

2026 CFA® Exam Prep

IFT Mock Exams

Level III

Mock Exam 1: Session 2

PORTFOLIO MANAGEMENT PATHWAY

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Errata information can be found at <https://goo.gl/UVXdAv>

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Exam 1 Session 2

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Start time: 2:00 PM

End time: 4:12 PM

QUESTION 1**TOPIC: PORTFOLIO MANAGEMENT PATHWAY – FIXED INCOME****THE TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS**

Alan Dunphy is a fixed income manager with Blue Jay Advisors. He meets with a potential client, Carl Jacobsen, who is the chief risk officer of a life insurance firm, ADI. Jacobsen needs fixed income portfolio management to meet ADI's two types of obligations: short term obligations of expected claims and long term future obligations. ADI is interested in passive exposure to fixed-income instruments for its bond portfolio. Blue Jay offers two strategies for passive investment.

Strategy 1 To minimize tracking risk by fully replicating a range of benchmarks comprised of 1 – 3 years government bonds.

Strategy 2 To match primary risk factors through an enhanced indexing strategy for a subset of the bonds included in the S&P U.S. Treasury Bond 10+ Year Index. The strategy can also be customized according to the client's sustainability preferences.

Dunphy informs the client that for investors who wish to have exposure to an index, Blue Jay offers 1 – 3 Year Government Bond Index linked ETF.

A client – DVI Pension Fund of Blue Jay, wants a fixed income portfolio to immunize a single 12-year liability. Dunphy suggests two portfolios of government bonds that pay semi-annual coupons but with the same market value. The risk and return characteristics of the two portfolios are given in Exhibit 3:

Exhibit 3

	Portfolio I	Portfolio II
Cash flow yield annualized	8.55%	8.56%
Macaulay duration annualized	11.95	12.01
Convexity annualized	170	200

These statistics are based on aggregating the interest and principal cash flows for the bonds that constitute the portfolios. Dunphy explains to the client that the chosen portfolio would need to be rebalanced over time to maintain its target duration.

Durham Corporation asks Dunphy to build and manage a portfolio of fixed-income bonds to retire multiple corporate debt liabilities. The debt liabilities have a market value of USD 60,550,110, a modified duration of 7.10, and a BPV of USD 42,991. Dunphy buys a portfolio of government bonds with a market value of USD 73,370,000, a modified duration of 3.15, and a BPV of USD 23,112. The initial surplus of USD 12,819,890 and the negative duration gap of USD 19,879 are deliberate. Dunphy decides to pursue a contingent immunization strategy to retire the debt at a lower cost than the duration matching approach. The futures contract that he buys is based on a 10-year T-note with

a par value of USD 100,000. It is estimated to have a BPV of USD 108.1514 per contract. He purchases 220 contracts.

1.1 Describe two advantages of 1 -3 Year Government Bond Index linked ETF for ADI and one disadvantage for following Strategy 1.

1.2. Describe how using Strategy 2 for ADI's long term liabilities addresses its sustainability preferences.

1.3 Select the *most* appropriate portfolio (Portfolio I, Portfolio II) for Dunphy's client if his objective is to minimize variance in the realized rate of return over the 12-year horizon. **Justify** your response.



1.4 Calculate the number of contracts (N_f) to hedge the debt liabilities fully. **Determine** whether Dunphy is over-hedging or under-hedging the risk exposure based on the view that 10-year yields will decline. **Justify** your response.

