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Chartered Financial Analyst Level 3

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Topic Break Down

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Topic 1, Ethics	71
Topic 2, Fixed Income Investment	1
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Topic 4, Alternative Assets	114
Topic 5, Quantitative Methods	12
Topic 6, Corporate Finance	1
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QUESTION NO: 1

Smiler Industries is a U.S. manufacturer of machine tools and other capital goods. Dat Ng, the CFO of Smiler, feels strongly that Smiler has a competitive advantage in its risk management practices. With this in mind, Ng hedges many of the risks associated with Smiler's financial transactions, which include those of a financial subsidiary. Ng's knowledge of derivatives is extensive, and he often uses them for hedging and in managing Smiler's considerable investment portfolio.

Smiler has recently completed a sale to Frexa in Italy, and the receivable is denominated in euros. The receivable is €10 million to be received in 90 days. Smiler's bank provides the following information:

Smiler borrows short-term funds to meet expenses on a temporary basis and typically makes semiannual interest payments based on 180-day LIBOR plus a spread of 150 bp. Smiler will need to borrow \$25 million in 90 days to invest in new equipment. To hedge the interest rate risk on the loan, Ng is considering the purchase of a call option on 180-day LIBOR with a term to expiration of 90 days, an exercise rate of 4.8%, and a premium of 0.000943443 of the loan amount. Current 90day LIBOR is 4.8%.

Smiler also has a diversified portfolio of large cap stocks with a current value of \$52,750,000, and Ng wants to lower the beta of the portfolio from its current level of 1.25 to 0.9 using S&P 500 futures which have a multiplier of 250. The S&P 500 is currently 1,050, and the futures contract exhibits a beta of 0.98 to the underlying.

Because Ng intends to replace the short-term LIBOR-based loan with long-term financing, he wants to hedge the risk of a 50 bp change in the market rate of the 20-year bond Smiler will issue in 270 days. The current spread to Treasuries for Smiler's corporate debt is 2.4%. He will use a 270-day, 20-year Treasury bond futures contract (\$100,000 face value) currently priced at 108.5 for the hedge. The CTD bond for the contract has a conversion factor of 1.259 and a dollar duration of \$6,932.53. The corporate bond, if issued today, would have an effective duration of 9.94 and has an expected effective duration at issuance of 9.90 based on a constant spread assumption. A regression of the YTM of 20-year corporate bonds with a rating the same as Smiler's on the YTM of the CTD bond yields a beta of 1.05.

What position should Smiler take to alter the beta of the equity portfolio?

- A. Long 72 futures contracts.
- B. Short 72 futures contracts.
- C. Long 70 futures contracts.

ANSWER: B

Explanation:

The equation to determine the number of contracts and the direction of the trade (long or short) is:

number of contracts =
$$\left(\frac{\beta_{\text{Target}} - \beta_{\text{Current}}}{\beta_{\text{Futures}}} \right) \left(\frac{\text{portfolio value}}{\text{future contract value}} \right)$$
 which in numeric terms is:

$$\left(\frac{0.9 - 1.25}{0.98} \right) \left(\frac{\$52,750,000}{1,050 \times \$250} \right)$$

number of contracts = -71.77; short 72 contracts.

(Study Session 15, LOS 42.a)

QUESTION NO: 2

Cindy Hatcher, CFA, has spent the last ten years as a portfolio manager with Bernhardt Capital. While working for Bernhardt, Hatcher was responsible for maintaining and improving the company's code of ethics and guidelines for ethical money management. As a result of Hatcher's efforts, Bernhardt saw a dramatic decline in the number of complaints received from their individual and institutional customers.

One of Bernhardt's direct competitors, Smith Investments, is keenly aware of Hatcher's reputation for ethical business practices and has offered her a job as their compliance officer. Hatcher has been apprised of several potential ethical problems at Smith that she will be directly responsible for fixing through implementation of policies and procedures that will prevent ethical dilemmas. The management at Smith is willing to grant Hatcher the authority to construct and implement policies to eliminate the ethical problems at the company.

Hatcher agrees to accept the position with Smith and resigns from employment with Bernhardt. As her first initiative with the company, Hatcher distributes to all employees at Smith a survey intended to acquaint her with the company's common business practices. Her goal is to identify those factors that are most likely to interfere with Smith's compliance with the CFA Institute's Code of Ethics and Standards of Practice. After collecting and analyzing the anonymous responses to the survey, Hatcher has identified the following four issues as the most frequently cited questionable business practices:

1. Many Smith employees have relatives who are clients of the firm. For relatives' accounts where the Smith employee does not have beneficial ownership, trades are generally executed in conjunction with trades for other discretionary accounts held at the firm. Only in accounts where the Smith employee has beneficial ownership are trades delayed until all discretionary account trading is completed.
2. Many of Smith's employees either personally own or maintain, through a family member, beneficial ownership of stocks that are also held in accounts for many of the firm's clients. While the company maintains a strict disclosure policy to the firm of such beneficial ownership and an "at will" disclosure policy to its clients, employees are not barred from trading these securities for their personal benefit even if their clients also own or have a direct or indirect financial interest in the same securities.
3. Account managers meet weekly to discuss the issues and concerns of the client portfolios managed at the firm. During the meetings it is not unusual for individual clients to be identified and discussed. Information regarding the client's holdings and investment strategy is discussed as well as personal needs related to the client's portfolio. The meetings are held in order to provide guidance and continuing education to all of the firm's account managers.
4. At the suggestion of fixed-income analysts at the firm, most of the portfolio managers working for Smith have been adding B-rated corporate fixed-income securities to their portfolios. Analysts originally made (and continue to make) the suggestion due to the attractive yield potential offered by this class of investments. Smith's portfolio managers were thrilled with the idea since the returns on many of the portfolios' equity positions have been stifled by high profile accounting scandals.

Management at Smith Investments has been pleased with Hatcher's efforts so far but is concerned about the firm's ability to maintain compliance with the CFA Institute's Global

Investment Performance Standards (GIPS®). The managing director of the firm, Erich Prince, has made the following comments to Hatcher:

"I am concerned that we will not be able to claim compliance with GIPS at the end of the year since our new information system has inhibited our ability to include terminated portfolios in the historical record up to the last full measurement period before they were terminated. Also, we are unable to regroup portfolios that utilize hedging into separate composites from those that do not utilize hedging. These portfolios are currently grouped according to traditional value and growth strategies based on the capitalization of portfolio holdings (i.e., large vs. small)."

Hatcher eases Prince's mind by telling him she will "ensure full compliance with GIPS by the end of the quarter."

Smith's portfolio managers have been adding B-rated corporate fixed-income securities to their portfolios at the recommendation of the firm's fixed-income analysts. With regard to this situation,

Smith's employees have violated the CFA Institute's Code and Standards for which of the following reasons?

- A.** Fixed-income analysts are recommending debt securities that are below an investment grade credit rating.
- B.** Portfolio managers have failed to consider the investment policy statement of each portfolio before adding the fixed-income securities to the portfolios.
- C.** Fixed-income analysts have failed to provide a detailed description of the investment characteristics of the corporate fixed-income securities to the portfolio managers.

ANSWER: B

Explanation:

The portfolio manager's at Smith Investments have violated Standard III (C) Suitability by failing to consider the suitability of the fixed-income investments for each individual portfolio. It is possible that some of the portfolios would meet the requirements to take on the risk of investing in below investment grade bonds but is unlikely that most of the firm's portfolios would have objectives and constraints that would allow below investment grade bonds into the portfolio. (Study Session 1, LOS 2.a)

QUESTION NO: 3

Stephanie Mackley is a portfolio manager for Durango Wealth Management (DWM), a regional money manager catering to wealthy investors in the southwestern portion of the United States. Mackley's clients vary widely in terms of their age, net worth, and investment objectives, but all must have at least \$1 million in net assets before she will accept them as clients.

Many of Mackley's clients are referred to her by Kern & Associates, an accounting and consulting firm. DWM does not provide any direct compensation to Kern & Associates for the referrals, but Mackley's who is the president of her local CFA Society, invites Kern & Associates to give an annual presentation to the society on the subject of tax planning and minimization strategies that Kern & Associates provides for its clients. Kern & Associates' competitors have never received an invitation to present their services to the society. When Mackley receives a referral, she informs the prospect of the arrangement between DWM and Kern & Associates.

DWM maintains a full research staff that analyzes and recommends equity and debt investments. All of the in-house research is provided to the firm's portfolio managers and their clients. In addition, DWM provides a subscription service to outside investors and portfolio managers. Aaron Welch, CFA, a private contractor, researches and reports on high-tech firms in the U.S. and other developed countries for several portfolio management clients. One of his latest reports rated InnerTech Inc., a small startup that develops microscopic surgical devices, as a strong buy. After reviewing the report carefully, Mackley decides to purchase shares of InnerTech for clients with account values over \$6 million. She feels that accounts with less than this amount cannot accept the risk level associated with InnerTech stock.

Two days after purchasing InnerTech for her clients, the stock nearly doubles in value, and the clients are ecstatic about the returns on their portfolios. Several of them give her small bouquets of flowers and boxes of chocolates, which she discloses to her supervisor at DWM. One client even offers her the use of a condo in Vail, Colorado for two weeks during ski season, if she can reproduce the results next quarter. Mackley graciously thanks her clients and asks that they refer any of their friends and relatives who are in need of asset management services. She provides brochures to a few clients who mention that they have friends who would be interested. The brochure contains a description of Mackley's services and her qualifications. At the end of the brochure, Mackley includes her full name followed by "a Chartered Financial Analyst" in bold font of the same size as her name. Following is an excerpt from the brochure:

"DWM can provide many of the investment services you are likely to need. For those services that we do not provide directly, such as estate planning, we have standing relationships with companies that do provide such services. I have a long history with DWM, serving as an investment analyst for six years and then in my current capacity as a portfolio manager for twelve years. My clients have been very satisfied with my past performance and will likely be very satisfied with my future performance, which I attribute to my significant investment experience as well as my participation in the CFA Program. I earned the right to use the CFA designation thirteen years ago. All CFA charter-holders must pass a series of three rigorous examinations that cover investment management and research analysis."

Two weeks later, some of Mackley's clients request that she provide supporting documentation for the research report on InnerTech, so they can familiarize themselves with how DWM analyzes investment opportunities. Mackley asks Welch for the documents, but Welch is unable to provide copies of his supporting research since he disposed of them, according to the company's policy, one week after issuing and distributing the report. Mackley informs Welch that obtaining the supporting documents is of the utmost importance, since one of the clients requesting the materials, Craig Adams, is about to inherit \$20 million and as a result will be one of the firm's most important clients. Welch agrees to recreate the research documents in order to support the firm's relationship with Adams.

Does Mackley's signature at the end of her brochure violate any CFA Institute Standards of Professional Conduct?

- A. No.
- B. Yes, because "a Chartered Financial Analyst" should not be written in bold.
- C. Yes, because "a Chartered Financial Analyst" should not be written in bold and should not include "a."

ANSWER: C

Explanation:

According to Standard V11(B) Reference to CFA Institute, the CFA Designation, and the CFA Program, proper use of the designation would stipulate that CFA and Chartered Financial Analyst always be used as adjectives. Also, the designation may not be written in bold type. (Study Session 1, LOS 1.b)

QUESTION NO: 4

Jacques Lepage, CFA, is a portfolio manager for MontBlanc Securities and holds 4 million shares of AirCon in client portfolios. Lepage issues periodic research reports on AirCon to both discretionary and nondiscretionary accounts. In his October investment report, Lepage stated, "In my opinion, AirCon is entering a phase, which could put it 'in play' as a takeover target. Nonetheless, this possibility appears to be fully reflected in the market value of the stock." One month has passed since Lepage's October report and AirCon has just announced the firm's executive compensation packages, which include stock options (50% of which expire in one year), personal use of corporate aircraft (which can be used in conjunction with paid vacation days), and a modest base salary that constitutes a small proportion of the overall package. While he has not asked, he believes that the directors of MontBlanc will find the compensation excessive and sells the entire position immediately after the news. Unbeknownst to Lepage, three days earlier an announcement was made via Reuters and other financial news services that AirCon had produced record results that were far beyond expectations. Moreover, the firm has

established a dominant position in a promising new market that is expected to generate above-average firm growth for the next five years.

A few weeks after selling the AirCon holdings, Lepage bought 2.5 million shares of Spectra Vision over a period of four days. The typical trading volume of this security is about 1.3 million shares per day, and his purchases drove the price up 9% over the 4-day period. These trades were designated as appropriate for 13 accounts of differing sizes, including performance-based accounts, charitable trusts, and private accounts. The shares were allocated to the accounts on a pro rata basis at the end of each day at the average price for the day.

One of the investment criteria used in evaluating equity holdings is the corporate governance structure of the issuing company. Because Lepage has dealt with this topic extensively, he has been asked to present a talk of corporate governance issues to the firm's portfolio managers and analysts at the next monthly meeting. At the meeting, Lepage makes the following comments: "When evaluating the corporate governance policies of a company, you should begin by assessing the responsibilities of the company's board of directors. In general, the board should have the responsibility to set long-term objectives that are consistent with shareholders' interests. In addition, the board must be responsible for hiring the CEO and setting his or her compensation package such that the CEO's interests are aligned with those of the shareholders. In that way the board can spend its time on matters other than monitoring the CEO. A firm with good corporate governance policies should also have an audit committee made up of independent board members that are experienced in auditing and related legal matters. The audit committee should have full access to the firm's financial statements and the ability to question auditors hired by the committee."

According to the CFA Institute Code and Standards, Lepage's ignorance of AirCon's press release to Reuters three days before he sold shares of the company:

A. constitutes a violation.

B. is not a violation because he does not have access to Reuters at MontBlanc Securities.

C. constitutes a violation because, by trading on the information, Lepage would have traded on information that was already incorporated into the stock price and, thus, would have constituted an unwarranted trade.

ANSWER: A

Explanation:

Under CFA Institute Standard V(A) Diligence and Reasonable Basis, Lepage is required to exercise due diligence and thoroughness. His ignorance of information that is of material (disseminated before Lepage's decision to sell the shares of AirCon) is an obvious violation of the Standard. (Study Session 1, LOS Lb)

QUESTION NO: 5

Cynthia Farmington, CFA, manages the Lewis family's \$600 million securities portfolio. Farmington and the Lewis family have agreed that they should hire a manager of alternative investments to manage a portion of the portfolio containing those assets. As part of the hiring process, they attempted to do the necessary due diligence. They assessed each manager's organization, the relative efficiency of the markets each manager has invested in, the character of each manager, and the service providers, such as lawyers, that each manager has used. In particular, they hoped to find a manager who has run an operation with low employee turnover, has invested in efficient and transparent markets, has sound character, and has utilized reputable providers of external services.

Eventually, Farmington hires the firm owned and managed by Bruce Carnegie, CFA, to diversify the Lewis portfolio into alternative investments. Carnegie will manage the portion of the portfolio containing these assets, and Farmington will continue to manage the remainder of the portfolio in a mix of approximately 50/50 high-grade stocks and bonds. Over the

past ten years, the stock portion of the portfolio has closely tracked the S&P 500 and the bond portfolio has closely tracked a broad bond index.

Carnegie and Farmington meet to discuss how Carnegie should proceed. Farmington mentions that she and the Lewis family have agreed that the main goal of the alternative investments that Carnegie will manage should be to enhance the return of the overall portfolio. Diversification is only a secondary goal. In particular, Farmington says the Lewis family has expressed an interest in having the portfolio take positions in private equity. Farmington says that she envisions that Carnegie should take five positions of about 55 million each in distinct private equity investments, and each position should have about a 5-year horizon.

Farmington states that she has grown very dependent on benchmarks for her investing activities, and has concerns with respect to how she and Carnegie will monitor the success of the portfolio allocation in private equity. She has read that there can be a problem with the valuation of private equity indices in that they depend on price-revealing events like IPOs, mergers, and new financing. Thus, the repricing of the index occurs infrequently. Carnegie concludes that the solution is to follow the commonly accepted practice of creating their own private equity benchmark.

Farmington asks Carnegie to explain the choices that exist in the private equity market. Carnegie explains that there are two basic categories: venture capital funds and buyout funds. Farmington asks that Carnegie explain the pros and cons of one over the other. Carnegie states that buyout funds would probably have higher return potential, fewer losses, earlier cash flows, and less error in the measurement of the returns.

Carnegie comments that before he proceeds he will need to communicate with the clients. Farmington says this communication is not necessary because the Lewis family has largely followed her advice with very few questions. Even when the market has fallen and the portfolio has not done well, the Lewis family has not asked for any changes.

Given that Farmington states that high return is more important than diversification, the choice to focus on private equity is:

- A. not appropriate because private equity offers good diversification, but the returns are comparatively low.
- B. appropriate because private equity offers a high return but relatively low diversification.
- C. appropriate because private equity offers both a high return and good diversification.

ANSWER: B

Explanation:

Historically, private equity returns have generally been higher than stock returns over most periods. Since a source of the return is often associated with IPOs and other market activity, the returns tend to be correlated with stock returns. This lowers the amount of diversification private equity can offer a standard stock and bond portfolio. (Study Session 14, LOS 40.d)

QUESTION NO: 6

Lucy Sakata, CFA and Gary Lowenstein, CFA are portfolio managers for the Murray Funds, a provider of investment funds to institutional and wealthy individual investors. Murray frequently indexes in developed markets, but uses full blown active management in less efficient markets and when they think their analysts have a particular expertise. The vast majority of Murray's clients attempt to minimize tracking error.

One of the Murray's funds invests in a Hong Kong index and is marketed as a way for investors to participate in the growth of the Asian economies. The index represents the best known Hong Kong stocks and Murray uses a full replication strategy for the fund. The index is a market cap-weighted index and ten firms represent over 70% of the index's total market cap. _Sakata would like to market the Hong Kong fund to institutions with a required minimum investment of \$50 million. Many potential

clients are institutions who outsource their foreign equity management and are subject to maximum holdings on individual stocks.

Murray also has a Canada fund that invests in an index which represents the 25 largest cap stocks in Canada. It is marketed as a way for investors to exploit the growth in demand for commodities. The index adjusts for stock splits and repurchases as necessary. Most of the index's return has come from capital gains, rather than dividends, due to the tremendous increase in global demand for commodities. To encourage long-term holding, Murray places a back-end load of 3% on fund redemptions that are made within two years of initial investment.

Sakata and Lowenstein discuss the fundamental law of active management and how it applies to three hypothetical managers who invest against the broad large-cap U.S. market, as represented by the S&P 500 index.

- Manager A under-weights and over-weights the 500 individual stocks of the S&P 500 index as she sees appropriate, keeping industry exposures similar to those of the index. She has an information coefficient of 0.05 and is restricted to long-only positions.
- Manager B holds cash and long S&P 500 futures. He tries to generate excess returns by altering the duration of the cash position and has an information coefficient of 0.05.
- Manager C has an information coefficient of 0.07, and she uses a long-short strategy for the 500 stocks in the S&P 500 index.

Sakata is consulting with the trustees of the Powell Foundation. The foundation has a position in the three Murray funds described in Exhibit 1 below.

Exhibit 1: Powell Foundation Holdings

	Fund 1	Fund 2	Fund 3
Active return	3.30%	1.20%	4.50%
Active risk	5.30%	3.60%	6.70%
Fund size (in millions)	73.1	115.0	89.4
% of Powell Foundation Portfolio	20%	45%	35%
Current manager's tenure	11 years	4 years	16 years
EPS growth for 1 year	-2.3%	2.7%	5.9%
Median market cap (in billions)	\$29.8	\$17.2	\$28.1
P/B ratio	0.87	3.01	4.88
Management fees (% of assets)	0.55%	0.41%	0.79%

Murray has a value fund that invests in stocks in the U.S. Lowenstein is considering several equity style index providers as a benchmark for the fund. The characteristics of the index providers and the methodologies they use to construct equity style indices are described in Exhibit 2 below.

Exhibit 2: Comparison of Index Providers

	Provider A	Provider B
Licensing fee charged to ETF Funds	fixed rate	% of assets under management
Number of variables used to characterize value/growth	Seven	Three
Value/Growth categories	strong value, value, neutral, growth, strong growth	value and growth

In regard to the index providers, Lowenstein makes the following statements:

Statement 1: "I would like to use the indices from either provider in a returns-based style analysis.

Based on the information in the table, I believe that if I regress a value manager's returns against Provider B's indices, the manager's selection return will appear artificially large."

Statement 2: "If an index provider uses buffering rules, a fund tracking that index will experience lower transactions costs."

Determine which of the following is the most likely reason that the Hong Kong fund will be inappropriate for the institutional investors.

- A. Illiquid stocks comprising the index.
- B. The weighting scheme of the index.
- C. The lack of potential excess returns.

ANSWER: B

Explanation:

Many institutional investors may not be able to mimic a value-weighted index, if they are subject to maximum holdings and the index holds concentrated positions. This is the case for the potential clients and the index in this question. Ten firms represent over 70% of the index's total market cap and the index is market cap weighted.

Since they constitute 70% of total market cap, the 10 stocks likely represent large-cap firms and are very liquid. They are also the best known stocks. There is no evidence that the institutional investors demand excess returns (as described in the first paragraph, the vast majority of clients attempt to minimize tracking error), so this response does not represent a valid concern either. (Study Session 11, LOS 33.d)

QUESTION NO: 7

Kim Simpson, CFA, manages a \$75 million multi-cap growth portfolio. Simpson utilizes a growth at a reasonable price (GARP) investment strategy and her investment universe consists of small, medium and large capitalization stocks. She turns the entire portfolio over once each year. Simpson is concerned about the amount of trading costs she has generated through the implementation of her investment strategy. Simpson decides to conduct a trade cost analysis with the cooperation of her trader, Janet Long, CFA. Simpson believes the results of the trading analysis can be used to improve trading performance and help to refine her investment strategy. The first trade they examine is a purchase of 2000 shares of

Technology Company that was completed using a market order. Simpson remembers adding to her Technology Company position based on her analyst's recommendation that the company was going to generate earnings significantly above the consensus estimate in a soon to be released earnings report. The order was split into two trades as shown in Figure 1.

Figure 1: Technology Company buy order for 2000 shares

<i>Shares Purchased</i>	<i>Purchase Price</i>	<i>Ask Size</i>	<i>Ask Price</i>	<i>Bid Size</i>	<i>Bid Price</i>
700	\$79.25	700	\$79.25	900	\$79.00
1,300	\$80.00	800	\$80.10	1,100	\$79.75

In conducting a comprehensive analysis of the trading markets, Simpson states that she is most concerned about market liquidity. Simpson defines a market with good liquidity as one with diversity of opinion, many buyers/sellers and relatively wide bid-ask spreads. In addition to reviewing market liquidity, Simpson believes that, in order to assess market quality, both the ease with which investors can obtain accurate information and the certainty that a trade will be completed must be evaluated.

Simpson and Long review their trade of Nano Corporation, a small biotechnology company. Simpson used a limit order because her analyst had established a specific buy target and she wanted to hold down transaction costs. To handle both explicit and implicit trading costs, Simpson measures execution costs using implementation shortfall. The buy order for 100,000 shares of Nano stock has the following timeline:

- Nano stock price closes at \$35.00 per share.
- Day one: Simpson places a limit order for 100,000 shares of Nano stock at \$34.75 per share or better at the opening of trading. However, Nano's stock never falls below \$35.00 per share and closes at \$36.50 per share.
- Day two: Simpson adjusts her limit order price to \$37.00 per share or better. Long is able to fill 50,000 shares of the order at \$36.75 per share. Nano's stock climbs to \$38.00 per share during the day and Simpson moves the limit price to \$40.00 per share or better. Long completes the purchase of the remaining 50,000 shares of Nano at \$40.00 per share, which is also the closing price of Nano's stock.
- The commission for each block trade is \$2,500.

Long suggests implementing the Best Execution concept as established by the CFA Institute in its Trade Management Guidelines. Long states best execution would accept a high portfolio turnover strategy provided the overall portfolio value is greater after trading costs. Long asserts that her professional relationships are integral to best execution.

Which one of the following trader motivations best describe the Technology Company trade?

- A. Information-motivated.
- B. Value-motivated.
- C. Liquidity-motivated.

ANSWER: A

Explanation:

The Technology Company trade was based on information-motivated trading. Simpson's analyst obtained some piece of information that motivated her to have Simpson acquire more shares of Technology Company. Simpson quickly executed the order through a market order. (Study Session 16, LOS 45.j)

QUESTION NO: 8 - (SIMULATION)

SIMULATION

In 1955, David Peebles, founder of the successful California-based Peebles Winery, set up the Tokay Endowment. The Tokay Endowment was established to attract talented individuals to the wine industry and to encourage research designed to produce California grapes that would be competitive with those produced in France. The initial \$1 million contribution has grown to \$75 million. Peebles' grandson was recently given responsibility for management of the endowment. He believes the endowment's asset mix needs to be updated to reflect the alternative investments of hedge funds, managed futures, and private equity. The private equity investment will be an indirect investment using middle-market buyout funds (labeled "buyout funds" in the exhibits below). The endowment currently has 60% invested in equities and 40% in bonds. The endowment must maintain a 50% equity weighting and the grandson wants to invest 20% of total assets in the alternative investment category.

Exhibit 1: Returns and Standard Deviation for the Most Recent 10-year Period

	<i>Annualized Return</i>	<i>Standard Deviation</i>
Tokay equities	9.8%	14.9%
Tokay bonds	6.9%	4.3%
Buyout funds	13.9%	15.2%
Hedge funds	14.6%	7.1%
Managed futures	12.5%	11.9%

Exhibit 2: Correlations for the Most Recent 10-year Period

	<i>Tokay Equities</i>	<i>Tokay Bonds</i>	<i>Buyout Funds</i>	<i>Hedge Funds</i>	<i>Managed Futures</i>
Tokay equities	1.00				
Tokay bonds	0.37	1.00			
Buyout funds	0.86	0.28	1.00		
Hedge funds	0.70	0.01	0.45	1.00	
Managed futures	0.02	0.10	-0.04	-0.14	1.00

A trusted financial advisor recommended investing in hedge funds rather than managed futures because hedge funds offer a better risk/return profile.

Discuss two reasons managed futures should be added to Tokay's Endowment portfolio.

ANSWER: See explanation below

Explanation:

3 points for each:

1. For the exam;

Positively correlated with positive stock returns (1 point) and negatively correlated with negative stock returns (2 points).

Discussion:

Managed futures may perform best when Tokays stock and bond investments are performing relatively poorly. Academic research suggests that historically when stocks and bonds have significant negative returns, the returns of managed futures are positive. In addition, managed futures have positive correlation with stocks and bonds when they report positive returns.

2. For the exam:

Very liquid (2 points) and provide leverage (1 point).

Discussion:

Managed futures provide Tokay Endowment the opportunity to swiftly respond to major price movements either upward or downward in the financial and commodity markets. The transaction does not require liquidation of other investment holdings or adding to overall portfolio risk, but the investment is highly leveraged.

QUESTION NO: 9

Jacques Lepage, CFA, is a portfolio manager for MontBlanc Securities and holds 4 million shares of AirCon in client portfolios. Lepage issues periodic research reports on AirCon to both discretionary and nondiscretionary accounts. In his October investment report, Lepage stated, "In my opinion, AirCon is entering a phase, which could put it 'in play' as a

takeover target. Nonetheless, this possibility appears to be fully reflected in the market value of the stock." One month has passed since Lepage's October report and AirCon has just announced the firm's executive compensation packages, which include stock options (50% of which expire in one year), personal use of corporate aircraft (which can be used in conjunction with paid vacation days), and a modest base salary that constitutes a small proportion of the overall package. While he has not asked, he believes that the directors of MontBlanc will find the compensation excessive and sells the entire position immediately after the news. Unbeknownst to Lepage, three days earlier an announcement was made via Reuters and other financial news services that AirCon had produced record results that were far beyond expectations. Moreover, the firm has established a dominant position in a promising new market that is expected to generate above-average firm growth for the next five years.

A few weeks after selling the AirCon holdings, Lepage bought 2.5 million shares of Spectra Vision over a period of four days. The typical trading volume of this security is about 1.3 million shares per day, and his purchases drove the price up 9% over the 4-day period. These trades were designated as appropriate for 13 accounts of differing sizes, including performance-based accounts, charitable trusts, and private accounts. The shares were allocated to the accounts on a pro rata basis at the end of each day at the average price for the day.

One of the investment criteria used in evaluating equity holdings is the corporate governance structure of the issuing company. Because Lepage has dealt with this topic extensively, he has been asked to present a talk of corporate governance issues to the firm's portfolio managers and analysts at the next monthly meeting. At the meeting, Lepage makes the following comments: "When evaluating the corporate governance policies of a company, you should begin by assessing the responsibilities of the company's board of directors. In general, the board should have the responsibility to set long-term objectives that are consistent with shareholders' interests. In addition, the board must be responsible for hiring the CEO and setting his or her compensation package such that the CEO's interests are aligned with those of the shareholders. In that way the board can spend its time on matters other than monitoring the CEO. A firm with good corporate governance policies should also have an audit committee made up of independent board members that are experienced in auditing and related legal matters. The audit committee should have full access to the firm's financial statements and the ability to question auditors hired by the committee."

Determine whether Lepage's statements in his presentation to MontBlanc's portfolio managers and analysts regarding the responsibilities of the board of directors and the audit committee are correct or incorrect.

- A. Only the statement regarding the board is correct.
- B. Only the statement regarding the audit committee is correct.
- C. Both statements are correct or both statements are incorrect.

ANSWER: B

Explanation:

Lepage's first statement is incorrect- While it is a noble goal for a board to structure management compensation packages to align the managers' interests with those of the shareholders, best practices in corporate governance dictate that the board must continue to evaluate the effectiveness of management in managing the firm in accordance with shareholders' interests.

Lepage's second statement is correct. Good corporate governance practices provide the audit committee independence from firm management and the authority to hire an auditor and scrutinize the auditor's work, including any financial statements produced internally. (Study Session 1, LOS

1.b)

QUESTION NO: 10

Shirley Riley, CFA, has just been promoted, from vice president of trading to chief investment officer (CIO) at Crane & Associates, LLC (CA), a large investment management firm. Riley has been with CA for eight years, but she has much to learn as she assumes her new duties as CIO. Riley has decided to hire Denny Simpson, CFA, as the new compliance officer for CA. Riley and Simpson have been reviewing procedures and policies throughout the firm and have discovered several potential issues. **Communications with Clients**

Portfolio managers are encouraged to communicate with clients on a regular basis. At a minimum, managers are expected to contact clients on a quarterly basis to review portfolio performance. Each client must have an investment policy statement (IPS) created when their account is opened, specifying the objectives and constraints for their portfolio. IPSs are reviewed at client request at any time. Any time market conditions dictate a change in the investment style or strategy of a client portfolio, the client is notified immediately by phone or email.

Employee Incentive Program

CA offers several incentive programs to employees. One of the most popular of these programs is the CA IPO program. Whenever CA is involved in an initial public offering (IPO), portfolio managers are allowed to participate. The structure is simple—for every 100 shares purchased on behalf of a client, the manager is awarded five shares for his own account. The manager is thus rewarded for getting an IPO sold and at the same time is able to share in the results of the IPO. Any-time shares are remaining 72 hours before the IPO goes public, other employees are allowed to participate on a first-come, first-serve basis. Employees seem to appreciate this opportunity, but CA does not have exact numbers on employee participation in the program.

Private Equity Fund

CA has a private equity fund that is internally managed. This fund is made available only to clients with more than \$5 million in assets managed by CA, a policy that is fully disclosed in CA's marketing materials. Roughly one-third of the fund's assets are invested in companies that are either very small capitalization or thinly traded (or both). The pricing of these securities for monthly account statements is often difficult. CA support staff get information from different sources— sometimes using third party services, sometimes using CA valuation models. In some instances, a manager of the private equity fund will enter an order during the last trading hour of the month to purchase 100 shares of one of these small securities at a modest premium to the last trade price. If the trade gets executed, that price can then be used on the account statements. The small size of these trades does not significantly affect the fund's overall position in any particular company holding, which is typically several thousand shares.

Soft Dollar Usage

Several different managers at CA use independent research in developing investment ideas. One of the more popular research services among CA managers is "Beneath the Numbers (BTN)," which focuses on potential accounting abuses at prominent companies. This service often provides early warnings of problems with a stock, allowing CA managers the opportunity to sell their clients' positions before a negative surprise lowers the price. Stocks covered by BTN are typically widely held in CA client accounts. Managers at CA have been so happy with BTN that they have also subscribed to a new research product provided by the same authors—"Beneath the Radar (BTR)." BTR recommends small capitalization securities that are not large enough to attract much attention from large institutional investors. The results of BTR's recommendations are mixed thus far, but CA managers are willing to be patient.

As they discuss these issues, Riley informs Simpson that she is determined to bring CA into full compliance with the CFA Institute's "Asset Manager Code of Professional Conduct." The following questions should be answered with the Asset Manager Code as a guide.

Trading stocks during the last trading hour of a month to establish a fair market price:

- A.** does not violate the Asset Manager Code of Professional Conduct.
- B.** is acceptable so long as the trade is not material relative to the overall CA position in the security.
- C.** is not consistent with the Asset Manager Code of Professional Conduct.

ANSWER: C

Explanation:

This type of trading is clearly market manipulation. Even though the 100 shares may be insignificant, the trade sets the price for the entire position. Such trades, especially entered as buy orders, are an unethical attempt to manipulate prices higher and justify a higher return for the period. However, even a sell transaction made under similar circumstances would be market manipulation. (Study Session 2, LOS 6.b)

QUESTION NO: 11

Geneva Management (GenM) selects long-only and long-short portfolio managers to develop asset allocation recommendations for their institutional clients.

GenM Advisor Marcus Reinhart recently examined the holdings of one of GenM's long-only portfolios actively managed by Jamison Kiley. Reinhart compiled the holdings for two consecutive non-overlapping five year periods. The Morningstar Style Boxes for the two periods for Kiley's portfolio are provided in Exhibits 1 and 2.

Exhibit 1: Morningstar Style Box: Long-Only Manager for Five-Year Period 1

	Value	Blend	Growth
Large-cap	20	30	40
Mid-cap	2	3	5
Small-cap	0	0	0

Exhibit 2: Morningstar Style Box: Long-Only Manager for Five-Year Period 2

	Value	Blend	Growth
Large-cap	45	30	20
Mid-cap	1	2	2
Small-cap	0	0	0

Reinhart contends that the holdings-based analysis might be flawed because Kiley's portfolio holdings are known only at the end of each quarter. Portfolio holdings at the end of the reporting period might misrepresent the portfolio's average composition. To compliment his holdings-based analysis, Reinhart also conducts a returns-based style analysis on Kiley's portfolio. Reinhart selects four benchmarks:

1. SCV: a small-cap value index.
2. SCG: a small-cap growth index.
3. LCV: a large-cap value index.
4. LCG: a large-cap growth index.

Using the benchmarks, Reinhart obtains the following regression results:

$$\text{Period 1: } R_p = 0.02 + 0.01(\text{SCV}) + 0.02(\text{SCG}) + 0.36(\text{LCV}) + 0.61(\text{LCG})$$

Period 2: $R_p = 0.02 + 0.01(SCV) + 0.02(SCG) + 0.60(LCV) + 0.38(LCG)$

Kiley's long-only portfolio is benchmarked against the S&P 500 Index. The Index's current sector allocations are shown in Exhibit 3.

Exhibit 3: S&P 500 Index Sector Allocations

Sector	Percent Allocation
Energy	12
Materials	3
Industrials	11
Consumer Discretionary	9
Consumer Staples	10
Health Care	12
Financials	19
Information Technology	17
Telecommunications	4
Utilities	3

GenM strives to select managers whose correlation between forecast alphas and realized alphas has been fairly high, and to allocate funds across managers in order to achieve alpha and beta separation. GenM gives Reinhart a mandate to pursue a core-satellite strategy with a small number of satellites each focusing on a relatively few number of securities.

In response to the core-satellite mandate, Reinhart explains that a Completeness Fund approach offers two advantages:

Advantage 1: The Completeness Fund approach is designed to capture the stock selecting ability of the active manager, while matching the overall portfolio's risk to its benchmark.

Advantage 2: The Completeness Fund approach allows the Fund to fully capture the value added from active managers by eliminating misfit risk.

Reinhart is concerned that the portfolio managed by Kiley has style drift. Is Reinhart's concern supported by either holdings-based style analysis or returns-based style analysis?

- A. Only the holdings-based style analysis supports style drift.
- B. Only the returns-based style analysis supports style drift.
- C. Both approaches support style drift.

ANSWER: C

Explanation:

The change in allocations in Exhibits 1 and 2 indicate large changes in investment style.

Allocations moved from a growth-oriented style in the first 5-year period to a value-oriented style in the second 5-year period. The returns based analysis confirms these findings—the slopes changed markedly for LCV (large increase in the second 5-year period) and LCG (large decrease in the second 5-year period). (Study Session 11, LOS 33.i,k)

QUESTION NO: 12

Milson Investment Advisors (MIA) specializes in managing fixed income portfolios for institutional clients. Many of MIA's clients are able to take on substantial portfolio risk and therefore the firm's funds invest in all credit qualities and in international markets. Among its investments, MIA currently holds positions in the debt of Worth Inc., Enertech Company, and SBK Company. Worth Inc. is a heavy equipment manufacturer in Germany. The company finances a significant amount of its fixed assets using bonds. Worth's current debt outstanding is in the form of noncallable bonds issued two years ago at a coupon rate of 7.2% and a maturity of 15 years. Worth expects German interest rates to decline by as much as 200 basis points (bps) over the next year and would like to take advantage of the decline. The company has decided to enter into a 2-year interest rate swap with semiannual payments, a swap rate of 5.8%, and a floating rate based on 6month EURIBOR. The duration of the fixed side of the swap is 1.2. Analysts at MIA have made the following comments regarding Worth's swap plan:

- "The duration of the swap from the perspective of Worth is 0.95."
- "By entering into the swap, the duration of Worth's long-term liabilities will become smaller, causing the value of the firm's equity to become more sensitive to changes in interest rates." Enertech Company is a U.S.-based provider of electricity and natural gas. The company uses a large proportion of floating rate notes to finance its operations. The current interest rate on Enertech's floating rate notes, based on 6-month LIBOR plus 150bp, is 5.5%. To hedge its interest rate risk, Enertech has decided to enter into a long interest rate collar. The cap and the floor of the collar have maturities of two years, with settlement dates (in arrears) every six months. The strike rate for the cap is 5.5% and for the floor is 4.5%, based on 6-month LIBOR, which is forecast to be 5.2%, 6.1%, 4.1%, and 3.8%, in 6, 12, 18, and 24 months, respectively. Each settlement period consists of 180 days. Analysts at MIA are interested in assessing the attributes of the collar. SBK Company builds oil tankers and other large ships in Norway. The firm has several long-term bond issues outstanding with fixed interest rates ranging from 5.0% to 7.5% and maturities ranging from 5 to 12 years. Several years ago, SBK took the pay floating side of a semi-annual settlement swap with a rate of 6.0%, a floating rate based on LIBOR, and a tenor of eight years. The firm now believes interest rates may increase in 6 months, but is not 100% confident in this assumption. To hedge the risk of an interest rate increase, given its interest rate uncertainty, the firm has sold a payer interest rate swaption with a maturity of 6 months, an underlying swap rate of 6.0%, and a floating rate based on LIBOR.

MIA is considering investing in the debt of Rio Corp, a Brazilian energy company. The investment would be in Rio's floating rate notes, currently paying a coupon of 8.0%. MIA's economists are forecasting an interest rate decline in Brazil over the short term.

Which of the following is closest to the payoff on Enertech's collar 24 months from now? Enertech will:

- A. make a payment of \$0.0020 per dollar of notional principal.
- B. make a payment of \$0.0035 per dollar of notional principal.
- C. will receive a payment of \$0.0035 per dollar of notional principal.

ANSWER: A**Explanation:**

In a long interest rate collar, the firm purchases an interest rate cap and sells an interest rate floor, locking in a range of interest rates that the firm will pay. This position is frequently taken by borrowers with floating rate debt. The firm can manage its cash flow risk within the effective range of interest rates defined by the collar. If the underlying interest rate rises above the cap strike rate, the cap payoff to the borrower (purchaser of the cap) will mitigate the higher interest payments on the firm's debt. If the underlying interest rate falls below the floor strike, the borrower (seller of the floor) will make a payment which will offset the decrease in interest payments on the firm's debt. The payoff is made in arrears, so for Enertech's collar, the caplet and floorlet that expire in 18 months would payoff (if they were in the money at 18 months) in 24 months. Thus, to determine the payoff from the collar that occurs in 24 months, we must determine whether the cap or the floor is in the money at the 18th month. In the vignette, LIBOR is expected to be 4.1% in 18 months. This is below the floor strike of 4.5%. Therefore, Enertech will need to make a payment calculated as follows:

$$\begin{aligned} \text{floor payoff} &= \text{notional principal} \times \left[\max(\text{strike rate} - \text{actual rate}, 0) \left(\frac{\text{days in period}}{360} \right) \right] \\ &= \text{notional principal} \times \left[\max(0.045 - 0.041, 0) \left(\frac{180}{360} \right) \right] \\ &= \text{notional principal} \times [0.002] \end{aligned}$$

Enertech will need to make a payment equal to \$0,002 per dollar of notional principal (Study Session 15, LOS 43x)

QUESTION NO: 13

Joan Nicholson, CFA, and Kim Fluellen, CFA, sit on the risk management committee for Thomasville Asset Management. Although Thomasville manages the majority of its investable assets, it also utilizes outside firms for special situations such as market neutral and convertible arbitrage strategies. Thomasville has hired a hedge fund, Boston Advisors, for both of these strategies. The managers for the Boston Advisors funds are Frank Amato, CFA, and Joseph Garvin, CFA. Amato uses a market neutral strategy and has generated a return of \$20 million this year on the \$100 million Thomasville has invested with him. Garvin uses a convertible arbitrage strategy and has lost \$15 million this year on the \$200 million Thomasville has invested with him, with most of the loss coming in the last quarter of the year. Thomasville pays each outside manager an incentive fee of 20% on profits. During the risk management committee meeting Nicholson evaluates the characteristics of the arrangement with Boston Advisors. Nicholson states that the asymmetric nature of Thomasville's contract with Boston Advisors creates adverse consequences for Thomasville's net profits and that the compensation contract resembles a put option owned by Boston Advisors.

Upon request, Fluellen provides a risk assessment for the firm's large cap growth portfolio using a monthly dollar VAR. To do so, Fluellen obtains the following statistics from the fund manager. The value of the fund is \$80 million and has an annual expected return of 14.4%. The annual standard deviation of returns is 21.50%. Assuming a standard normal distribution, 5% of the potential portfolio values are 1.65 standard deviations below the expected return.

Thomasville periodically engages in options trading for hedging purposes or when they believe that options are mispriced. One of their positions is a long position in a call option for Moffett Corporation. The option is a European option with a 3-month maturity. The underlying stock price is \$27 and the strike price of the option is \$25. The option sells for \$2.86. Thomasville has also sold a put on the stock of the McNeill Corporation. The option is an American option with a 2-month maturity. The underlying stock price is \$52 and the strike price of the option is \$55. The option sells for \$3.82. Fluellen assesses the credit risk of these options to Thomasville and states that the current credit risk of the Moffett option is \$2.86 and the current credit risk of the McNeill option is \$3.82.

Thomasville also uses options quite heavily in their Special Strategies Portfolio. This portfolio seeks to exploit mispriced assets using the leverage provided by options contracts. Although this fund has achieved some spectacular returns, it has also produced some rather large losses on days of high market volatility. Nicholson has calculated a 5% VAR for the fund at \$13.9 million. In most years, the fund has produced losses exceeding \$13.9 million in 13 of the 250 trading days in a year, on average. Nicholson is concerned about the accuracy of the estimated VAR because when the losses exceed \$13.9 million, they are typically much greater than \$13.9 million. In addition to using options, Thomasville also uses swap contracts for hedging interest rate risk and currency exposures. Fluellen has been assigned the task of evaluating the credit risk of these contracts. The characteristics of the swap contracts Thomasville uses are shown in Figure 1.

Fluellen later is asked to describe credit risk in general to the risk management committee. She states that cross-default provisions generally protect a creditor because they prevent a debtor from declaring immediate default on the obligation owed to the creditor when the debtor defaults on other obligations. Fluellen also states that credit risk and credit VAR can be quickly calculated because bond rating firms provide extensive data on the defaults for investment grade and junk grade corporate debt at reasonable prices.

Regarding Fluellen's comments on the credit risk of the Moffett and McNeill options:

- A. Fluellen is only correct regarding the Moffett option.
- B. Fluellen is only correct regarding the McNeill option.
- C. Fluellen is incorrect regarding both the Moffett and McNeill options.

ANSWER: C

Explanation:

Fluellen is incorrect regarding the Moffett option. There is no current credit risk of this option because it is a European option and cannot be exercised until maturity. It only has potential credit risk (i.e., the risk of non-payment at maturity, at which time the value of the option will likely be different than its current value). However, it would be correct to say that the current value of the potential credit risk is its current market value, which is the \$2.86.

Fluellen is incorrect regarding the McNeill option. There is no credit risk in an option to the seller (Thomasville). Once the option is sold, it is the buyer of the option that faces the risk that the seller will not honor the contract. That is, once the seller receives the option premium when the option is sold, the option seller has no other payments due to them. (Study Session 14, LOS 40.i)

QUESTION NO: 14

International Opportunity Investors (IOI) manages substantial euro-priced equity portfolios for two

U.S.-based investors, Mark Taylor and Cindy Amsler. Taylor and Amsler have invested in European stocks because of recent media reports suggesting that, due to continued interest rate increases in the United States, European stocks will outperform U.S. stocks over the next few years. Their portfolios are well diversified and similar to the local index portfolio in capitalization weightings.

Ted Tavinsky, IOI's portfolio manager asks his assistant, Tim Treblehorn, to review the relationship between international asset returns and the level of currency risk assumed when investing in foreign securities. The findings, Tavinsky believes, will prove useful in marketing the fund to North American investors. Treblehorn relays two fundamental conclusions to Taylor. First, correlations between international markets have been increasing, and the result has been reduced diversification benefits for international investors. Second, currency risk is typically less than half that of foreign stock risk, but the actual risk assumed is much lower because currency returns and stock returns are not perfectly positively correlated.

Taylor however is very concerned that the U.S. downturn may spread to the global economy. He states that he would like to explore the possibility of investing in the BRIC countries (Brazil, Russia, India, and China). Tavinsky replies that the prospects for the BRIC countries are quite good. Relative to the current G6 countries (U.S., Japan, U.K., Germany, France, and Italy), the stronger economic growth for emerging markets should result in higher stock returns.

Furthermore, the increased growth in these markets will increase the demand for capital, which should strengthen their currency values.

Amsler is a novice investor and has hesitantly invested in the overseas markets. In order to calm her fears, Tavinsky and Treblehorn investigate the possibility of hedging using futures contracts on an equity index as well as a euro forward contract. They have chosen futures contracts written on the Eurostoxx equity index for her portfolio because the price changes of the contract have a high correlation with the returns on Amsler's equity portfolio. Amsler's equity portfolio has a market value of €15,000,000 and a beta of 1.15 relative to the local underlying index.

Tavinsky and Treblehorn collect data for spot exchange rates, futures contract prices and betas, as well as U.S. and European interest rates. Tavinsky and Treblehorn are bearish on the European stock market over the next year as noted by their forecasted return for it.

Spot U.S. dollar / euro exchange rate	\$1.05
One year risk-free rate in Europe	2%
One year risk-free rate in the United States	4%
Price of futures contract written on the Eurostoxx equity index	€120,000
Beta of futures contract written on the Eurostoxx equity index, relative to the local underlying index	0.975
Forecasted return of the local underlying index over one year	-12%
Forecasted spot U.S. dollar/ exchange rate in one year	\$1.12

Tavinsky has told Amsler that he and Treblehorn will calculate the value of her portfolio in hedged and unhedged scenarios. Tavinsky states that if, at the beginning of the year, he were to fully hedge the systematic risk of Amsler's equity portfolio using the index futures, the appropriate futures position to accomplish this would be 125 contracts. Treblehorn states that if they decide to hedge the currency risk of the portfolio as well, the principal for the forward contract that will hedge the currency risk of the hedged equity position will be €15,000,000, using a "hedging the principal" strategy.

Lastly, Tavinsky and Treblehorn calculate the forecasted return on the portfolio assuming that currency risk is hedged. Assuming that both equity and currency risk are hedged, Tavinsky calculates that the dollar return would be 8.8%. Treblehorn states that the forecasted spot U.S. dollar / euro exchange rate in one year of \$1.12 should be used for the forward contract rate.

Assuming a futures position based on the expected exchange rate in one year turns out to be a perfect hedge and the currency risk is not hedged, the dollar return on the Amsler equity portfolio is closest to:

- A. a 9% gain.
- B. an 11% gain.

C. a 7% loss.

ANSWER: A

Explanation:

If the futures position was a perfect hedge, the euro rate of return on the equity portfolio will be the local risk-free rate of 2%. This would translate into an ending portfolio value of €15,300,000. The dollar equivalent of that portfolio would be (€15,300,000) (\$1.12 / €) = \$17,136,000, which is an 8.8% return (\$17,136,000 / \$15,750,000 - 1).

QUESTION NO: 15

Sue Gano and Tony Cismesia are performance analysts for the Barth Group. Barth provides consulting and compliance verification for investment firms wishing to adhere to the Global Investment Performance Standards (GIPS®). The firm also provides global performance evaluation and attribution services for portfolio managers. Barth recommends the use of GIPS to its clients due to its prominence as the standard for investment performance presentation. One of the Barth Group's clients, Nigel Investment Advisors, has a composite that specializes in exploiting the results of academic research. This Contrarian composite goes long "loser" stocks and short "winner" stocks. The "loser" stocks are those that have experienced severe price declines over the past three years, while the "winner" stocks are those that have had a tremendous surge in price over the past three years. The Contrarian composite has a mixed record of success and is rather small. It contains only four portfolios. Gano and Cismesia debate the requirements for the Contrarian composite under the Global Investment Performance Standards.

The Global Equity Growth composite of Nigel Investment Advisors invests in growth stocks internationally, and is tilted when appropriate to small cap stocks. One of Nigel's clients in the Global Equity Growth composite is Cypress University. The university has recently decided that it would like to implement ethical investing criteria in its endowment holdings. Specifically, Cypress does not want to hold the stocks from any countries that are deemed as human rights violators.

Cypress has notified Nigel of the change, but Nigel does not hold any stocks in these countries.

Gano is concerned that this restriction may limit investment manager freedom going forward. Gano and Cismesia are discussing the valuation and return calculation principles for both portfolios and composites, which they believe have changed over time. In order to standardize the manner in which investment firms calculate and present performance to clients, Gano states that GIPS require the following:

Statement 1: The valuation of portfolios must be based on market values and not book values or cost. Portfolio valuations must be quarterly for all periods prior to January 1, 2001. Monthly portfolio valuations and returns are required for periods between January 1, 2001 and January 1, 2010.

Statement 2: Composites are groups of portfolios that represent a specific investment strategy or objective. A definition of them must be made available upon request. Because composites are based on portfolio valuation, the monthly requirement for return calculation also applies to composites for periods between January 1, 2001 and January 1, 2010.

The manager of the Global Equity Growth composite has a benchmark that is fully hedged against currency risk. Because the manager is confident in his forecasting of currency values, the manager does not hedge to the extent that the benchmark does. In addition to the Global Equity Growth composite, Nigel Investment Advisors has a second investment manager that specializes in global equity. The funds under her management constitute the Emerging Markets Equity composite. The benchmark for the Emerging Markets Equity composite is not hedged against currency risk. The manager of the Emerging Markets Equity composite does not hedge due to the difficulty in finding currency hedges for thinly traded emerging market currencies. The manager focuses on security selection in these markets and does not try to time the country markets differently from the benchmark.

The manager of the Emerging Markets Equity composite would like to add frontier markets such as Bulgaria, Kenya, Oman, and Vietnam to their composite, with a 20% weight- The manager is attracted to frontier markets because, compared to emerging markets, frontier markets have much higher expected returns and lower correlations. Frontier markets, however, also have lower liquidity and higher risk. As a result, the manager proposes that the benchmark be changed from one reflecting only emerging markets to one that reflects both emerging and frontier markets. The date of the change and the reason for the change will be provided in the footnotes to the performance presentation. The manager reasons that by doing so, the potential investor can accurately assess the relative performance of the composite over time.

Cismesia would like to explore the performance of the Emerging Markets Equity composite over the past two years. To do so, he determines the excess return each period and then compounds the excess return over the two years to arrive at a total two-year excess return. For the attribution analysis, he calculates the security selection effect, the market allocation effect, and the currency allocation effect each year. He then adds all the yearly security selection effects together to arrive at the total security selection effect. He repeats this process for the market allocation effect and the currency allocation effect.

Which of the following best describes Cismesia's calculation of the two-year excess return and two-year attribution analysis for the Emerging Markets Equity composite?

- A. The calculations for both the excess return and attribution analysis are correct.
- B. The calculations for both the excess return and attribution analysis are incorrect.
- C. The calculations for the excess return are correct but the calculations for the attribution analysis are incorrect.

ANSWER: B

Explanation:

To perform a multi-year excess return calculation, one cannot simply add or compound the excess returns over all years. Instead, the excess return in the first period must be compounded at the benchmark return for the second period. The excess return in the second period must be compounded at the portfolio return for the first period. These are then added together. The same is true for multi-year attribution analysis and the calculation of each attribute's contribution over all years. (Study Session 17, LOS 48.e)