

Level III of the CFA® Exam

Item-Set Questions with Answers - Portfolio Management Pathway – Volume 1

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Case 1: Joyce Walker

Joyce Walker is a portfolio manager at South-March Associates, an asset advisory firm. Walker is managing the equity portion of Lakehouse Limited Endowment's (LLE) policy portfolio. The portfolio is currently invested in international ex-US equities and is being managed by four individuals – Gina Eco, Blake Morris, Carl Smith, and Mehmet Akhtar.

Exhibit 1 displays details concerning the funds managed by the individuals

**Exhibit 1:
Equity Portion of LLE's Policy Portfolio**

	Eco	Smith	Morris	Akhtar
Asset under management (\$ millions)	5.0	2.5	3.5	2.0
Expected alpha	0.0	5.5%	7.2%	10.1%
Expected tracking risk	0.0	3.6%	6.5%	8.1%
Standard deviation	10%	4%	7%	2%
Dividend yield	0.0	2.1	1.3	1.6
P/E	16	10	14	25
P/B	6.0	4.3	0.7	15.8
5-year consensus expected earnings growth	5.0%	3.1%	6.8%	10.5%
Annualized manager's return	15.1%	22.1%	12.7%	17.0%
Annualized manager's normal benchmark return*	15.1%	18.0%	13.7%	16.1%
Annualized investor benchmark return*	15.1%	12.1%	11.6%	17.3%
Equity investment style	N/A	Value	Value	Growth

Walker's colleague, Levin Alexei, is reviewing the allocation presented in Exhibit 1. He tells Walker that a true/misfit distinction between portfolio risk and returns is crucial. He supports his statement by providing the following justifications:

Justification 1: The true/misfit distinction will allow for an optimized allocation to managers such that misfit risk is eliminated and true active returns are maximized.

Justification 2: The distinction allows for the performance appraisal of active managers.

Following Alexei's advice, Walker compiles details concerning the benchmarks used for each of the four managers (Exhibit 2).

Exhibit 2:

	Eco	Smith	Morris	Akhtar
Manager's normal benchmark	MSCI US Broad Market Index	MSCI World ex-US Value Index	MSCI World ex-US Value index	MSCI World ex-US index
Investor's benchmark	MSCI US Broad Market Index	MSCI World ex-US index	MSCI World ex-US index	MSCI World ex-US Growth index

*All returns are gross of management fees

Following his analysis of the equity allocation, Walker holds a meeting with LLE's chief executive. During the meeting the executive entrusts Walker with the management of \$10 million which the fund has received from a wealthy donor. The executive shares his desire for an active equity exposure to emerging market equities. However Walker has little expertise concerning this equity category.

Walker believes that exposure to the U.S. equity market can be highly profitable and devises a strategy to manage the \$10 million by undertaking a long futures position in the S&P500 equity index. For the emerging market equity allocation, he narrows down his selection to Octavia Wilde, an active manager benchmarked to the MSCI Emerging Markets Index (EMI). Wilde undertakes a short futures position in the MSCI EMI.

Q.1 Based on the information presented in Exhibit 1, Morris's value investment style can *most likely* be classified as:

- A. Low P/E.
- B. Contrarian.
- C. High dividend yield.

The correct answer is **B**.

Based on the information provided in Exhibit 1, Morris's value investment style can be classified as Contrarian. This is because his portfolio's Price-to-book (P/B) ratio is below 1.0, which is the lowest among the three equity managers. A contrarian investment style is one where the investor tends to follow a crowd-adverse strategy, meaning they buy assets that are currently not popular or are undervalued. The low P/B ratio indicates that the stocks in Morris's portfolio are undervalued, which is a characteristic of a contrarian investment style. This is because a low P/B ratio suggests that the market price of the stocks is less than their book value, indicating that the stocks are undervalued. Therefore, Morris's investment style can be classified as Contrarian.

A is incorrect. While it is true that a low P/B ratio is consistent with a value bias, it does not necessarily mean that the investment style is Low P/E. The P/E ratio, or Price-to-earnings ratio, is a different financial metric that measures the price paid for a share relative to the annual net income or profit earned by the firm per share. A low P/E ratio could indicate that the company's earnings are high relative to its share price, which could suggest that the stock is undervalued. However, in this case, Morris's portfolio has a P/E ratio of 14, which is not the lowest among the three equity managers. Therefore, his investment style cannot be classified as Low P/E based on the information provided.

C is incorrect. A High Dividend Yield investment style is one where the investor focuses on stocks that pay high dividends relative to their market price. However, Morris's portfolio has a dividend yield of 1.3, which is not the highest among the three equity managers. Therefore, his investment style cannot be classified as High Dividend Yield based on the information provided. Furthermore, a contrarian investor will typically search for stocks that are facing problems and are trading at low P/B ratios, often below 1.0. This is consistent with the characteristics of Morris's portfolio, further supporting the classification of his investment style as Contrarian.

CFA Level III, Portfolio Management Pathway, Learning Module 2: Active Equity Investing: Strategies, LOS 2(b): Analyze bottom-up active strategies, including their rationale and associated processes

Q.2 To reduce the active risk of the portfolio, LLE will *most likely* increase allocation to:

- A. Akhtar.
- B. Smith.
- C. Eco.

The correct answer is **C**.

Active risk is a measure of the deviation of the return of an investment portfolio from the return of a benchmark index. In the context of this question, the active risk of the portfolio is minimized by allocating more to the manager with the lowest tracking error.

According to the data provided in Exhibit 1, Eco has an expected tracking risk of 0.0%, which is the lowest among all four managers. This means that Eco's returns are expected to deviate the least from the benchmark index, hence contributing the least to the active risk of the portfolio. Therefore, increasing allocation to Eco would most likely reduce the active risk of the portfolio.

A is incorrect. Akhtar, despite having the highest expected alpha (10.1%) and the highest 5-year consensus expected earnings growth (10.5%), also has the highest expected tracking risk (8.1%). This means that Akhtar's returns are expected to deviate the most from the benchmark index, hence contributing the most to the active risk of the portfolio. Therefore, increasing allocation to Akhtar would most likely increase, not decrease, the active risk of the portfolio.

B is incorrect. Smith, despite having a relatively high expected alpha (5.5%) and a relatively low standard deviation (4%), also has a relatively high expected tracking risk (3.6%). This means that Smith's returns are expected to deviate more from the benchmark index than Eco's returns, hence contributing more to the active risk of the portfolio. Therefore, increasing allocation to Smith would not reduce the active risk of the portfolio as much as increasing allocation to Eco.

CFA Level III, Portfolio Management Pathway, Learning Module 2: Active Equity Investing: Strategies, LOS 2(b): Analyze bottom-up active strategies, including their rationale and associated processes

Q.3 The manager that has outperformed his asset class benchmark by the highest margin is:

- A. Morris
- B. Akhtar
- C. Smith

The correct answer is **C**.

To determine which manager has outperformed their asset class benchmark by the highest margin, we need to calculate the misfit active return for each manager and compare them. Misfit active return is calculated by subtracting the investor's benchmark from the manager's normal benchmark.

The misfit active return for Smith is calculated as follows:

Misfit active return for Smith = Manager's normal benchmark – Investor's benchmark = 18.0% –

Similarly, the misfit active return for Morris is calculated as follows:

Misfit active return for Morris = Manager's normal benchmark – Investor's benchmark = 13.7% –

And the misfit active return for Akhtar is calculated as follows:

Misfit active return for Akhtar = Manager's normal benchmark – Investor's benchmark = 16.1% –

Comparing these misfit active returns, we can see that Smith has the highest misfit active return of 5.9%, which means that Smith has outperformed his asset class benchmark by the highest margin.

A is incorrect. The misfit active return for Morris is 2.1%, which is lower than the misfit active return for Smith. Therefore, Morris has not outperformed his asset class benchmark by the highest margin.

B is incorrect. The misfit active return for Akhtar is -1.2%, which means that Akhtar has underperformed his asset class benchmark. Therefore, Akhtar has not outperformed his asset class benchmark by the highest margin.

CFA Level III, Portfolio Management Pathway, Learning Module 3: Active Equity Investing: Portfolio Construction, LOS 3(c): Distinguish between Active Share and active risk and discuss how each measure relates to a manager's investment strategy

Q.4 Concerning the benefits of a true/misfit distinction, Alexei is *least* accurate concerning:

- A. Justification 1 only.
- B. Justification 2 only.
- C. both of his justifications.

The correct answer is **A**.

Alexei's first justification is the least accurate. The true/misfit distinction does allow for the creation of optimal solutions that maximize active return at every level of active risk. However, it does not necessarily eliminate misfit risk. Misfit risk arises when the manager's investment style or strategy deviates from the benchmark. This can occur due to a variety of reasons, such as the manager's unique investment insights, market timing ability, or simply due to the manager's preference for certain types of securities.

While the true/misfit distinction can help in identifying and quantifying the misfit risk, it does not provide a mechanism to eliminate it. In fact, a nonzero amount of misfit risk might be desirable because a high level of true active return may more than compensate for this type of risk. Therefore, Alexei's claim that the true/misfit distinction will allow for an optimized allocation to managers such that misfit risk is eliminated is not accurate.

B is incorrect. Alexei's second justification is accurate. The true/misfit distinction does allow for the performance appraisal of active managers. By separating the true active returns from the misfit returns, we can better evaluate the manager's skill in generating excess returns over the benchmark. This can help in identifying managers who are truly skilled and those who are simply taking on additional misfit risk to boost their returns.

C is incorrect. As explained above, Alexei's first justification is the least accurate, not both of his justifications. His second justification is accurate and provides a valid reason for the importance of the true/misfit distinction in the performance appraisal of active managers.

CFA Level III, Portfolio Management Pathway, Learning Module 3: Active Equity Investing: Portfolio Construction, LOS 3(c): Distinguish between Active Share and active risk and discuss how each measure relates to a manager's investment strategy

Q.5 Based on the information provided in Exhibits 1 and 2 and the vignette, Alexei has *correctly* defined the normal benchmark for:

- A. Eco.
- B. Smith.
- C. Akhtar.

The correct answer is **B**.

Smith's normal benchmark, the MSCI World ex-US Value Index, accurately represents his investment style and universe. This is crucial as the normal benchmark is used to evaluate the performance of the portfolio manager and should therefore reflect the manager's investment style and universe.

A is incorrect. The normal benchmark defined by Alexei for Eco is the MSCI US Broad Market Index. However, this is not an accurate representation of Eco's investment universe. Eco is managing international ex-US equities. Therefore, her normal benchmark should be an international ex-US equity index. Using a US Broad Market Index as a benchmark for a portfolio of international ex-US equities would not provide an accurate measure of Eco's performance.

C is incorrect. Akhtar's normal benchmark, as defined by Alexei, is the MSCI World ex-US index. However, this benchmark does not accurately represent Akhtar's investment style, which is growth. A more appropriate benchmark for Akhtar would be an index that reflects growth stocks in the international ex-US equity market. Using a benchmark that does not reflect the manager's investment style can lead to inaccurate performance evaluations.

CFA Level III, Portfolio Management Pathway, Learning Module 3: Active Equity Investing: Strategies, LOS 3(b): Analyze bottom-up active strategies, including their rationale and associated processes

Q.6 The strategy employed by Walker to manage the \$10 million entrusted by LLE's chief executive is *most likely* classified as:

- A. Completeness fund.
- B. Equitized market neutral.
- C. Alpha and beta separation.

The correct answer is **C**.

Walker's strategy can be classified as an alpha and beta separation. This is because he is gaining exposure to the U.S. equity markets via a long futures position, which represents the beta component of the strategy. Beta refers to the systematic risk of a portfolio and is associated with market movements. By taking a long futures position in the S& P500 equity index, Walker is essentially gaining exposure to the overall market movements, which is the beta component of the strategy.

On the other hand, the alpha component of the strategy is represented by the active exposure to emerging markets through the allocation of funds to Wilde. Alpha refers to the excess return of a portfolio over its benchmark index, which is achieved through active management. Wilde, being an active manager benchmarked to the MSCI Emerging Markets Index (EMI), is expected to generate alpha by outperforming the benchmark through her investment decisions. Therefore, Walker's strategy of combining these two components - the beta exposure through the long futures position and the alpha generation through the active management - is what makes it an alpha and beta separation strategy.

A is incorrect. A completeness fund is a portfolio of active managers with an overall risk exposure similar to the investor's benchmark. In this case, Walker is not creating a portfolio of active managers. Instead, he is using a futures contract to gain exposure to the U.S. equity market and is allocating funds to a single active manager for exposure to emerging markets. Therefore, this strategy does not fit the definition of a completeness fund.

B is incorrect. An equitized market-neutral strategy is one where the profits are uncorrelated with market movements, and profits are generated based primarily on stock price movements. In Walker's strategy, the long futures position in the S& P500 equity index means that the strategy's returns are, in fact, correlated with market movements. Therefore, this strategy cannot be classified as equitized market neutral.

CFA Level III, Portfolio Management Pathway, Learning Module 3: Active Equity Investing: Portfolio Construction, LOS 3(h): Discuss the long-only, long extension, long/short, and equitized market-neutral approaches to equity portfolio construction, including their risks, costs, and effects on potential alphas
