Question #1 of 21

Question ID: 1602315

The internal rate of return (IRR) methodology is most appropriate for measuring the returns of:

A) private equity and venture capital. ✓

B) public equity indices and mutual funds. ✗

C) private equity and public equity indices. ✗

D) venture capital and mutual funds. ✗

Explanation

IRR is most appropriate for measuring the returns of private equity and venture capital because the timing and size of cash flows are important in determining the profitability of the investment. Public equity indices and mutual funds are measured using time-weighted returns, which ignore the effects of contributions and withdrawals and measure the performance of a lump sum.

(LO 2.4.3)

Question #2 of 21

Question ID: 1706104

Janna Hui, CAIA, is considering investing as a limited partner in a private equity fund. She is carefully studying all the various payout provisions. What provision in the limited partnership agreement establishes how distributions are made from a fund, how they will be split, and the priority of pay-outs?

A) Drawdown/payout provision. ✗

B) Distribution clawback provision. ✗

C) Waterfall provision. ✓

D) Carried interest provision. ✗

Explanation

The waterfall provision describes how capital is distributed to the fund's investors. For example, the returns to a limited partnership often are split between the providers of capital (i.e., investors or limited partners) and decision makers (i.e., the managers or general partner). The distribution waterfall sets the rules and procedures for the distribution of profits.

(LO 2.4.7)

Question #3 of 21

Question ID: 1602314

Jody Matheny, CAIA is examining methods to evaluate various project alternatives within her capital budgeting responsibilities. Among the various analytical approaches, Matheny has settled on using an IRR approach. Which of the following statements regarding IRR is most accurate?

A) An investment with a large negative IRR is very sensitive to distant cash flows, and IRR does not always rank investments accurately. ✓

B) IRR allows for different reinvestment rates over the life of the project, and can only have one solution, simplifying comparisons between projects. ✗

C) IRR is especially useful in ranking the relative performance of multiple investments. ✗

D) In cases where there is a large positive IRR, the magnitude of the longest-term cash flow in the project's life will have a large impact on the IRR. ✗

Explanation

IRR does not always rank projects accurately, and the inability to vary the reinvestment rate can be restrictive. An investment with a large negative IRR is very sensitive to distant cash flows.

(LO 2.4.3)

Question #4 of 21

Question ID: 1706103

A $1 million investment is expected to produce $300,000 cash inflows for each of the next 5 years, and zero thereafter. The cost of capital for the investment is 10%. All cash inflows are expected to be reinvested at the investment's cost of capital. The modified IRR of the investment is closest to:

A) 12.85%. ✓

B) 11.35%. ✗

C) 15.25%. ✗

D) 10.15%. ✗

Explanation

To calculate the modified IRR (MIRR), first calculate the future value of all cash inflows, reinvested at 10%:

$$300{,}000(1.10)^4 + 300{,}000(1.10)^3 + 300{,}000(1.10)^2 + 300{,}000(1.10)^1 + 300{,}000 = \$1{,}831{,}530$$

Next, find the interest rate that equates the present value of the future value ($1,831,530) and the present value of the cash outflows ($1 million).

$$1{,}831{,}530/(1+MIRR)^5 = \$1{,}000{,}000$$

$$MIRR = 12.87\%$$

Notice that the IRR in this question equals 15.24%, which assumes that all the cash inflows are reinvested at 15.24%. The MIRR is lower than the IRR because the MIRR used a lower reinvestment rate assumption (i.e., 10%).

(LO 2.4.4)

Question #5 of 21

Question ID: 1602320

What provision forces a hedge fund manager to return incentive fees that the manager previously received?

A) Carry-down.

B) Takeback.

C) Backfilling.

D) Clawback.

Explanation

Clawbacks allow investors in a hedge fund to take back incentive fees previously received by the fund manager. A clawback arrangement will typically apply when a fund manager does not earn a rate of return above some hurdle rate over a period of time. Note that in practice, clawbacks are rare in the hedge fund world.

(LO 2.4.7)

Question #6 of 21

Question ID: 1602323

In a meeting with a private equity firm's board of directors, one of the directors makes the following two claims:

Claim 1: Relative to a deal-by-deal carried interest arrangement, a fund-as-a-whole carried interest arrangement is more protective of the limited partners.

Claim 2: Relative to a deal-by-deal carried interest arrangement, a fund-as-a-whole carried interest arrangement might dilute the ability of the firm to attract talented general partners.

Which of the claims made by the director is accurate?

A) Claim 1 is inaccurate and Claim 2 is accurate. ✗

B) Claim 1 is accurate and Claim 2 is inaccurate. ✗

C) Claims 1 and 2 are accurate. ✓

D) Claims 1 and 2 are inaccurate. ✗

Explanation

The fund-as-a-whole carried interest arrangement is more protective of the limited partner, but might dilute the ability of the firm to attract talented general partners.

(LO 2.4.7)

Question #7 of 21

Question ID: 1602307

Gladys Onyung and Abby Stricter plot the cumulative value of a one-time $1 investment in a market index over the 1950–2010 period. Onyung's graph exhibits extraordinary volatility in the final decade. Relative to Onyung's graph, the volatility in Stricter's graph is much more consistent over time. Which of the following choices most accurately describes the type of data graphed by each analyst?

A) Onyung graphed logarithmic returns and Stricter graphed logarithmic returns. ✗

B) Onyung graphed logarithmic returns and Stricter graphed arithmetic returns. ✗

C) Onyung graphed arithmetic returns and Stricter graphed logarithmic returns. ✓

D) Onyung graphed arithmetic returns and Stricter graphed arithmetic returns. ✗

Explanation

Relative to arithmetic returns, logarithmic returns provide a more smoothed graph of cumulative returns. For instance, a 10% change in wealth at a high wealth level is much larger than a 10% change in wealth at a low wealth level, but the return volatility is identical. If logarithms are not used, then wealth volatility will appear much larger for high wealth levels relative to low wealth levels even though the percent change in wealth is identical.

(LO 2.4.1)

Question #8 of 21

Question ID: 1602313

Forecasted IRRs for four investments are as follows:

Investment	IRR
Investment W	−20%
Investment X	−10%
Investment Y	10%
Investment Z	20%

Suppose forecasts for economic growth improve such that all terminal period cash flow forecasts double. Which of the four investment IRRs is most sensitive to the change in terminal period cash flow forecasts?

A) The IRR of Investment W.

B) The IRR of Investment Z.

C) The IRR of Investment X.

D) The IRR of Investment Y.

Explanation

High negative IRRs are highly sensitive to changes in terminal period cash flows. High positive IRRs are less sensitive to changes in terminal period cash flows than they are to high negative cash flows.

(LO 2.4.3)

Question #9 of 21

Question ID: 1706102

Jack Myers, CAIA is examining his fund returns and is also modeling returns over various time intervals. Which of the following return types allow for the modeling of different time intervals in an internally consistent method?

A) Log returns. ✓

B) Simple returns. ✗

C) Normally distributed returns. ✗

D) Discretely compounded returns. ✗

Explanation

Log returns are more accurate than discretely compounded returns when modeling different time intervals. However, many funds use discrete compounding for reporting due to simplicity.

(LO 2.4.1)

Question #10 of 21

Question ID: 1602321

Which of the following terms does not describe a hurdle rate that allows the general partner to share only in profits in excess of the hurdle rate?

A) True preferred return. ✗

B) Soft hurdle rate. ✓

C) Hard hurdle rate. ✗

D) Floor. ✗

Explanation

A soft hurdle rate allows the general partner to share in all profits if the performance of the fund is above the hurdle rate. A hard hurdle rate (also known as a "true preferred return" or a "floor") allows the general partner to share only in profits that are in excess of the hurdle rate.

(LO 2.4.7)

Question #11 of 21

Question ID: 1602317

Which of the following is least likely to be considered a complex cash flow pattern?

A) A borrowing type cash flow pattern. ✗

B) A sale/leaseback cash flow pattern. ✗

C) A multiple sign change cash flow pattern. ✗

D) An abnormally large initial investment cash flow pattern. ✓

Explanation

An abnormally large initial investment does not, by itself, create a complex cash flow pattern.

(LO 2.4.3)

Question #12 of 21

Question ID: 1602327

A contract's notional principal is best defined as the:

A) profit earned on the asset underlying the derivative contract. ✗

B) face amount of the asset underlying the derivative contract. ✓

C) initial equity investment on a derivative contract. ✗

D) profit earned on a derivative contract. ✗

Explanation

Notional principal is the face amount on the underlying asset upon which cash flows on a derivative instrument are based.

(LO 2.4.8)

Question #13 of 21

Question ID: 1602310

Which of the following statements is least accurate about the internal rate of return (IRR)?

A) IRR is a dollar-weighted return. ✗

B) IRR measures the compound growth of a lump sum. ✓

C) IRR is the discount rate that equates the present value inflows with the present value of its outflows. ✗

D) IRR assumes all cash flows are reinvested in the original investment. ✗

Explanation

IRR (or dollar-weighted return) or is a discount rate that sets an investment's net present value to zero. The time-weighted return, not the IRR, measures the growth of a lump sum.

(LO 2.4.2)

Question #14 of 21

Question ID: 1602316

Henry Brightside recently analyzed the difficulties comparing IRRs when there are differences in the timing of cash flows across investments. Which of the following challenges related to the IRR measure is Brightside citing?

A) Scale differences. ✓

B) Time-weighting difficulties. ✗

C) Complex cash flow pattern differences. ✗

D) Aggregation difficulties. ✗

Explanation

Difficulties arise when comparing IRRs when investments have scale differences, which are differences in the timing of cash flows and/or differences in investment size. Complex cash flow patterns involve borrowing type cash flow patterns or multiple sign change cash flow patterns. Aggregation difficulties refer to the issues encountered when aggregating the results of several investments. Time-weighted difficulties refer to the fact that the IRR uses dollar-weighted returns.

(LO 2.4.3)

Question #15 of 21

Question ID: 1602309

An analyst examines hedge fund returns over a 120-month period using daily data. Based on this information, the analyst uses which of the following return computation intervals?

A) Continuous. ✗

B) Decade. ✗

C) Monthly. ✗

D) Daily. ✓

Explanation

The return computation interval is the smallest time interval over which returns are computed. In this example, the return computation interval is daily.

(LO 2.4.1)

Question #16 of 21

Question ID: 1602325

The provision in which limited partners have the right to reclaim incentive fees from the general partners is best known as:

A) the clawback clause. ✓

B) the vesting provision. ✗

C) the fallback provision. ✗

D) the retraction provision. ✗

Explanation

The clawback clause is a provision allowing investors to reclaim incentive fees from the fund manager.

(LO 2.4.7)

Question #17 of 21

Question ID: 1602319

Which of the following is an incentive-based fee distributed from the fund to the fund managers?

A) The management fees. ✗

B) The carried interest. ✓

C) The hurdle rate. ✗

D) The clawback rate. ✗

Explanation

Carried interest is the percentage split of profits the fund managers earn after meeting the minimum hurdle rate, and is paid on top of management fees.

(LO 2.4.7)

Question #18 of 21

Question ID: 1602318

When comparing incentive fees to call options, which of the following has the biggest influence on the strike price for the manager?

A) The carried interest.

B) The clawback rate.

C) The management fee.

D) The hurdle rate.

Explanation

The payoffs of incentive fees are similar to the payoffs of call options. For the manager, the underlying asset is the firm's net asset value. The strike price is the NAV that the firm must exceed before the manager receives incentive fees. The hurdle rate is the rate at which the NAV must grow before the manager receives incentive fees.

(LO 2.4.7)

Question #19 of 21

Question ID: 1602322

Which of the following clauses is the opposite of vesting?

A) The management fee clause.

B) The hurdle rate clause.

C) The carried interest clause.

D) The clawback clause.

Explanation

Vesting denotes the process and timetable by which the general partners are legally transferred their incentive payments. A clawback clause is a provision whereby limited partners have the right to reclaim ("clawback") incentive fees from the general partner. This is likely to happen if the fund experiences profits early, and losses later. Therefore, a clawback is the opposite of vesting.

(LO 2.4.7)

Question #20 of 21

Question ID: 1602311

The internal rate of return is the interest rate that:

A) minimizes the net present value.

B) sets the net present value to zero.

C) ignores cash inflows and outflows when deriving the net present value.

D) maximizes the net present value.

Explanation

The internal rate of return (IRR) is the interest rate that equates the present value of an investment's cash inflows with the present value of the investment's cash outflows. In other words, the IRR is the return associated with a zero net present value.

(LO 2.4.2)

Question #21 of 21

Question ID: 1602326

Which of the following is a provision that allows investors in a hedge fund to take back incentive fees previously received by a fund manager?

A) Rebate rate.

B) Retrieval.

C) NAV rewind.

D) Clawback.

Explanation

Clawbacks allow investors in a hedge fund to take back incentive fees previously received by a fund manager. A clawback arrangement will typically apply when the fund manager does not earn a rate of return above some hurdle rate over a reasonable period of time.

(LO 2.4.7)