


Question #1 of 28

Question ID: 1819359

Which of the following investments would most likely have a negative inflation beta?

- A) Real estate. 
- B) Fixed income securities. 
- C) Commodity futures. 
- D) Private equity. 

Explanation

Negative inflation beta suggests that the returns of assets are falling as a result of inflation. Fixed income securities generally are not immune to inflation risks (with the exception of inflation-linked bonds) and so they would likely exhibit negative inflation beta. Commodity futures, private equity, and real estate are all examples of real assets whose returns should rise with inflation levels and thereby exhibit positive inflation beta.

(LO 2.2.5)

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Question ID: 1819356

The additional compensation to endowments for investing in illiquid assets, such as private equity, is referred to as the:

- A) value premium. 
- B) liquidity premium. 
- C) endowment model premium. 
- D) equity market premium. 

Explanation

Illiquid assets face greater liquidity risk than liquid assets. In exchange for the higher risk, investors are compensated with additional returns (i.e., a liquidity premium) for holding illiquid assets.

(LO 2.2.4)

Question #3 of 28

Question ID: 1819341

Which type of foundation is most similar to an endowment?

- A) Community
- B) Corporate.
- C) Independent.
- D) Operating.

Explanation

Operating foundations are most similar to endowments. Here the income that is generated is used to cover the operating costs of the charity. (LO 2.2.1)

Question #4 of 28

Question ID: 1819346

Which of the following general statements regarding endowments and foundations is most accurate?

- A) The range of assets suitable for investment is wider for endowments than for foundations.
- B) Endowments have shorter time horizons than foundations.
- C) Both endowments and foundations are considered large institutional investors.
- D) Endowments are subject to fewer regulations than foundations.

Explanation





Most foundations are subject to regulations regarding distributing a minimum percentage of their assets annually to maintain tax-free status. Endowments are not subject to such regulations.

Both endowments and foundations have long-term time horizons unless otherwise stated. Endowments and foundations could be small or large, and they are both able to invest in the full range of investments, including alternative investments. (LO 2.2.1)

Question #5 of 28

Question ID: 1819353

As prescribed by the endowment model, an advantage of investing in alternative assets such as hedge funds would most likely be the:

- A) decrease to total portfolio liquidity risk. 
- B) reduction to the probability of a liquidity crisis occurring. 
- C) reduction to the severity of potential liquidity crises. 
- D) associated liquidity premium. 

Explanation





Investing in illiquid assets, such as hedge funds, increases the liquidity risk of a portfolio including both the likelihood and severity of a liquidity crisis. As compensation for the higher risk, investors earn additional returns in the form of a liquidity premium.

(LO 2.2.3)

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Question ID: 1819357

Which of the following reasons for outperformance of endowment portfolios can be described as investment managers staying with the original investors (such as the endowment) and allowing only limited entry of new investors?

- A) First-mover advantage. 
- B) Aggressive tactical allocation strategy. 
- C) The network effect. 
- D) Superior manager research. 

Explanation

The first-mover advantage refers to the top endowments invested in alternative investments much earlier than their peers. The managers of those investments generally stick with the original investors and allow limited entry of new investors.

(LO 2.2.4)

Question #7 of 28

Question ID: 1819349

A university endowment has an annual spending policy of 4.5% of the three-year rolling asset value. Consumer price inflation is expected to be 2% per annum, while the Higher Education Price Index (HEPI) is expected to increase by 1.5% per annum. The investment objective of the endowment should be to achieve a total "nominal" rate of return of at least:

- A) 6.5% 
- B) 8.0% 
- C) 6.0% 
- D) 4.5% 





Explanation

The nominal rate of return would include inflation as measured by the HEPI, totaling $4.5\% + 1.5\% = 6\%$. The consumer price inflation is irrelevant in this case because the HEPI is used as the more relevant measure of inflation. (LO 2.2.2)

Question #8 of 28

Question ID: 1819347

Within the context of intergenerational equity, which of the following spending rates will most likely benefit the future beneficiaries?

- A) High current spending rate. 
- B) Low current spending rate. 
- C) Consistent spending rate. 
- D) Inflation-adjusted spending rate. 

Explanation

A low current spending rate benefits the future beneficiaries and a high current spending rate benefits the current beneficiaries. Consistent spending rates allow for an increased ability to cope with economic downturns allow for increased wealth in the long-term (irrespective of periods of high or low portfolio returns). The inflation-adjusted spending rate answer is incorrect because it is uncertain whether an inflation-adjusted rate is relatively low or high.

(LO 2.2.2)

Question #9 of 28

Question ID: 1819362

Within the context of liquidity-driven investing, which of the following assets are considered to be illiquid and therefore, unsuitable to cover annual endowment spending needs?

- A) Tier 1. 
- B) Tier 2. 
- C) Tier 3. 
- D) Tiers 2 and 3. 

Explanation





Tier 3 assets are risky and illiquid (e.g., private equity, hedge funds) and therefore, not suitable to cover annual endowment spending needs.

(LO 2.2.5)

Question #10 of 28

Question ID: 1819350

In response to recent historical performance, which of the following best characterizes the allocation trend for endowment and foundation portfolios?

<u>Equities</u>	<u>Alternative Investments</u>	
A) Increased weight	Increased weight	
B) Increased weight	Decreased weight	
C) Decreased weight	Decreased weight	
D) Decreased weight	Increased weight	

Explanation

Recent weak performance in equities has led to decreased allocations to equities and increased allocations to alternative investments.

(LO 2.2.3)

Question #11 of 28

Question ID: 1819365

Which of the following statements regarding leveraged hedge funds is most accurate?

- A) Leveraged funds can usually sustain their leverage for at least the short term.
- B) Leveraged funds usually have few restrictions on redemptions.
- C) Leveraged funds must be prepared for small to moderate drawdowns.
- D) Leveraged funds may face illiquidity risk.

Explanation

When hedge funds are all forced to sell at the same time due to credit line reductions and investor redemptions, leveraged funds face illiquidity risk. Leveraged funds usually have many redemption restrictions. Leveraged funds must be prepared for potentially large drawdowns. Short-term leverage may not be sustainable or affordable during crisis periods, for example.

(LO 2.2.5)

Question #12 of 28

Question ID: 1819343

Which of the following situations would cause the real values of endowments and foundations to increase, all else being equal?

- A) Low amounts of gifts.
- B) Low investment returns.
- C) High spending rates.
- D) Low inflation rates.

Explanation

Low inflation rates would allow the real values to remain relatively higher. High spending rates, low amounts of gifts from donors, and low investment returns would all cause the real values to decrease.

(LO 2.2.1)

Question #13 of 28

Question ID: 1819351

Which of the following statements about endowments and the endowment model is correct?

- A) The endowment model stipulates that fixed income allocations should be lower than historical levels.
- B) The endowment model focuses on the need to meet moderate return targets.
- C) Endowments have generally increased their equity allocation in the last decade.
- D) Smaller endowments tend to allocate a higher percentage to alternative investments.

Explanation

Smaller endowments tend to allocate relatively less to alternative investments, but this trend is showing an increase over time. In the last decade, endowments have lowered their allocation to domestic equity investments and increased their allocations to hedge funds, private equity, venture capital, and natural resources. The endowment model considers the need to meet high return targets.

(LO 2.2.3)

Question #14 of 28

Question ID: 1819354

Which of the following is least likely a role of alternative assets in endowment portfolios?

- A) Diversifier.
- B) Liquidity risk reducer.
- C) Return enhancer.
- D) Portfolio volatility reducer.

Explanation

Endowments sought out alternative assets as a way to increase expected returns of and provide diversification benefits to their portfolios. Through diversification benefits, alternative assets could increase the expected portfolio returns, while reducing the expected portfolio volatility. Alternative assets, however, have higher liquidity risk than other asset classes and therefore increase the liquidity risk of endowment portfolios.

(LO 2.2.3)

Question #15 of 28

Question ID: 1819360

Which of the following describes the most likely effect of a financial crisis on bid-ask spreads and trading volume?

	<u>Bid-Ask Spreads</u>	<u>Trading Volume</u>	
A)	Increase	Increase	✗
B)	Increase	Decrease	✓
C)	Decrease	Increase	✗
D)	Decrease	Decrease	✗

Explanation

Illiquidity risk and price volatility increase in times of crisis as demonstrated by higher bid-ask spreads and lower trading volumes.

(LO 2.2.5)

Question #16 of 28

Question ID: 1819340

Which of the following characteristics best describes a foundation as opposed to an endowment?

- A) A foundation is subject to maximum spending requirements. ✗
- B) A foundation is more likely to be funded from ongoing donations. ✗
- C) A foundation is a grant-making entity. ✓
- D) A foundation usually has a perpetual life. ✗

Explanation





Foundations are grant-making entities, while endowments are usually funds set up by educational, health care, or religious groups.

Foundations often have set lives (long-term), while endowments usually have perpetual lives. Foundations are subject to *minimum* spending requirements. Foundations are *less likely* to be funded from ongoing donations. (LO 2.2.1)

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Question ID: 1819366

Which of the following is least likely to be a valid reason to rebalance an endowment portfolio?

- A) Minimize risk. 
- B) Prevent asset drift. 
- C) Maximize short-term returns. 
- D) Earn returns by providing market liquidity. 

Explanation

Rebalancing is important in order to prevent drift, whereby the best-performing assets would begin to dominate the portfolio. Portfolio risk increases when such assets are overvalued and volatile, therefore rebalancing is required to minimize risk. Rebalancing is also important because it provides market liquidity through purchases when prices fall and through sales when prices rise. Market participants who provide liquidity may earn extra returns.

(LO 2.2.6)

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Question ID: 1819342

Which of the following types of foundations is most likely subject to the most amount of unsystematic risk?

- A) Operating. 
- B) Corporate. 
- C) Independent. 
- D) Community. 

Explanation

Independent foundations are funded by an individual or family and usually consist of a single one-time gift with no subsequent gifts. The donation of a single stock creates a significant amount of unsystematic risk that should be reduced through diversification.

(LO 2.2.1)

Question #19 of 28

Question ID: 1819344

Which of the following statements regarding endowments and foundations is most accurate?

- A) Corporate foundations tend to support charities in their local area.
Independent foundations are the most similar to endowments in that the
- B) investment income is used to fund the recipient organization's operating
expenses.
- C) Endowments tend to have limited lives and foundations tend to survive in
perpetuity.
- D) In the U.S., endowments have an annual minimum spending rate of 5%.

Explanation

Corporate foundations usually support charities in the local area based on the locale of the majority of the corporation's employees or customers. In the U.S., foundations have an annual minimum spending rate of 5%. Foundations tend to have limited lives and endowments tend to survive in perpetuity. Operating (not independent) foundations are most similar to endowments in that the investment income is used to fund the recipient organization's operating expenses.

(LO 2.2.1)

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Question ID: 1819363

Which of the following numerical ranges represents the liquidity beta of most forms of alternative investments?

- A) Below 0.
- B) Between 0 and 0.5.
- C) Above 1.
- D) Between 0.5 and 1.

Explanation

Alternative investments tend to have a beta greater than one. This high liquidity beta means that alternative investments may perform poorly during a financial crisis due to their illiquidity risk.

(LO 2.2.5)

Question #21 of 28

Question ID: 1819364

Which of the following methods is least effective to utilize for endowment portfolios to avoid liquidity problems?

- A) Stagger allocations to investments over several years.
- B) Seek further gifts and donations.
- C) Reallocating from commodity futures to private equity investments.
- D) Borrow capital for short-term funding requirements.

Explanation

Reallocating from more liquid assets (e.g., commodity futures) to less liquid assets (e.g., private equity) is more likely to result in liquidity problems. The other methods would all increase the portfolio's liquidity position.

(LO 2.2.5)

Question #22 of 28

Question ID: 1819367

Which of the following statements within the context of avoiding tail risk is correct?

- A) The use of equity put options has more certainty of tail risk avoidance than hedge fund strategies.
- B) The cost of hedge fund strategies is generally higher than that of equity put options.
- C) The use of a put spread involves buying an in-the-money put option and at the same time selling a put option even more in-the-money.
- D) The use of exchange-traded options would still bear liquidity risk in times of crisis.

Explanation





Although hedge fund strategies have less certainty of tail risk avoidance compared to equity put options, the lower cost of the former is a significant advantage. Exchange-traded options bear no liquidity risk even in times of crisis. The use of a put spread involves buying an out-of-the-money put option and at the same time selling a put option even more out-of-the-money.

(LO 2.2.7)

Question #23 of 28

Question ID: 1819361

Which of the following is generally considered with regard to modern investment approaches for foundations and endowments?

- A) Current income. 
- B) Future income and capital appreciation. 
- C) Current income and capital appreciation. 
- D) Capital appreciation. 

Explanation

A total return investment approach is generally now used by foundations and investments whereby both current income and capital appreciation are considered. Current income could be generated by fixed income securities and capital appreciation by equity securities. Future income is unknown and therefore cannot be used in planning an investment approach.

(LO 2.2.5)

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Question ID: 1819355

A manager of a large endowment explains that the superior return performance of the endowment can be partly attributed to investments in hedge funds and private equity funds ahead of other investors. He further notes that the fund stayed with the original investors and allowed limited entry to new investors. Which of the following factors best explains the manager's comments?

- A) Outsourced CIO model.
- B) Liquidity risk premium.
- C) Network effect.
- D) First-mover advantage.

Explanation

The manager's comments indicate a *first-mover advantage*, implying that the endowment was able to invest in alternative investments ahead of other investors, providing superior returns.

The *network effect* refers to endowments' special access to funds run by alumni. The *liquidity risk premium* describes investing in relatively illiquid investments to pick up additional return, given that endowments have very long time horizons and few liabilities. The *outsourced CIO model* is used by smaller endowments to give external consultants the ability to make security and manager selection recommendations without a vote.

(LO 2.2.4)

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Question ID: 1819345

Which of the following terms best describes the value of the initial gift to an endowment?

- A) Deposit.
- B) Corpus.
- C) Donation.
- D) Capital base.

Explanation





The value of the initial gift to endowment is known as the corpus.

(LO 2.2.1)

Question #26 of 28

Question ID: 1819352

As suggested by David Swensen, the endowment model seeks to increase portfolio returns by investing in assets with higher expected returns. A consequence of the endowment model approach is a(n):

- A) increase in portfolio volatility. 
- B) increase in the portfolio's liquidity risk. 
- C) reduction in portfolio diversification. 
- D) decrease in the portfolio's equity exposure. 

Explanation





The endowment model seeks higher portfolio returns by increasing portfolio diversification and incorporating an equity tilt. The model suggests that higher returns can be realized by increasing exposures to assets with higher expected returns, such as alternative assets, which have higher liquidity risk. The consequence of investing a greater percentage of assets in securities with higher liquidity risk is that the liquidity risk of the portfolio increases.

(LO 2.2.3)

Question #27 of 28

Question ID: 1819358

Which of the following statements regarding the tactical asset allocation (TAA) model is correct?

- A) The TAA model takes a long-term approach to making asset allocation decisions. 
- B) It may be prudent to place percentage limits on the size of TAA positions. 
- C) The TAA model specifically overweights high-priced assets and underweights low-priced assets. 
- D) It is less risky to tactically allocate between assets of different risk and return attributes. 

Explanation


In practice, TAA strategies could reasonably fail and therefore, percentage limits are often placed on such positions. The TAA model takes a short-term approach to making asset allocation decisions (i.e. 3 to 12 months). It is less risky to tactically allocate between assets of similar risk and return attributes. The TAA model specifically underweights overvalued assets and overweights undervalued assets.

(LO 2.2.4)

Question #28 of 28

Question ID: 1819348

A university endowment has an annual spending policy of 4.5% of the 3-year rolling asset value. Consumer price inflation is expected to be 2% per annum, while the Higher Education Price Index (HEPI) is expected to increase by 1.5% per annum. The investment objective of the endowment should be to achieve a total "real" rate of return of at least:

- A) 4.5% 
- B) 6.0% 
- C) 8.0% 
- D) 6.5% 

Explanation

In order to preserve the purchasing power of the endowment, the real required rate of return (i.e., excluding inflation) should be equal to the spending rate of 4.5%. Note that the nominal rate of return would include inflation as measured by the HEPI, totaling $4.5\% + 1.5\% = 6\%$. (LO 2.2.2)