

2027 CFA® Exam Prep

IFT Mock Exams

Level III

Mock Exam 1: Session 1

PORTFOLIO MANAGEMENT PATHWAY

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Exam 1 Session 1

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	Total	132

Start time: 9:00 AM

End time: 11:12 AM

QUESTION 1**TOPIC: PERFORMANCE MEASUREMENT****THE TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS**

Felix Severin, a senior investment consultant at AJI Finanz, meets with Ann Jaehn, a management trainee. Jaehn has just completed a 10-year monthly performance appraisal for three trading strategies: positive asymmetry (X), low beta (Y), and negative asymmetry (Z). The results of her analysis are summarized in Exhibit 1 below.

Exhibit 1: Return Profile Summary

Strategy	X	Y	Z
Cumulative return	150.00%	35.50%	-16.05%
Annualized return	5.85%	2.05%	-1.30%
Annualized standard deviation	6.35%	5.10%	6.60%
Sharpe ratio	0.61	0.02	-0.50
Capture ratio	2.50	1.00	0.40
Beta	0.63	0.50	0.66
Drawdown (maximum)	-25.0%	-26.4%	-45.4%

Jaehn's report highlights the differences between the three return profiles. She explains to Severin that a convex return profile can lead to higher risk-adjusted returns by not participating in periods when the market is not trending strongly upward. Avoiding large drawdowns is beneficial as it shows the robustness and risk management of the processes.

Severin next examines the return profile of an L/S hedge fund that AJI Finanz invests in, and asks Monika Kruse, an analyst, about the fund's benchmark. Kruse replies that because both broad market indexes and the risk-free rate will be weakly correlated or uncorrelated with hedge fund returns, she uses a peer group universe to benchmark the fund's returns. Severin is skeptical of the peer group's appropriateness as a benchmark and wants to know its limitations.

1.1 Compare the return profiles of the positive asymmetry profile, low beta, and negative asymmetry strategies based on the metrics given in Exhibit 1. Based on the capture ratio and drawdown, **describe** the strategy with the highest return performance.

- Positive Asymmetry X
 - Cumulative return
 - Annualized return
 - Annualized standard deviation
 - SR
 - CR

- Beta
- Drawdown (maximum)
- Low Beta Y
 - Cumulative return
 - Annualized return
 - Annualized standard deviation
 - SR
 - CR
 - Beta
 - Drawdown (maximum)
- Negative Asymmetry Z
 - Cumulative return
 - Annualized return
 - Annualized standard deviation
 - SR
 - CR
 - Beta
 - Drawdown (maximum)

1.2 Identify three limitations of using hedge fund peer universes as a benchmark for the L/S hedge fund.

QUESTION 2**TOPIC: PORTFOLIO CONSTRUCTION****THE TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS**

Robert Nelson, age 68, meets with Andrew Mesa, CFA of Acuva Wealth Managers, to discuss his retirement goals and retirement funding needs as part of his IPS. He recently sold off his advertising company and plans to retire next year. Robert has a taxable investment portfolio with a current market value of USD 5,000,000 invested in traditional assets with a cost basis of USD 2,000,000. Robert and his wife, Kate, 67, will rely on this investment portfolio to cover expenses estimated at USD 170,000 annually in real terms. Robert's income from the business sale in nominal terms is USD 130,000 annually. This income is not indexed to future inflation, which is expected to be 3% annually. Robert is worried about the effects of inflation and wants to assess whether his income sources would be sufficient in 10 years to cover the impact of inflation.

Robert's primary goals are to provide for the couple and maintain their standard of living in retirement. Robert favors large-cap dividend-paying stocks over riskier stocks for his portfolio. He expects an annual pretax capital gains return of 7% and 2% in nominal dividend income from his securities portfolio. The capital gains tax rate is 25%. Stock dividends are taxed annually at a rate of 30%. Robert has meticulously reinvested all these distributions back into his portfolio.

Robert has private real estate worth USD 100 million. He wishes to grow his investment resources, leave an inheritance for his two independent children, and donate to his favorite charity in 10 years. Robert and Kate's respective paternal families have an average life expectancy of 80 years.

2.1 Discuss how Mesa should create the investment objectives section of Robert's IPS.

2.2 Determine whether Robert can meet the couple's retirement needs in 10 years after accounting for the effects of inflation on his business income and his securities portfolio value. **Justify** your response.

2.3 Discuss how Mesa should reflect on Robert's investment horizon in the IPS.

QUESTION 3**TOPIC: ETHICAL AND PROFESSIONAL STANDARDS****THE TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS**

Titan Asset Management Case Scenario

Titan Asset Management is a well-managed firm that offers a range of mutual funds and investment plans for both private and institutional clients. The board of directors of Titan adopted the CFA Institute Asset Manager Code of Professional Conduct (Asset Manager Code) a year ago to establish and promote ethical behavior within the firm. The board has just instituted a review of each manager's ability to ensure his department's compliance with the Asset Manager Code. Amara Bhatia, CFA, the recently appointed Chief Compliance Officer, is responsible for reviewing and evaluating the compliance of each department.

Bhatia meets with Tom Preston, CEO of Titan, to discuss the procedures implemented over the last year and to address the Manager's responsibility outlined in the Asset Manager Code's six principles. Preston responds, "We tried to address the following principles while implementing the policies and procedures of the Code:

Principle 1: Act for the benefit of clients and be professional and ethical in all our dealings at all times.

Principle 2: Act with skill, competence, and diligence. Communicate accurately and promptly with our clients while maintaining independence and objectivity.

Principle 3: Stay abreast of all rules of the capital markets."

Bhatia then reviews three current compliance procedures of the firm that were under Preston's supervision before her appointment:

Risk management process:	The risk profile of a client's investment matches his risk appetite and ability. A comprehensive risk management process is implemented for portfolios and investment strategies to identify, measure, and manage risk. The risk management techniques implemented are consistent with the investment style and philosophy of our portfolio managers.
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Portfolio information review:	Accurate and complete portfolio information is provided to clients. The investment committee regularly reviews this information to confirm its accuracy.
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Business-continuity plan review: Procedures for safeguarding client accounts and handling inquiries in case of emergencies or market disruptions. The current plan requires backing up all of the firm's computer systems and client records daily. The backups are stored in an offsite storage facility. Titan employs an external recovery firm to implement specific emergency plans. The recovery firm is responsible for covering critical business functions. It implements plans to communicate with employees, critical vendors, and suppliers in the event of a facility or communication disruption. The same firm also provides plans for contacting and communicating with clients in an extended disruption.

Bhatia next discusses the client disclosure policies with Shiras Nathan, head of customer relations. Nathan states, "Regarding the Asset Manager Code relating to client services, we ensure the following policies: All disclosures are accurate and complete, and we show all our calculations, including the complicated ones. We communicate with clients regularly and provide performance reports whenever they request them. All conflicts of interest arising due to the firm or employee holdings in the same securities as clients, allocation of investments among similar portfolios, use of soft dollars, and directed brokerage arrangements are disclosed."

Finally, Bhatia asks about disclosures regarding management fees. Nathan responds that the disclosures contain the following information:

"Titan charges a 2% asset-based management fee. In addition to the management fee, clients pay distribution and service fees to buy and sell shares in a fund that cannot exceed 0.75 percent of a fund's average net assets per year. Titan charges fees that may not exceed 0.25 percent for marketing material or prospectuses sent to potential investors."

After completing her evaluations, Bhatia begins working on her report, preparing recommendations to present at the upcoming board meeting.

3.1. Which of the principles is inconsistent with the Asset Manager Code of Professional Conduct?

- A. Principle 1.
- B. Principle 2.
- C. Principle 3.

3.2. Which of the three compliance procedures reviewed by Bhatia is consistent with the required and recommended standards of the Asset Manager Code of Professional Conduct?

- A. The risk management process.

- B.** Portfolio information.
- C.** Business-continuity plan.

3.3 Which of Nathan's client service policies is consistent with the Asset Manager Code of Professional Conduct?

- A.** Performance reports frequency.
- B.** Complete, accurate disclosures, including complex calculations.
- C.** Conflicts of interest disclosures.

3.4. Are the firm's disclosures regarding management fees consistent with the required and recommended standards of the Asset Manager Code?

- A.** Yes.
- B.** No, because the average or expected expenses or fees clients are likely to incur are not mentioned.
- C.** No, because complicated language is used.

QUESTION 4**TOPIC: ECONOMICS****THE TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS****Alpine Investments Case Scenario**

Andrew Baker, a senior portfolio manager at Alpine Investments, evaluates the performance of US equities relative to US investment-grade corporate bonds for future allocations for Alpine's Balanced Fund. Baker forecasts the following variables, given in Exhibit 1.

Exhibit 1: Equity Market Data

Expansion rate for P/E per year	0.20%
Forecasted dividend yield	2.5%
Real GDP growth estimate	3.0%
Premium for corporate earnings growth over nominal GDP	1.0%
Expected inflation	2.5%
Repurchase yield	0.5%
YTM on a long-term government bond	6.0%
Equity risk premium forecast	3.2%

Baker is considering investing in international equities for his Global Multi-asset Portfolio. He asks Clarke, a research analyst, about his capital market expectations for the near future. Clarke collects the data displayed in Exhibit 2.

Exhibit 2: Asset Class (Emerging Market Equities)

Standard deviation	20.50%		
Correlation Matrix	US Equities	Emerging Market Equities	GM
US Equities	1.0	0.60	0.85
Emerging Market Equities	0.60	1.0	0.70
GM	0.85	0.70	1.0

Clarke provides the following facts and estimates:

- The Sharpe ratio of GM Portfolio and the segmented market is estimated to be 0.33.
- The standard deviation of GM is estimated to be 9.5%.
- The risk-free rate of interest is 4.5%.
- The standard deviation of US equities is 23.0%.
- US equities are estimated to be 80% integrated, and Emerging Market Equities are estimated to be 60% integrated.

Baker asks Clarke about the future fiscal and monetary outlook. Clarke makes the following statements: