

Guideline Answers

Level III 2025 Portfolio Management Mock Exam 1 – Session 1

QUESTION SET 1: PORTFOLIO MANAGEMENT

1. **B**

LOS: *formulate a portfolio positioning strategy given forward interest rates and an interest rate view that coincides with the market view*

Reducing portfolio duration below that of the benchmark is least likely to generate excess returns under Yeti's forecast that the yield curve and interest rates should remain stable.

The two basic ways in which a manager may actively position a bond portfolio versus a benchmark index to generate excess return under a static or stable yield curve are to increase risk by adding duration and to add leverage to the portfolio.

Reference: "Yield Curve Strategies," 2025, L3, Portfolio Management Pathway, Volume 2, Learning Module 5, Section 3 "Yield Curve Strategies"

2. **B**

LOS: *describe risk considerations for spread-based fixed-income portfolios*

During an economic downturn, the probability of a downgrade or default is higher in the near-term than in the long-term. As a result, high-yield issuers may experience an inversion in the credit spread curve.

Given that Nucor would be selling longer-duration bonds and buying shorter-duration bonds with the same rating, the trade is likely to reduce both spread duration and DTS (duration times spread).

Reference: "Fixed-Income Active Management: Credit Strategies," 2025, L3, Portfolio Management Pathway, Volume 2, Learning Module 6, Section 2 "Key Credit and Spread Concepts for Active Management"

3. **C**

LOS: *discuss liquidity risk in credit markets and how liquidity risk can be managed in a credit portfolio*

Statement 3 is least likely correct as bond liquidity is typically highest immediately after issuance.

Statement 1 is correct as bid–ask spreads on government bonds and higher-rated corporate bonds are generally lower than spreads on lower-rated corporates. Statement 2 is correct as conventional corporate bonds normally have lower bid–ask spreads than corporate bonds with non-standard or complex features, such as embedded options.

Reference: “**Fixed-Income Active Management: Credit Strategies,**” 2025, L3, Portfolio Management Pathway, Volume 2, Learning Module 6, Section 4 “Liquidity and Tail Risk”
“**Overview of Fixed-Income Portfolio Management,**” 2025, L3, Core, Portfolio Construction, Volume 2, Learning Module 2, Section 4 “Bond Market Liquidity”

4.

A

LOS: *describe the use of structured financial instruments as an alternative to corporate bonds in credit portfolios*

While covered bonds offer real estate cash flow exposure similar to that of ABS, given the dual recourse (i.e., to both the issuing financial institution and the underlying asset pool) as well as the substitution of non-performing assets, covered bonds usually involve lower credit risk.

CLOs are not dual recourse, and asset-backed securities have exposure to consumer loans and lower-rated tranches would likely underperform if credit spreads widen.

Reference: “**Fixed-Income Active Management: Credit Strategies,**” 2025, L3, Portfolio Management Pathway, Volume 2, Learning Module 6, Section 8 “Structured Credit”

QUESTION SET 2: PORTFOLIO CONSTRUCTION

Part A

LOS: *discuss investment considerations that are important in allocating to different types of alternative investments*

A market-neutral hedge fund is the most liquid option among the choices given and is therefore more appropriate for the foundation. Market-neutral hedge funds typically have a one-year lock-up and then offer redemptions quarterly or annually thereafter.

The other three investments mentioned have lock-ups of greater than ten years.

Reference: “**Asset Allocation to Alternative Investments,**” 2025, L3, Core, Portfolio Construction, Volume 2, Learning Module 3, Section 6 “Liquidity”

Part B

LOS: *discuss investment considerations that are important in allocating to different types of alternative investments*

Secondaries are “seasoned” and have less J-curve impact as compared to private equity investments. Therefore, secondary market interests typically last less than ten years and can be realized earlier. Since the investment committee does not want to lock up capital for more than ten years, a secondary market investment would be appropriate for the foundation.

Reference: “**Asset Allocation to Alternative Investments,**” 2025, L3, Core, Portfolio Construction, Volume 2, Learning Module 3, Section 6 “Liquidity”

Part C

LOS: *discuss the importance of liquidity planning in allocating to alternative investments*

The call-down structure of a private equity fund creates a need to model a hypothetical path to achieving and maintaining a diversified, fully invested allocation to private investments. The three primary challenges faced by institutions include:

- Achieving and maintaining the desired allocation;
- Handling capital calls; and
- Planning for the unexpected.

Reference: “**Asset Allocation to Alternative Investments,**” 2025, L3, Core, Portfolio Construction, Volume 2, Learning Module 3, Section 13 “Liquidity Planning”

Part D

LOS: *discuss considerations in monitoring alternative investment programs*

The factors that Stern should mention to Miller include:

- Key person risk—Most alternative investment strategies depend to a large extent on the skill of a few key investment professionals. These are known as “key persons.” Key persons are typically specified in the fund documents, with certain rights allocated to the limited partners in the event a key person leaves the firm.
- Alignment of interests—Alignment of interests issues can be from the complexity of the organization, structure of management fees, compensation of investment professionals, growth in assets under management, and the amount of capital the key professionals have committed to the funds that they are managing.
- Style drift—Investors should understand where the fund manager has a competitive advantage and skill and confirm that the investments are consistent with the manager’s advantage.
- Risk management—The investor should understand the manager’s risk management philosophy and processes and periodically confirm that the fund is abiding by them. Where a fund makes extensive use of leverage, a robust risk management framework is essential.
- Client/asset turnover—A significant gain or loss in clients or assets of the manager could signal a significant underlying problem.
- Client profile—Investors should gauge the profile of the fund manager’s clients. They should confirm that the other clients are long-term investors and that they have similar investment goals and desired outcomes.
- Service providers—Investors should ensure that the fund manager has engaged independent and reputable third-party service providers, including administrators, custodians and auditors.

Reference: “**Asset Allocation to Alternative Investments,**” 2025, L3, Core, Portfolio Construction, Volume 2, Learning Module 3, Section 15 “Monitoring the Investment Program”

QUESTION SET 3: ETHICAL AND PROFESSIONAL STANDARDS

1. **B**
LOS: *demonstrate a thorough knowledge of the CFA Institute Code of Ethics and Standards of Professional Conduct by interpreting the Code and Standards in various situations involving issues of professional integrity*

Reporting the violation to governmental or regulatory organizations is not mandatory under the Standards. It may, however, be required under applicable regulations.

Reference: “**Guidance for Standards I–VII,**” 2025, L3, Core, Ethical and Professional Standards, Volume 5, Learning Module 2, Section 1 “Standard I(A) Knowledge of the Law”

2. **A**
LOS: *describe the structure of the CFA Institute Professional Conduct Program and the disciplinary review process for the enforcement of the CFA Institute Code of Ethics and Standards of Professional Conduct*

Shultz’s matter will be handled by the Disciplinary Review Committee (DRC), a volunteer committee.

Reference: “**Code of Ethics and Standards of Professional Conduct,**” 2025, L3, Core, Ethical and Professional Standards, Volume 5, Learning Module 1, Section 1 “Preface”

3. **B**
LOS: *demonstrate a thorough knowledge of the CFA Institute Code of Ethics and Standards of Professional Conduct by interpreting the Code and Standards in various situations involving issues of professional integrity*

There is no violation for a conflict of interest if it has been fully and fairly disclosed in advance, using effective and relevant communication.

Soft dollars are permissible if they are used to benefit clients. Whistleblowing for personal gain is not allowed.

Reference: “**Guidance for Standards I–VII,**” 2025, L3, Core, Ethical and Professional Standards, Volume 5, Learning Module 2, Section 54 “Standard VI(A) Avoid or Disclose Conflicts”