations with other assets tend to be biased upward in absolute value compared to the true correlations and the true variance of the asset is biased downward."

Board member Arnold Brown asks O'Reilly about the use of high-frequency (daily) data in developing capital market expectations. O'Reilly answers:

"Sometimes it is necessary to use daily data to obtain a data series of the desired length. High-frequency data are more sensitive to asynchronism across variables and, as a result, tend to produce higher correlation estimates."

Board member Harold Melson noted he recently read an article on psychological traps related to making accurate and unbiased forecasts. He asks O'Reilly to inform the board about the anchoring trap and the confirming evidence trap. O'Reilly offers the following explanation:

"The anchoring trap is the tendency for forecasts to be overly influenced by the memory of catastrophic or dramatic past events that are anchored in a person's memory. The confirming evidence trap is the bias that leads individuals to give greater weight to information that supports a preferred viewpoint than to evidence that contradicts it."

The board asks O'Reilly about using a multifactor model to estimate asset returns and covariances among asset returns. O'Reilly presented the factor covariance matrix for global equity and global bonds shown in Exhibit 1 and market factor sensitivities and residual risk shown in Exhibit 2.

Exhibit 1
Factor Covariance Matrix

	Global Equity	Global Bonds
Global Equity	0.0225	0.0022
Global Bonds	0.0022	0.0025

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Exhibit 2
Market Factor Sensitivities and Residual Risk

	Sensitivities		Residual Risk
	Global Equity	Global Bonds	
Market 1	1.20	0	12.0%
Market 2	0.90	0	7.0%
Market 3	0	0.95	1.8%

Finally, the board asks about forecasting expected returns for major markets given that price earnings ratios are not constant over time and that many companies are repurchasing shares instead of increasing cash dividends. O'Reilly responds that the Grinold-Kroner model accounts for those factors and then makes the following forecasts for the European equity market:

- Dividend yield will be 1.95%
- Shares outstanding will decline 1.00%
- Long-term inflation rate will be 1.75% per year
- An expansion rate for P/E multiples of 0.15% per year
- Long-term corporate real earnings growth at 3.5% per year

25. With respect to his explanation of survivorship bias, O'Reilly *most likely* is:

- A. correct.
- B. incorrect, because survivorship bias results in a downward bias to reported returns.
- C. incorrect, because survivorship bias results in an overly pessimistic view of expected returns.

26. With respect to his explanation of appraisal data bias, O'Reilly *most likely* is:

- A. correct.
- B. incorrect, because the true variance of the asset is biased upward.
- C. incorrect, because calculated correlations with other assets tend to be biased downward in absolute value.

27. With respect to his answer to Brown's question, O'Reilly *most likely* is:

- A. correct.
- B. incorrect, because high-frequency data are less sensitive to asynchronism.
- C. incorrect, because high-frequency data tend to produce lower correlation estimates.

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28. Is O'Reilly's explanation of the anchoring trap *most likely* correct?
- A. Yes.
 - B. No, because the anchoring trap is the tendency to temper forecasts so that they do not appear extreme.
 - C. No, because the anchoring trap is the tendency for the mind to give a disproportionate weight to the first information it receives on a topic.
29. Given the data in Exhibits 1 and 2, the covariance between Market 1 and Market 2 is *closest* to:
- A. 0.0017.
 - B. 0.0225.
 - C. 0.0243.
30. Given O'Reilly's forecasts for the European market, the expected long-term equity return using the Grinold-Kroner model is *closest* to:
- A. 6.35%.
 - B. 7.35%.
 - C. 8.35%.

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Aina Monts Case Scenario

Aina Monts, CFA, is a fixed income portfolio manager at Girona Advisors. She has been awarded the management of a €150 million portfolio for Fondo de Pensiones Lerida, a pension fund based in Barcelona, Spain. The previous manager was fired for underperforming the benchmark by more than 100 basis points in each of the last three years. Lerida's primary objective is to immunize its liabilities, which have a duration of 4.40 years, while achieving a total rate of return in excess of the Barclays Capital U.S. Aggregate Bond Index. The benchmark's duration is currently 4.42 years. At Girona's portfolio review meeting, Monts makes the following statement:

Statement 1: "We will invest the €150 million in a multi-sector portfolio with a yield-to-maturity of 6.75%. This is above Lerida's required rate of return of 6.25%. The duration of the portfolio will be equal to the duration of the liabilities and we will manage the portfolio with an expectation of beating the Barclays Capital U.S. Aggregate Bond Index."

Exhibit 1 presents key characteristics of Lerida's portfolio for the current period and from one year ago. Since rates have shifted over this period, Monts informs Lerida that an additional investment must be made to rebalance the portfolio and reestablish the original dollar duration. Monts plans to rebalance using the existing security proportions.

Exhibit 1
Fondo de Pension Lerida
Portfolio Characteristics

Sector	Market Value (€000's)		Duration (years)	
	One Year Ago	Current	One Year Ago	Current
Treasury	42,000	40,950	5.4	5.0
Mortgage (MBS)	37,000	36,316	3.9	3.7
Corporate "Bullets"	71,000	69,403	4.7	4.5

Monts will rebalance the portfolio by investing in securities that her research group has identified as providing the most attractive total return potential. Sector allocations for her portfolio and the benchmark, are presented in Exhibit 2.

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Exhibit 2
Sector Weightings

	Portfolio			Benchmark		
Sector	% of Portfolio	Duration	Contribution to Spread Duration	% of Portfolio	Duration	Contribution to Spread Duration
Treasury	27.92	5.0	0.00	30.00	3.8	0.00
Mortgage - MBS	24.76	3.7	0.92	22.90	4.0	0.92
Corporate	47.32	4.5	2.13	47.10	5.0	2.37
Total	100.00		3.05	100.00		3.29

Monts also uses security selection in addition to sector rotation as sources of alpha and is evaluating several new trades. At the portfolio review meeting, Monts makes the following statements:

Statement 2: “I am concerned that certain types of securities in the portfolio pose a risk of not providing sufficient cash flow to pay liabilities when they come due. The allocation to mortgage-backed securities in the portfolio, for instance, exposes us to contingent claims risk. We should therefore increase the allocation to non-callable fixed-rate corporate bonds, which do not expose us to contingent claims risk.”

Statement 3: “Our research team anticipates that the credit fundamentals of most issuers will deteriorate over the coming months as the economy contracts. The market consensus is not in line with our view yet and spreads do not reflect the proper valuation.”

Statement 4: “Structural analysis of corporate bonds is a key part of our research process. Given Girona’s view that interest rates are in secular decline, we expect callable bonds to outperform bullets. In the event interest rates rise sharply, put structures will provide investors with some protection.”

31. Based on Monts’ Statement 1, the extension of classical immunization theory that Monts will use to meet Lerida’s investment objective is *best* described as:

- A. contingent immunization.
- B. symmetric cash flow matching.
- C. multiple liability immunization.

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32. Based on Exhibit 1, the cash required to rebalance the Lerida portfolio *is closest* to:
- A. €533,000.
 - B. €3,331,000.
 - C. €12,027,000.
33. Based on the data in Exhibit 2, Mont's positioning of the portfolio would suggest that the sector that poses the *most* tracking error relative to the benchmark is:
- A. treasury.
 - B. mortgage.
 - C. corporate.
34. Is Mont's Statement 2 *mostly likely* correct?
- A. Yes.
 - B. No, she is incorrect about corporate bonds.
 - C. No, she is incorrect about mortgage-backed securities.
35. The strategy that is most likely to benefit from the environment described by Monts in Statement 3 is to:
- A. increase exposure to the crossover sector.
 - B. rotate from consumer non-cyclical to consumer cyclical sectors.
 - C. shift the portfolio's positions to shorter duration corporate bonds.
36. Is Monts' Statement 4 *most likely* correct?
- A. Yes.
 - B. No, because callable bonds would underperform.
 - C. No, because putable bonds would not provide protection.

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Stewart Mink Case Scenario

Stewart Mink manages the interest rate risk for Casford Bank, a small bank operating in the retail and small business market. It is January 1 and Mink is evaluating various exposures of the bank for the coming year. Given the bank's overall interest rate exposure, Mink's primary goal is to protect the bank should interest rates decline but retain the upside should interest rates go up.

Mink is concerned about an upcoming reset on a floating rate loan to Texmaco. Details on the loan and other relevant information are provided in Exhibit 1.

Exhibit 1
Texmaco Loan Information

Face Value	\$60 million
Loan Due Date	One year from now
Rate	180-day LIBOR + 200 bps
Reset frequency	Every six months
Next reset	June 30 th
Current spot 180 day LIBOR	5 percent

He gathers the following information on European style interest rate option contracts that could be used to hedge the Texmaco loan.

Exhibit 2
Information on Interest Rate Options

Notional Amount	\$60 million
Underlying	180-day spot LIBOR
Day count convention	30/360
Call exercise rate	6.0 percent
Call premium	\$100,000
Put exercise rate	4.5 percent
Put premium	\$130,000
Exercise date for both put and call	June 30 th

Mink evaluates a put hedging strategy and a collar hedging strategy. He also examines methods to lower the cost of the collar.

Finally, Mink discusses the collar with Stan Peters, the bank's Chief Financial Officer, who indicates that the board of directors is concerned with potential volatility in the bank's earnings. Peters proposes that Mink initiate a long straddle at exercise rates of 5.0% instead of the collar.

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Mink responds: "I did not use a straddle for the following reasons:

Reason 1: The straddle will not protect against significant decreases in the LIBOR rate.

Reason 2: The straddle is more expensive to implement than the collar."

37. For Mink to achieve his primary goal, he should enter into a:

- A. long put option position with a strike below the current market rate.
- B. short call option position with a strike above the current market rate.
- C. collar with a call strike above the current market rate and a put strike below the current market rate.

38. Based on Exhibits 1 and 2, the effective cost of the put that would hedge the Texmaco loan at the time of its next reset is *closest* to:

- A. \$130,000.
- B. \$134,550.
- C. \$139,100.

39. Given a 180-day spot LIBOR of 6.0% on the June 30th reset date, what is the effective interest rate at the reset of the Texmaco loan, assuming a collar constructed from the loan and the options described in Exhibit 2?

- A. 8.16%
- B. 8.28%
- C. 8.39%

40. For the collar that is constructed from the Texmaco loan and the options described in Exhibit 2, excluding the option premium(s), the rate Casford will receive for the last half of the year will be within the range of:

- A. 4.5 to 6.0%.
- B. 4.5 to 8.0%.
- C. 6.5 to 8.0%.

41. Compared to the collar created from the Texmaco loan and the options described in Exhibit 2, which of the following combination of option exercise rates will provide the lowest cost collar?

	Put	Call
A.	4.0%	5.5%
B.	4.0%	6.5%
C.	5.0%	6.5%

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42. Are Mink's responses to Peters' proposed strategy *most likely* correct?

- A. Yes.
- B. No, because Reason 1 is incorrect.
- C. No, because Reason 2 is incorrect.

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Alan Severn Case Scenario

Alan Severn, a portfolio manager at Morgan Capital, a British institutional asset manager, is meeting the investment committee for Cotswold Industries' pension plan. Cotswold, based in the United Kingdom and a client of Morgan, has traditionally been conservative, and the pension plan's portfolio is currently invested in U.K. stocks and bonds. Cotswold would like to evaluate the addition of a diversified U.S. stock index to the existing portfolio.

In order to help the investment committee with its evaluation, Morgan has provided the data in Exhibit 1.

Exhibit 1
Returns, Standard Deviations and Correlations

Expected Return Current Portfolio (£)	11.5%
Standard Deviation of Returns Current Portfolio (£)	13.5%
Expected Return of US Index (\$)	14.5%
Standard Deviation of Returns of US Index (\$)	16.0%
Correlation of US Index Returns (£) and Current Portfolio Returns (£)	0.65
Expected Percentage Change in Exchange Rate (£/\$)	6.7%
Standard Deviation of Exchange Rate Change (£/\$)	8.5%
Correlation of US Index Returns(\$) and Percentage Exchange Rate Change (£/\$)	0.45

Severn states: "In general, changing the asset allocation to include developed and emerging market international securities to the current portfolio will result in a new efficient frontier of portfolios where each new portfolio will offer higher levels of return but at higher levels of risk, provided the international securities have low correlations with the current portfolio."

James Bruch, a committee member, responds "I think we should not expand our investments to international markets." He elaborates with the following statements:

Statement 1: "Currencies can fluctuate wildly and investing in U.S. stocks exposes us to currency risk which could negatively impact returns, for this reason we should not invest in international markets."

Statement 2: "Because most U.K. companies have an international presence, we should focus on diversifying across different industries in the U.K. and not worry about diversifying globally across different countries."

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Statement 3: "Emerging markets are volatile and expose us to political risks. They are prone to suffering frequent financial crises, and offer no risk diversification benefits during these times because correlations with developed markets such as the U.K increase."

Severn responds to Bruch:

"Currency risk should not prevent us from investing globally. Currency risk can be eliminated by hedging with currency forwards or by diversifying across multiple currencies. Furthermore, the correlations between equity and currency markets are so low that overall currency risk is minimal."

"It is true that emerging markets are subject to periodic crises, but most of the time the crisis does not spread beyond the local region and correlations between emerging and developed markets remain low. Emerging markets are more likely to enjoy superior economic growth and over the years have become more integrated with developed economies. This increased integration with developed markets will result in attractive equity market returns."

43. Based on the information in Exhibit 1, a portfolio with a 70% allocation to the current portfolio and a 30% allocation to the U.S. stock index will have standard deviation of returns that is *closest* to:

- A. 12.4%.
- B. 13.1%.
- C. 14.4%.

44. Based on Exhibit 1, the currency risk contribution of the investment in the U.S. stock index is *closest* to:

- A. 1.9%.
- B. 5.2%.
- C. 8.5%.

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45. Is Severn's statement about changing the asset allocation of the current portfolio accurate?

- A. Yes.
- B. No, he is incorrect about the impact on risk.
- C. No, he is incorrect about the impact on return.

46. In his response to Bruch's Statement 1, Severn is *least likely* correct with respect to:

- A. hedging with currency forwards.
- B. diversifying across multiple currencies.
- C. correlations between equity and currency markets.

47. Is Bruch's recommendation in Statement 2 appropriate?

- A. Yes.
- B. No, because the portfolio is not well diversified internationally.
- C. No, because country correlations are less than industry correlations.

48. In his response to Bruch's Statement 3, Severn is *least likely* correct with respect to:

- A. economic growth and equity returns.
- B. integration and equity market returns.
- C. the spread of crises and market correlations.

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Daksa Kapoor Case Scenario

Daksa Kapoor, CFA, lives in London, where she works as the fixed income portfolio manager for the Cray Investments pension fund. Kapoor's portfolio holds £60 million in U.K. sovereign bonds, £110 in U.K. corporate bonds, and £85 million in U.K. mortgage-backed securities. The duration of this £255 million portfolio is 6.25 years.

The board of directors has established a policy prohibiting investment in any security rated below A by any of the major rating agencies. Recently, a bond held in the portfolio was downgraded to A3 by Moody's. The A3 rating is Moody's lowest A rating. Kapoor is worried about the possibility of another downgrade (to Baa1), which would require an immediate sale with significant transactions costs due to poor liquidity.

Kapoor is considering adding leverage to the portfolio by borrowing £55 million in a two-month repo agreement involving physical delivery of the portfolio's holdings of AAA-rated U.K. sovereign bonds. The duration of this liability is 0.17 years. The proceeds of the repo agreement would be invested in additional U.K. corporate bonds and the resulting £310 million portfolio would have a duration of 5.82 years.

If the repo agreement is not entered into, Kapoor intends to reduce the portfolio's duration to 4.00 years. She is considering using an interest rate futures contract. The futures contract is priced at £97,800 and the duration of the cheapest-to-deliver bond is 8.35 years. The conversion factor for the futures contract is 1.15.

The fixed income portfolio is benchmarked against the U.K. total bond market index. Kapoor has proposed adding non-U.K. bonds to the portfolio. In a presentation to the board of directors, she explains that her goal is to seek excess returns from international bonds. To achieve this goal, she will seek bond markets:

- I: that have the lowest correlations with U.K. bonds; and
- II: whose currencies are expected to appreciate relative to the British pound.

Kapoor is evaluating a £25 million block of German, euro-denominated bonds for possible inclusion in the portfolio. The duration of these bonds is 14.7 years. She has estimated the return correlation between German and U.K. bonds as 0.66 and the German country beta as 0.44.

49. The credit derivative that would *best* mitigate Kapoor's concerns about the A3-rated bond is a:

- A. credit forward.
- B. binary credit option.
- C. credit spread option.

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50. The characteristic of the repurchase agreement considered by Kapoor that would *most likely* increase the repo rate is the:
- A. term.
 - B. collateral.
 - C. delivery requirement.
51. If Kapoor enters into the repo and invests the proceeds as indicated, the duration of the portfolio's equity position will be *closest* to:
- A. 5.65 years.
 - B. 5.99 years.
 - C. 7.04 years.
52. If the interest rate futures contract is used to reduce the interest rate exposure in Kapoor's portfolio, the number of futures contracts that should be sold is *closest* to:
- A. 611.
 - B. 703.
 - C. 808.
53. Which of these statements is *most* accurate regarding Kapoor's two-part approach to achieving excess returns from non-U.K. bonds?
- A. Both parts are appropriate.
 - B. Part I is appropriate, but part II is inappropriate.
 - C. Part I is inappropriate, but part II is appropriate.
54. If U.K. interest rates increase by 50 basis points, the percentage change in the value of the German bonds that Kapoor is evaluating will be *closest* to:
- A. 3.23%.
 - B. 4.85%.
 - C. 6.47%.

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Sing-Siew Lee Case Scenario

Sing-Siew Lee is a senior consultant with Stowe Partners, a firm that provides GIPS compliance and verification services. Lee is preparing to meet with two clients, Orion Advisory Research and Gardere Associates.

Orion Advisory Research

Orion Advisory Research is an investment firm that manages retail and institutional accounts. Orion also manages a private equity fund. Orion has provided information on its measurement and reporting practices in order to help Lee evaluate the firm's compliance with the Global Investment Performance Standards (the GIPS® standards).

Trading Expenses

Commissions are negotiated and deducted when calculating rates of return. For separately managed retail accounts that have bundled fees, the gross return is reduced by the entire amount of the bundled fee. Custody fees for certain off-shore securities are charged on a per-transaction basis and are included in trading expenses.

Asset Valuation

Orion values its investments at the lower of cost or book value. Trade date accounting is used consistently for all transactions. In some cases, transactions may be recorded up to three days after the trade date.

Private Equity

Orion values the private equity fund on an annual basis and presents the following multiples: 1) total value to since-inception paid-in capital, 2) since inception distributions to since-inception paid-in capital, 3) since-inception paid-in capital to cumulative committed capital, and 4) residual value to since-inception paid-in capital. Orion aggregates its various strategies in its composites. The composites are separated by vintage year.

Lee advises Orion's pricing and valuation committee to use the hierarchy of valuation methodologies presented in Exhibit 1 to establish fair values for its investments in private equity.

Exhibit 1
Hierarchy of Private Equity Valuation Methodologies

Methodology	Order	Description
1	Best	Present value of risk adjusted cash flows
2	Next-Best	Market transactions
3	Least Preferred	Market-based multiples

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Gardere Associates

Gardere Associates is an investment fund that directly invests in commercial real estate. Gardere has asked Lee for advice on GIPS compliance. Lee indicates that an important disclosure requirement is presentation of total return, income return and capital return. Lee uses the information presented in Exhibit 2 to illustrate return calculations.

Exhibit 2
Selected Financial Information for Gardere Associates

Item	Date	Amount
Beginning Capital	March 31, 2010	\$12,500,000
Capital Contribution (weight=0.51)	May 15, 2010	\$1,500,000
Portfolio Fair Value	March 31, 2010	\$11,700,000
Portfolio Fair Value	June 30, 2010	\$13,000,000
Capital Expenditures		\$2,700,000
Property Sales Proceeds		\$3,500,000
Earned Investment Income		\$120,000
Non-recoverable Expenses		\$312,000
Interest Expense on Debt		\$220,000
Property Taxes Paid		\$31,000

Prior to issuing his final reports to Orion and Gardere, Lee provides a statement with the following comments regarding the verification reports:

Comment 1: "It is recommended that the verification report cover all periods for which the firm claims GIPS compliance."

Comment 2: "The verification report confirms that the firm's processes and procedures are designed to calculate and present performance results in compliance with the GIPS standards."

Comment 3: "The verification report confirms that Stowe Partners has sole responsibility for maintaining the data and information necessary to perform the required calculations for the client."

55. With regard to trading expenses, Orion is **not** in compliance with GIPS® standards in its treatment of:

- A. custody fees.
- B. bundled fees.
- C. commissions.

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56. Do Orion's policies on asset valuation *most likely* comply with GIPS standards?
- A. Yes.
 - B. No, because valuations should be based on fair value.
 - C. No, because settlement date accounting should be used for all transactions.
57. Orion's private equity disclosure *least likely* meets GIPS standards with respect to the:
- A. use of multiples.
 - B. timing of valuations.
 - C. construction of composites.
58. Does Lee's proposed hierarchy of private equity valuation methodologies in Exhibit 1 *most likely* meet GIPS standards?
- A. Yes.
 - B. No, the correct order of methodologies is 2, 3, 1.
 - C. No, the correct order of methodologies is 3, 2, 1.
59. Based on the information in Exhibit 2, Gardere's total return for the second quarter is *closest* to:
- A. 7.77%.
 - B. 12.53%.
 - C. 14.15%.
60. Which of the comments made by Lee is *not* consistent with GIPS verification standards?
- A. Comment 1.
 - B. Comment 2.
 - C. Comment 3.

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