

Level III of the CFA® Exam

Mock Questions with Answers - Portfolio Management - Morning
Session

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Case 1: Jerry Lawson
Topic: Performance Measurement
Total Value of this Question Set is 12 Points

Jerry Lawson is an equity portfolio manager at GreenDeals Investment Management (GDIM), an asset management firm in the US. Every quarter, Lawson hires a financial consultant to perform a thorough analysis of the portfolio holdings of his clients' accounts. For the next four quarters, Lawson hired Joseph Riso, a financial analyst and an expert in performing portfolio evaluations and measuring returns. While talking about appropriate benchmark construction during an introductory meeting with Lawson, Riso made the following comments:

Statement 1: "At the investment manager level, a number of different types of benchmarks can satisfy the criteria for an acceptable benchmark. Of these types, the custom security benchmark is the one that meets all of the required benchmark properties and satisfies all of the benchmark validity criteria."

Statement 2: "Broad market indexes as benchmarks are unambiguous. However, style indexes and factor model based benchmarks can be ambiguous and, thus, are sometimes not appropriate to serve as benchmarks."

After the meeting, Riso was assigned the task of analyzing the quality of the benchmark for an institutional fund worth \$10 million and a private wealth account worth \$7 million. The institutional fund constitutes mostly of large-cap value stocks, both domestic and international. During his analysis of the fund's benchmark, Riso gathered the following information:

1. When large-cap growth stocks outperformed the market as a whole, the fund produced a positive excess return relative to its benchmark.
2. When large-cap growth stocks underperformed the market as a whole, the fund outperformed the market, but the benchmark underperformed the market.

Riso then proceeded towards evaluating the benchmark quality of the private wealth account, owned by Kellie James, a practicing physician in a community hospital. The account has a stated investment mandate that permits active management using long positions only. As part of his evaluation process, Riso gathered the following information:

1. The historical beta of the account relative to the benchmark equaled 1.02.
2. The tracking error of the account relative to the benchmark was 15%, and the tracking error of the account relative to the market index was 17%.
3. Over the past month, the risk exposures of the benchmark were significantly greater than the risk exposures of the managed account.
4. The ratio of negative active positions to positive active positions was 1.5.

Lawson is also responsible for heading a portfolio management team for a large pension fund sponsored by Crest Enterprises (CE), a large firm operating in the industrial sector of the U.S.

economy. The financial committee at CE instructed Lawson to perform a thorough evaluation of the performance of their pension assets for the month of June 2010. Lawson assigned this task to Riso and Andrew Ellerd, a financial analyst at GDIM with considerable experience in performance evaluation of institutional accounts. After a comprehensive assessment and performing rigorous calculations, Riso and Ellerd came up with numbers that helped them in determining the sources of the fund's returns. A portion of the results of their macro attribution analysis is provided in Exhibit 1.

Exhibit 1: Macro Attribution Analysis

Decision Making Levels	Returns
Aggregate manager investment style benchmarks	3.65%
Aggregate asset category benchmarks	3.76%
Aggregate actual return of the managers	3.81%
Allocation effects	0.00%

Q.61 Riso is *most* accurate with respect to:

- A. Statement 1 only.
- B. Statement 2 only.
- C. both statements 1 and 2.

Correct answer: **C**

Both statements made by Riso are accurate.

Statement 1 is accurate because a custom security-based benchmark does indeed meet all of the required benchmark properties and satisfies all of the benchmark validity criteria. A custom security-based benchmark is a type of benchmark that is specifically designed to reflect the unique investment strategy and risk/return profile of a particular portfolio. It is constructed using the same securities that are held in the portfolio but in different proportions. This type of benchmark is considered to be the most appropriate for evaluating the performance of a portfolio because it accurately reflects the portfolio's investment strategy and risk/return profile. Therefore, it satisfies all of the benchmark validity criteria, which include measurability, investability, appropriateness, and specificity.

Statement 2 is also accurate. Broad market indexes as benchmarks are unambiguous because they represent a wide cross-section of the market and are, therefore, easy to understand and interpret. However, style indexes and factor model-based benchmarks can be ambiguous. Style indexes may be ambiguous because the definition of investment style implied by them may not align with the investment process of the manager being evaluated. Factor model-based benchmarks can be ambiguous because multiple benchmarks can be constructed with the same factor exposures, but each benchmark can earn different returns. This ambiguity can make it difficult to accurately evaluate a portfolio's performance using these types of benchmarks.

CFA Level III, Performance Measurement, Learning Module 1: Portfolio Performance Evaluation, LOS 1(j): Describe types of asset-based benchmarks. & LOS 1(k): Discuss tests of benchmark quality.

Q.62 With respect to the information, Riso gathered about the institutional fund, which of the following point(s) *most likely* indicates (indicate) that the benchmark is of poor quality?

- A. Point 1 only.
- B. Point 2 only.
- C. Both points 1 and 2.

Correct answer: **C**

Option C is the correct answer because both points 1 and 2 indicate that the benchmark is of poor quality.

Point 1 suggests that the manager's ability to identify attractive and unattractive investment opportunities is positively correlated with whether the manager's style is in or out of favor. This is a sign of a poor benchmark because a good benchmark should display a correlation between active return (A) and style return (S) that is not statistically different from zero. In other words, the performance of the manager's style should not significantly influence the active return of the portfolio. If it does, it means that the benchmark is not accurately reflecting the risk and return characteristics of the portfolio, which is a sign of poor quality.

Point 2 shows a negative relationship between the portfolio return minus the market return (P-M) and style return (S). This is another sign of a poor benchmark because a good benchmark should have a significant positive correlation between these two variables. This means that when the manager's style is in favor, both the benchmark and the account should outperform the market. If this is not the case, it suggests that the benchmark is not accurately reflecting the performance of the portfolio, which is another sign of poor quality.

A is incorrect. Point 1 alone does not necessarily indicate that the benchmark is of poor quality. While it is true that a good benchmark should display a correlation between active return (A) and style return (S) that is not statistically different from zero, this point alone does not provide enough evidence to conclude that the benchmark is of poor quality. It is possible that other factors are influencing the correlation between active return and style return, and without more information, it is not possible to definitively say that the benchmark is of poor quality based on this point alone.

B is incorrect. Similarly, point 2 alone does not necessarily indicate that the benchmark is of poor quality. While a good benchmark should have a significant positive correlation between the portfolio return minus the market return (P-M) and style return (S), this point alone does not provide enough evidence to conclude that the benchmark is of poor quality. It is possible that other factors are influencing this correlation, and without more information, it is not possible to definitively say that the benchmark is of poor quality based on this point alone.

CFA Level III, Performance Measurement, Learning Module 1: Portfolio Performance Evaluation, LOS 1(k): Discuss tests of benchmark quality.

Q.63 Which respect to the information Riso gathered about the private wealth account, which of the following point(s) *most likely* indicates (indicate) that the benchmark is of poor quality?

- A. Point 4 only.
- B. Points 3 and 4 only.
- C. Points 1 and 3 only.

Correct answer: **A**

Point 1 indicates that the historical beta of the account relative to the benchmark equaled 1.02. Beta is a measure of the systematic risk of a security or a portfolio in comparison to the market as a whole. A beta of 1.02 suggests that the account's returns are very closely aligned with the benchmark's returns. This is indicative of a good benchmark as it shows that there are minimal systematic biases in the benchmark relative to the account.

Point 2 shows that the tracking error of the account relative to the benchmark was 15%, and the tracking error of the account relative to the market index was 17%. Tracking error is a measure of the divergence between the price behavior of a position or a portfolio and the price behavior of a benchmark. The fact that the volatility of the account's returns relative to the benchmark is less than the volatility of the account's returns versus the market index ($15\% < 17\%$) also suggests that the benchmark is appropriate.

Point 3 states that over the past month, the risk exposures of the benchmark were significantly greater than the risk exposures of the managed account. This is not necessarily indicative of a poor benchmark. An active manager is always making bets against the benchmark, and a good benchmark will exhibit risk exposures at times greater than those of the managed portfolio and at times smaller.

Point 4, however, indicates that the ratio of negative active positions to positive active positions was 1.5. This suggests that the manager is holding 60% of the portfolio in negative positions. Since the account is long-only, when a good benchmark is built, the manager should be expected to hold largely positive active positions. Therefore, this point most likely indicates that the benchmark is of poor quality.

CFA Level III, Performance Measurement, Learning Module 1: Portfolio Performance Evaluation, LOS 1(k): Discuss tests of benchmark quality.

Q.64 Which of the following is *least* accurate about the performance of Crest Enterprises's pension account during June 2010?

- A. Fund sponsors invested in all of the managers and asset categories precisely at the established policy allocations.
- B. During June 2010, the return due to style bias was positive.
- C. During June 2010, the managers' active management decisions had a positive impact on the change in the fund's value.

Correct answer: **B**

The return to style bias is calculated by subtracting the aggregate asset category benchmarks from the aggregate manager investment style benchmarks. In this case, the calculation is 3.65% - 3.76%, which equals -0.11%. This indicates a negative return to style bias, which contradicts the statement in option B that the return due to style bias was positive during June 2010. Therefore, option B is the least accurate statement about the performance of Crest Enterprises' pension account during June 2010.

A is incorrect. The statement in option A is that fund sponsors invested in all of the managers and asset categories precisely at the established policy allocations. This is supported by the allocation effects in the macro attribution analysis, which is 0.00%. This indicates that the actual allocations matched the policy allocations perfectly. Hence there were no allocation effects. Therefore, the statement in option A is accurate.

C is incorrect. The statement in option C is that the managers' active management decisions had a positive impact on the change in the fund's value during June 2010. This is supported by the calculation of the return to active management, which is calculated by subtracting the aggregate manager investment style benchmarks from the aggregate actual return of the managers. In this case, the calculation is 3.81% - 3.65%, which equals 0.16%. This indicates a positive return to active management, hence the statement in option C is accurate.

CFA Level III, Performance Measurement, Learning Module 1: Portfolio Performance Evaluation, LOS 1(h): Identify and interpret investment results attributable to the asset owner versus those attributable to the investment manager.

LOS 1(e): Interpret the sources of portfolio returns using a specified attribution approach

Case 2: Yini Leon
Topic: Portfolio Construction
Total Value of this Question Set is 12 Points

Yini Leon is a portfolio manager at Rapid Investment Advisors, which focuses mainly on small institutions and local college endowments. Rhino Tech College is a client that has 2,000 students. Rhino's endowment's portfolio of \$200 million supports 5% of its current annual spending needs and has an asset concentration of 60% in stocks and remaining in bonds. The college is planning to double student count to 4,000 students over the next five years.

Leon wants to recommend the addition of alternative investments (a 20% allocation to a hedge fund strategy) to the endowment portfolio of Rhino. Rhino's Investment Committee has indicated to Leon its four main considerations for the combined portfolio when looking at the allocation to hedge funds:

- Maximize risk-adjusted returns.
- Limit downside risk.
- Avoid layering of fees.
- No negative liquidity impact.

After the discussion, Leon prepares the following information on several short-listed funds, showing their past performance contribution to a 48% stocks/32% bonds/20% hedge fund strategy portfolio. Leon believes historical returns are good proxies for future returns.

Fund category	Strategy	Mean return	Standard deviation	Sharpe ratio	Sortino ratio	Max draw down
60/40 Stocks/Bonds	Traditional portfolio	6.90%	8.66	0.62	1.13	14.0%
US small cap long/short equity	Equity	7.50%	8.75	0.68	1.23	27.0%
Event driven	Event driven	7.25%	7.85	0.71	1.31	20.5%
Fixed inc arbitrage (Grade A+ bonds)	Relative value	7.50%	7.80	0.75	1.39	12.5%
Fund of funds (equity)	Multi-manager	6.40%	7.80	0.62	1.11	21.2%

In a subsequent meeting with Rhino's Investment Committee, Leon presents her