

# UpperMark™ Study Handbook

CAIA® Level I

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Volume 1

Topic 1: CAIA Ethical Principles

Topic 2: Introduction to Alternative Investments



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It is recommended that candidates use any exam preparation product together with the original CAIA curriculum readings.<sup>1</sup>

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# Preface

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UpperMark, Inc. is a leading provider of study materials for the Chartered Alternative Investment Analyst (CAIA) Association®, the sponsoring body of the CAIA<sup>SM</sup> designation. Our company mission is to provide the highest quality study products and services to assist CAIA candidates in their successful preparation for the CAIA exams. Our goal is to enhance individual study efforts and help clients make the most of their valuable time. We design our products to cover the CAIA curriculum material thoroughly, and we revise them for each CAIA exam to accommodate curriculum changes.

The CAIA Level I curriculum is composed of eight Topics based on the reading materials in the *CAIA Level I 2026 Curriculum*.

The CAIA Level I exam is composed of two sets of 100 multiple-choice questions. Additional information on the format of the exam is provided in Appendix 1 of this *Study Handbook* and in our Exam Primer located in our Study Center.

This UpperMark<sup>TM</sup> *Study Handbook* provides a comprehensive and concise account of each learning objective (L.O.) in Topics 1-2 of the CAIA Level I Study Guide. We have compiled the *Study Handbook* using the reference materials recommended by the CAIA Association and have organized it as follows.

- Each Reading in the Study Guide is presented as a separate chapter.
- Keywords defined in the Study Guide are indicated in ***bold italics***.
- Sub-bullets associated with learning objective statements are indicated as capitalized subheadings (e.g., TYPES OF IRR).
- The lists of learning objectives and keywords for each Reading are provided at the start of the chapter. We suggest that you first read through the learning objectives of a Reading as they provide a broad overview of the material covered in the Reading.
- Space is provided at the end of each chapter to record your *Personal Study Notes*.
- A set of sample exam questions is presented at the end of each chapter. For each set of exam questions, a detailed answer key provides the correct responses, explanations for the responses, and learning objectives addressed.
- A comprehensive index is provided at the end of the *Handbook*.

As we prepare our *Study Handbooks*, we sometimes find that some material in the curriculum warrant more explanation than provided in the CAIA reference texts. In these cases, we include the supplementary information in a footnote so that you know that material is not from the reference texts.

The CAIA Association may provide some equations on the exam for calculation-based questions. These equations are in the CAIA Equation Exception List, provided in Appendix 2 of this Study Handbook. Further, in this Handbook, the first occurrence of each equation on the list is followed by a (G) to indicate that it will be *given* on the exam. You do not need to memorize these equations, but you should be able to readily use and manipulate them.

UpperMark further supports CAIA candidates by offering other exam preparation products and services, including our *TestBank* software, *Courses*, and *Flashcards*. For further information about additional products, please visit our website at [www.uppermark.com](http://www.uppermark.com).

To plan your study program, we suggest reading our Exam Primer. Broadly, your approach should be to read a Reading in the Handbook, watch the Course for the Reading for clarification and insight, and then practice all of the questions for the Reading in TestBank. For further guidance on structuring your study plan, please refer to our Exam Primer.

We wish you the best as you prepare to succeed on your CAIA Level I exam.

Padideh Jalali, Ph.D., CAIA  
President and CEO  
UpperMark, Inc.

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# Topic 1

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## CAIA Ethical Principles

This Topic is composed of two Readings.

1. Reading 1.1 discusses professionalism and fiduciary responsibility for professionals in the investment industry, and informs on how, as fiduciaries, to best serve clients.
2. Reading 1.2 presents the CAIA Ethical Principles, which define the ethical and professional expectations of CAIA members and candidates.



# Reading 1.1

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## Professionalism and Fiduciary Responsibility

This Reading describes the participants and purpose of the investment industry, reviews value creation in the industry, discusses the notion of professionalism and fiduciary responsibility for investment professionals, and discusses the concept of a professional client-first mindset.

### Learning Objectives

#### **1.1.1 Demonstrate knowledge of the purpose, role, and participants of the investment industry.**

- i. Distinguish between the participants within the investment industry
- ii. Justify the four facets of purpose of the investment industry
- iii. Analyze the current investment industry relative to alternative systems
- iv. Understand the four facets of purpose of the investment industry

#### Keywords

1. Agent
2. Principal
3. Stakeholder
4. Value chain

#### **1.1.2 Demonstrate knowledge of purpose of the investment industry and value creation within the industry.**

- i. Assess how value is created in the investment industry
- ii. Understand the role of sustainable finance
- iii. Understand the role of capital allocation in the investment industry
- iv. Describe how public and private markets create value
- v. Describe stewardship with respect to investment industry activity
- vi. Understand different value models

#### Keywords

1. Capital allocation
2. Social-license principle
3. Stewardship
4. Sustainability
5. Triple bottom line

#### **1.1.3 Demonstrate knowledge of professionalism and fiduciary responsibility.**

- i. Evaluate the purpose of fiduciary duty and the four areas of fiduciary obligations
- ii. Understand the five values that support a true fiduciary and professional mindset
- iii. Recommend how investors can navigate instances when the "right" choice is not obvious
- iv. Assess the role of culture on industry professionalism
- v. Understand the challenges that associate with the four areas of fiduciary obligations

#### Keyword

1. Social license compact

#### **1.1.4 Demonstrate knowledge of a client-first approach.**

- i. Discuss the role of trust in client relationships
- ii. Contrast the professional mindset with the characteristics and trademarks of our current system
- iii. Recommend how investors can navigate instances when the "right" choice is not obvious
- iv. Justify the role a professional mindset has in creating value for a client
- v. Describe the virtuous circle of positive forces with respect to the fiduciary and professional mindset

#### Keywords

1. Misaligned industry
2. Professional industry
3. Unnecessary industry

This L.O. describes the investment industry and its purpose.

### Investment industry

The investment industry is a subset of the finance industry, together with safekeeping, payment, lending, and insurance. Key activities in the industry are allocating capital and wealth and risk management services; and may be framed in an ecosystem model, with participants that interact and pursue their motivations in markets and marketplaces using various technologies (i.e., knowledge to achieve practical goals).

### Investment ecosystem

An ecosystem is a set of entities that interact with one another in their environment and with the environment itself via interaction of the participants, technologies, and markets.

### PARTICIPANTS IN THE INVESTMENT INDUSTRY

1. Participants
  - These are the ecosystem's key components and resources, and include institutions and agents such as asset owners, asset managers, consultants, brokers, investment banks, and service providers; regulators; and end savers.
2. Technologies
  - These refer to factors in getting things done. They are derived from functions (e.g., governance, regulation, investment theory, and ideation) and implemented in processes such as investment strategies for allocating capital and business models of asset owners and asset managers.
3. Markets
  - These are the markets for securities and marketplaces for talent and services, which enable interactions needed for value to be created.

Framing the investment industry as a complex, adaptive ecosystem helps investors understand its complex connections and motivational forces and the effects of political, social, and environmental factors on the industry.

### FOUR FACETS OF PURPOSE OF THE INVESTMENT INDUSTRY

The investment industry has four facets of purpose, all of which overlap.

1. Fundamental purpose
  - This purpose is to contribute to society via increases in societal wealth and well-being. The wealth-management role is clear. However, the well-being component is often controversial as it relates to climate change, biodiversity loss, and inequality concerns. Despite the controversy, the industry's purpose must consider well-being since a dollar is worth more in a world worth living in.
2. Intrinsic purpose
  - This purpose is to mobilize the sourcing and allocation of capital to where it is needed. This enables savers' excess funds to be made available to entities that need them to enact their ideas.

3. Core purpose
  - This purpose is to provide wealth and risk management to end savers. The industry's role is to select investments with potentially attractive returns so that wealth can be increased and combine them in quality portfolios that efficiently manage risk.
4. Collateral purpose
  - This purpose is to produce jobs, opportunities, and rewards for investment professionals and organizations. It is not a primary purpose of the industry; it is a means to an end.

The industry's mission is to combine these facets of purpose to secure and sustain the mobilization of investment capital for jobs and growth and the provision of investment services, ultimately for society's wealth and well-being.

Most industries and systems change and adapt over time. As more time passes, the environment tends to evolve more, which causes the system to adapt. Most systems are path dependent, that is, future changes depend on the system's current structure, which itself resulted from changes to the previous structure. For instance, without legislation that created joint-stock companies, the current system would not have asset managers in listed equities.<sup>1</sup>

## CURRENT INVESTMENT INDUSTRY RELATIVE TO ALTERNATIVE SYSTEMS

Different future systems may replace (partially or entirely) the current system. The most plausible scenario may involve new entrants and technologies disintermediating current participants and making current industry structures obsolete. For instance, new challenger organizations resulting from decentralized finance and trading crypto assets may provide services transacting in tokenized assets, likely bypassing normal financial services regulation that focuses on fiduciary duty. Thus, to remain relevant and dominant, the investment industry system needs to continue to be based on significant levels of trust and deliver demonstrable value to participants.

### Investment industry players

- A key investment industry player is the *principal* (i.e., asset owner), which is an individual or a legal entity.
  - Individuals range from individual savers and investors to end savers in pension funds.
  - Legal entities (also referred to as allocators) include governments, corporations, trusts, endowments, and foundations; and are typically responsible for collective investment funds that pool many individuals' investments. Asset owners also include pension funds, family offices for the wealthy, and sovereign wealth funds for governments.
- Multiple *agents* or intermediaries (referred to as the *value chain*) provide services to the principal (or client) and aim to create value for the clients and in aggregate for the system via their contributions.
  - Agents include asset managers that range in scale from small boutiques to large, global organizations; and range in scope from specializing in one asset class to operating across several asset classes.
  - Other agents include index providers, advisers, consultants, research providers, and data providers.
- *Stakeholders* include all participants with a stake in the industry, with inner stakeholders critically and directly engaged (e.g., principals and agents) and wider stakeholders

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<sup>1</sup> A joint-stock company is a business entity owned by its shareholders, with each shareholder owning a share of the company based on the amount invested. It is a predecessor to the modern corporation.

(e.g., governments, regulators, standard setters, and civil society) lightly and indirectly engaged. Some of these industry players are listed in Table 1.

Asset Owners	Agents	Wider Stakeholders
Pension funds	Asset managers	Governments
Endowments & foundations	Investment banks	Regulators
SWFs	Index providers	Standard setters
Insurance companies	Consultants/advisors	Investee entities
Mutual funds	Research providers	Co-investors
Outsourced CIOs	Data providers	Academics
Family offices		Civil society

**Table 1: Industry players**

Asset owners have traits of both principal and agent. These entities function with numerous stakeholders and have primary accountability to their end beneficiaries, investors, and savers. Depending on their economies of scale, asset owners can manage the assets at the end of the chain by building their internal expertise or by outsourcing to external asset managers (i.e., buying other agents' expertise). Most asset owners do not have sufficient scale to internalize and thus outsource.

#### Defining an asset owner or allocator

Asset owners have several qualifying characteristics.

1. They work directly for a group of beneficiaries (or savers or investors) as the manager of their assets in a fiduciary capacity (upholding loyalty, prudence, and care) under delegated responsibility.
2. They work with a sponsoring entity (typically a government or part thereof, company, or nonprofit).
3. They work within explicit law and have an implicit societal license to operate because of their societal trust and legitimacy.
4. They deliver mission-specific outcomes to beneficiaries and stakeholders in the form of payments or benefits into the future.
5. They use business models that combine a governance budget (resources and processes) and a risk budget (reflecting a mix of financial assets that delivers on the mission).

Pension funds are the largest group of asset owners that have all of these traits. Sovereign funds, endowments, foundations, and OCIOs (outsourced CIOs/fiduciary managers) also fully qualify; but OCIOs are agents of asset owners, serving the role of asset owners. Other institutions (e.g., insurance companies and mutual funds) partly qualify as asset owners. For instance, mutual funds do not have mission-specific outcomes, and mutual funds and insurance companies do not directly work with a sponsoring entity (they work with asset owners connected with sponsoring entities).

L.O.  
1.1.2

DEMONSTRATE KNOWLEDGE OF PURPOSE OF THE INVESTMENT INDUSTRY AND VALUE CREATION WITHIN THE INDUSTRY.

### HOW VALUE IS CREATED IN THE INVESTMENT INDUSTRY - IN PUBLIC & PRIVATE MARKETS

A key purpose of the investment industry is to provide and efficiently allocate capital for investment. Private markets are more successful at value creation than public markets since private fund general partners (GPs) are actively involved in asset allocation to portfolio companies. Despite this, little capital is provided for new primary investments compared to that used for financial engineering or transfers of ownership.

- In developed markets, funds withdrawn from listed equity markets via acquisitions for cash and share buybacks exceed the amounts raised in rights issues and initial public offerings. Many large listed firms no longer rely on equity markets to raise cash for capital expenditures, and the number of listed equities has halved. Share buybacks are often funded by bond issuance, implying that listed firms' managers engage in financial engineering on themselves.

### ROLE OF CAPITAL ALLOCATION IN THE INVESTMENT INDUSTRY

While the investment industry does not engage significantly in *capital allocation*, it has two key activities.

#### 1. Wealth and risk management

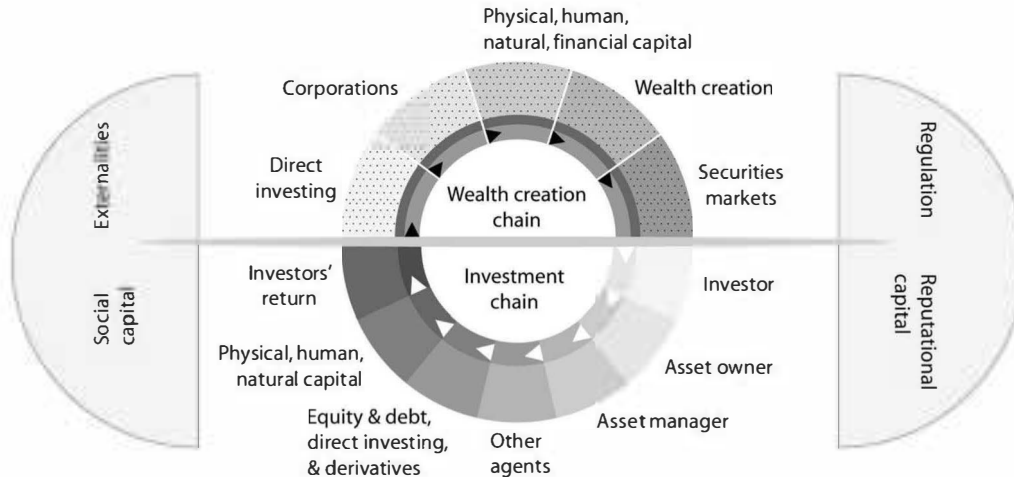
- The most significant activity is wealth and risk management; i.e., constructing portfolios to suit asset owners' risk budgets or risk tolerances and managing investors' risk (generally performed by asset owners, asset managers, and consultants). While risk management has both point-in-time (i.e., cross-sectional) and through-time aspects, most efforts involve managing point-in-time risk with an emphasis on relative risk (or tracking error risk).

#### 2. STEWARDSHIP

- *Stewardship* refers to engaging with company management on the best ways to generate sustainable long-term growth and manage the company's risks and agency issues. As argued by Kay in his book, *Other People's Money*, even with no new investment in capital stock, the investment industry is needed to maintain the existing stock of assets via stewardship.

Thus, the industry earns a higher value creation score for managing wealth and risk than for allocating capital. The score would be better if risk management's emphasis was through-time risk and absolute risk (instead of point-in-time risk and tracking error risk). While a decent value creation score is given for stewardship (which relates to the fundamental purpose of contributing to society via increases in societal wealth and well-being), improvement is needed. An activity observed less than expected is provision of capital for new investments, which will be critical in the great energy transition that lies ahead.

Figure 1 depicts the chains of intermediation in investing and wealth creation. As illustrated, they are highly fragmented, with numerous agents aiming to contribute to value creation; but, in practice, create a complex, expensive web.



**Figure 1: Investment Chain and Wealth Creation Chain**

Value created at the organization level can be mapped from the industry level, but also reflects unique aspects of the organization's identity, captured in its purpose, which reflects a mapping to the multiple stakeholders. This suggests that industry organizations share a mission in the client-first delivery of wealth to their clients and end investors, and contribute to societal wealth and well-being in multiple, unique ways.

- Organization-level purpose likely reflects three factors: the passion of the organization's people, organization's competencies, and effectiveness of the profit and performance drivers.
- Value created can also be mapped to individuals employed in the industry, as they contribute to societal wealth and well-being via contributions to their organizations. Alignment of the individuals' personal purpose with the organization's purpose is also a key component of belonging and strong employee experience.

A key aspect of purpose and value creation comes from sustainable finance.

### ROLE OF SUSTAINABLE FINANCE

**Sustainability**, as defined in the Brundtland report (1987), "meets the needs of the present without compromising the ability of future generations to meet their own needs." Investment organizations have increasingly considered combining conventional financial purpose with sustainability considerations, where goals are often not easy to reconcile.

Asset owners, who have fiduciary responsibility, are focused on performance as a goal, and asset managers (i.e., for-profit organizations) are also interested in performance since their main goal is profit. Goals beyond performance and profit include organizational well-being, net-zero ambitions, and other net-positive goals.

While tension exists between achieving financial goals and these broader goals, the goals may overlap to some extent, allowing sustainability to be pursued when associated with improved financial outcomes. This suggests two ways to create value.

1. From the financial outcome: investing for sustainability impact can lead to improved financial outcome.
2. From the impact: value creation that the investment strategy generates on real-world issues (e.g., climate change).

Organizations select their sustainability strategy based on factors that reflect their purpose and vision, as well as their culture and capabilities.

- For some asset owners (e.g., endowments engaged in mission investing), sustainability goals may be part of their mission.
- For all asset owners and asset managers, their view of their social license to operate influences their sustainability strategy choices. The *social-license principle* refers to investment organizations relying on a covenant from society to pursue financial goals. It is based on realizing socially-valued goals, which legitimizes pursuit of commercial goals.

## VALUE MODELS

### What is value creation in the corporate sector and the investment industry?

There are different value models: shareholder value, shared value, and systems value. A shareholder value model underscores the importance of financial returns for a business.

A shared value model stresses that companies should focus on maximizing shareholder value and their contribution to society.

- In 1994, John Elkington introduced the "*triple bottom line*" concept to explain that corporations should focus not only on their economic value but also on the environmental and social value they add (or destroy).<sup>2</sup>
- Porter and Kramer (2011) argued that a company's competitiveness and its community's health are mutually dependent; thus, shared value is necessary for reshaping capitalism and its relationship to society.
- Eccles and Youmans (2015) also suggested that shareholder value should not be a company's objective but the outcome of its activities in line with its objective to survive and grow.
- Hart and Zingales (2017) support Friedman's basic premise on shareholder value; however, they argued that value creation is more than financial return: directors have a fiduciary duty to maximize shareholders' welfare (not value), which may include "pro-social aims."<sup>3</sup>

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<sup>2</sup> The triple bottom line is a sustainability framework that measures a company's success in three key areas: profit, people, and the planet.

<sup>3</sup> Milton Friedman argued that a company's key responsibility is to generate value and maximize financial returns for shareholders.

A system-value model places a business within society and places society within the environment. In this framework, the investment industry is not independent of society or the environment; it affects (and is affected by) both.

- A value-creating investment industry is central to a well-functioning modern society (e.g., it contributes indirectly to the wider economy via jobs, communities, product innovation, and capital and infrastructure spending). However, realization of the industry's purpose should be judged by its impact and by the value it creates.
- From this system's view, value creation in the investment industry should:
  1. Be seen as activities used to create future wealth and well-being for stakeholders (in line with its fundamental purpose).
  2. Be judged through various stakeholder lenses with inevitable subjectivity.
  3. Occur over extended periods of time, with its progress assessed looking back and forward.

**L.O.  
1.1.3**

**DEMONSTRATE KNOWLEDGE OF PROFESSIONALISM AND FIDUCIARY RESPONSIBILITY.**

### PURPOSE OF FIDUCIARY DUTY AND FOUR AREAS OF FIDUCIARY OBLIGATIONS

The purpose of fiduciary duty is to compel key agents in the investment chain to adopt high standards of professional practice so that their clients are protected from agents' abuse of power.

Agents who manage investments for others are bound by fiduciary obligations that vary across jurisdictions. Fiduciary obligations generally comprise four areas.

1. Loyalty
  - This refers to acting according to the specific power of investment by placing beneficiaries' interests first when establishing investment strategies and avoiding conflicts of interest.
2. Prudence and care
  - This refers to investing to the standards of a prudent person, exercising good judgment and reasonable care.
3. Diversification
  - This entails diversifying according to principles of accepted investment theory and practice.
4. Impartiality
  - This refers to not favoring interests of one or more particular beneficiary over others.

### CHALLENGES ASSOCIATED WITH THE AREAS OF FIDUCIARY OBLIGATIONS

The areas of fiduciary obligations present some challenges.

1. No objective interpretation
  - There is generally no objective interpretation of the obligations, and expert opinion may differ on the correct application. In practice, investment theory together with peer practice is typically used.
2. No static interpretation
  - Interpretation of fiduciary duty is not fixed in time. Fiduciary duty, like investment principles and practice evolves over time. For instance, fiduciary duty interpretation has changed in the context of emerging fields such as sustainable and impact investing.

3. No globally consistent interpretation
  - There is no globally consistent interpretation of the obligations and scope of fiduciary duty, particularly related to the types of agents to which the duty applies.
  - In the UK, fiduciary duty has developed from common law origins to affect asset owner and asset manager practices. Similarly, U.S. pension funds have been influenced by the 1974 ERISA legislation. While legal frameworks of asset owners and asset managers differ across countries, the underlying fiduciary duty is similar.
4. Financial interests first
  - Part of the fiduciary mindset is to always put financial interests first. However, this has been debated in the field of sustainable investing, where environmental, social, and governance (ESG) factors are considered to contribute to maximization of risk-adjusted returns (via an additional risk or a source of positive engagement).
  - Pension fund interpretations of fiduciary duty have historically resulted in conservative pursuit of sustainable investing. However, more recent legal guidance supports the view that fiduciary duty can consider sustainability impact, provided that sustainability also affects financial outcomes.

In general, fiduciary duty is an important codification of professionalism and parallel to the concept of "license to operate." An element of the fiduciary mindset is that investors with fiduciary obligations must bear responsibility for both client and societal needs.

Professionalism applies to both the organization and the individual, and involves both a professional mindset (i.e., value-derived motivations and intentions expressed in actions) and a professional skill set (i.e., competencies to fulfill professional obligations to clients).

Professionalism is evident in commitment to long-term value creation for clients, typically in ongoing relationships. Ongoing relationships also further the concept of fiduciary duty from a one-off transaction providing a financial benefit to a continuing obligation for new actions to remain in the clients' best interests. With a continuing obligation, fiduciary duty can be summarized as always acting with loyalty, prudence, and care. Professionalism is the source of the investment industry's license to operate, since it gives legitimacy to organizations that have fiduciary responsibilities.

#### Operating with a fiduciary and professional mindset

Having a fiduciary and professional mindset begins with an understanding of purpose and its alignment to the client, and is embedded in creating a strong identity around key organizational principles (e.g., culture, stakeholder mapping, incentives, fee philosophy, talent philosophy, and diversity principles) that guide the operation of the organization.

#### FIVE VALUES THAT SUPPORT A TRUE FIDUCIARY AND PROFESSIONAL MINDSET

There are five values that support a true fiduciary and professional mindset.

1. Ethical and professional behavior
  - A firm adopts a culture that encourages, respects, and applauds ethical and professional behavior, which creates an environment in which individuals can easily act ethically and professionally.

## 2. Partnership

- A firm aligns itself with the client and acts as a peer and partner, recognizing that its specialist skills contribute to the success of the client's mission (rather than being an advantage over the client). Partnership is a commitment to trust, empathy, and building of strong relationships over the long term via honest conversations over realistic expectations and resolution of issues.

## 3. Client first

- Putting the client first means knowing the client and understanding their needs; then making decisions to meet those needs. It involves loyalty to the client and being purpose-driven, both of which enhance alignment.

## 4. Transparency, integrity, and accountability

- These values are in all aspects of the professional lives of individuals and their firms. In particular, communications with all stakeholders (clients, employees, and colleagues; investee companies; regulators; etc.) must be transparent, accurate, and authentic.

## 5. Public responsibility and clean license to operate

- Public responsibility is one of the components that defines a profession. Given that a professional mindset recognizes that investment decisions have implications beyond meeting the client's needs, it aims to generate outcomes that not only reflect favorably on the firm and the industry, but also demonstrate concern for society as a whole.
- Public responsibility is essentially captured in the *social license compact*: society grants privileges to the investment profession, which in return affirms that it will act responsibly. Specifically, the investment profession's warranty involves specifying certain behaviors.
  - i. Responsibility to society
  - ii. Accepted standards of fair practice
  - iii. Accepted body of knowledge and practice
  - iv. Processes for learning from experience
  - v. Standards for accreditation, codes of discipline, and sanctions, achieved via collective assurance

Key components of the professionalism skill set include areas that coincide with the definition of a profession.

### 1. Professionals adhere to a "best practice" standard

- This involves specified investment content skills and practice, built on strong evidence that is in line with industry best practices.

### 2. Professionals strive to continue to learn and grow their knowledge base

- This means individuals are quick to adapt to new content and situations, and handle change and continuous development well. This involves principles of self-learning and self-improvement.

### 3. Professionals are diligent, competent, and objective throughout the investment process

- This relates to the quality of research and due diligence as well as to strong engagement with the client.

### 4. Professionals judge risks comprehensively and avoid unnecessary risks

- Applying expertise to understand risk is paramount in the professional skill set.

An investment professional's skill set can be considered based on a list of skills and competencies aligned with their suitability to investment roles. The skills and competencies govern the talent and expertise, experience, and accomplishments that professionals need to perform at the highest level. Table 2 provides a sample list of the skills and abilities required by investment professionals in aggregate.

<b>Skills</b>	<b>Technical</b>	<b>Soft</b>	<b>Leadership</b>	<b>T-Shaped</b>
	<ul style="list-style-type: none"> <li>• Solutions</li> <li>• Investment foundations</li> <li>• Finance</li> <li>• IT</li> <li>• Management science</li> </ul>	<ul style="list-style-type: none"> <li>• Innovation</li> <li>• Collaboration</li> <li>• Relationship</li> <li>• Humility</li> <li>• Consultative/selling</li> </ul>	<ul style="list-style-type: none"> <li>• Vision and mission</li> <li>• Ethical culture</li> <li>• Governance stakeholders</li> <li>• Crisis management</li> <li>• Comfortable globally</li> </ul>	<ul style="list-style-type: none"> <li>• Situational fluency</li> <li>• Connects disciplines</li> <li>• Diverse perspectives</li> <li>• Network connections</li> <li>• System understanding</li> </ul>
<b>Abilities</b>	<b>Digital</b>	<b>Emotional</b>	<b>Creative</b>	<b>Systematic</b>
	<ul style="list-style-type: none"> <li>• Data science</li> <li>• Statistical intelligence</li> </ul>	<ul style="list-style-type: none"> <li>• Emotional intelligence</li> <li>• Resilience</li> </ul>	<ul style="list-style-type: none"> <li>• Creative intelligence</li> <li>• Idea ownership</li> </ul>	<ul style="list-style-type: none"> <li>• Behavioral understanding</li> <li>• Inter-connections</li> </ul>

**Table 2: Investment Professional's Skills and Abilities**

## ROLE OF CULTURE ON INDUSTRY PROFESSIONALISM

The importance of culture in establishing professionalism in an organization cannot be overstated. Culture is an attribute that attaches to a group (e.g., team, organization, or industry) and affects the way people in the group think and behave, based on shared values and beliefs.

- A professional culture is heavily influenced by the group's leaders. The leaders' behavior and professionalism is generally adopted by the individuals in the group. Further, the professionalism of each individual in the group affects the others, so each individual essentially has a leadership role.
- Culture is developed over time and embodies institutional memory, incorporated from the actions of past and present leaders.

Culture influences organizations via three main channels.

1. Aligns values and beliefs, establishes expectations and trust, and reduces uncertainty.
2. Builds focus on factors that matter in all organizational settings and situations.
3. Captures the power of strong communication and engagement in the organization and in client interactions.

A culture with behavior that is consistent with these principles contributes greatly to achieving professionalism in the investment industry.

**L.O.  
1.1.4****DEMONSTRATE KNOWLEDGE OF A CLIENT-FIRST APPROACH.**PROFESSIONAL MINDSET AND CHARACTERISTICS OF OUR CURRENT SYSTEM

The notion of putting the client first can really only be guaranteed if there is only one client. A firm with multiple clients and even multiple products cannot guarantee that it can always put each client first. Therefore, in practice, the goal is to treat all clients fairly.

- Achieving this goal is complex to operationalize: it depends on the organization's values and governance arrangements as well as regulation. The value system affects how well governance delivers required standards; and this needs several mechanisms, including training, compliance, and applying cultural principles and practice. Cultural practice involves ensuring, via attention to values and behaviors, a balance of interests between clients (who come first), the organization, wider society, and the investment professional.

Putting clients first also involves how the value created is divided up. In contrast to a business, a professional subject to fiduciary responsibility is not free to maximize its profits. There is a trade-off: forgoing the opportunity to maximize short-term profits in return for the privileges of the relationship in which trust and respect can be monetized over the long term. A profession that puts clients first has fees and rewards that are fair and reflect the value delivered.

There are three areas where the "right" choice is not always clear.

1. Conflicts of interest

- Conflicts of interest may be between organization and client and between clients. The most common example is that investment organizations have different products with different commercial benefits that they can use to fulfill client needs. Therefore, they can select the most profitable product instead of the best choice based on the client's needs. Since, in practice, the right choice may not always be clear, conflicts need to be finely balanced.

2. Trade-off between benefits and costs for different stakeholders

- An investment may have benefits and costs for different stakeholders. For example, an investment may be financially attractive in part because its waste product is unregulated, but the waste has detrimental effects on the health of the local population, who are the client's beneficiaries and the labor force of the client's sponsor.

3. Insufficient knowledge of the client (e.g., goals, context, and values)

- For example, an asset manager can choose to increase either the client's money-weighted return or the short-term alpha. Most clients' goal is a long-term, money-weighted return. However, in the context of a client's total portfolio, an organization's product that is expected to enhance returns may increase the client's exposure to a specific risk and thus threaten the money-weighted return.

Navigating uncertainty

When the right choice is not obvious, the choice must be made within a well-ordered, transparent process with balanced rules and principles. The process should begin with the organization's beliefs, values, and desired culture, from which principles can be derived to guide its operations and decision-making. Transparency, integrity, and accountability are factors that can help with difficult choices.

Since directly observing client-first behaviors may be challenging, the next best approach is to observe culture. While an organization's culture is not tangible, it may be evaluated using a series of questions.

1. Is there well-managed capacity and capability to support achieving client expectations?
2. Is there a process and attitude to listen to clients and regularly get their feedback?
3. Is significant attention and sophistication given to understanding and managing client risks?
4. Do professionals understand professional and ethical practice and its boundaries and practical application?
5. How does the professional prioritize the client, firm, and self and regard for societal interests?
6. How does the organization view the principle of fair rewards, and can it demonstrate that it aligns with this principle?
7. What levels of trust exist between the organization and its clients?

Exhibiting client-first principles also requires rejecting bad habits that affect the organization's professionalism (e.g., poor conflict-of-interest practices, unfair rewards, overclaiming, and greenwashing).

### ROLE OF TRUST IN CLIENT RELATIONSHIPS

Trust is a two-sided concept that involves expectations and beliefs about the likelihood that someone's future actions will benefit another's interests. In the investment industry, it is related to whether the asset manager is worthy of trust and whether the allocator is willing to trust.

- From the perspective of trust involving the asset manager, the allocator, and a context in which trust is conferred, strategic and objective considerations influence some organizational contexts (e.g., transactions involving parties that do not know each other well). However, in other contexts (e.g., involving professional closeness), trust may depend more on relational considerations.
- From the allocator's perspective, the key situation that requires trust is dependency on the asset manager when there is risk exposure over a long period. The significance of trust increases with the investment's level of risk and the exposure's duration.

Trust is earned by asset managers who build credibility, communicate effectively, and exhibit professionalism.

- Credibility is a reasonably tangible element of trust in a relationship, since it has objective features and can be divided into two parts.
  1. End investors need assurance that the investment professional or organization is accredited to provide the necessary services, which includes regulation of the organization and product.
  2. End investors need assurance of the value proposition, and validation of the thesis that the asset manager can add value and thus deserves to be trusted (e.g., performance track records and other factors relevant to the value proposition).
- Communication is also tangible in relationships where effective technology is a feature.
- However, professionalism is more tacit and has subjective elements, with values and competencies being essential.

### Features of trust in the investment industry

1. Trust has value to both the allocator granting trust and the asset manager receiving trust by enabling value creation in the investment to develop over time.
2. Levels of trust vary by geography and demography, and can reflect cultural factors. Trust also correlates with market experiences.
3. Trust is a factor during the entire investment life cycle, but has additional significance at the few pivotal moments in a relationship when interventions are needed.
4. Trust can be helped by technology, but also requires human involvement.
5. Brand can support trust, but can also compromise it if the brand promise is not fulfilled.
6. Information is essential for trust; investors that feel less informed trust the system less. Investors are better informed through knowledge from financial education.
7. Innovation (e.g., new products or investment ideas and better engagement) and proactive use of technology can enhance trust; those who trust the system more are more likely to benefit from innovation.

These professionalism targets represent a high bar that is not attainable by all professionals or organizations due to incentives (e.g., enhanced rewards and making themselves look better) that make professionalism hard to practice. Commercial pressures make asset managers more likely to fall short; pressures also exist to perform as allocators.

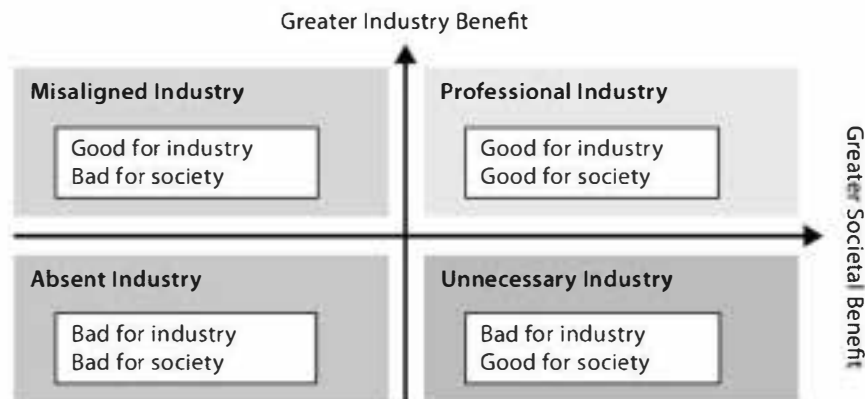
There are three widespread investment industry failings.

1. Weakness in the value proposition, where the value created does not match the fees charged
2. Misalignments in the values of asset management firms with their clients
3. Communication with inadequate accuracy and honesty

While short-term rewards in the industry can sometimes be increased by not being professional, adopting professionalism principles is the long-term commercially beneficial route since the implied alignments also provide the benefit of enlightened self-interest. Indeed, as the industry has matured, its alignments and competencies have improved.

### How much value does the industry produce?

The investment industry is a dynamic ecosystem. As illustrated in Figure 2, at different times, the industry can secure more or less value for itself and provide more or less value to society.<sup>4</sup>



**Figure 2: States of the Investment Industry and Society**

<sup>4</sup> The top right quadrant, labeled "Professional Industry", is the most desirable state since the greatest benefits are provided to both the industry and society in this state.

Based on investment firms' high profit margins and increases in compensation and number of employees in the industry, the state of the investment industry appears to have moved upward over the past 40-50 years. The question is whether the state is a *misaligned industry* (good for the industry but bad for society) or a *professional industry* (good for everyone).<sup>5</sup>

- In the short term, a misaligned industry is not an issue. However, in the long term, high rewards to the industry at society's expense results in the industry being untrusted and likely to have a smaller asset base. This is because principals will be skeptical and have a higher bar for allocations to expensive investment products; thus will allocate more to low-cost products (e.g., passive products for institutional and fractional trading apps and ETFs for retail investors). The risk is that this form of industry is not sustainable and may collapse into a transactional or contractual form that is not good for the industry or society.
- The professional industry state is beneficial to both industry and society, providing value first to clients then to wider stakeholders in society. It is considered ethical and is trusted, with a clean license to operate, which implies a large asset base and more long-term revenue potential for a sustainable industry. It also creates larger rewards for society.
  - While transitioning to the professional industry presents no issue in the long term, issues may exist in the short term. In contrast to a business that can, by law, maximize short-term profits, a profession cannot and thus may need to forgo high short-term returns for long-term value creation. Earning long-term client trust is a monetizable investment. Thus, the transition may require investment firms that are not in a professional mindset to absorb a short-term cost to gain the long-term benefit.

In the *unnecessary industry*, efficient technology platforms can be used to reduce costs. However, the issue is that an industry that is not driven by a fiduciary culture does not have the trust to support commitments in wealth-creating ideas in the long term. Thus, this industry does not get the rewards associated with the assumed risk, which results in poorer outcomes.

### ROLE OF PROFESSIONAL MINDSET IN CREATING VALUE FOR A CLIENT

A professional and fiduciary mindset in an organization and among individual professionals creates value for clients and portfolios via several features.

1. Values and behaviors aligned with fiduciary duty and focus on client interests
2. Effective client relationships with trust and empathy, in which communication is transparent, accurate, and authentic.
3. Working with a holistic (or systemic) model and actions that relate to value creation relative to a mix of goals
4. Adopting fair rewards given the resources and outcomes involved
5. Strong regard for public responsibility and adherence to a clean social license

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<sup>5</sup> The CAIA reference text describes the misaligned industry as "partially good for the industry but bad for society", instead of "good for the industry...". This is not consistent with the schematic.

### VIRTUOUS CIRCLE OF POSITIVE FORCES WITH RESPECT TO THE FIDUCIARY AND PROFESSIONAL MINDSET

The fiduciary and professional mindset adds value to an organization since it creates a virtuous circle of positive forces, depicted in Figure 3.

- The portfolio benefits from high-grade skill and attention, which makes realizing performance goals more likely.
- The client benefits from best investment performance reinforced by trust in the asset manager, which makes a sustainable relationship more likely.
- The asset manager benefits from a sustainable, commercially successful client relationship, reinforcing the self-fulfilling formula of the fiduciary and professional culture.

If this circle works as planned, organizations' business outcomes are likely to improve over time. Thus, the circle makes a compelling case for organizations to foster a culture of professionalism.



**Figure 3: Virtuous Circle of Positive Forces**

The virtuous circle also applies to clients, and the case for client value is even stronger because of trust in the professional setting.

- Value can be created for clients when their savings are committed to wealth-creating outcomes over long time horizons; supported by trust, patience, and knowledge. However, without trust, clients would not assume risk and those with little investment expertise will likely leave their savings in cash.
- An investment organization with a fiduciary and professional mindset that wants to invest in building long-term trust will allow clients to take appropriate risk over long horizons. The resulting compounding of returns will add significant value compared to cash investments.

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Reference: CAIA Level I, 2026 Curriculum.

## Personal Study Notes

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## Reading 1.1 – Practice Exam Questions

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1. Which of the following best describes the fundamental purpose of the investment industry?
  - A. to mobilize the sourcing and allocation of capital to where it is needed
  - B. to contribute to society via increases in societal wealth and well-being
  - C. to produce opportunities, and rewards for investment organizations
  - D. to provide wealth and risk management to end savers
  
2. The investment industry currently earns a higher value creation score for which of the following?
  - A. capital allocation
  - B. stewardship
  - C. wealth and risk management
  
3. Which of the following is the best definition of sustainability as given in the 1987 Brundtland report?
  - A. Balances between the components of social and environmental concerns for present and future generations.
  - B. Addresses necessary changes for how resources are currently developed and used.
  - C. Meets the needs of the present without compromising the ability of future generations to meet their own needs.
  
4. Other than prudence and care, fiduciary obligations include which of the following areas?
  - A. diversification and impartiality
  - B. loyalty and objectivity
  - C. independence and transparency
  - D. client first and partnership
  
5. Which of the following are the three components of the virtuous circle of positive forces with respect to the fiduciary and professional mindset?
  - A. portfolio, client, and asset manager
  - B. client, asset manager, and industry
  - C. capital allocation, portfolio, and client
  - D. stewardship, asset manager, and portfolio

## Answers & Explanations

Question Number	Answer	Learning Objective	Explanation
1.	B	1.1.1	<p>The investment industry's fundamental purpose is to contribute to society via increases in societal wealth and well-being.</p> <p>Other responses -</p> <ul style="list-style-type: none"> <li>• Mobilizing the sourcing and allocation of capital to where needed is the intrinsic purpose.</li> <li>• Producing opportunities, etc. for investment professionals and organizations is the collateral purpose.</li> <li>• Providing wealth and risk management to end savers is the core purpose.</li> </ul>
2.	C	1.1.2	<p>The investment industry earns a higher value creation score for managing wealth and risk (vs. for allocating capital).</p> <p>The score would be higher if risk management is focused on through-time risk and absolute risk.</p>
3.	C	1.1.2	<p>The 1987 Brundtland report defined sustainability as "meeting the needs of the present without compromising the ability of future generations to meet their own needs".</p>
4.	A	1.1.3	<p>Fiduciary obligations comprise four areas -</p> <ol style="list-style-type: none"> <li>1. Loyalty</li> <li>2. Prudence and care</li> <li>3. Diversification</li> <li>4. Impartiality</li> </ol>
5.	A	1.1.4	<p>The virtuous circle of positive forces is made up of the portfolio, the client, and the asset manager.</p>

# Reading 1.2

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## Ethics

This Reading presents the eight CAIA Ethical Principles, which define the ethical and professional expectations of CAIA members and candidates. The Reading also presents some case studies on ethical misconduct in the investment industry.

### Learning Objectives

- 1.2.1 Demonstrate knowledge of the relationship between professionalism and ethics.**
- Understand the key elements of professionalism and fiduciary responsibility
  - Identify the eight ethical principles
  - Contrast the ethical principles that guide "doing the right things" with those that guide "doing things right"
- 1.2.2 Demonstrate knowledge of foundational components of ethical principles.**
- Understand the foundational ideas and concepts associated with the principles
  - Analyze the value creation equation
  - Support the role of professionalism in the organizational value chain
  - Justify the four components of assurance of quality

#### Keywords

- |                         |                         |                      |
|-------------------------|-------------------------|----------------------|
| 1. Assurance of quality | 5. Impartiality         | 9. Prudence and care |
| 2. Conflict of interest | 6. Investment ecosystem | 10. Trust            |
| 3. Ethics               | 7. License to operate   | 11. Values           |
| 4. Fiduciary duty       | 8. Loyalty              |                      |

- 1.2.3 Demonstrate knowledge of CAIA Ethical Principles.**
- Explain principle 1 and support its underlying components
  - Explain principle 2 and support its underlying components
  - Explain principle 3 and support its underlying components
  - Explain principle 4 and support its underlying components
  - Explain principle 5 and support its underlying components
  - Explain principle 6 and support its underlying components
  - Explain principle 7 and support its underlying components
  - Explain principle 8 and support its underlying components
  - Understand the benefits of a principle-based approach to ethics

#### Keywords

- |                   |              |                  |
|-------------------|--------------|------------------|
| 1. Accountability | 2. Integrity | 3. Moral courage |
|-------------------|--------------|------------------|

- 1.2.4 Demonstrate knowledge of historical ethical breaches in the finance industry.**
- Ethical misconduct at MF Global
  - Ethical misconduct at Archegos Capital Management
  - Ethical misconduct at Bear Stearns
  - Ethical misconduct at the New York State Common Retirement Fund

**L.O.  
1.2.1****DEMONSTRATE KNOWLEDGE OF THE RELATIONSHIP BETWEEN PROFESSIONALISM AND ETHICS.**KEY ELEMENTS OF PROFESSIONALISM AND FIDUCIARY RESPONSIBILITY

This L.O. begins with a summary of the key elements of professionalism and fiduciary responsibility, discussed in the previous Reading.

1. Meaning of the investment industry: ecosystem subset of finance.
2. The industry's multiple purposes: allocation of capital; wealth and risk management by balancing risk and return; and service of society.
3. Participants/players: end saver/principal through multiple agents.
4. How value is created in the industry: portfolio construction, stewardship, and sustainability.
5. Why this system (vs. another) exists: path dependency and possible impermanence.
6. How fiduciary duty affects the system: binds agents to high standards of professional practice in order to protect clients.
7. A fiduciary and professional mindset: long-term value creation for the client.
8. A professional skill set's key components: best practice standards, continuous learning, diligence, competence, and risk management.
9. Role of culture: alignment of values and beliefs; focus on significant things, and engagement.
10. Meaning of putting the client first: treating all clients fairly.
11. How to make the "right" choice when it is not always clear: navigating conflicts of interest; trade-off between stakeholders' benefits and costs; and addressing insufficient knowledge of the client.
12. Exhibiting a client-first approach, the role of trust in a successful client relationship and investment outcome, and how the above elements compare to the traits of our current system.
13. How a professional and fiduciary mindset adds value to clients, portfolios, and organizations; and why organizations should focus on fostering and supporting a culture of professionalism.

There are several key takeaways from the previous Reading.

1. Understanding professionalism requires understanding the investment industry ecosystem. This entails deeper thinking and broader context than most professionals have explored.
2. Professionalism should be considered through the lens of organizational purpose and vision; which must consider goals, motivations, and boundaries. However, the industry has generally not reflected on this sufficiently.
3. Professionalism is best codified via balanced use of principles together with rules and policies; not only using rules and policies.
4. Clarity on exact organizational purpose and the ideals of professionalism will improve industry outcomes. This applies to investment organizations and investee entities under investment organizations' stewardship.

## 8 ETHICAL PRINCIPLES – THAT GUIDE "DOING THE RIGHT THINGS" AND "DOING THINGS RIGHT"

CAIA's ethical principles define professionalism in two broad classifications: principles that guide "doing the right things" and those that guide "doing things right." The principles map to a combination of competencies, values and ethics, and accountabilities; they do not define every detail or account for every circumstance. Thus, professionals need to think critically and exercise judgment when faced with ethical uncertainty. A summary of the principles is presented below; details are discussed later in this Reading.

### Professionalism: Doing the right things

1. Ethical and professional behavior
  - A firm and its professionals adhere to and promote a culture that encourages, respects, and celebrates ethical and professional behavior. This creates an environment that enables individuals to easily act ethically and professionally.
  - Recognizing that investment decisions and behaviors have broad implications (public responsibility), an ethical and professional mindset aims to create outcomes that reflect well on the firm as a whole and shows concern for broader stakeholders (notably, society as a whole). While clients come first, their interests should not come at the expense of other stakeholders. A key test is how a firm manages externalities in its business and portfolios; considering factors such as sustainability, human rights, inclusiveness, and human capital.
2. Partnership
  - A firm and its professionals aim to align themselves with the client and serve as a peer and partner. The firm knows that its specialist skills are not a source of advantage or superiority over clients, but are critical to the success of the client's mission. Partnership is a commitment to trust; empathy; and building of strong, long-term relationships via honest conversations about realistic expectations and resolution of issues.
3. Client-first mindset
  - Putting the client first involves knowing the client, understanding their needs (Principle 2), and making decisions to meet those needs. It entails loyalty to the client and being purpose-driven, both of which enhance alignment and build trust.
4. High standards of conduct: Transparency, integrity, and accountability
  - These values are in all aspects of professional activities. In particular, communications with all stakeholders (clients, employees, investee companies, regulators, etc.) should be transparent, accurate, and authentic.

### Professionalism: Doing things right

1. High standards of practice
  - This involves complying with specified investment content skills and practice, based on strong evidence and rigorous thinking, consistent with industry theory and continuously reviewed best practices to execute duties and responsibilities.
2. Professional work
  - This relates to the quality of research and due diligence conducted, and the scope of thinking. It involves considerable, continued engagement with client context. Application of expertise in understanding risk must be prominent in the professional skill set. The understanding is holistic and comprises the various components that affect relevant risks and outcomes.
3. Continued learning
  - This refers to individuals being quick to adapt to new content and capable of change and continuous development, and includes the principles of self-learning and self-improving.