Alternative Investments

(Time: 15 Min.)

1. Compared to traditional investments, alternative investments are most likely to be more:

A. transparent

B. leveraged

C. liquid

Answer: B

Alternative investments tend to use more leverage and are typically less liquid and less transparent than traditional investments.

2. A portfolio manager who adds hedge funds to a portfolio of traditional securities is most likely seeking to:

A. increase expected returns only.

B. both increase expected returns and decrease portfolio variance.

C. decrease portfolio variance only.

Answer: B

For a portfolio of traditional securities, adding alternative investments such as hedge funds can potentially increase the portfolio’s expected returns, because these investments often have higher expected returns than traditional investments, and decrease portfolio variance, because returns on these investments are less than perfectly correlated with returns on traditional investments.

3. Capital provided for companies beginning operation but before commercial manufacturing and sales have occurred best describes which stage in venture capital investing?

A. Seed-stage

B. Early-stage

C. Later-stage

Answer: B

Early-stage financing is capital provided for companies moving into operation and before commercial manufacturing and sales have occurred.

4. Which of the following statements is *least likely* an advantage of investing in hedge funds through a fund of funds? Funds of funds provide:

A. an increase in expected return through diversification.

B. expertise in selecting funds and conducting due diligence.

C. access to successful funds that may otherwise be closed to new investors.

Answer: A

Diversification results in risk reduction, not return enhancement. Further, the fees charged by the fund of funds manager will likely reduce returns relative to direct hedge fund investment.

5. Which classification of hedge funds is *least likely* to use a short position in stock as a part of its strategy?

A. Market-neutral funds.

B. Emerging-market funds.

C. Distressed securities funds.

Answer: B

Emerging-market funds invest in less liquid and less efficient assets of emerging markets that are difficult to short.

6. The period of time within which a hedge fund must fulfill a redemption request is the:

A. lockup period.

B) notice period.

C) withdrawal period.

Answer: B

A notice period, typically 30 to 90 days, is the amount of time a fund has after receiving notice of a redemption request to fulfill the redemption request. A lockup period is a minimum length of time before an investor may redeem shares or make withdrawals.

7. A typical hedge fund fee structure is *least likely* to include a:

A. base fee.

B. high water mark.

C. negative incentive fee.

Answer: C

C is correct because the fee structure can include a base fee and “high water mark” but not a negative performance fee. The lowest performance fee would be zero.



8. A form of direct investment in mortgages is:

A. commercial mortgage-backed securities.

B. whole loans.

C. mortgage real estate investment trusts.

Answer: B

Whole loans (i.e., commercial property mortgages) are considered direct investments. Commercial mortgage-backed securities (CMBS) and mortgage REITs are indirect investments.

9. A Canadian hedge fund has a value of C$100 million at the beginning of the year. The fund charges a 2% management fee based on assets under management at the beginning of the year and a 20% incentive fee with a 10% hard hurdle rate. Incentive fees are calculated net of management fees. The value at the end of the year before fees is C$112 million. The net return to investors is closest to:

A. 10%.

B. 8%.

C. 9%.

Answer: A

Management Fee: C$100.0 × 2.0% = C$2.0 million  
Gross value at end of year (given) = C$112.0 million  
Incentive fee = [(C$112.0 − C$100.0 − C$2.0 − (C$100.0 × 10.0%)] × 20% = C$0  
Total fee = C$2.0 million  
Net of fee: C$112.0 − C$2.0 = C$110.0 million  
Net return = (C$110.0 / C$100.0) − 1 =10.0%

10. A hedge fund started with an initial investment of €75 million. The end-of-year value after fees for Year 1 was €70 million. For Year 2, the end-of-year value before fees is €90 million. The fund has a 2 and 20 fee structure. Management fees are paid independently of incentive fees and are calculated on end-of-year values. Incentive fees are calculated using a high water mark and a soft hurdle rate of 2%. Total fees paid for Year 2 are:

A. €4.4 million.

B. €5.8 million.

C. €4.8 million.

Answer: C

Management fee = €90 million\* 0.02 = €1.8 million.  
Gross return = (€90/€75) − 1 = 20.0%. The soft hurdle rate was exceeded.  
Because of the high water mark, incentive fees are paid only on the increase in value above the previous high value of €75 million.  
Incentive fee = (€90 million − €75 million) \* 0.20 = €3.0 million.  
Total fee: €1.8 million + €3.0 million = €4.8 million.

