2027 CAIA® EXAM PREP

SchweserNotes™

CAIA Ethical Principles, Institutional Asset Owners, and Asset Allocation

Level II Book 1

KAPLAN SCHWESER

Kaplan Schweser's Path to Success

CAIA® Level II Exam

Welcome

As the head of Advanced Designations at Kaplan Schweser, I am pleased to have the opportunity to help you prepare for the CAIA exam. Kaplan Schweser has decades of experience in delivering the most effective CAIA exam prep products in the market and I know you will find them to be invaluable in your studies.

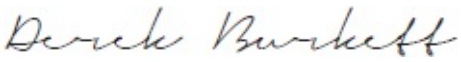
Our products are designed to be an integrated study solution across print and digital media to provide you the best learning experience, whether you are studying with a physical book, online, or on your mobile device.

Our core product, the SchweserNotes™, addresses all Topic Areas, Readings, and Learning Objectives in the CAIA curriculum. The SchweserNotes are written to clearly and succinctly address the content of each Learning Objective, which form the basis for all exam questions. Our Mock Exams and QuickSheet will help you in the later stages of your study preparation by helping you recall and retain im portant concepts.

All purchasers of the SchweserNotes receive online access to the Kaplan Schweser online platform (our learning management system or LMS) at www.Schweser.com. In the LMS, you will see a dashboard that tracks your overall progress and performance and also includes an Activity Feed, which provides structure and organization to the tasks required to prepare for the CAIA exam. You also have access to the online and eBook versions of the SchweserNotes so that you always have easy access to the readings. There are Reading Quiz questions at the end of each reading. I strongly encourage you to enter your Reading Quiz answers online and use the dashboard to track your progress and stay motivated.

Again, thank you for trusting Kaplan Schweser with your CAIA exam preparation. We're here to help you throughout your journey to become a CAIA charterholder.

Regards,



Derek Burkett, CFA, FRM, CAIA
Vice President (Advanced Designations)

Contact us for questions about your study package, upgrading your package, purchasing additional study materials, or for additional information:
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Book 1: CAIA Ethical Principles, Institutional Asset Owners, and Asset Allocation

SchweserNotes™ 2027

CAIA Level II



SCHWESERNOTES™ 2027 CAIA® LEVEL II BOOK 1: CAIA ETHICAL PRINCIPLES, INSTITUTIONAL ASSET OWNERS, AND ASSET ALLOCATION

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WELCOME TO THE 2027 SCHWESERNOTES™

Thank you for trusting Kaplan Schweser to help you reach your career and educational goals. We are very pleased to be able to help you prepare for the CAIA Level II exam. In this introduction, I want to explain the resources included with the SchweserNotes, suggest how you can best use Kaplan Schweser materials to prepare for the exam, and direct you toward other educational resources you will find helpful as you study for the exam.

SchweserNotes

The SchweserNotes consist of four volumes that include complete coverage of all CAIA assigned readings and learning objectives (LOs) as well as reading quizzes (multiple-choice and/or constructed response [essay-type] questions for every reading) to help you master the material and check your retention of key concepts.

Practice Questions

To retain the material, it is important to quiz yourself often. We offer the SchweserPro™ QBank, which contains hundreds of Level II practice questions and explanations. We also offer Topic Quizzes online to further help you retain and apply what you have learned.

OnDemand Class

Our OnDemand Class provides comprehensive online instruction for every reading in the CAIA curriculum. This video lecture series brings the personal attention of a classroom into your home or office with approximately 40 hours of instruction. The class offers in-depth coverage of difficult concepts as well as a discussion of example questions. All videos are available for viewing at any time throughout the exam season. Candidates enrolled in the OnDemand Class also have the ability to email questions to the instructor at any time.

Mock Exams

Schweser offers four full 4-hour practice exams. These online exams are important tools for gaining the speed and skills you will need to pass the exam. The Mock Exams contain answers with full explanations for self-grading and evaluation.

Late-Season Review

Late-season review and exam practice can make all the difference. Our OnDemand Review Package helps you evaluate your exam readiness with products specifically designed for late-season studying. This study package includes the OnDemand Review Workshop (15-hour archived online workshop covering essential curriculum topics) and Schweser's Secret Sauce® (a concise summary of the CAIA curriculum).

Level II Exam Weightings

When preparing for the exam, be familiar with the weights assigned to each topic area within the curriculum. The Level II exam weights by question format are as follows:

Book	Topic Area	Multiple Choice Exam Weight	Essay Question Exam Weight
1	CAIA Ethical Principles	0%	10%
1	Institutional Asset Owners	5%–11%	0%–10%
1	Asset Allocation	10%–16%	0%–10%
2	Risk and Risk Management	5%–11%	0%–10%
2	Methods and Models	7%–13%	0%–10%
3	Accessing Alternative Investments	3%–9%	0%–10%
3	Due Diligence and Selecting Managers	6%–12%	0%–10%
4	Volatility and Complex Strategies	5%–11%	0%–10%
4	Universal Investment Considerations	4%–10%	0%–10%
4	Emerging Topics	0%	10%
	Total	**70%**	**30%**

How to Succeed

The CAIA Level II exam is a significant challenge that requires substantial time and effort—there are no shortcuts to success! To be fully prepared, you must learn the material, understand key concepts, and master essential terminology and techniques. The exam consists of 100 multiple-choice and 3 multi-part essay

questions, which you'll need to answer both quickly and accurately. While most candidates spend between 250 and 300 hours studying, the actual preparation time needed will depend on your individual background and expertise.

Expect CAIA Association to test your understanding in ways that demonstrate your mastery of the Level II curriculum. Start your studies early and follow your study plan closely. Begin by reading the SchweserNotes and completing the practice questions for each reading. After finishing each book, use the topic quiz questions to understand how certain concepts might appear on the exam.

It is recommended that you complete your initial review of the entire curriculum at least two weeks before your exam window (earlier, if possible). This will give you sufficient time for practice and focused review. During the final review period, be sure to utilize all available Schweser Mock Exams. This stage will provide a clear assessment of your study effectiveness and highlight which readings require additional review. Practicing with exam-like questions from all topic areas and refining your time management skills will be key factors in your exam-day success.

Best regards,

Eric Smith

Eric Smith, CFA, FRM, FDP
Director, Advanced Designations
Kaplan Schweser

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Readings and Learning Objectives

TOPIC 1

CAIA Association. *CAIA Curriculum Level II Volume I.* Self-published, CAIA Association, 2026.

Reading 1.1: Professionalism and Fiduciary Responsibilities

1.1.1: Demonstrate knowledge of the purpose, role, and participants of the investment industry.
Including:

- Distinguish between the participants within the investment industry.
- Justify the four facets of purpose of the investment industry.
- Analyze the current investment industry relative to alternative systems.
- Understand the four facets of purpose of the investment industry.

1.1.2: Demonstrate knowledge of the purpose of the investment industry and value creation within the industry.
Including:

- Assess how value is created in the investment industry.
- Understand the role of sustainable finance.
- Understand the role of capital allocation in the investment industry.
- Describe how public and private markets create value.
- Describe stewardship with respect to investment industry activity.
- Understand different value models.

1.1.3: Demonstrate knowledge of professionalism and fiduciary responsibility.
Including:

- Evaluate the purpose of fiduciary duty and the four areas of fiduciary obligations.
- Understand the five values that support a true fiduciary and professional mindset.
- Assess the role of culture on industry professionalism.
- Understand the challenges that associate with the four areas of fiduciary obligations.

1.1.4: Demonstrate knowledge of a client-first approach.
Including:

- Discuss the role of trust in client relationships.
- Contrast the professional mindset with the characteristics and trademarks of our current system.
- Recommend how investors can navigate instances when the “right” choice is not obvious.
- Justify the role a professional mindset has in creating value for a client.
- Describe the virtuous circle of positive forces with respect to the fiduciary and professional mindset.

Reading 1.2: Ethics

1.2.1: Demonstrate knowledge of the relationship between professionalism and ethics.
Including:

- Understand the key elements of professionalism and fiduciary responsibility.
- Identify the eight ethical principles.

- Contrast the ethical principles that guide “doing the right things” with those that guide “doing things right.”

1.2.2: Demonstrate knowledge of foundational components of ethical principles.
Including:

- Understand the foundational ideas and concepts associated with the principles.
- Analyze the value creation equation.
- Support the role of professionalism in the organizational value chain.
- Justify the four components of assurance of quality.

1.2.3: Demonstrate knowledge of the CAIA Ethical Principles.
Including:

- Explain principle 1 and support its underlying components.
- Explain principle 2 and support its underlying components.
- Explain principle 3 and support its underlying components.
- Explain principle 4 and support its underlying components.
- Explain principle 5 and support its underlying components.
- Explain principle 6 and support its underlying components.
- Explain principle 7 and support its underlying components.
- Explain principle 8 and support its underlying components.
- Understand the benefits of a principles-based approach to ethics.

1.2.4: Demonstrate knowledge of historical ethical breaches in the finance industry.
Including:

- Ethical misconduct at MF Global.
- Ethical misconduct at Archegos Capital Management.
- Ethical misconduct at Bear Stearns.
- Ethical misconduct at the New York State Common Retirement Fund.
- Ethical misconduct at CalPERS.

TOPIC 2

CAIA Association. *CAIA Curriculum Level II Volume I*. Self-published, CAIA Association, 2026.

Reading 2.1: Types of Asset Owners and the Investment Policy Statement

2.1.1: Demonstrate knowledge of endowments and foundations, pension funds, sovereign wealth funds, and family offices.
Including:

- Understand the different purposes endowments and foundations serve.
- Contrast the four types of pension funds.
- Discuss the role of SWFs in today’s market.
- Understand how family offices operate.

2.1.2: Demonstrate knowledge of risk and return within strategic asset allocations.
Including:

- Discuss strategic asset allocations based on observation and reasoning.
- Understand the reasons that alternative assets raise return estimation challenges.
- Understand the reasons for placing caps and floors on asset allocations.

2.1.3: Demonstrate knowledge of asset allocation objectives and the constraints within investment policy.

Including:

- Explain asset owners' objectives within allocations.
- Contrast internal and external constraints.
- Identify types of internal constraints.
- Identify types of external constraints.

2.1.4: Demonstrate knowledge of the purpose of investment policy statements (IPS) and the parties involved in an IPS.

Including:

- Discuss the six benefits of a thoughtfully developed IPS.
- Explain the introduction, scope, and purpose of an IPS.
- Identify roles and responsibilities within an IPS.

2.1.5: Demonstrate knowledge of return, risk, and spending policies in investment policy statements (IPS).

Including:

- Discuss investment objectives within an IPS.
- Explain time horizons within an IPS.
- Discuss risk tolerance within an IPS.
- Discuss spending policies within an IPS.

2.1.6: Demonstrate knowledge of investment guidelines and criteria in investment policy statements (IPS).

Including:

- Discuss asset allocation guidelines within an IPS.
- Explain selection and retention criteria for investment managers or funds within an IPS.
- Discuss strategic investment guidelines set within an IPS.
- Discuss performance measurement and evaluation within an IPS.
- Identify additional considerations within an IPS.

Reading 2.2: Foundations and the Endowment Model

2.2.1: Demonstrate knowledge of foundations and endowments.

Including:

- Contrast the differences between foundations and endowments.

2.2.2: Demonstrate knowledge of spending challenges arising from inflation within intergenerational equity.

Including:

- Understand the factors contributing to the change in endowment value.
- Contrast the four approaches to applying a spending rate.
- Evaluate the challenge in maintaining the real value of an endowment over time.

2.2.3: Demonstrate knowledge of the endowment model.

Including:

- Interpret asset allocation in the endowment model.
- State the endowment model's case against bonds.
- Understand the role of alternative investments in the endowment model.

2.2.4: Demonstrate knowledge of the outperformance of endowments.

Including:

- Identify the six attributes of the endowment model.
- Discuss aggressive asset allocation within the endowment model.
- Discuss effective investment manager research within the endowment model.

- Understand first-mover advantage in the endowment model.
- Discuss the advantage of access to a network of talented alumni within the endowment model.
- Interpret the role of acceptance of liquidity risk in the endowment model.
- Explain the advantage of sophisticated investment staff and board oversight within the endowment model.
- Identify the outsourced CIO model.

2.2.5: Demonstrate knowledge of the risks of the endowment model.
Including:

- Understand spending rates and spending rules.
- Explain the relationship between spending rates and inflation.
- Interpret spending rates and liquidity issues.
- Understand how spending rates relate to liquidity-driven investors.
- Discuss avoiding liquidity issues from a financial crisis.
- Identify leverage risk within the endowment model.

2.2.6: Demonstrate knowledge of tactical asset allocation and liquidity rebalancing.
Including:

- Understand the relationship between tactical asset allocation and liquidity rebalancing.

2.2.7: Demonstrate knowledge of tail risk.
Including:

- Discuss tail risk and its implications in endowments.

Reading 2.3: Pension Fund Portfolio Management

2.3.1: Demonstrate knowledge of the development, motivations, and types of pension plans.
Including:

- Understand how pension plans are developed.
- Discuss motivations for using pension plans.
- Identify the three basic types of pension plans.

2.3.2: Demonstrate knowledge of risk tolerance and asset allocation in pension plans.
Including:

- Contrast the three approaches to managing assets in defined benefit plans.
- Identify four factors that drive the impact of liabilities on a plan’s risk.
- Identify four major factors that affect the risk tolerance of a plan’s sponsor.
- Understand the two buckets used to strategically allocate assets in a pension plan.

2.3.3: Demonstrate knowledge of defined benefit plans.
Including:

- Understand how job mobility and pension plan portability relate.
- Define accumulated benefit obligation and projected benefit obligation as liabilities within pension plans.
- Describe surplus risk and calculate funded status as they relate to pension plans.
- Explain why defined benefit plans are withering.
- Understand asset allocation as it relates to liability-driven investing within pension plans.
- Discuss liability-driven pension plan investing.

2.3.4: Demonstrate knowledge of governmental social security plans.
Including:

- Identify the background and purpose of governmental social security plans.

2.3.5: Demonstrate knowledge of the differences between defined benefit and contribution plans.
Including:

- Understand the basics of defined contribution plans.
- Identify plan differences in portability, longevity risk, and investment options.

- Explain asset allocation in defined contribution plans.
- Understand the role of target-date funds and alternative investments within pension plans.

2.3.6: Demonstrate knowledge of the role of annuities for retirement income.
Including:

- Discuss the financial phases that are relative to retirement.
- Identify three important risks to retirees.
- Estimate exposure to longevity risk within annuities and calculate the expected economic life of a fund.
- Identify two major types of annuities.
- Calculate the value of a growth annuity.

2.3.7: Demonstrate knowledge of interest rate swaps.
Including:

- Explain how pensions use interest rate swaps.
- Understand the mechanics of interest rate swaps.
- Describe the initial valuation of an interest rate swap.
- Calculate the expected payments and valuation of an interest rate swap.
- Discuss risks in interest rate swaps.

Reading 2.4: Sovereign Wealth Funds

2.4.1: Demonstrate knowledge of the sources of sovereign wealth.
Including:

- Understand the reserve account of a central bank and the factors influencing the size of the reserve account.
- Calculate a given country's account surplus or deficit.
- Identify five factors that likely contribute to the appreciation of a country's currency.
- Distinguish the risks associated with a country reliant on commodity exports.

2.4.2: Demonstrate knowledge of four types of SWFs.
Including:

- Describe the characteristics of stabilization funds.
- Describe the characteristics of reserve funds and savings funds.
- Describe the characteristics of development funds.

2.4.3: Demonstrate knowledge of the establishment and management of SWFs.
Including:

- List four common motivations that may lead to the establishment of a SWF.
- Discuss the investment management of various types of SWFs.
- Describe Dutch disease and discuss various types of sterilization policies.
- Discuss managing the size of a SWF.

2.4.4: Demonstrate knowledge of the governance and political risks of SWFs.
Including:

- Evaluate the governance of SWFs.
- Discuss the principles of the Linaburg-Maduell Transparency Index.
- Understand the Santiago Principles.

2.4.5: Demonstrate knowledge of the economics of the management of three SWFs.
Including:

- Analyze the governance and management of the Norwegian Government Pension Fund Global.
- Analyze the governance and management of China Investment Corporation (CIC).
- Analyze the governance and management of Temasek Holdings (Singapore).

Reading 2.5: Family Offices and the Family Office Model

2.5.1: Demonstrate knowledge of how to identify family offices and their competitive advantages.
Including:

- Understand what qualifies as a family office.
- Discuss the natural advantages family offices have that help them manage their overall portfolios.

2.5.2: Demonstrate knowledge of the goals, benefits, and business models of family offices.
Including:

- Understand various general goals of family offices.
- Describe the benefits provided by a family office, as compared to a private bank or traditional asset manager.
- Discuss the characteristics of the various models and structures of family offices.

2.5.3: Demonstrate knowledge of generational family office goals.
Including:

- Contrast the goals of first-generation wealth with the goals of second generation and beyond wealth.
- Understand the risk management practices of first-generation wealth.
- Identify the process of benchmarking first-generation wealth.

2.5.4: Demonstrate knowledge of the macroeconomic exposures of family offices.
Including:

- Discuss how macroeconomic factors affect family office investment decisions.

2.5.5: Demonstrate knowledge of the constraint of income taxes for family offices.
Including:

- Discuss how the importance of tax efficiency affects how family office investments are structured.
- Contrast the tax impacts of short-term and long-term capital gains in the United States.
- Evaluate the benefit to taxable investors of Section 1256 contracts.
- Calculate after-tax profits for a given portfolio.
- Assess how family offices can increase tax efficiency with hedge funds.

2.5.6: Demonstrate knowledge of the lifestyle assets of family offices.
Including:

- Discuss the treatment of art as a lifestyle asset in the management of family wealth.
- Discuss storage costs and other costs of lifestyle assets, and describe the function of free ports.
- Understand the consideration and use of lifestyle assets as constraints in the asset allocation process when constructing a family office investment portfolio.
- Identify concierge services offered through family offices.

2.5.7: Demonstrate knowledge of family office governance.
Including:

- Identify structures of governance within family offices.
- Explain the challenges of family wealth sustainability.
- Identify strategies to maintain family wealth.
- Understand the process of family office inheritance and strategies of succession.

2.5.8: Demonstrate knowledge of charity and philanthropy.
Including:

- Distinguish the primary characteristics of charity and philanthropy.

2.5.9: Demonstrate knowledge of the considerations private wealth managers must make when investing client portfolios.
Including:

- Identify the primary investment goals and constraints of individual investors.

- Describe the time horizons, risk tolerance, and illiquidity tolerance of individual investors.
- Describe the tax considerations for private wealth investors.
- Identify important behavioral finance considerations when advising individual investors on investments.
- Describe the barriers preventing individual investors from gaining access to alternative investments.

TOPIC 3

CAIA Association. *CAIA Curriculum Level II Volume I*. Self-published, CAIA Association, 2026.

Reading 3.1: Asset Allocation Processes and the Mean-Variance Model

3.1.1: Demonstrate knowledge of asset allocation processes and the mean-variance model.
Including:

- Understand the origin of mean-variance optimization.
- Discuss the tradeoff between expected returns and volatility.
- Evaluate risk and return with utility.
- Interpret and calculate risk aversion and interpret the shape of the utility function.
- Interpret and calculate utility functions in terms of expected returns and variance.
- Interpret and calculate utility functions with higher moments.
- Interpret and calculate utility functions with value at risk.
- Identify investor risk aversion based on the asset allocation decision.
- Understand how to manage assets with risk aversion and growing liabilities.

3.1.2: Demonstrate knowledge of how the mean-variance optimization is implemented.
Including:

- Interpret and calculate mean-variance optimization.
- Interpret and calculate mean-variance optimization with a risky and riskless asset.
- Interpret and calculate mean-variance optimization with growing liabilities.
- Interpret and calculate mean-variance optimization with various degrees of risk aversion.

3.1.3: Demonstrate knowledge of mean-variance optimization with multiple risky assets and with hurdle rates.
Including:

- Evaluate portfolio optimization with a riskless asset and multiple risk assets.
- Assess the value of unconstrained optimization.
- Evaluate hurdle rates in the context of a mean-variance optimal portfolio.

3.1.4: Demonstrate knowledge of issues using optimization for portfolio selection.
Including:

- Interpret optimizers as error maximizers.
- Discuss portfolio optimization and smoothing of illiquid returns.
- Understand data issues for large-scale optimization.
- Understand how mean-variance ignores higher moments.
- Discuss three ways to address skewness and kurtosis in mean-variance optimization.

3.1.5: Demonstrate knowledge of adjustments of the mean-variance approach for illiquidity and factor exposure.
Including:

- Understand the liquidity penalty function.
- Apply the factor exposure constraint to the liquidity penalty function.
- Calculate adjustments for illiquidity.
- Calculate adjustments for factor exposure.

3.1.6: Demonstrate knowledge of how to mitigate estimation error risk in mean-variance optimization.
Including:

- Discuss estimation error risk reduction through objective measures of estimation error risk.
- Describe sampling to reduce the effect of estimation error.
- Discuss shrinkage to reduce the effect of estimation error.
- Discuss the use of constraints in mean-variance optimization.

3.1.7: Demonstrate knowledge of the Black-Litterman Model.
Including:

- Contrast the Black-Litterman model with traditional mean-variance optimization techniques.
- Evaluate the suitability of traditional mean-variance optimization versus the Black-Litterman framework for portfolios containing alternative investments.
- Identify the basic inputs of the BL Model.
- Assess how alternative calibrations of key Black-Litterman parameters (τ, Ω, and δ) influence posterior expected returns and strategic asset allocation outcomes, particularly for private market asset categories.

3.1.8: Demonstrate knowledge of applying Private Market data in the Black-Litterman Model.
Including:

- Evaluate the impact of using adjusted versus unadjusted private market return data on volatility, correlation, and cornering behavior in portfolio optimization.
- Assess alternative methods for specifying error terms (ω_k) for private market views, including τ-scaled statistical approaches versus implementation-based IRR dispersion.
- Contrast optimized portfolio outcomes across different specifications of ω_k and τ.
- Explain why certain configurations lead to cornering behavior despite diversification constraints.

3.1.9: Demonstrate knowledge of applying investor constraints to the Black-Litterman Model.
Including:

- Evaluate how investor profiles and constraint structures influence Black-Litterman optimized allocations across public and private asset categories.
- Assess the interaction between neutral allocations, risk bands, and illiquidity limits in shaping strategic asset allocation outcomes under BL optimization.
- Justify asset-class allocation differences across investor objectives based on risk tolerance, diversification effects, and expected return tradeoffs.
- Contrast optimized allocations across investor objectives.
- Explain why certain private market asset classes are favored or excluded under varying constraint regimes.

Reading 3.2: Total Portfolio Approach

3.2.1: Demonstrate knowledge of the history of the total portfolio approach.
Including:

- Justify the criticisms of traditional institutional investment models relative to TPA.
- Assess the impact bucketing has on portfolio construction relative to factor or exposure analysis.
- Evaluate the perverse role asset class structures can have on the alignment of interest for investment teams.
- Explain why traditional institutional investment models may struggle with dynamism.

- Identify common outcomes from transitioning to TPA.

3.2.2: Demonstrate knowledge of the core dimensions of the total portfolio approach.
Including:

- Discuss the four primary dimensions of TPA.
- Understand the use and role of a reference portfolio.
- Understand the portfolio construction outcomes of adopting TPA.
- Contrast TPA with traditional investment models (e.g., SAA).

3.2.3: Demonstrate knowledge of the role of governance in the total portfolio approach.
Including:

- Discuss the impact of the TPA governance model.

3.2.4: Demonstrate knowledge of the role of factors in the total portfolio approach.
Including:

- Explain how a factor lens is used in a risk-return framework.
- Contrast factors with asset classes in building a diversified portfolio.
- Apply the four steps in implementing a factor approach.
- Discuss the challenges of a factor-based approach.

3.2.5: Demonstrate knowledge of the role of competition for capital in the total portfolio approach.
Including:

- Explain competition for capital in the context of TPA.
- Argue for a competition for capital mindset.
- Contrast a competition for capital mindset with portfolio optimization models.
- Understand how to implement a competition for capital framework.
- Explain the challenges associated with a competition for capital approach.

3.2.6: Demonstrate knowledge of the role of culture in the total portfolio approach.
Including:

- Evaluate the impact of a long-term focus and agility on the culture of an organization.
- Discuss the implementation of a successful total portfolio culture.

3.2.7: Demonstrate knowledge of transitioning to the total portfolio approach.
Including:

- Understand the transition in governance and culture.
- Summarize the common misconceptions of TPA.
- Discuss the organizational conditions necessary to implement TPA.

3.2.8: Demonstrate knowledge of implementing the total portfolio approach.
Including:

- Construct the TPA journey from a mindset shift to one portfolio, one purpose.
- Contrast the various TPA models.
- Apply the structural view of TPA.

3.2.9: Demonstrate knowledge of maintaining the total portfolio approach.
Including:

- Assess the challenges organizations face in maintaining TPA.

3.2.10: Demonstrate knowledge of how TPA changes the relationship between LPs and GPs.
Including:

- Contrast the GP-LP relationship in the SAA model versus the TPA model.
- Justify the GP change in mindset to a solutions provider for TPA adopters.

Reading 3.3: Other Asset Allocation Approaches

3.3.1: Demonstrate knowledge of the core-satellite approach.
Including:

- Apply the core-satellite approach.

3.3.2: Demonstrate knowledge of top-down and bottom-up asset allocation approaches.
Including:

- Understand the bottom-up approach.
- Understand the top-down approach.
- Understand the mixed approach.

3.3.3: Demonstrate knowledge of risk budgeting.
Including:

- Identify specifications in risk budgeting.
- Define risk in risk budgeting as well as risk buckets.
- Apply additional filters to risk budgeting including an objective function, correlations, and expected returns.

3.3.4: Demonstrate knowledge of factor-based implementations of a risk budgeting approach.
Including:

- Describe attributing the risk of a portfolio to three attributes of each asset.
- Understand how to use factor-based returns and risk buckets.
- Calculate the risk contribution to each risk factor.

3.3.5: Demonstrate knowledge of risk parity.
Including:

- Interpret risk parity with two risky assets.
- Understand Sharpe ratios and leverage within risk parity.
- Identify the three steps in implementing the risk parity approach.
- Discuss how to create a portfolio using the risk parity approach.
- Understand the primary economic rationale for the risk parity approach.
- Interpret the volatility anomaly and risk parity.
- Discuss the criticisms of three popular rationales for risk parity.

3.3.6: Demonstrate knowledge of other quantitative portfolio allocation strategies.
Including:

- Understand the market-weighted strategy.
- Interpret an equally-weighted or 1/N diversification strategy.
- Describe inverse volatility-weighted portfolio strategies.
- Discuss minimum volatility portfolio allocation strategies.
- Understand equivalence between allocation strategies.
- Describe risk allocation based on return factors.
- Understand four practical issues with allocation based on return factors.

3.3.7: Demonstrate knowledge of tactical asset allocation.
Including:

- Understand tactical asset allocation and its various applications.

3.3.8: Demonstrate knowledge of successful tactical asset allocation process.
Including:

- Understand the TAA process and return predictability.
- Understand the TAA process and model-based return prediction.
- Identify important characteristics of sound TAA model development.
- Contrast an unconditional analysis with a conditional empirical analysis approach using SAA models.
- Apply conditional analyses using TAA models.
- Describe technical analysis underlying TAA models.

Reading 3.4: Commitment Pacing and Cash Flow Analysis

3.4.1: Demonstrate knowledge of cash commitments and illiquidity.
Including:
- Understand the complexity introduced into asset allocations when using drawdown fund vehicles.
- Assess the typical sources of liquidity for unfunded commitments and the risks of each.
- Explain funding risk.
- Understand the importance of cash flow modeling for LP portfolios.

3.4.2: Demonstrate knowledge of the overcommitment strategy.
Including:
- Utilize the overcommitment ratio.
- Identify the optimal overcommitment ratio.

3.4.3: Demonstrate knowledge of the Takahashi-Alexander model.
Including:
- Identify the main inputs of the TA model.
- Explain the TA model.
- Apply the TA model given a set of assumptions.
- Assess the limitations of the TA model.

3.4.4: Demonstrate knowledge of historical simulation models.
Including:
- Contrast historical simulation models with the TA model.
- Explain the mechanics of the HS model.
- Assess the relative efficacy of the HS model with the TA model.

3.4.5: Demonstrate knowledge of Monte Carlo-based cash flow modeling.
Including:
- Contrast Monte Carlo-based cash flow models with the TA model.
- Explain the mechanics of the Monte Carlo cash flow model.
- Construct a commitment pacing schedule using Monte Carlo models.

3.4.6: Demonstrate knowledge of the complexities of managing unfunded commitments.
Including:
- Contrast the primary means of allocating unfunded commitments.
- Assess the tradeoffs and portfolio implications of the various options for allocating unfunded commitments.

Reading 3.5: Active Management for LPs

3.5.1: Demonstrate knowledge of liquid alternative investments.
Including:
- Understand the spectrum of liquid alternative products.
- Identify the distinct types of alternative investments.
- Describe the factors driving the growth of liquid alternative investments.
- State the regulatory constraints that affect liquid alternative investments.
- State the main factors that contribute to the differences between the returns of private placement vehicles and those of alternative investments.

3.5.2: Demonstrate knowledge of direct investment by LPs and the challenges of co-investing.
Including:
- Explain the different models of direct investment.
- Understand the drivers for direct investment.
- Identify the most common type of direct investment.
- Understand the challenges of co-investing from the LP perspective.
- Understand the challenges of co-investing from the GP perspective.

3.5.3: Demonstrate knowledge of co-investment.
Including:
- List the three alternative co-investing structures.
- Explain the basics of co-investing.
- Identify the investment processes for co-investing.
- Identify advantages of co-investing.
- Identify expected disadvantages of co-investing.

3.5.4: Demonstrate knowledge of observations regarding historical returns of co-investment.
Including:
- Interpret evidence on the performance track record of co-investment.
- Identify the specific capabilities that investors must develop to be successful in co-investments.
- Describe the impact that co-investing has on the private equity “J-curve.”

3.5.5: Demonstrate knowledge of secondary markets for private partnerships.
Including:
- Describe the development of the secondary private fund market.
- Interpret the size of the secondary market.
- Identify private fund buyer motivations.
- Identify private fund seller motivations.
- State the secondary market private fund investment process.
- Interpret and calculate the valuation of secondary private fund stakes.
- Evaluate limitations of the private fund secondary market.

3.5.6: Demonstrate knowledge of GP-led secondaries.
Including:
- Distinguish between the four main types of GP-led secondaries.
- Understand the mechanics of continuation funds.
- Support the role of GP-led secondaries in the private markets.
- Assess the risks of continuation funds.

3.5.7: Demonstrate knowledge of the basic elements and considerations of funds of funds (FoFs).
Including:
- Contrast private market and hedge fund funds of funds.
- Explain different sub-types of FoFs (primary, secondary, seeding).
- Identify the management functions delegated to FoFs.
- Assess the benefits and disadvantages of investing in FoFs.
- Contrast FoFs with multistrategy funds.

3.5.8: Demonstrate knowledge of historical returns of funds of funds.
Including:
- Assess private market FoF historical returns.
- Assess HF FoF historical returns.

Reading 3.6: Rebalancing Strategies

3.6.1: Demonstrate knowledge of two simple rebalancing strategies.
Including:
- Understand the need to rebalance.
- Discuss the purpose of a buy and hold strategy.
- Calculate portfolio value and holdings with a buy and hold strategy.
- Summarize the risk return profile of a buy and hold strategy.
- Explain the constant mix rebalancing strategy.
- Calculate portfolio value and holdings with a constant mix strategy.

- Summarize the risk return profile of a constant mix strategy.

3.6.2: Demonstrate knowledge of rebalancing portfolios with directional exposures.
Including:

- Explain rebalancing from the perspective of the expected values of a portfolio.
- Understand how to rebalance when assets follow a random walk.
- Calculate portfolio rebalancing when individual assets trend.
- Calculate portfolio rebalancing when individual asset prices mean-revert.
- Interpret the empirical evidence on the effect of rebalancing.
- Calculate the effects of rebalancing when prices do not mean-revert.

3.6.3: Demonstrate knowledge of the CPPI rebalancing strategy.
Including:

- Explain the CPPI strategy.
- Calculate portfolio value and holdings with a CPPI strategy.
- Summarize the risk return profile of a CPPI strategy.
- Identify three variations of CPPI.

3.6.4: Demonstrate knowledge of the Option-Based Portfolio Insurance (OBPI) rebalancing strategy.
Including:

- Explain the OBPI strategy.
- Calculate portfolio value and holdings with an OBPI strategy.
- Apply option replication strategies to a portfolio.
- Summarize the risk return profile of an OBPI strategy.

3.6.5: Demonstrate knowledge of the dynamic rebalancing strategy.
Including:

- Calculate rebalancing using dynamic strategies with illiquid assets.

3.6.6: Demonstrate knowledge of costs related to actively reallocating across alternative investments.
Including:

- Understand incentive fees, foregone loss carryforward costs and the calculation of after-fee return.
- Identify two potential costs of staying with a manager below its high-water mark.
- Explain two types of potential costs of replacing managers unrelated to incentive fees.

The following is a review of the CAIA Ethical Principles designed to address the learning objectives set forth by CAIA Association®. Cross-reference to CAIA Association Reading 1.1.

READING 1.1

PROFESSIONALISM AND FIDUCIARY RESPONSIBILITIES

Topic 1

EXAM FOCUS

This reading begins by describing the investment industry and justifies the main purpose of the industry. It continues by discussing how the industry creates value and the importance of fiduciary duty and professionalism. Finally, it concludes by addressing the client-first mindset. For the exam, focus on the concepts of sustainable finance, true fiduciary and professional mindset, professional culture, and client trust. This material is identical to the ethics section in the CAIA Level I curriculum. However, the Level I exam tests the material in multiple-choice format, while the Level II exam tests the material in constructed-response (essay) format.

INVESTMENT INDUSTRY

LO 1.1.1: Demonstrate knowledge of the purpose, role, and participants of the investment industry.

Including:

- **Distinguish between the participants within the investment industry.**
- **Justify the four facets of purpose of the investment industry.**
- **Analyze the current investment industry relative to alternative systems.**
- **Understand the four facets of purpose of the investment industry.**

Industry Participants

The major participants in the investment industry are asset owners, asset managers, consultants, brokers, investment banks, service providers, and regulators. The participants interact with technologies and markets in the investment ecosystem. Through technology, professionals consider factors such as regulation and investment theory, which shape investment strategies and capital allocation. Markets refer to the securities to be transacted to generate wealth as well as the need for skilled investment professionals and service providers (e.g., traders, custodians).

Asset owners act as fiduciaries in managing the assets of beneficiaries/investors. Asset owners (acting as the **principal**) are commonly pension funds, family offices, sovereign wealth funds, endowments, or foundations. The size of the asset owner will largely determine whether it is able to develop sufficient skills and expertise to manage assets internally. If not, the owner will need to outsource some investment activities to external asset managers who act as **agents**.

Asset managers can be relatively small, specialized firms or extremely large firms that manage trillions of dollars in assets. In addition, they may choose to concentrate on only one asset class (e.g., fixed income, equities, alternative investments) or invest in numerous asset classes.

Additional **stakeholders** such as consultants, brokers, and data providers provide specialized services—and, in the process, add value (within the **value chain**) to clients and the overall system. Other participants, such as governments and regulators, operate in a more administrative and oversight role.

Industry Purpose

The purpose of the investment industry can be broken down into four parts: (1) intrinsic, (2) core, (3) fundamental, and (4) collateral.

The **intrinsic purpose** refers to simply matching savers (those with excess capital to invest) with spenders (those who need to borrow capital to achieve their objectives). There is also the **core purpose**, which is portfolio management. This involves picking the most appropriate investments that will generate optimal returns over the long term, but within the constraint of acceptable risk levels. In addition, there is the **fundamental purpose**, which is to enhance overall societal wealth and well-being. The investment industry enhances societal well-being if its activities result in greater access to capital

markets for everyone. Finally, the **collateral purpose** looks to provide opportunities for employment as well as investment firm growth.

Industry Changes

The investment industry exhibits path dependency, whereby the current system has evolved from past systems (e.g., the development of new asset classes such as alternative investments). Thus, the current system will shape the types of changes that occur in the future. Alternative systems could replace current aspects of the investment industry regarding fiduciary duties. For example, the increasing prominence of decentralized finance or transactions involving cryptocurrency assets may avoid regulatory restrictions. Ultimately, any evolution of the investment industry would still require trust and value creation to ensure use and acceptance by society in general.

VALUE CREATION

LO 1.1.2: Demonstrate knowledge of the purpose of the investment industry and value creation within the industry.

Including:

- **Assess how value is created in the investment industry.**
- **Understand the role of sustainable finance.**
- **Understand the role of capital allocation in the investment industry.**
- **Describe how public and private markets create value.**
- **Describe stewardship with respect to investment industry activity.**
- **Understand different value models.**

Capital allocation involves transferring surplus funds from savers to entities that require funds for implementing investment ideas. In theory, providing and allocating capital is one of the main objectives of the investment industry. However, in practice, raising capital occurs less than expected, given the frequent use of cash and share buybacks to reduce the amount of equity shares outstanding. Given the limited role of capital allocation as a wealth-creating activity (e.g., new investment), private markets are more successful than public markets in value creation.

In the investment industry, wealth and risk management are the main forms of value creation. These activities occur most frequently during portfolio creation and portfolio management (i.e., balancing returns with investor risk tolerances over the long term). Current attention is placed on risk management at given

points in time as well as relative risk (i.e., portfolio risk relative to an appropriate benchmark). Improvement in this area would be more focus on continuous risk management as well as absolute risk.

Another important form of value creation is **stewardship**, which focuses on improving societal wealth and well-being. Stewardship involves activities such as creating a dialogue with corporate managers to promote sustainable long-term growth and to manage relevant risks. A relatively untapped source of value creation in the investment industry involves allocating capital to new investments (e.g., alternative energy sources).

Sustainable Finance

The value that is created by a firm must consider the individual characteristics of the firm, as noted in the firm's mission or objective. That value creation should also consider all relevant stakeholders, including society in general.

The main idea behind **sustainable finance** is to satisfy asset owners' current needs while not jeopardizing the interests of future stakeholders. In that regard, financial professionals frequently rank profit for clients and investors as the primary goal (more traditional), but additional potential goals include improved organizational and/or societal well-being (more focused on **sustainability**). Ideally, the primary and potential goals will not conflict, which will allow profit and sustainability objectives to be pursued concurrently.

The investment industry operates on the basis of implied consent from society to pursue profit-oriented objectives, while at the same time improving the well-being of society and the environment. This **social license principle** has a direct impact on the chosen sustainability strategies.

System-Value Perspective

The **triple bottom line** concept suggests that corporations should consider not only their economic contributions but also their environmental and social effects. From a system-value perspective, the investment industry and society are integrated and must be evaluated together. Value creation is earning a required financial return (i.e., maximizing shareholder *value*) and potentially an even higher return (i.e., maximizing shareholder *welfare*). The investment industry positively impacts society by providing employment opportunities and capital.