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CAIA®

EXAM PREP

SchweserNotes™

Accessing Alternative Investments & Due Diligence and Selecting Managers

Level II Book 3

KAPLAN SCHWESER

Book 3: Accessing Alternative Investments & Due Diligence and Selecting Managers

SchweserNotes™ 2027

CAIA Level II

KAPLAN SCHWESER

SCHWESERNOTES™ 2027 CAIA® LEVEL II BOOK 3: ACCESSING ALTERNATIVE INVESTMENTS & DUE DILIGENCE AND SELECTING MANAGERS

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Readings and Learning Objectives

TOPIC 6

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

Reading 6.1: Hedge Fund Replication

6.1.1: Demonstrate knowledge of replication products and their potential benefits.
Including:

- Understand basics of hedge fund replication products.
- Evaluate the potential benefits to investors of using replication products.

6.1.2: Demonstrate knowledge of the case for using hedge fund replication.
Including:

- Estimate the risk and return of a given fund of hedge funds.
- Describe three theories for the increased beta and decreased alpha in hedge fund returns.
- Contrast the level of alpha that is generated by the aggregate of hedge fund managers with the alpha available to investors who select individual managers.
- Discuss how replication products can serve as a source of alpha or alternative beta.

6.1.3: Demonstrate knowledge of the benefits of replication products.
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6.2.1: Demonstrate knowledge of issues in private and listed investment access.
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- Define financial market segmentation.
- Identify potential advantages of listed assets.
- Identify potential advantages of privately organized assets.
- Understand the relative amount of fees charged on investments.

- Describe the role that governance plays in the creation of wealth through private equity.

6.2.2: Demonstrate knowledge of unlisted real estate funds.
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- Understand the role and purpose of closed-end real estate funds.
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6.3.1: Demonstrate knowledge of the basic concepts of asset tokenization.
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- Describe tokenization.
- Justify the benefits of tokenization.
- Apply examples of tokenization to various real assets.

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6.3.5: Demonstrate knowledge of the steps in tokenizing real assets.
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6.4.2: Demonstrate knowledge of private and listed real performance in real estate.
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6.4.3: Demonstrate knowledge of challenges in the PME method to evaluate private asset performance.
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- Understand two propositions regarding allocating assets in private or listed markets.

TOPIC 7

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

Reading 7.1: Selection of a Fund Manager

7.1.1: Demonstrate knowledge of the importance of fund selection across managers through time and the relationship between GPs and LPs.
Including:

- Compare the performance of high and low quartile private fund managers through time.
- Understand the dynamic between GPs and LPs.
- Explain adverse selection in GP-LP relationships.
- Describe the life cycle aspect of the GP-LP relationship.
- Identify the entry and establish phase of private market funds.
- Identify the build and harvest phase of private market funds.
- Identify the decline or exit phase.

7.1.2: Demonstrate knowledge of the manager selection process and several issues inherent in fund management.
Including:

- Understand the fund manager selection process.
- Understand how moral hazard, adverse selection, and the holdup problem impact fund management.

7.1.3: Demonstrate knowledge of how to screen fund management.
Including:

- Identify questions regarding the nature of a fund's investment program.
- Identify questions regarding the investment objective of funds.
- Identify questions regarding the investment process of funds.
- Identify questions regarding the value added by the fund manager.

7.1.4: Demonstrate knowledge of historical performance review.
Including:

- Identify critical decisions regarding performance review.
- Understand implications of relying on past performance.

- Discuss the importance of analyzing past assets under management.
- Interpret drawdown.
- State five classic statistical issues when using past data to predict the future.
- Apply statistical systems to understand portfolio risk management systems.

7.1.5: Demonstrate knowledge of manager selection and deal sourcing.
Including:

- Determine the wish list of fund characteristics.
- Recommend systems to assess a management team's competence.
- Understand how to source deals.

7.1.6: Demonstrate knowledge of fund culture.
Including:

- Understand the importance of a fund's culture.

7.1.7: Demonstrate knowledge of investment monitoring.
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- Identify six activities of monitoring private partnerships.
- Explain the objectives of monitoring.
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Reading 7.2: Cases in Tail Risk

7.2.1: Demonstrate knowledge of risks driven by market losses.
Including:

- Identify the reasons why Amaranth Advisors, LLC collapsed.
- Understand the processes that led to the collapse of Long-Term Capital Management.
- Identify the reasons why Carlyle Capital Corporation collapsed.
- Understand the concept of volatility of volatility derivatives.

7.2.2: Demonstrate knowledge of risks driven by leverage and behavioral biases.
Including:

- Evaluate the relationship between declining investment opportunities and leverage.
- Describe the link between behavioral biases and risk taking.

7.2.3: Demonstrate knowledge of the impact of trading technologies in financial crises.
Including:

- Discuss how the unwind hypothesis and crowded trades explain the Quant Meltdown of August 2007.
- Discuss how a circuit breaker can help prevent a flash crash.
- Discuss how technical issues at one large market participant can impact the financial markets.

7.2.4: Demonstrate knowledge of cases of failures that occurred due to fraud.
Including:

- Understand the reasons for the failures of Bayou Management.
- Understand the reasons for the failure of Bernie Madoff.
- Understand the reasons for the failure of Lancer Group.
- Understand the reasons for the failure of the venture capital startup Theranos.
- Evaluate the failures in diligence by venture capitalists invested with FTX.

7.2.5: Demonstrate knowledge of cases involving complexity and perverse incentives.
Including:

- Understand the role played by Treasury STRIPS in the 1980s.

- Understand the role and process of collateralized mortgage obligations in the 1990s.
- Understand the role and process of residential mortgage-backed securities in the 2000s.
- Identify key takeaways from three fixed income cases.

7.2.6: Demonstrate knowledge of four major lessons from analysis of fund failures.
Including:

- Discuss the lessons that emerge from the analysis of various types of hedge fund failures.

Reading 7.3: Investment Process Due Diligence

7.3.1: Demonstrate knowledge of investment due diligence.
Including:

- Describe different approaches to due diligence.
- Describe and compare quantitative due diligence and qualitative due diligence.
- Understand the importance of investment due diligence.
- State internal fund functions.
- Distinguish between investment process and operational due diligence.
- Understand costs and importance of due diligence.
- Identify the role of due diligence checklists and questionnaires.

7.3.2: Demonstrate knowledge of the Alternative Investment Standards.
Including:

- Understand the main components of the Alternative Investment Standards including: Disclosure, Valuation, Risk Management, and Fund Governance.

7.3.3: Demonstrate knowledge of the investment strategy or investment mandate.
Including:

- Describe details of investment strategies.
- Discuss strategy drift within the investment mandate.
- Understand leverage within strategy drift.
- Understand how investment markets and securities are related.
- Describe the relationship between the due diligence process and competitive advantage.
- Identify key persons within investment strategies.

7.3.4: Demonstrate knowledge of investment implementation processes and accompanying risks.
Including:

- Discuss how to implement investment strategies.
- Interpret risks within investment processes.
- Understand how to detect investment process risks.

7.3.5: Demonstrate knowledge of asset custody and valuation.
Including:

- Understand the role of custodians in safeguarding assets.
- Describe the role of the current portfolio position in the due diligence process.
- Evaluate principles of fund asset valuation.
- Discuss conflicts of interest with respect to fund asset valuation.
- Identify challenges in listed asset valuation.
- Understand the relationship between asset level and fair asset values.
- Interpret internal valuation of assets.

7.3.6: Demonstrate knowledge of portfolio risk review.
Including:

- Understand the role of risk review.
- Identify the role of the chief risk officer.
- State general questions that must be asked in a risk review.

- Identify risks of special concern in the risk review.
- Understand the relationship between risk review and leverage.
- Understand how leverage magnifies losses and probabilities of various loss levels.
- Identify subscription and redemption risks.

Reading 7.4: Operational Due Diligence

7.4.1: Demonstrate knowledge of the importance of Operational Due Diligence (ODD).
Including:
- Understand the role of Operational Due Diligence.
- Explain how ODD evolved following the Madoff scandal.
- Assess the evolving ODD challenges facing investment leaders.

7.4.2: Demonstrate knowledge of a comprehensive ODD framework.
Including:
- Identify the elements of governance within an ODD framework.
- Recommend an ODD framework for organizations.
- Construct an ODD process framework.
- Explain how operational alpha can be delivered.

7.4.3: Demonstrate knowledge of risks and remedies in operations.
Including:
- Identify operational errors, agency conflicts, and operational fraud of a fund.
- Understand why operational due diligence is driven by operational risk.
- List the major components to controlling operational risk.
- Understand how investors can mitigate operational risk.
- Describe how perverse incentives can motivate the reporting of performance.
- Discuss oversight procedures of the trade life cycle.
- Explain the role of an SEC risk alert with respect to a fund's investment process.

7.4.4: Demonstrate knowledge of key operational activities and key elements of the ODD process.
Including:
- Understand due diligence with respect to the execution of trades.
- Understand due diligence with respect to posting of trades.
- Understand due diligence with respect to trade allocation.
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- Identify core elements of the ODD process.
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- Discuss the use of third-party sources for due diligence review.

7.4.5: Demonstrate knowledge of cash fund management and movement.
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- Evaluate the reasons for analyzing cash flow to and from investors.
- Discuss the role of unencumbered cash.

7.4.6: Demonstrate knowledge of how to analyze external parties and check principals.
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- Describe various models for selecting personnel for investigation.

- List areas that are commonly included in background investigations.
- Understand how to organize and interpret information from investigations.
- Understand the process of asset verification.

7.4.7: Demonstrate knowledge of analysis of fund compliance.
Including:

- Understand the importance of personal trading compliance of fund employees.
- Identify common compliance risks regarding personal trading.
- Discuss compliance risks regarding nonpublic and inside information.
- Understand the role of electronic communication monitoring.
- Analyze the work of third-party compliance consultants.

7.4.8: Demonstrate knowledge of processes and role of on-site manager visits as well as meta risk and information technology.
Including:

- Understand how to select visit locations.
- Explain why desk reviews are not best practice.
- Identify the risk alert's three tasks on desk and site review.
- Understand the due diligence role played by information technology.
- Discuss five due diligence questions that surround information technology.
- Define meta risk.

7.4.9: Demonstrate knowledge of performing operational due diligence on emerging managers.
Including:

- Describe the difficulties an emerging manager may encounter in the operational due diligence process.

7.4.10: Demonstrate knowledge of funding, applying, and concluding ODD.
Including:

- Contrast approaches to resource allocation for operational due diligence.
- Understand how to document the operational due diligence process.
- State the relationship between due diligence and the operational decision.

7.4.11: Demonstrate knowledge of institutional due diligence practices for digital assets.
Including:

- Understand due diligence areas of focus unique to digital asset fund investments.
- Distinguish between liquid and illiquid market crypto investments.
- Describe the various liquid market crypto investment options.

Reading 7.5: Due Diligence of Terms and Business Activities

7.5.1: Demonstrate knowledge of the document collection process in due diligence.
Including:

- Understand the purpose and role of the document collection process.

7.5.2: Demonstrate knowledge of unlisted manager-investor relationships.
Including:

- Apply the ILPA guiding principles to private fund structures.
- Support the use of the ILPA guiding principles in fund management.

7.5.3: Demonstrate knowledge of structural review of funds and fund managers.
Including:

- Understand the importance of legal fund structures.
- Describe how master-feeder trusts work.
- Understand how side pocket arrangements operate.

- Discuss the role of the documentation of registrations.
- Understand the role of fund manager organization and ownership.

7.5.4: Demonstrate knowledge of terms for liquid and illiquid private funds.
Including:

- Understand redemption terms.
- Describe potential benefits of lockups.
- Understand the relationships between the LPA, fund term, and distributions.
- Understand terminations and divorces within funds.
- Describe investment limits and legal liability limits.
- Understand investor relations.

7.5.5: Demonstrate knowledge of side letters to limited partnership agreements.
Including:

- Evaluate the various issues involving side letters.

7.5.6: Demonstrate knowledge of private-placement memorandums (PPM).
Including:

- State the key functions of the offering memorandum (OM) and PPM.
- Understand the function of side letters.
- Identify different purposes of legal counsel reviews and ODD document reviews.
- Analyze other common private placement memorandum terms.

7.5.7: Demonstrate knowledge of fund fees and expenses.
Including:

- Identify the timing of fee collections.
- Understand the role of fee offsets.
- Understand the contribution of GP contributions with respect to fund risk taking.

7.5.8: Demonstrate knowledge of private fund audited financial statement reviews.
Including:

- Define the role of audited financial statements.
- Understand valuation policies.

7.5.9: Demonstrate knowledge of business activities, continuity planning, disaster recovery, and insurance.
Including:

- Understand the process of business continuity planning and disaster recovery.
- Describe the role of information technology in continuity planning and disaster recovery.
- Discuss the role of fund insurance in operational due diligence.

The following is a review of the Accessing Alternative Investments principles designed to address the learning objectives set forth by CAIA Association®. Cross-reference to CAIA Association Reading 6.1.

READING 6.1

HEDGE FUND REPLICATION

Topic 6

EXAM FOCUS

This reading focuses on hedge fund replication methods and the investment products that use replication. Factor-based replication approaches attempt to construct replicator portfolios from liquid instruments to capture a portion of excess returns earned by hedge funds and earn similar returns. The bottom-up approach uses a simplified algorithm of well-defined hedge fund trading strategies. For the exam, be able to describe the benefits of replication products, contrast the approaches to replication, identify the challenges in applying the approaches, and describe the implications of empirical studies.

REPLICATION PRODUCTS

LO 6.1.1: Demonstrate knowledge of replication products and their potential benefits.

Including:

Understand basics of hedge fund replication products.
Evaluate the potential benefits to investors of using replication products.

Alternative betas are the portions of an asset's return that are not available or easily separated from the return based on the risk of traditional assets. For example, common stocks may have exposure to volatility and commodity risk, which are typically considered alternative risks. However, these risks are linked to the traditional equity beta risks.

Hedge fund replication products (also known as clones or trackers) are designed to capture both traditional and alternative betas of hedge fund

benchmarks. The two primary approaches to gaining exposure to alternative risks are factor-based replication and algorithmic (bottom-up) replication, with the payoff-distribution replication approach as another alternative. Factor-based and payoff-distribution replications are constructed using statistical techniques and are designed to replicate selected return characteristics of hedge fund benchmarks. The **algorithmic replication approach** is based on algorithmic trading models designed to capture a simplified version of the trading strategies of active hedge fund managers. Replication approaches are based on the assumption that alpha is generated through trading strategies rather than top manager expertise. Replication products may therefore capture some of the alpha provided by the benchmark.

Replication products help investors enhance returns, diversify risk, and provide valuable benchmark information that is useful in comparing hedge funds. Different types of hedge fund strategies are able to capture risk exposures not available with traditional assets. For example, return enhancer strategies are designed to earn alpha through alternative beta exposure and improve the risk-adjusted return of the portfolio. Two common return enhancer hedge fund strategies are equity long/short funds and global macro funds. Higher returns are sought through exposure to significant systematic risks. Replication products may capture certain liquidity-related exposures and time-varying betas, although products built from liquid securities generally cannot replicate illiquidity risk beta. While equity beta is considered a traditional source of risk, the dynamic nature of beta over time is considered to be an alternative source of risk.

Another benefit of hedge fund replication products is their ability to serve as risk diversifiers. Rather than attempting to capture alpha, or excess returns, these strategies are designed to capture returns with low correlation to traditional assets. Most relative value funds and some commodity trading advisors (CTAs) with less systematic exposure to equity, fixed-income, or commodity markets are considered risk diversifiers. In addition to reducing overall risk, they also may enhance returns through exposure to alternative risks. For example, convertible bond arbitrage funds have exposure to implied volatility, credit, and liquidity risks. These hedge fund strategies may generate a low return but reduce the overall portfolio risk through low correlation with traditional assets.

CASE FOR USING HEDGE FUND REPLICATION

LO 6.1.2: Demonstrate knowledge of the case for using hedge fund replication.

Including:

- **Estimate the risk and return of a given fund of hedge funds.**
- **Describe three theories for the increased beta and decreased alpha in hedge fund returns.**
- **Contrast the level of alpha that is generated by the aggregate of hedge fund managers with the alpha available to investors who select individual managers.**
- **Discuss how replication products can serve as a source of alpha or alternative beta.**

Estimating Risk and Return of Funds of Funds

Estimates of rolling beta and rolling alpha were performed on the Center for International Securities and Derivatives Markets (CISDM) Fund of Funds Index using a 24-month rolling window. The S&P 500 Index was used as the benchmark. The following equation can be used for the alpha estimate:

$$\overline{R}_{t,CISDM} - r_f = \alpha_t + \beta_t(\overline{R}_{t,SP} - r_f)$$

where:

$\overline{R}_{t,CISDM}$ = estimated 24-month average return of the CISDM Fund of Funds Index

$\overline{R}_{t,SP}$ = estimated 24-month average return on the S&P 500 Index

β_t = estimated beta of the CISDM Index

α_t = estimated alpha of the CISDM Index

r_f = monthly rate for 30-day market reference rate (SOFR)

Over the 1994 to 2025 period, there was a large variance in beta with a noticeable rise between 2004 and 2007, and an overall decline since then. There has been an overall decline in alpha since 2001, and most recently, the value has been near zero.

Theories for Increased Beta and Decreased Alpha

Changes in trading strategies, liquidity, technology, and regulation are all possible explanations for the decline in alpha and have led to the development of several explanatory hypotheses: the fund bubble, capacity constraints, and increased allocation to active funds.

- **Fund bubble hypothesis** suggests the supply of hedge fund managers increased as traditional fund managers were enticed by the substantially higher incomes of hedge fund managers. This led to an increase in the number of less-qualified hedge fund managers who generated lower returns, thus lowering the industry average returns.

- **Capacity constraint hypothesis** suggests that the generation of alpha is a zero-sum game. In other words, only a few hedge fund managers can generate alpha consistently, and as their assets under management grow, alpha becomes even more difficult to obtain.
- **Increased allocation to active funds hypothesis** suggests that the growth in popularity of hedge funds led increasing numbers of investors with traditional portfolios to allocate money to hedge funds. This led to an increase in both the correlation between traditional assets and hedge funds and the systematic risk for hedge funds because many of these investors tended to withdraw assets from both traditional and hedge fund accounts during periods of increased financial stress and uncertainty.

In summary, these three hypotheses together suggest that while the generation of alpha is possible for a few superior hedge fund managers, there is an increase in less-qualified managers who are not able to generate alpha. Less-qualified managers may either lack the skill to outperform benchmarks or have less flexibility due to constraints that require them to match benchmark performance.

An important issue that underlies the ability to replicate or track hedge fund performance relates to the investability of the benchmark. Noninvestable benchmarks are difficult to replicate. In addition, the extent to which the replication fund reflects the benchmark's risk and return parameters is also questionable.

Aggregate Alpha

Much evidence exists to support the ability of some individual hedge fund managers to earn positive alpha, but this ability has not been consistently demonstrated across the industry. The existence of active managers and the fact that investors are willing to pay fees for their services suggests that markets are not fully efficient. However, markets cannot be overly inefficient or else there would exist many more active managers who want to earn those fees and, in effect, move the markets toward greater efficiency. The overall conclusion is that markets are neither fully efficient nor inefficient, but that they are efficiently inefficient. In other words, markets as a whole are sufficiently inefficient to allow managers to earn fees and investors to earn returns as compensation for taking risks. However, markets are not so inefficient so as to allow an excessive number of managers to earn easy profits. Therefore, pockets of market inefficiency will exist and the more skilled managers will be able to find and