Level I of the CFA® 2025 Exam

Questions with Answers - Alternative Investments

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Q.1074 Which of the following is *not* exhibited by alternative investments in comparison to traditional investments?

A. More liquidity of assets held.

B. Less regulation and transparency.

C. More specialization by investment managers.

The correct answer is **A.**

Alternative investments are generally less liquid than traditional investments, as they tend to involve less frequently traded assets such as private equity, hedge funds, real estate, and commodities. These assets are often held for longer periods of time and may have limited secondary markets, making it difficult to sell them quickly. This can result in longer lock-up periods and limited opportunities for investors to exit their positions.
B is incorrect. Less regulation and transparency are often exhibited by alternative investments in comparison to traditional investments, as they are typically subject to fewer regulatory requirements and may have less public disclosure.

C is incorrect. More specialization by investment managers is often exhibited by alternative investments in comparison to traditional investments, as they tend to involve more complex and specialized strategies that require a high level of expertise and skill from investment managers.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.1215 Which of the following can *most likely* be categorized as alternative investments?

A. U.S Treasury Bills.

B. Real estate investments.

C. Corporate common shares.

The correct answer is **B.**

Alternative investments are non-traditional investments that do not fall within the traditional asset classes of stocks, bonds, and cash. Real estate investments, along with private equity, hedge funds, commodities, and other tangible assets such as art and wine, are commonly classified as alternative investments.

A is incorrect. U.S. Treasury Bills are typically considered traditional investments, as they are a type of fixed-income security that is issued and backed by the U.S. government.

C is incorrect. Corporate common shares are typically considered traditional investments, as they are publicly traded on stock exchanges and are part of the equity asset class.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.1218 Which of the following is *least likely* a category of alternative investments?

A. ETFs.

B. Fine wines.

C. Eurobonds.

The correct answer is **C.**

ETFs, private equity funds, commodities, real estate, and other investments such as antiques, collectibles, fine wines are categories of alternative investments. Traditional investments include stocks, bonds and cash.

A is incorrect. They are traded on stock exchanges and typically track indices, commodities, bonds, or a mix of investment types. However, there are ETFs that focus on alternative investment strategies or assets, such as those that invest in commodities or use leverage and short-selling strategies. Despite this, the broad accessibility and regulatory structure of ETFs align more closely with traditional investment vehicles, making this option a plausible but not the most accurate answer.

B is incorrect. Fine wines represent a classic example of an alternative investment. Investing in fine wines involves purchasing rare or highly sought-after wines with the expectation that their value will increase over time. This market is less correlated with traditional financial markets, offering potential diversification benefits. The value of fine wines can be influenced by factors such as vintage quality, brand reputation, and global demand, distinguishing it from more conventional investments. The tangible and collectible nature of fine wines, along with their unique market dynamics, solidifies their status as an alternative investment.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.1220 Including those assets with low correlations of returns with traditional assets into the portfolio will *most likely*:

A. Increase the risk of the portfolio.

B. Decrease the risk of the portfolio.

C. Decrease the return of the portfolio.

The correct answer is **B.**

The purpose of diversification in a portfolio is to reduce risk by spreading investments across multiple asset classes, such as stocks, bonds, and alternative investments, that have low correlations with each other. When assets with low correlations are added to a portfolio, it can potentially reduce the portfolio's overall volatility and decrease the risk of losses during market downturns. This is because if one asset class is performing poorly, another asset class may perform well and offset those losses, reducing the overall risk of the portfolio.

A is incorrect. Including assets with low correlations with traditional assets will typically not increase the risk of the portfolio but rather can help to diversify the portfolio and reduce overall risk.

C is incorrect. Including assets with low correlations with traditional assets may decrease the overall return of the portfolio if the added assets have lower expected returns than the existing assets in the portfolio. However, diversification can also increase the potential for higher returns by providing exposure to a broader range of investment opportunities. Ultimately, the effect on portfolio returns will depend on the specific assets added and their performance over time.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (b): Compare direct investment, co-investment, and fund investment methods for alternative investments.

Q.1224 The manager of a typical limited partnership hedge fund is *most likely* called a:

A. Limited partner.

B. General partner.

C. Partnership manager.

The correct answer is **B.**

In a limited partnership hedge fund, there are typically two types of partners: limited partners and general partners. The limited partners are the investors who provide the capital for the fund and have limited liability for the fund's debts and obligations. The general partner, on the other hand, is responsible for managing the fund's investments and operations and has unlimited liability for the fund's debts and obligations.

The general partner is also commonly referred to as the fund manager or investment manager. They are responsible for making investment decisions on behalf of the fund, executing trades, managing risk, and reporting to the limited partners on the fund's performance. The general partner is typically compensated through management and performance fees based on the fund's assets under management and performance.

A is incorrect. Referring to the manager of a limited partnership hedge fund as a limited partner is a misunderstanding of the fund's operational structure. While limited partners do play a crucial role by providing the necessary capital for the fund, they do not partake in the day-to-day management or investment decision-making processes. Their involvement is primarily financial, and they entrust the management of the fund to the general partner.

C is incorrect. Although the term "partnership manager" might seem like a plausible title for the manager of a limited partnership hedge fund, it is not the term commonly used within the industry. The specific titles of "limited partner" and "general partner" are deeply ingrained in the legal and operational frameworks of limited partnerships. These titles carry specific legal implications, particularly concerning liability and management authority. Therefore, while "partnership manager" could be seen as a descriptive term, it lacks the precision and legal significance of the term "general partner."

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (c): Describe investment ownership and compensation structures commonly used in alternative investments.

Q.1225 Restrictions on redemption of funds invested in hedge fund until the specific time during which withdrawals are not allowed is *most likely* called a:

A. Lock-up period.

B. High-water mark.

C. Non-withdrawal period.

The correct answer is **A.**

A lock-up period is a restriction on investors' ability to redeem or withdraw their funds from a hedge fund for a specific period of time, typically one to three years. During the lock-up period, investors are unable to redeem their shares or withdraw their invested capital from the fund, even if they experience a change in financial circumstances, or the fund's performance does not meet their expectations.

Lock-up periods are commonly used in hedge funds to provide fund managers with a longer-term investment horizon and to prevent a sudden outflow of capital from the fund, which could disrupt the fund's investment strategy or cause liquidity issues. The lock-up period also helps to align the interests of the fund manager and investors, as the fund manager is incentivized to make long-term investments and avoid short-term trading strategies that may result in higher turnover or transaction costs.

B is incorrect. The high-water mark is a term used to describe a method for calculating performance fees in a hedge fund, which ensures that the fund manager is only paid performance fees on gains that exceed the fund's previous highest net asset value.

C is incorrect. The non-withdrawal period is not a commonly used term in the hedge fund industry.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.1226 An investment company that invests in a number of hedge funds to provide diversification to investors is *most likely* called a/an:

A. Fund of funds.

B. Limited partnership.

C. Asset management company.

The correct answer is **A.**

A fund of funds (FOF) is an investment vehicle that pools capital from investors and invests that capital in a diversified portfolio of hedge funds or other alternative investments. FOFs offer investors access to a diversified range of hedge funds, which can help to reduce the risk associated with investing in a single hedge fund. FOFs also provide smaller investors with access to a range of hedge funds that might not be available to them individually due to high minimum investment requirements.

B is incorrect. A limited partnership is a common legal structure used by hedge funds to organize their operations and structure their relationships with investors.

C is incorrect. An asset management company is a firm that manages investment portfolios on behalf of clients, which can include mutual funds, pension funds, and other institutional investors. Asset management companies may invest in a range of asset classes, including stocks, bonds, and alternative investments.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.1235 Which of the following is *most likely* the appropriate name for the provision which requires managers to return periodic incentive fees if the investors received less than 80% of the profits generated by the fund?

A. Claw back provision.

B. Committed capital clause.

C. Loss reimbursement clause.

The correct answer is **A.**

A clawback provision requires managers to return periodic incentive fees if the investors received less than 80% of the generated profits. The compensation for the hedge funds firm is typically structured as a “2 and 20” fee where the “2” refers to the management fees charged, and the 20 refers to the carried interest on any returns above the preferred return. The clawback provision allows the limited partners to “claw back” any carry paid during the life of the fund on previous portfolio investments in order to normalize the final carry to the originally agreed percentage. Therefore, the clawback provision protects the LP's from paying a carry on one investment, and then having a subsequent investment incur losses.

B is incorrect. The committed capital clause is related to the amount of capital that an investor commits to providing to a fund, which the fund can call upon as needed for investment purposes. This clause does not deal with the distribution of profits or the adjustment of incentive fees based on the fund's performance. Therefore, it does not directly address the scenario where managers are required to return incentive fees if the investors receive less than 80% of the profits.

C is incorrect. The loss reimbursement clause typically refers to a provision that might require the fund to reimburse investors for losses under certain conditions. However, this term does not specifically address the scenario of adjusting incentive fees based on the profit-sharing agreement between the investors and the managers. The clawback provision is the more accurate term for a mechanism that ensures managers return a portion of the incentive fees if the agreed-upon profit distribution criteria are not met.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (c): Describe investment ownership and compensation structures commonly used in alternative investments.

Q.1252 A rate used as a benchmark for calculating incentive fees for management when the returns are above a specific benchmark rate is *most likely* called a/an:

A. Hard hurdle rate.

B. High water mark.

C. Incentive fee rate.

The correct answer is **A.**

A hard hurdle rate is when incentive fees are earned only on returns exceeding a pre-established benchmark.

B is incorrect. A high-water mark the highest value, net of fees, that a fund has reached in history. It reflects the highest cumulative return used to calculate an incentive fee.

C is incorrect. The incentive fee is fees paid to the general partner from the limited partner(s) based on realized net profits.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (c): Describe investment ownership and compensation structures commonly used in alternative investments.

Q.1256 Which of the following alternative investment vehicles is the *least* transparent?

A. REITs.

B. Hedge funds.

C. Commodities futures.

The correct answer is **B.**

Private equity and hedge fund are the least transparent when it comes to publicly disclosing information.

A is incorrect. Real estate investment trusts (REITs) issue shares that trade publicly like shares of stock. They are therefore regulated and disclose their information to the public.

C is incorrect. Commodities futures are exchange traded and are therefore regulated and required to disclose information to the public.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.2007 A highly risk-averse investor with a long time horizon is *most likely* to invest in which type of alternative investment?

A. Commingled funds.

B. Global macro funds.

C. Market neutral funds.

The correct answer is **A.**

A highly risk-averse investor will typically avoid hedge funds. Real estate funds, such as a commingled fund, offer a hedge against unexpected inflation. Investors in commingled fund investments benefit from economies of scale and diversification.

B is incorrect. Global macro hedge funds are actively managed funds that attempt to profit from broad market swings caused by political or economic events.

C is incorrect. A market-neutral fund is a hedge fund that seeks a profit regardless of an upward or downward market environment, typically through the use of paired long and short positions or derivatives.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.2013 Commingled funds are *most likely* an example of:

A. Leveraged equity.

B. Free and clear equity.

C. Aggregation vehicles.

The correct answer is **C.**

Commingled funds are investment vehicles that combine money from multiple investors into a single fund, which is then managed by a professional investment manager. These funds are also referred to as pooled funds, collective investment funds, or simply "commingled" funds.

Commingled funds are considered aggregation vehicles because they pool the assets of multiple investors into a single fund, which can then be invested in a variety of different assets such as stocks, bonds, and real estate. This allows investors to achieve greater diversification and potentially higher returns than they would be able to achieve on their own.

A and B are incorrect. Leveraged equity involves borrowing money to invest in equity securities in order to amplify potential returns. Free and clear equity refers to equity ownership without any outstanding debt or encumbrances.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.3273 Which of the following is *most likely* a feature of alternative investments such as private equity funds and hedge funds compared to traditional investments?

A. Lower fees.

B. Active management.

C. High diversification within the alternative investment portfolio.

The correct answer is **B.**

Private equity funds and hedge funds are both alternative investment vehicles that use different strategies to generate returns that are not correlated with traditional investments such as stocks and bonds. These vehicles are typically managed by experienced investment professionals who employ active management strategies to identify investment opportunities and manage risk.

A and C are incorrect. In contrast to traditional investments, alternative investments such as private equity and hedge funds tend to have higher fees, as the investment managers must be compensated for their expertise and active management approach. Additionally, while diversification may be a component of alternative investment strategies, it is not necessarily a defining feature of these vehicles.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (c): Describe investment ownership and compensation structures commonly used in alternative investments.

Q.3308 High water marks serve to:

A. Ensure that the fund achieves a specified hurdle rate.

B. Restrict the value of investments to a certain maximum.

C. Prevent investors from paying twice for the same performance.

The correct answer is **C.**

High water marks serve to prevent investors from paying twice for the same performance.

A is incorrect. High water marks reflect the highest cumulative return used to calculate an incentive fee, and it is the highest value, net of fees, that the fund has reached. However, the use of high water marks does not ensure that the fund achieves a specified hurdle rate. The hurdle rate is set based on a risk-free rate proxy plus a premium but may also be set as an absolute, nominal, or real return target.

B is incorrect. High water marks specify the highest value that the fund has reached. This measure will be reset each time the value of the fund increases. However, it does not restrict the value of investments made in the fund.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (c): Describe investment ownership and compensation structures commonly used in alternative investments.

Q.3326 Which of the following statements *most accurately* highlights risk measurement issues associated with alternative investments?

A. Sortino ratios are meaningless.

B. Sharpe ratios tend to be underestimated.

C. Standard deviation may not be a relevant measure of risk.

The correct answer is **C.**

Standard deviation is not a relevant and reliable measure of risk given the illiquid nature of assets. The illiquid nature means that estimates, rather than observable transaction prices, may be used for valuation purposes thereby understating the volatility of returns. In addition, standard deviation ignores the diversification impact for a broad portfolio of managers and alternative investments.

A is incorrect. The Sortino ratio is an appropriate measure of performance given that it uses downside deviation rather than standard deviation as a measure of risk. Downside risk measures focus on the left-hand side tail of the return distribution where losses occur. A measure of downside risk is preferred for alternative investments as returns tend to be leptokurtic, negatively skewed.

B is incorrect. Sharpe ratios may not be the appropriate risk-return measure for alternative investments. These measures will be overstated due to the combined effect of smoothed (inflated) returns and an understated volatility of returns.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.3329 In contrast to traditional investments, alternative investments:

A. Generate absolute returns.

B. Have a broad manager specialization.

C. Have historically demonstrated low mean returns.

The correct answer is **A.**

Alternative investments are investments that are not traditional investments, such as stocks, bonds, and cash. Alternative investments can include private equity, hedge funds, real estate, commodities, and other assets. One of the key differences between traditional and alternative investments is the way they generate returns.
Traditional investments generally aim to generate relative returns, which means their goal is to outperform a benchmark, such as a stock index or bond index. In contrast, alternative investments generally aim to generate absolute returns, which means their goal is to achieve a positive return regardless of market conditions or benchmark performance.

B is incorrect. While alternative investments can be managed by specialized managers, such as hedge fund managers or private equity managers, they can also be managed by generalist managers or institutional investors.

C is incorrect. The performance of alternative investments can vary widely depending on the specific investment strategy, asset class, and market conditions. While some alternative investments may have lower mean returns than traditional investments, others may have higher mean returns or be able to generate returns with lower volatility or lower correlation to traditional investments.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.3333 The average Sharpe ratio of an investor's portfolio increased following the inclusion of alternative investments in a portfolio dominated by traditional investments. Which of the following factors is *least likely* attributed to the increase in the risk-return measure?

A. Account leverage.

B. Illiquidity premium.

C. Lack of transparency.

The correct answer is **C.**

The increase in the portfolio's Sharpe ratio due to the inclusion of alternative investments can be attributed to illiquidity premiums, account leverage, and/or active managers' exploitation of less efficiently priced assets that serves to increase mean returns of alternative investments.

A is incorrect. Account leverage can contribute to an increase in the Sharpe ratio by amplifying the returns of an investment portfolio. Leverage involves using borrowed funds to increase the potential return on investment. While it also increases the risk, if the returns generated from leveraged investments exceed the cost of borrowing, the overall returns of the portfolio can increase without a proportionate increase in perceived risk (standard deviation), thus potentially improving the Sharpe ratio. However, it's important to note that excessive leverage can lead to significant losses and increase the risk beyond acceptable levels.

B is incorrect. The illiquidity premium refers to the higher expected returns that investors demand for investing in assets that are not easily sold or converted into cash without a significant loss in value. Alternative investments, such as private equity, hedge funds, and real estate, often come with higher illiquidity premiums compared to traditional investments like stocks and bonds. This premium can contribute to higher overall returns for the portfolio, improving the Sharpe ratio, assuming the increase in returns is not fully offset by an increase in risk (as measured by standard deviation).

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.3901 Which of the following is *least likely* a category of alternative investments?

A. Collectible.

B. Infrastructures.

C. Supranational bonds.

The correct answer is **C.**

Supranational bonds are not typically classified as alternative investments. They are bonds issued by multinational organizations such as the World Bank or the International Monetary Fund (IMF) and are considered part of the traditional fixed-income investment category.

A is incorrect. Collectibles, such as art, antiques, and rare items, are considered alternative investments. These investments do not fall under traditional categories like stocks, bonds, or cash and are known for their unique value and potential for appreciation over time.

B is incorrect. Infrastructures, such as investments in transportation systems, utilities, and other physical assets, are also classified as alternative investments. These investments are characterized by their long-term horizons and their role in providing essential services.

Q.4196 Which of the following is *most likely* an advantage of co-investing in alternative investments?Co-investing:

A. allows for reduced management fee compared to direct investing.

B. requires more complex due diligence compared to direct investing.

C. allows the investor to access the fund's process and procedures.

The correct answer is **C.**

When an investor co-invests with a fund, they gain insights into the fund's investment process and procedures, which can help build knowledge and expertise in the alternative asset class. This can make it easier for the investor to transition to direct investing in the future, as they will have already gained some experience and familiarity with the investment process.

A is incorrect. Reduced management compared to direct investment is not necessarily an advantage of co-investing, as direct investor avoids paying regular management fees to an external manager.

B is incorrect. Direct investing may require more complex due diligence than co-investing as the investor lacks the assistance of a fund investor.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (b): Compare direct investment, co-investment, and fund investment methods for alternative investments.

Q.4197 Which of the following is *most likely* a practical investment method suitable for an investor inexperienced in investment and conducting due diligence?

A. Co-investing

B. Direct investing

C. Fund investing

The correct answer is **C.**

Fund investing involves investing in a professionally managed fund that pools money from multiple investors and invests in a diversified portfolio of assets. This can be a good option for inexperienced investors because they do not have to conduct their own due diligence on individual investments. Instead, the fund manager makes the investment decisions and manages the portfolio on behalf of the investors. This can provide a level of diversification, risk management, and expertise that may be difficult for inexperienced investors to achieve independently.

A is incorrect. Co-investing may not be the best option for inexperienced investors, as they would still be responsible for conducting their due diligence on individual investments.

B is incorrect. Direct investing can also be challenging for inexperienced investors, as they need the knowledge, expertise, and resources to research and analyze individual investment opportunities. Therefore, fund investing is likely the most suitable option for an inexperienced investor looking to invest in alternative assets.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (b): Compare direct investment, co-investment, and fund investment methods for alternative investments.

Q.4198 Which of the following alternative investment method is *most likely* considered both direct and indirect forms of investment?

A. Co-investing

B. Direct investing

C. Fund investing

The correct answer is **A.**

Co-investing involves investing alongside a fund manager or other investors in a specific investment opportunity. In this sense, co-investing is a direct form of investment, as the investor invests directly in the underlying asset alongside the other investors.

However, co-investing can also be considered an indirect form of investment, as the investor invests in the investment opportunity through the fund or other investment vehicle. This means that the investor is not directly responsible for managing the investment and may have limited control over the investment decisions.

B is incorrect. Direct investing is typically considered a purely direct form of investment, as the investor invests directly in the underlying asset without the involvement of a fund or other investment vehicle.

C is incorrect. Fund investing is typically considered an indirect form of investment, as the investor invests in the fund or other investment vehicle, which invests in a diversified portfolio of assets.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (b): Compare direct investment, co-investment, and fund investment methods for alternative investments.

Q.4199 Which of the following statements is *least likely* accurate regarding alternative investment methods?

A. In co-investing, investors can invest both directly and indirectly in an asset.

B. Direct investments often involve huge and complex investors who can compete directly with fund managers to reach profitable assets.

C. The level of due diligence in fund investing is more complex than in direct investing.

The correct answer is **C.**

In general, the level of due diligence required for direct investing is typically higher than that needed for fund investing. This is because direct investors are responsible for conducting their due diligence on individual investments and managing their portfolios. In contrast, fund investors rely on the expertise of the fund manager to make investment decisions and manage the portfolio.

A is incorrect. Co-investing allows investors to invest both directly and indirectly in an asset.

B is incorrect. Direct investments can require significant resources and expertise to identify and execute profitable investment opportunities, and large institutional investors may have an advantage in this regard.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (b): Compare direct investment, co-investment, and fund investment methods for alternative investments.

Q.4200 Which of the following is *least likely* accurate regarding partnership structure in alternative investments?

A. The general partner (GP) bears limited liability in case of adverse investment events.

B. The number of limited partners (LPs) in a fund may be limited, and they play passive roles in the fund.

C. Partnership agreements (LPAs) and side letters help to manage principal-agent conflict between the GPs and LPs.

The correct answer is **A.**

The general partner (GP) usually bears unlimited liability for the partnership's debts and obligations. This is because the GP is responsible for managing the partnership and making investment decisions and assumes greater risk than the limited partners (LPs). On the other hand, LPs have limited liability and are only liable for the amount of their investment in the partnership.

B is incorrect. Limited partners (LPs) are investors in a partnership who contribute capital to the partnership but do not participate in the management of the partnership. The number of LPs in a fund may be limited depending on the terms of the partnership agreement. LPs typically play passive roles in the fund by leaving the management and decision-making to the general partner (GP).

C is incorrect. Principal-agent conflicts can arise in a partnership when the general partner (GP) acts in their interest instead of the interest of the limited partners (LPs). Limited partnership agreements (LPAs) and side letters are legal agreements that outline the terms and conditions of the partnership and can include provisions that address potential conflicts of interest. These agreements can help manage principal-agent conflicts and ensure that the GP acts in the best interest of the LPs.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (c): Describe investment ownership and compensation structures commonly used in alternative investments.

Q.4201 Which of the following statements *most likely* describes the deal-by-deal type of waterfall in alternative investments?

A. The performance fee is paid on per deal, which is advantageous to the general partners (GPs).

B. The performance fee is paid on a per-deal basis, which is advantageous to the limited partners (LPs).

C. Distributions are made to the limited partners (LPs) until their initial investment is recouped and the hurdle rate has been met, which benefits the LPs.

The correct answer is **A.**

In the deal-by-deal (also called American) waterfall, performance fees are accumulated on per-deal methods. This makes the GP receive payments before LPs get their rates of return (hurdle rate) on the fund and initial investments; hence, it benefits the GPs.

B is incorrect. It contradicts option A.

C is incorrect. It describes the whole-of-fund waterfall. The whole-of-fund waterfall method ensures that the LPs receive their initial investment back and are compensated for the risk they take by investing in the fund before the GP receives any profits.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (c): Describe investment ownership and compensation structures commonly used in alternative investments.

Q.4227 Which of the following *accurately* represents a similarity between the hedge and private equity funds?

A. Both are structured as partnerships.

B. The initial investment has to be repaid before the fund manager earns an incentive fee.

C. Investors pay a management fee based on the assets under management at the end of a period.

The correct answer is **A.**

Both hedge funds and private equity funds are commonly structured as partnerships, with the fund manager serving as the general partner and the investors serving as limited partners. The partnership structure provides a number of benefits, including limited liability for the limited partners and flexibility in terms of fund management and investment strategy.

B is incorrect. This is a characteristic that is specific to private equity funds but not hedge funds. In a private equity fund, the general partner typically earns an incentive fee, known as carried interest, after the limited partners have received a certain minimum return on their investment, known as the hurdle rate.

C is incorrect. Both hedge funds and private equity funds charge management fees, but the way these fees are calculated can vary. Hedge fund managers typically charge a management fee based on the total assets under management at the end of a period, as the statement suggests. Private equity, on the other hand, often charges management fees based on committed capital, especially during the initial investment period, and later it could be based on the invested capital.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (c): Describe investment ownership and compensation structures commonly used in alternative investments.

Q.4326 Which of the following statements is *least likely* a characteristic of alternative investments?

A. Alternative investments are typically found in less efficient markets.

B. Alternative investments are typically short-term, liquid investments.

C. Alternative investments offer greater diversification potential and higher expected returns.

The correct answer is **B.**

Alternative investments are not short-term, liquid investments. This is one of the key characteristics that distinguish them from traditional investments such as stocks and bonds. Alternative investments, which include assets like real estate, private equity, hedge funds, and commodities, are generally illiquid and require a longer investment horizon. This is due to several factors, including restrictions on withdrawals, the nature of the underlying assets, and the lack of a secondary market.

The illiquidity of alternative investments can pose challenges for investors who need to access their capital quickly. However, it can also provide opportunities for higher returns, as investors are often compensated for taking on illiquidity risk. Therefore, while alternative investments can offer diversification benefits and potentially higher returns, they are not typically short-term, liquid investments.

A is incorrect. Alternative investments are typically found in less efficient markets. This is another characteristic that distinguishes them from traditional investments. Less efficient markets can provide opportunities for skilled managers to exploit pricing inefficiencies and generate higher returns. However, they can also pose additional risks, including information asymmetry and higher transaction costs.

C is incorrect. Alternative investments offer greater diversification potential and higher expected returns. This is one of the reasons why investors consider adding them to their portfolios. The returns from alternative investments are often less correlated with those from traditional asset classes, which can help to reduce portfolio risk. Furthermore, because alternative investments often involve more complex strategies and less efficient markets, they have the potential to deliver higher returns.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.4327 Given the unique characteristics of alternative investments, which of the following investor types is *most likely* to allocate a larger share of their portfolio to alternative investments?

A. Individual investors with short-term financial goals.

B. Small businesses looking for quick returns on investment.

C. Large pension funds, sovereign wealth funds, and not-for-profit endowments.

The correct answer is **C.**

Large pension funds, sovereign wealth funds, and not-for-profit endowments are most likely to allocate a larger share of their portfolio to alternative investments. These types of investors typically have long investment horizons, significant capital, and the ability to withstand periods of illiquidity, which aligns well with the characteristics of alternative investments.
Alternative investments often require large capital outlays and have long investment horizons, which can be a barrier for individual investors and small businesses. Additionally, these types of investors often have the resources and expertise to understand and manage the complex risks associated with alternative investments. They also benefit from the low correlation of returns with traditional asset classes, which can help to diversify their portfolios and reduce overall risk.
A is incorrect. Individual investors with short-term financial goals are less likely to allocate a larger share of their portfolio to alternative investments. These types of investments often require a long investment horizon and can be illiquid, which may not align with the needs of investors with short-term financial goals.

B is incorrect. Small businesses looking for quick returns on investment are also less likely to allocate a larger share of their portfolio to alternative investments. These types of investments often require large capital outlays and have long investment horizons, which may not align with the needs of small businesses looking for quick returns.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.4328 Which of the following is *least likely* typically considered an alternative investment category?

A. Real estate.

B. Private equity.

C. Government bonds.

The correct answer is **C.**

Government bonds are not typically considered an alternative investment category. Alternative investments are typically characterized by their complexity, lack of regulation, limited liquidity, and the potential for high returns. They are often used by investors to diversify their portfolios and hedge against market volatility. Government bonds, on the other hand, are considered traditional investments.
They are issued by governments to raise capital and are backed by the full faith and credit of the issuing government. They are highly regulated, relatively simple to understand, and offer a fixed rate of return. Government bonds are also highly liquid, meaning they can be easily bought and sold in the market. Therefore, they do not possess the characteristics typically associated with alternative investments.
A is incorrect. Real estate is also considered an alternative investment. It involves investing in physical properties, such as residential, commercial, or industrial real estate. Like private equity, real estate investments can be illiquid and require a long-term commitment, but they can also offer high potential returns and serve as a hedge against inflation.

B is incorrect. Private equity is considered an alternative investment. It involves investing in companies that are not publicly traded on a stock exchange. Private equity investments are typically illiquid and require a long-term commitment, but they can offer high potential returns.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.4331 A tech company has developed new software that has the potential to revolutionize the industry. The company has secured a patent for this software. Under which category of Alternative Investments would this patent *most likely* fall?

A. Real Assets.

B. Commodities.

C. Infrastructure.

The correct answer is **A.**

The patent for the software developed by the tech company would fall under the category of Real Alternative Assets. Real assets are physical or tangible assets that have value due to their substance and properties. Real assets include precious metals, commodities, real estate, agricultural land, oil and natural gas, and other natural resources. In the context of financial investment, real assets are considered as an alternative investment class that includes all tangible assets.

The Real Assets category includes intellectual property rights such as patents, copyrights, and trademarks. In this case, the patent secured by the tech company for its new software is an intellectual property right that protects the company's exclusive right to use and profit from its invention. This patent has value and can be considered a real asset, but it does not fall under the categories of commodities or infrastructure, which are other types of real assets.

B is incorrect. Commodities are basic goods used in commerce that are interchangeable with other goods of the same type. Commodities include agricultural products, fuels, and metals. A patent for software does not fall under this category because it is not a basic good used in commerce and it is not interchangeable with other goods of the same type.

C is incorrect. Infrastructure refers to the basic physical systems of a business or nation, such as transportation, communication, sewage, water, and electric systems. A patent for software does not fall under this category because it is not a basic physical system.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.4332 An investor is considering diversifying their portfolio by investing in alternative investments such as real estate properties or hedge funds. He understands that these types of investments often have a long-term nature and lack liquidity, requiring specialized knowledge for evaluation and management. Given this, the investor is aware that they will be heavily dependent on the decisions of the manager over extended periods. In this context, what is the most crucial factor that the investor *most likely* needs to consider before making such an investment?

A. The investor's ability to quickly liquidate the investment.

B. The investor's understanding of market trends and risk management.

C. The investor's ability to anticipate higher returns from the investment.

The correct answer is **B.**

The most crucial factor that the investor needs to consider before making an investment in alternative investments such as real estate properties or hedge funds is their understanding of market trends and risk management. Alternative investments are complex and often require specialized knowledge for evaluation and management. They are also typically illiquid and long-term in nature, which means that the investor will be heavily dependent on the decisions of the manager over extended periods.
Therefore, it is crucial for the investor to have a good understanding of market trends and risk management to make informed decisions and manage the risks associated with these investments. This understanding will also help the investor assess the performance of the manager and make necessary adjustments to their investment strategy if needed.
A is incorrect. By their nature, alternative investments are often illiquid and long-term, which means that the investor should be prepared to hold onto the investment for an extended period. If the investor's primary concern is liquidity, then alternative investments may not be the best choice for them.

C is incorrect. While the potential for higher returns is one of the reasons why investors consider alternative investments, it should not be the most crucial factor in the decision-making process. The potential for higher returns is often accompanied by higher risks, and without a good understanding of market trends and risk management, the investor may end up losing their investment.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.4333 Which of the following strategies can less sophisticated alternative investment investors *most likely* employ in order to align the interests of the manager with their own?

A. They can invest only in low-risk assets to ensure minimal losses.

B. They can insist on managing their investments themselves without any professional help.

C. They can negotiate a fee structure where the manager's compensation is tied to the performance of the investment.

The correct answer is **C.**

Less sophisticated investors, such as retail investors, can align the interests of the manager with their own by negotiating a fee structure where the manager's compensation is tied to the performance of the investment. This is known as a performance-based fee structure. It incentivizes the manager to perform well because their compensation is directly linked to the success of the investment.

This aligns the manager's interests with those of the investor, as both parties benefit from a well-performing investment. This strategy is often employed by investors who lack the knowledge or time to manage their investments themselves. It allows them to leverage the expertise of professional investment managers or financial advisors while ensuring that these professionals are motivated to achieve the best possible results.

A is incorrect. Investing only in low-risk assets to ensure minimal losses is not a strategy that aligns the interests of the manager with those of the investor. While it may reduce the risk of financial loss, it does not incentivize the manager to perform well. Furthermore, investing only in low-risk assets may limit the potential for high returns, which could be detrimental to the investor's financial goals.

B is incorrect. Insisting on managing their investments themselves without any professional help is not a viable strategy for less sophisticated investors. This is because they may lack the necessary knowledge, skills, and experience to effectively manage their investments. Without professional help, they may make poor investment decisions, which could result in significant financial losses.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (c): Describe investment ownership and compensation structures commonly used in alternative investments.

Q.4334 In the context of alternative investments, which of the following *most likely* describes why an investor might choose to invest in real estate, private equity, hedge funds, or commodities?

A. They can be sold off instantly like a stock, providing quick returns.

B. They do not require any specialized knowledge for evaluation and management.

C. They can potentially offer higher expected returns and help diversify the investor's portfolio.

The correct answer is **C.**

Alternative investments such as real estate, private equity, hedge funds, or commodities can potentially offer higher expected returns and help diversify the investor's portfolio. These types of investments are often less correlated with traditional asset classes like stocks and bonds, which can help to reduce portfolio risk through diversification. Additionally, because they often require specialized knowledge for evaluation and management, they can provide opportunities for skilled managers to generate excess returns.

A is incorrect. Alternative investments such as real estate, private equity, hedge funds, or commodities are typically not as liquid as stocks and cannot be sold off instantly. These types of investments often require a longer-term commitment and may have restrictions on withdrawals or sales.

B is incorrect. Alternative investments often require specialized knowledge for evaluation and management. This is one of the reasons why investors may be more reliant on manager decisions when investing in these types of assets. The complexity and unique characteristics of these investments often require a deep understanding of the specific market, industry, or asset class.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Q.4335 An investor is considering diversifying their portfolio by including alternative investments. In this context, which of the following strategies would *most likely* be appropriate for the investor to ensure that the investment strategy aligns with their objectives and risk tolerance?

A. Defer strategy or risk assessment after investment.

B. Outsourcing the investment process to a professional without understanding their investment strategy.

C. Either taking control of the investment process or outsourcing it to a professional, ensuring that the investment strategy aligns with their objectives and risk tolerance.

The correct answer is **C.**

Either taking control of the investment process or outsourcing it to a professional, ensuring that the investment strategy aligns with their objectives and risk tolerance is the most appropriate strategy for an investor considering diversifying their portfolio with alternative investments. This approach allows the investor to maintain control over their investment strategy, whether they choose to manage the investments themselves or delegate this responsibility to a professional.
It ensures that the investment strategy aligns with their objectives and risk tolerance, which is crucial for successful investment management. This approach also allows the investor to monitor the performance of the investments and make adjustments as necessary, which can help to mitigate the potential risks associated with alternative investments. It is a proactive and informed approach to investment management that can help to maximize returns and minimize risks.
A is incorrect. Investing in alternative investments without any strategy or risk assessment is not a suitable approach for managing these types of investments. Alternative investments can be complex and risky, and it is important for investors to have a clear understanding of these risks and how they align with their investment objectives and risk tolerance. Investing without a strategy or risk assessment can lead to poor investment decisions and potential losses.
B is incorrect. Outsourcing the investment process to a professional without understanding their investment strategy is also not a suitable approach. While outsourcing can provide access to professional expertise and potentially improve investment outcomes, it is important for the investor to understand the investment strategy being used. This understanding allows the investor to ensure that the strategy aligns with their objectives and risk tolerance and to monitor the performance of the investments. Without this understanding, the investor may be exposed to unnecessary risks and potential losses.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (b): Compare direct investment, co-investment, and fund investment methods for alternative investments.

Q.4336 If a hedge fund has a hurdle rate of 8%, what does this *most likely* imply?

A. The fund needs to earn at least 8% before the investors can receive their returns.

B. The fund needs to earn at least 8% before the manager can invest in new opportunities.

C. The fund needs to earn at least 8% before the manager can receive their performance fee.

The correct answer is **C.**

A hurdle rate in the context of a hedge fund is a minimum rate of return that the fund must achieve before the fund's manager can receive a performance fee. Therefore, if a hedge fund has a hurdle rate of 8%, it means that the fund needs to earn at least 8% before the manager can receive their performance fee.
This mechanism is designed to align the interests of the fund manager and the investors. It ensures that the manager is rewarded for generating returns that exceed a certain threshold, thereby incentivizing the manager to perform well. The hurdle rate is typically set at a level that is considered to be a reasonable return on investment, taking into account the risk profile of the fund and market conditions.
A is incorrect. The hurdle rate does not determine when the investors can receive their returns. Investors typically receive returns from a hedge fund based on the fund's performance and the terms of their investment agreement, regardless of whether the fund has met its hurdle rate.

B is incorrect. The hurdle rate does not dictate when the manager can invest in new opportunities. The manager's ability to invest in new opportunities is typically determined by the fund's investment strategy and the availability of investable funds, not by the achievement of a certain rate of return.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (c): Describe investment ownership and compensation structures commonly used in alternative investments.

Q.4337 In the context of alternative investment structures, what does the clawback provision *most likely* imply in the event of poor fund performance? If the fund performs poorly in subsequent years:

A. the manager can reclaim some of the investors' returns.

B. the manager can reclaim some of the investors' initial investment.

C. the investors can reclaim some of the manager's performance fee.

The correct answer is **C.**

A clawback provision in the context of alternative investment structures is indeed a mechanism designed to protect the interests of investors. Specifically, it implies that if the fund performs poorly in subsequent years, the investors can reclaim some of the manager's performance fee. This is because the performance fee is typically based on the fund's profits, and if these profits are not sustained, the investors have the right to reclaim a portion of the fee that was previously paid to the manager.

This provision ensures that the manager's interests are aligned with those of the investors, as it incentivizes the manager to not only generate high returns but also to maintain these returns over time. It also provides a measure of protection for investors, as it allows them to recover some of their losses in the event of poor fund performance.

A is incorrect. Similarly, a clawback provision does not imply that the manager can reclaim some of the investors' returns if the fund performs poorly in subsequent years. Again, this would be contrary to the purpose of the clawback provision, which is to protect the interests of the investors. The manager's compensation is typically tied to the fund's performance, and if the fund performs poorly, it is the manager's compensation, not the investors' returns, that should be affected.

B is incorrect. A clawback provision does not imply that the manager can reclaim some of the investors' initial investment if the fund performs poorly in subsequent years. This would be contrary to the purpose of the clawback provision, which is to protect the interests of the investors, not the manager.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (c): Describe investment ownership and compensation structures commonly used in alternative investments.

Q.4339 In the context of a private equity fund structured as a limited partnership, which of the following is *most likely* the LPs?

A. Competing private equity firms.

B. Employees of the private equity firm.

C. Pension funds, endowments, or wealthy individuals.

The correct answer is **C.**

Pension funds, endowments, or wealthy individuals could potentially be the Limited Partners (LPs) in a private equity fund structured as a limited partnership. LPs are typically passive investors who provide capital to the fund but do not participate in its management. They are attracted to private equity funds because of the potential for high returns, and they are typically institutional investors with large amounts of capital to invest, such as pension funds and endowments, or high-net-worth individuals.

These investors are willing to accept the illiquidity and risk associated with private equity investments in exchange for the potential for high returns. The terms of their investment, including their share of the profits and losses of the fund, are set out in the partnership agreement.

A is incorrect. Competing private equity firms are unlikely to be LPs in a private equity fund. While it is theoretically possible, it would be unusual for a competing firm to invest in a fund managed by another firm, as this could create conflicts of interest and competitive issues. Furthermore, private equity firms typically raise their own funds and make their own investments, rather than investing in funds managed by other firms.

B is incorrect. Employees of the private equity firm are typically not LPs in the fund. While they may have a financial interest in the success of the fund, they are more likely to be involved in its management as part of the General Partner (GP), which has unlimited liability and makes the investment decisions for the fund.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (c): Describe investment ownership and compensation structures commonly used in alternative investments.

Q.4340 In the context of a limited partnership agreement (LPA), which of the following statements is *most likely*to be true regarding adjustments to LP terms in an LPA? Adjustments to LP terms are:

A. frequently made to increase the profit percentage of the GP.

B. never made as they are legally binding and cannot be changed.

C. sometimes made to address the unique legal, regulatory, or reporting requirements of a specific investor.

The correct answer is **C.**

Adjustments to Limited Partnership (LP) terms in a Limited Partnership Agreement (LPA) are sometimes made to address the unique legal, regulatory, or reporting requirements of a specific investor. An LPA is a flexible document that can be tailored to meet the specific needs and requirements of the partners involved. While the basic structure of the partnership and the distribution of profits and losses are typically set out in the LPA, there may be circumstances where adjustments are necessary.
For example, a specific investor may have unique legal or regulatory requirements that need to be accommodated. In such cases, the terms of the LPA can be adjusted to meet these requirements. This flexibility is one of the key advantages of LPs as a form of investment vehicle. It allows for a high degree of customization to meet the specific needs of the partners involved.
A is incorrect. Adjustments to LP terms are not frequently made to increase the profit percentage of the General Partner (GP). While it is possible for the GP to negotiate a higher profit percentage, this would typically require the agreement of all the Limited Partners (LPs). It is not a common occurrence and would not be a typical reason for adjusting the terms of an LPA.

B is incorrect. While it is true that the terms of an LPA are legally binding, they are not immutable. They can be changed if all the partners agree to the changes. Therefore, it is not accurate to say that adjustments to LP terms are never made as they are legally binding and cannot be changed.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (c): Describe investment ownership and compensation structures commonly used in alternative investments.

Q.4341 What does the "most favored nation" clause *most likely* ensure in the context of the side letter agreement between the GP and LP? It ensures that:

A. the LP will always receive the highest possible returns on their investment.

B. the clause ensures that the LP has the right to forgo a contractual capital contribution at any time.

C. any more favorable or additional terms negotiated outside of the LPA with other investors will also apply to a particular LP.

The correct answer is **C.**

In the context of private equity investments, a "most favored nation" clause in a side letter agreement between a General Partner (GP) and Limited Partner (LP) ensures that any more favorable or additional terms negotiated outside of the Limited Partnership Agreement (LPA) with other investors will also apply to a particular LP. This clause is designed to protect the interests of the LP by ensuring that they are not disadvantaged relative to other investors.
If the GP negotiates more favorable terms with another investor after the LPA has been signed, the "most favored nation" clause requires the GP to offer the same terms to the LP. This can include more favorable fee arrangements, information rights, or other terms. The "most favored nation" clause is a common feature in side letters and is an important tool for LPs to ensure that they receive the best possible terms in their investment.
A is incorrect. The "most favored nation" clause does not ensure that the LP will always receive the highest possible returns on their investment. The returns on a private equity investment are determined by the performance of the underlying investments, not by the terms of the LPA or any side letter agreement.

B is incorrect. The "most favored nation" clause does not give the LP the right to forgo a contractual capital contribution at any time. The obligation to make capital contributions is typically set out in the LPA and cannot be unilaterally waived by the LP. The "most favored nation" clause only ensures that the LP receives the same favorable terms as other investors, it does not give them the right to alter their contractual obligations.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (c): Describe investment ownership and compensation structures commonly used in alternative investments.

Q.4360 If an investor is seeking to invest alongside a venture capital firm in a promising startup, which of the following is *most likely* form of private equity investment is he considering?

A. Co-Investment.

B. Direct Investment.

C. Indirect Investment.

The correct answer is **A.**

In a co-investment, an investor partners with a lead sponsor, such as a venture capital firm, to invest in a specific opportunity. The lead sponsor sources, structures, and executes the transaction, while the co-investor provides additional capital. This allows the co-investor to participate directly in the investment alongside the lead sponsor.
Co-investments are often used in private equity and venture capital deals, where they allow investors to gain exposure to specific assets or companies rather than a diversified portfolio. In this case, the investor is seeking to invest alongside a venture capital firm in a promising startup, which is a typical example of a co-investment.
B is incorrect. A direct investment would involve the investor investing directly in a single, specific asset, such as a startup company. However, in this case, the investor is not investing directly, but rather partnering with a venture capital firm to make the investment. Therefore, this is not a direct investment.

C is incorrect. An indirect investment would involve the investor investing through a fund-of-funds vehicle that holds stakes in various other private funds. This is similar to a mutual fund, where the investor does not invest directly in the underlying assets but rather in the fund that holds those assets. In this case, the investor is not investing through a fund-of-funds but rather partnering with a venture capital firm to invest directly in a startup. Therefore, this is not an indirect investment.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (b): Compare direct investment, co-investment, and fund investment methods for alternative investments.

Q.4393 Which of the following investment structures is *most likely* similar to the structure of REITs and private real estate funds in terms of allowing investors to contribute or redeem capital throughout the life of the fund?

A. Hedge Funds.

B. Mutual Funds.

C. Exchange-Traded Funds (ETFs).

The correct answer is **B.**

Mutual Funds are the most similar to the structure of REITs and private real estate funds in terms of allowing investors to contribute or redeem capital throughout the life of the fund. Mutual funds, like REITs and private real estate funds, are structured as open-end funds. This means that they do not have a fixed number of shares. Instead, the fund issues new shares to investors when they buy in and redeems shares when investors want to sell.

This structure allows for a great deal of flexibility for investors, as they can enter and exit the fund at any time. This is similar to REITs and private real estate funds, which also allow investors to contribute or redeem capital throughout the life of the fund. The open-end structure of these investment vehicles is designed to accommodate the liquidity needs of investors, making them suitable for a wide range of investment strategies and objectives.

A is incorrect. Hedge Funds are not similar to the structure of REITs and private real estate funds. Hedge funds are typically structured as limited partnerships or limited liability companies, and they do not allow investors to contribute or redeem capital at any time. Instead, hedge funds usually have specific periods during which investors can enter or exit the fund, often with restrictions and penalties for early withdrawal. This is a significant difference from the open-end structure of REITs and private real estate funds.

C is incorrect. Exchange-traded funds (ETFs) are not the most similar to the structure of REITs and private real estate funds. While ETFs do offer a high degree of liquidity, they are structured as open-end funds but trade on an exchange like a stock. This means that their shares are not directly redeemable with the fund but must be bought and sold on the open market. This is a key difference from the structure of REITs and private real estate funds, which directly issue and redeem shares with investors.

CFA Level I, Alternative Investments, Learning Module 1: Alternative Investment Features, Methods and Structures. LOS (a): Describe features and categories of alternative investments.

Learning Module 2: Alternative Investment: Performance and Returns

Q.1219 When analyzing investment returns data, if we only include firms with better than average returns and exclude firms that performed poorly and ceased to exist over the given period, this type of bias is *most likely* known as:

A. Back fill bias.

B. Survivorship bias.

C. Time period bias.

The correct answer is **B.**

Survivorship bias occurs when we only consider the entities that "survived" a certain period and ignore those that did not. In this case, if you're only including firms with better-than-average returns and excluding those that performed poorly and ceased to exist, you are introducing survivorship bias. The firms that ceased to exist likely had lower returns, and ignoring them skews the data towards higher returns, leading to overly optimistic results.

A is incorrect. Backfill bias (or instant history bias) refers to a practice where a fund's historical record is inserted, in retrospect, into performance databases. This usually happens when the fund performs well in its early, non-public phase, and it's beneficial for the fund manager to include this in their record. It doesn't relate to excluding firms that performed poorly.

C is incorrect. Time period bias occurs when a test design is based on a time period that may make the results time-period specific.

Q.1257 A hedge fund has a beginning year value of $370 million and a 2 plus 20 fee structure with no hurdle rate or water mark. The structure of the hedge fund is set up so that the incentive fee is calculated net of the management fee. If the ending value of the fund is $400 million, then the total fees paid to the hedge fund for the period is *closest to*:

A. $12.4 million.

B. $15 million.

C. $16 million.

The correct answer is **A.**

$$\begin{aligned} \text{Management fee} &= \$400 \text{ million} \times 2\% = \$8 \text{ million} \\ \text{Incentive fee} &= (\$400 \text{ million} - \$8 \text{ million} - \$370 \text{ million}) \times 20\% = \$22 \text{ million} \times 20\% = \$4.4 \text{ m} \\ \text{Total fees} &= \text{Management fee} + \text{Incentive fee} = \$8 \text{ million} + \$4.4 \text{ million} = \$12.4 \text{ million} \end{aligned}$$

B is incorrect. It overestimates the total fees by not correctly applying the 2 plus 20 fee structure and the calculation method for the incentive fee, which should be net of the management fee.

C is incorrect. It significantly overestimates the total fees, likely due to a misunderstanding of how the incentive fee is calculated in relation to the management fee and the net gains of the fund.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.3287 Mega Star Investment is a hedge fund with $550 million initial capital and a '2 and 20' fee structure. The 2% management fee is based on year-end assets under management and the 20% incentive fee is not independent of the management fee. The value of the fund at the end of year one is $652 million. The investor's net return is *closest to*:

A. 12.47%.

B. 12.94%.

C. 15.31%.

The correct answer is **B.**

$$\text{Year-end fund value} = \$652 \text{ million}$$
$$\text{Management fee} = 2\% \times 652 = \$13.04 \text{ million}$$
$$\text{Incentive fee} = (652 - 550 - 13.04) \times 20\% = \$17.79 \text{ million}$$
$$\text{Investor's net return} = \frac{(652 - 550 - 13.04 - 17.79)}{550} = \frac{71.17}{550} = 12.94\%$$

A is incorrect. The option suggesting a 12.47% return does not accurately account for the calculation of both the management and incentive fees according to the '2 and 20' structure. It likely underestimates the impact of these fees on the final return to the investor.

C is incorrect. The 15.31% return overestimates the investor's net return by not properly accounting for the deduction of both the management and incentive fees from the year-end fund value. This option likely ignores the cumulative impact of these fees on the net return, leading to an inflated figure.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.3289 Rosy Garcia is considering investing in a hedge fund or in a fund of funds. Garcia invests $50 million in the hedge fund and receives a yearly gross return of 10%. The fund has a '2 and 20' fee structure with no hurdle rate and management fees are calculated on an annual basis on assets under management at the beginning of the year. Incentive fees are calculated independently of management fees. Garcia also invests $60 million in a fund of funds (FOF) and earns a 5% yearly gross return. Assuming that the fund of funds fee structure is '1 and 10' and that all other fee structures in the FOF are similar to that of the hedge fund, the return to the investor of investing directly in the hedge fund will be:

A. 2.5% greater than the return generated by investing in the FOF.

B. 2.3% greater than the return generated by investing in the FOF.

C. 3.1% greater than the return generated by investing in the FOF.

The correct answer is **A.**

For investing directly \$50 million in the hedge fund:

$$\$50 \text{ million} \times (10\%) = \$5 \text{ million profit}$$

Management fee:

$$\$50 \text{ million} \times (2\%) = \$1 \text{ million gross profit}$$

Incentive fee:

$$\$5 \text{ million} \times (0.20) = \$1 \text{ million}$$

Total fees:

$$\$1 \text{ million} + \$1 \text{ million} = \$2 \text{ million}$$

Return:

$$\frac{(\$5 \text{ million} - \$2 \text{ million})}{\$50 \text{ million}} = 6\%$$

For investing \$60 million in the FOF:

$$\$60 \text{ million} \times (5\%) = \$3 \text{ million gross profit}$$

The FOF charges a fee of 1%:

$$60 \text{ million}(1\%) = \$0.6 \text{ million}$$

and an incentive fee of

$$\$3 \text{ million} \times (0.10) = \$0.3 \text{ million}$$

Return:

$$\frac{(\$3 \text{ million} - \$0.6 \text{ million} - \$0.3 \text{ million})}{\$60 \text{ million}} = 3.5\%$$

So

$$6\% - 3.5\% = 2.5\%$$

B is incorrect. It suggests a difference of 2.3% between the returns of the hedge fund and the FOF, which does not align with the calculated difference based on the given fee structures and gross returns.

C is incorrect. It suggests a difference of 3.1% between the returns of the hedge fund and the FOF, which exceeds the actual calculated difference. The discrepancy arises from not accurately accounting for the specific fee structures and their impact on the net returns of each investment option.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS b: calculate and interpret alternative investment returns both before and after fees.

Q.3310 Right-Lance Capital is a hedge fund with $250 million as initial investment capital. A 2% management fee based on assets under management is charged at year-end, and a 20% incentive fee is charged on performance net of management fees. In the first year of operations, the fund earned a return of 16%. The investor's effective return given this fee structure is *closest to*:

A. 10.94%.

B. 11.20%.

C. 12.50%.

The correct answer is **A.**

$$\begin{aligned}
\text{Management fee} &= \$250 \text{ million} \times 1.16 \times 2\% = \$5.80 \text{ million} \\
\text{Incentive fee} &= (\$290 \text{ million} - \$250 \text{ million} - \$5.80 \text{ million}) \times 20\% = \$6.84 \\
\text{Total fees to Right} - \text{Lance Capital} &= \$5.80 \text{ million} + \$6.84 \text{ million} \\
&= \$12.64 \text{ million} \\
\text{Investor's return} &= \frac{(\$290 \text{ million} - \$250 \text{ million} - \$12.64 \text{ million})}{\$250 \text{ million}} = 10.94\%
\end{aligned}$$

B is incorrect. The option suggesting an 11.20% return does not accurately account for the total fees deducted from the fund's performance. It likely underestimates the impact of the incentive fee or miscalculates the management fee.

C is incorrect. Suggesting a 12.50% return overlooks the significant impact of the incentive fee on top of the management fee. This option significantly overestimates the investor's effective return by not properly accounting for the reduction in fund value due to the fees charged by Right-Lance Capital.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.3318 Clock Limited is a hedge fund with a total asset base of $10 million. The fund charges a 2% management fee based on assets under management at year-end and a 20% incentive fee in excess of a 0.5% hurdle rate. During the first year, the fund appreciates by 15%. If incentive fees are calculated independently and management fees are calculated at year-end, the investor's return net of performance fees is *closest to*:

A. 6.8%.

B. 8.1%.

C. 9.8%.

The correct answer is **C.**

$$\begin{aligned}
\text{Fund value at year-end} &= \$10 \text{ million} \times 1.15 = \$11.5 \text{ million} \\
\text{Management fees} &= \$11.5 \text{ million} \times 0.02 = \$0.23 \text{ million} \\
\text{Hurdle amount} &= \$10 \text{ million} \times 0.005 = \$0.05 \text{ million} \\
\text{Incentive fees} &= (\$11.5 \text{ million} - \$10 \text{ million} - \$0.05 \text{ million}) \times 0.20 = \$0.29 \text{ mil} \\
\text{Total fees paid to Clock Limited} &= \$0.23 \text{ million} + \$0.29 \text{ million} \\
&= \$0.52 \text{ million} \\
\text{Investor's net return} &= \frac{(\$11.5 \text{ million} - \$10 \text{ million} - \$0.52 \text{ million})}{\$10 \text{ million}} = 9.8\%
\end{aligned}$$

A is incorrect. The option suggesting a 6.8% net return does not accurately account for the calculation of management and incentive fees based on the fund's performance and the specified fee structure. It underestimates the net return to the investor after accounting for the total fees paid to Clock Limited.

B is incorrect. The option suggesting an 8.1% net return also fails to correctly calculate the impact of both the management fee and the incentive fee on the investor's return. This option does not properly apply the fee structure to the fund's performance, leading to an inaccurate estimation of the net return to the investor.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.3321 One of the key reasons for the integration of alternative investments with traditional investments in a portfolio context *most likely* includes:

A. Improved Sharpe ratio.

B. Attaining perfect correlation between the two categories.

C. Resulting portfolio risk is equal to the weighted average of individual standard deviations of asset classes.

The correct answer is **A.**

One of the reasons for including alternative investments in a portfolio of traditional investments includes the opportunity to improve the risk/return relationship within the portfolio context. The historically higher returns of alternative investments combined with portfolio risk reduction resulting from a less than perfect correlation between the asset category and traditional investments will result in an improvement of the overall risk-return tradeoff of the portfolio's Sharpe ratio.

B is incorrect. An imperfect and negative correlation between alternative investments and traditional investments serves to reduce portfolio risk relative to a weighting of individual standard deviations.

C is incorrect. When combining alternative with traditional investments, portfolio risk will reduce relative to the weighting of individual standard deviations due to the impact of correlation between the two (see above). This reduction will serve to increase the overall Sharpe ratio.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.3328 Graco Fund of Funds (FOF) invests $50 million each in the hedge funds, Lexor and Polygon. Graco FOF quotes a '2 and 20' free structure. The management fees are calculated based on asset values at year-end while incentive fees are calculated independently of management fees at year-end. At year-end, the value of investment in Lexor and Polygon was $45 million and $62 million, respectively. The investor's net-of-fees return is *closest to*:

A. 2.46%.

B. 3.89%.

C. 7.00%.

The correct answer is **A.**

Lexor's management fees

$$45,000,000 \times 2\% = 900,000$$

Polygon's management and incentive fees

$$62,000,000 \times 2\% = 1,240,000$$

$$(62,000,000 - 50,000,000) \times 20\% = 2,400,000$$

Total incentive and management fees

$$900,000 + 1,240,000 + 2,400,000 = 4,540,000$$

Net-of-fees return

$$\frac{(107\text{m} - 100\text{m} - 4.54\text{m})}{100\text{m}} = 2.46\%$$

B is incorrect. It likely overlooks the correct calculation of the incentive fees or misinterprets the '2 and 20' fee structure. The calculation of net-of-fees return must accurately account for both management and incentive fees based on the year-end values of the investments and the profits generated.

C is incorrect. It significantly overestimates the investor's net-of-fees return. It is essential to deduct both the management fees and the incentive fees from the total profits before calculating the net return to the investor.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.4202 Realest, a private real estate company, invested USD 20 million by constructing residential apartments in the first year. After six years, the company sells the apartments for USD 50 million. The company made an additional capital injection of USD 1.5 million and USD 0.8 million in years 2 and 3, respectively. The multiple of invested capital (MOIC) is *closest to:*

A. 0.57×

B. 3.14×

C. 2.24×

The correct answer is **C.**

Recall that MOIC is given by:

$$\text{MOIC} = \frac{\text{Realized value of investment} + \text{Unrealized value of investment}}{\text{Total amount of invested capital}}$$
$$= \frac{50}{20 + 1.5 + 0.8} = 2.24\times$$

A is incorrect. It suggests a MOIC of 0.57×, which would imply that the exit value of the investment is significantly less than the total invested capital. This does not align with the given scenario where the exit value (USD 50 million) is more than double the total invested capital (USD 22.3 million).

B is incorrect. It suggests a MOIC of 3.14×, which would imply an even higher return on the invested capital than what is calculated based on the given figures.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.4203 Which of the following is *most likely* a custom fee arrangement that is meant to attract investors into a start-up hedge fund?

A. Either/or fees.

B. Founder's shares.

C. Fees based on liquidity terms and asset size.

The correct answer is **B.**

Founder's shares are typically offered to the hedge fund's founders or management team at a discounted price or with other favorable terms. These shares often have a lower fee structure or other incentives attached to them that can be attractive to early investors. By offering founder's shares, hedge fund managers can align the interests of the investors with their own and create a sense of shared ownership and partnership between the investors and the management team.

A is incorrect. Either/or fees gives investors a choice between two fee structures, typically a performance-based fee or a fixed management fee. For example, an investor might have the option to pay a fixed management fee of 2% of assets under management or a performance-based fee of 20% of profits. This fee structure is used to provide investors with flexibility and can be attractive to investors uncertain about the hedge fund's expected returns.

C is incorrect. Fees based on liquidity terms and asset size offer different rates depending on the liquidity terms the investor is willing to take. Also, larger investors may give larger investors a discount. For example, a hedge fund might charge a higher management fee for assets under management up to a certain threshold and then charge a lower fee for assets above that threshold.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.4204 KTE capital is a hedge fund with initial investment capital of USD 200 million. The fund charged 1% based on the end-year asset under management and a 10% incentive fee. The fund specifies a hurdle rate of 5%, and the incentive fee is based on returns in excess of the hurdle rate. In the first year, the funds yield a return of 30%, and in the second year, the fund declined by 15%. If the management and incentive fees are calculated independently, the fund's net return in the second year is *closest to*:

A. -15.70%.

B. -15.85%.

C. -2.64%.

The correct answer is **B.**

In the first year,

$$\text{Management fee} = 200 \times 1.30 \times 0.01 = \text{USD } 2.6 \text{ million}$$
$$\text{Incentive fee} = (200 \times (1.30 - 0.05) - 200) \times 0.10 = \text{USD } 5 \text{ million}$$

As such,

$$\text{Total fees} = 2.6 + 5 = \text{USD } 7.6 \text{ million}$$

Therefore,

$$\text{Investor return} = \frac{260 - 200 - 7.6}{200} = 26.20\%$$

The ending value of the fund is, therefore:

$$\text{Ending value (1st year)} = 200 \times 1.2620 = \text{USD } 252.40 \text{ million}.$$

In the second year, the management fee is:

$$\text{Management fee} = (252.40 \times 0.85) \times 0.01 = \text{USD } 2.1454 \text{ million}$$

There is no incentive in the second year since the fund value declined. Note that in the second year, the fund declined to the value of:

$$252.40 \times 0.85 = \text{USD } 214.54 \text{ million}$$

So that the investor's return in the second year is:

$$\text{Investor return for the second year} = \frac{214.54 - 2.1454 - 252.40}{252.40} = -15.85\%$$

A is incorrect. This option underestimates the impact of the management fee on the fund's net return in the second year. It does not accurately reflect the calculation based on the fund's performance and the structure of the fees.

C is incorrect. It fails to reflect the substantial negative return experienced by the fund in the second year.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.4205 DEF investment group invested $150 million in a private equity fund with a 2.5% management fee based on the end-year asset under management (AUM) and a 20% incentive fee, which are calculated independently. The fund specifies a hurdle rate of 8%. In the first year, the fund yielded a return of 15%, and in the second year, it grew by 20%. The incentive fee paid in the second year is *closest to:*

A. $2.11 million.

B. $4.00 million.

C. $3.98 million.

The correct answer is **C.**

In the first year,

$$\text{Management fee} = 150 \times 1.15 \times 0.025 = \$4.3125 \text{ million}$$
$$\text{Incentive fee} = ((1.15 \times 150) - 150 - (0.08 \times 150)) \times 0.20 = \$2.1 \text{ million.}$$

Therefore, the total fees are:

$$4.3125 + 2.1 = \$6.4125 \text{ million}$$

Hence the return to investors in the first year is,

$$\text{Investor return} = \frac{1.15 \times 150 - 6.4125 - 150}{150} = 10.725\%$$

As such, the ending value of the first year (beginning value of the second year) is $166.0875 (= 1.10725 \times 150)$

As such, the incentive fee in the second year is,

$$\text{Incentive fee} = [(166.0875 \times 1.20 - 166.0875) - (0.08 \times 166.0875)] \times 0.20 = \$3.986 \text{ million.}$$

A is incorrect. The option suggests an incentive fee of \$2.11 million, which underestimates the actual incentive fee calculated based on the fund's performance and the specified fee structure. This option does not accurately account for the 20% return in the second year and its impact on the incentive fee calculation.

B is incorrect. This discrepancy may arise from not precisely accounting for the hurdle rate and its impact on the calculation of the incentive fee based on the returns exceeding this rate.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.4342 Which of the following statements is *least likely* a characteristic of alternative investments that the investor should consider when assessing their performance relative to other investments over time?

A. They often operate in more efficient markets compared to traditional investments.

B. They often require a longer investment horizon and are less liquid than traditional investments.

C. Unlike traditional investments, they require staggered capital commitments over time, where the entire capital is invested upfront.

The correct answer is **A.**

Alternative investments do not typically operate in more efficient markets compared to traditional investments. In fact, one of the key characteristics of alternative investments is that they often operate in less efficient markets. This is because alternative investments, such as hedge funds, private equity, and real estate, often involve complex strategies and structures that are not as easily understood or accessible as traditional investments like stocks and bonds.
These investments often involve a higher degree of risk and uncertainty, leading to inefficiencies in pricing and valuation. This can create opportunities for skilled managers to generate higher returns but also increase the risk of loss. Therefore, investors need to understand the unique characteristics and risks associated with alternative investments before adding them to their portfolios.
B is incorrect. It is also true that alternative investments often require a longer investment horizon and are less liquid than traditional investments. This is another characteristic of alternative investments that investors should consider when assessing their performance relative to other investments over time.

C is incorrect. Indeed, alternative investments often require staggered capital commitments over time, unlike traditional investments, where the entire capital is invested upfront. This is a characteristic of alternative investments that investors should consider when assessing their performance relative to other investments over time.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (a): Describe the performance appraisal of alternative investments.

Q.4343 Which of the following statements is most likely accurate regarding the performance appraisal of alternative investments compared to traditional investments?

A. Performance appraisal of traditional asset classes is more complex due to their standardized nature and the absence of further capital commitments.

B. Performance appraisal of alternative investments is straightforward due to their customized nature and the potential for higher returns.

C. Performance appraisal of traditional asset classes is straightforward due to their standardized nature and continuous price quotations, while alternative investments are more complex due to their unique features and potential for additional capital commitments.

The correct answer is **C.**

Performance appraisal of traditional asset classes is straightforward due to their standardized nature and continuous price quotations, while alternative investments are more complex due to their unique features and potential for additional capital commitments. Traditional asset classes such as public equity and debt securities are standardized, meaning they are uniform in nature and traded on public exchanges where prices are continuously quoted. This makes the performance appraisal of these assets relatively straightforward as it involves comparing the returns of these assets with their respective benchmarks.

On the other hand, alternative investments are customized and may require additional capital commitments at various stages of the investment. They may also involve complex strategies such as short selling or leverage. These unique features make the performance appraisal of alternative investments more complex. It involves assessing the returns of these investments in light of the additional risks and capital commitments they entail. Therefore, the performance appraisal of traditional asset classes is straightforward, while that of alternative investments is more complex.

A is incorrect. The standardized nature and absence of further capital commitments of traditional asset classes make their performance appraisal less complex, not more. The uniformity and continuous price quotations of these assets simplify the process of comparing their returns with their respective benchmarks.

B is incorrect. The performance appraisal of alternative investments is not straightforward due to their customized nature and the potential for higher returns. The unique features of these investments, such as the potential for additional capital commitments and the use of complex strategies, make their performance appraisal more complex. It involves assessing the returns of these investments in light of the additional risks and capital commitments they entail.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (a): Describe the performance appraisal of alternative investments.

Q.4344 Consider an investor who has committed capital to a private equity fund. The fund has charged a management fee and a setup fee and is now in the process of investing the capital for initiating operations for a startup. The investor is currently experiencing negative returns due to the fees and expenses incurred. However, the fund managers expect the startup to succeed, leading to asset appreciation and income generation in excess of costs. Based on this scenario, in which phase of the investment life cycle is the investor's capital currently?

A. Capital distribution phase.

B. Capital deployment phase.

C. Capital commitment phase.

The correct answer is **B.**

The investor's capital is currently in the Capital Deployment Phase. In the context of private equity, the capital deployment phase is the period during which the fund is actively investing the committed capital into portfolio companies. This phase typically involves the acquisition of assets, the initiation of operations, and the payment of various fees and expenses, including management fees and setup fees.

During this phase, investors often experience negative returns due to the costs associated with these activities. However, the expectation is that these investments will eventually generate returns that exceed these costs, leading to a positive return on investment. The capital deployment phase is a critical period in the investment life cycle, as the decisions made during this phase can significantly impact the ultimate success or failure of the investment.

A is incorrect. The Capital Distribution Phase is the period during which the private equity fund returns capital to its investors. This phase occurs after the capital deployment phase and typically involves the sale of portfolio companies and the distribution of the proceeds to investors. The investor in the scenario is not yet in this phase, as the fund is still in the process of deploying the capital and has not yet begun to generate returns.

C is incorrect. The Capital Commitment Phase is when investors commit to invest a certain amount of capital in a private equity fund. This phase occurs before the capital deployment phase and involves the legal and financial arrangements necessary to secure the commitment of capital.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.4345 A real estate fund is spending money on building and renovating properties. The cash outflows currently exceed the inflows, reducing the returns. However, the fund managers expect the properties to appreciate, leading to income generation in excess of costs. Based on this scenario, which phase of the investment life cycle is the real estate fund currently in?

A. Capital distribution phase.

B. Capital deployment phase.

C. Capital commitment phase.

The correct answer is **B.**

The real estate fund is currently in the Capital Deployment Phase. This phase of the investment life cycle is characterized by the active investment of capital into projects, such as building and renovating properties in the case of a real estate fund. During this phase, the fund is spending money, and cash outflows typically exceed inflows.

This can lead to a temporary reduction in returns. However, the goal of this phase is to create value that will generate future income. In the case of a real estate fund, this value is created through property appreciation and rental income. The capital deployment phase is a critical period in the investment life cycle, as the decisions made during this phase can significantly impact the fund's future performance.

A is incorrect. The Capital Distribution Phase is the final phase of the investment life cycle, during which the returns from the investment are distributed to the investors. This phase occurs after the capital deployment phase and is characterized by positive cash inflows as the fund begins to generate income. In the given scenario, the fund is not yet in this phase as it is still spending money, and the cash outflows exceed the inflows.

C is incorrect. The Capital Commitment Phase is the initial phase of the investment life cycle, during which investors commit capital to a fund. This phase occurs before the capital deployment phase and involves raising capital and setting the terms of the investment. In the given scenario, the fund is past this phase as it is already spending money on building and renovating properties.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.4346 You are a financial analyst at a private equity firm evaluating a potential investment opportunity. The investment requires an initial outlay of $1 million, followed by cash inflows of $200,000 at the end of each year for the next 7 years. You are tasked with calculating the Internal Rate of Return (IRR) to assess the viability of this investment. Which of the following *most likely* describes the process you would use to calculate the IRR for this investment?

A. You would set the net present value (NPV) of the cash flows equal to zero and solve for the discount rate, which is the IRR.

B. You would calculate the average annual return by dividing the total return ($1.4 million) by the initial investment ($1 million) and then subtract one to get the IRR.

C. You would calculate the IRR by dividing the initial investment ($1 million) by the total return ($1.4 million) and then subtracting one.

The correct answer is **A.**

The Internal Rate of Return (IRR) is a financial metric that is widely used in capital budgeting and corporate finance. It is a discount rate that makes the net present value (NPV) of all cash flows (both positive and negative) from a particular project equal to zero. IRR calculations rely on the same formula as NPV does.
The IRR can be calculated as the discount rate that makes the NPV of future cash flows equal to zero. In this case, the formula provided in Choice A is correct: 0 = -$1 million + ($200,000 / (1+IRR)) + ($200,000 / (1+IRR)^2) + ... + ($200,000 / (1+IRR)^7). This formula correctly represents the process of calculating the IRR, which involves setting the NPV of the cash flows equal to zero and solving for the discount rate.
B is incorrect. The method described in Choice B is incorrect in calculating the IRR. The IRR is not simply the average annual return divided by the initial investment minus one. This method does not consider the time value of money, which is a key component of the IRR calculation. The time value of money is the concept that money available at present is worth more than the same amount in the future due to its potential earning capacity.

C is incorrect. The method described in Choice C is also not the correct way to calculate the IRR. The IRR is not calculated by dividing the initial investment by the total return and subtracting one. This method, like the one in Choice B, does not consider the time value of money. The IRR calculation requires that the present value of future cash inflows be equal to the initial investment, considering the time value of money.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.4347 Imagine you are a private equity manager evaluating the performance of an investment. You have invested a total capital of $5 million in a project. After the project's completion, the total value returned to the investors is $15 million. The Multiple of Invested Capital (MOIC) for the project is *closest to:*

A. 0.33x

B. 3.00x

C. 7.00x

The correct answer is **B.**

The Multiple of Invested Capital (MOIC) is a performance measure used in private equity to evaluate the return on investment. It is calculated as:

$$\text{MOIC} = \frac{(\text{Realized Value of Investment} + \text{Unrealized Value of Investments})}{\text{Total Capital Invested}}$$

In this scenario, the total value returned to the investors is $15 million, and the total capital invested is $5 million.
Therefore, the MOIC is calculated as $15 million / $5 million, which equals 3x. This means that for every dollar invested in the project, $3 was returned to the investors. This strong performance indicates that the investment was successful and generated a significant return. The MOIC is a simple and straightforward measure that provides a clear picture of the return on investment, making it a valuable tool for private equity managers.

A is incorrect. This option suggests a MOIC of 0.33x, which would imply that for every dollar invested, only $0.33 was returned to the investors. The calculation error here likely stems from inverting the formula, dividing the total capital invested by the total value returned, which is not how MOIC is calculated.

C is incorrect. This option indicates a MOIC of 7.00x, suggesting that for every dollar invested, $7 were returned to the investors. This figure significantly overestimates the return on investment as per the given scenario.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.4348 An investor has a cash investment of $15,000 with a periodic rate of return of 7%. He borrowed an additional $5,000 at a periodic rate of 2% to increase his investment size. The leveraged rate of return for the period is *closet to:*

A. 8.0%

B. 8.6%

C. 9.0%

The correct answer is **B.**

The leveraged rate of return is calculated using the formula:

$$r_L = \frac{r_c \times (V_c + V_b) - (V_b \times r_b)}{V_c}$$

Where:
V_c = cash investment.
r = periodic rate of return.
r_b = borrowing rate of return.
V_b = amount of borrowed funds.
r_L = leveraged rate of return for the period.
In this case, the total investment is $20,000 ($15,000 cash investment + $5,000 borrowed), the borrowing cost is $100 (=$5,000 * 2%), and the cash investment is $15,000. The investment return is $1,400 (=$20,000 * 7%).

$$\text{Leveraged Rate of Return} = \frac{(\$1,400 - \$100)}{\$15,000} = 8.67\%$$

A is incorrect. A leveraged rate of return of 8.0% would imply that the investor's borrowing cost is higher or his investment return is lower than in the given scenario. This is not the case here, as the investor's borrowing cost is 2%, and his investment return is 7%, resulting in a leveraged return rate of 8.5%.

C is incorrect. A leveraged rate of return of 9.0% would imply that the investor's investment return is higher or his borrowing cost is lower than in the given scenario. This is not the case here, as the investor's borrowing cost is 2%, and his investment return is 7%, resulting in a leveraged return rate of 8.5%.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.4350 In the context of a financial crisis, such as the one in 2008, which of the following statements most likely describes the impact of limited access to borrowed funds on leveraged investments?

A. It can enhance the returns of leveraged investments as it reduces the risk of over-leveraging.

B. It has no significant impact on leveraged investments, as investors can rely on their equity positions.

C. It an lead to significant losses for leveraged investments due to the inability to meet margin calls, leading to forced liquidations at unfavorable prices.

The correct answer is **C.**

Limited access to borrowed funds during a financial crisis can lead to significant losses for leveraged investments due to the inability to meet margin calls, leading to forced liquidations at unfavorable prices. Leveraged investments are those that use borrowed funds to increase potential returns. However, they also increase potential losses.

In a financial crisis, lenders often tighten their lending standards, making it more difficult for investors to borrow funds. If an investor is unable to meet a margin call because they cannot borrow additional funds, they may be forced to sell their investments at unfavorable prices to cover the margin call. This can lead to significant losses.

The 2008 financial crisis provided a clear example of this, as many leveraged investors were forced to sell assets at depressed prices because they could not meet margin calls. This is why understanding the risks associated with leveraged investments, including the risk of limited access to borrowed funds, is crucial for investors.

A is incorrect. The statement that limited access to borrowed funds during a financial crisis can enhance the returns of leveraged investments as it reduces the risk of over-leveraging is incorrect. While it is true that limited access to borrowed funds can prevent over-leveraging, it does not necessarily enhance returns. In fact, it can lead to significant losses if investors cannot meet margin calls and are forced to sell their investments at unfavorable prices.

B is incorrect. The statement that limited access to borrowed funds during a financial crisis does not significantly impact leveraged investments as investors can rely on their equity positions is incorrect. Leveraged investments are risky and rely on borrowed funds to enhance potential returns. Limited access to these funds, especially during a financial crisis, can lead to significant losses. Equity positions alone may not be sufficient to cover these losses.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.4352 An investor is considering investing in an alternative investment fund. He is aware that, unlike traditional asset classes, alternative investments often impose additional performance fees calculated as a percentage of the fund's periodic returns. He is also aware that the fee structure can vary based on the timing and nature of his involvement in the fund. If he invests substantial capital in a hedge fund during its early stages, what might be the *most likely* impact on the incentive fees he faces and why?

A. He might face significantly higher incentive fees due to the fund's initial growth phase, as the fund manager may increase fees to capitalize on the growth.

B. He might face significantly lower incentive fees due to the fund's initial growth phase, as the fund manager may offer lower fees to attract more capital.

C. His incentive fees will remain unchanged regardless of the fund's growth phase, as alternative investment fees are typically flat and do not vary with the fund's performance.

The correct answer is **B.**

When an investor invests substantial capital in a hedge fund during its early stages, he might face significantly lower incentive fees due to the fund's initial growth phase. The fund manager may offer lower fees to attract more capital. In the early stages of a hedge fund, the fund manager often tries to attract as much capital as possible to grow the fund. One of the ways to do this is by offering lower incentive fees.

These lower fees can make the fund more attractive to potential investors, as they can keep a larger portion of any profits generated by the fund. This strategy can be particularly effective in attracting large investors, who can significantly boost the fund's capital. Once the fund has grown and established a track record of performance, the fund manager may increase the incentive fees. However, the initial investors who came in when the fees were lower may be able to continue enjoying the lower fee structure.

A is incorrect. It is unlikely that an investor would face significantly higher incentive fees due to the fund's initial growth phase. As mentioned above, fund managers often offer lower fees in the early stages of a fund to attract capital. Increasing fees during this phase could deter potential investors and hinder the fund's growth.

C is incorrect. While it is true that some alternative investment fees are flat and do not vary with the fund's performance, this is not always the case. Many alternative investments, including hedge funds, charge performance-based incentive fees. These fees are typically a percentage of the fund's profits, and they can vary depending on the fund's performance and the timing and nature of an investor's involvement in the fund.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.4353 An investor is considering investing in a new hedge fund. The fund manager offers the investor a choice between a standard fee structure and a founder's share fee structure. The standard fee structure includes a 2% management fee and a 20% performance fee. The founder's share fee structure, on the other hand, offers a 1.5% management fee and a 10% performance fee but only applies to the first $100 million in assets invested. The investor plans to invest $150 million in the fund.
Which of the following statements is *most likely* to be true regarding the fee structures offered to the investor? The investor will pay lower fees under the:

A. standard fee structure for the entire investment amount.

B. founder's share fee structure for the entire investment amount.

C. founder's share fee structure for the first $100 million and under the standard fee structure for the remaining $50 million.

The correct answer is **C.**

The investor will pay lower fees under the founder's share fee structure for the first $100 million and under the standard fee structure for the remaining $50 million. The founder's share fee structure offers a lower management fee (1.5% vs. 2%) and a lower performance fee (10% vs. 20%) compared to the standard fee structure. However, this lower fee structure only applies to the first $100 million in assets invested.
For the remaining $50 million, the investor would have to pay the standard fee structure, which is higher. Therefore, the investor would pay lower fees under the founder's share fee structure for the first $100 million and under the standard fee structure for the remaining $50 million. This strategy allows the investor to minimize the total fees paid while still investing the desired amount in the hedge fund.

A is incorrect. The investor will not pay lower fees under the standard fee structure for the entire investment amount. The standard fee structure has higher management and performance fees compared to the founder's share fee structure. Therefore, the investor would pay more in fees under the standard fee structure for the entire investment amount.

B is incorrect. The investor will not pay lower fees under the founder's share fee structure for the entire investment amount because this fee structure only applies to the first $100 million in assets invested. For the remaining $50 million, the investor would have to pay the standard fee structure, which is higher.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.4354 Which of the following statements is *most likely* to be true regarding "either/or" fee arrangement in alternative investments?

A. The fund manager will always choose the fixed management fee, as it guarantees a steady income stream.

B. The fund manager will always choose the variable performance fee, as it has the potential for higher returns.

C. The fund manager's choice will depend on the fund's performance, with the fixed management fee chosen during down years and the variable performance fee chosen during up years.

The correct answer is **C.**

The fund manager's choice will depend on the fund's performance, with the fixed management fee chosen during down years and the variable performance fee chosen during up years. This is because the fixed management fee of 1% is guaranteed regardless of the fund's performance, providing a steady income stream during periods of poor performance. On the other hand, the variable performance fee of 30% above a mutually agreed-upon annual hurdle has the potential for higher returns during periods of strong performance.
Therefore, the fund manager would likely choose the fixed management fee during down years when the fund's performance is below the hurdle rate and the variable performance fee during up years when the fund's performance is above the hurdle rate. This allows the fund manager to maximize their income while also aligning their interests with those of the investor, as they are incentivized to improve the fund's performance in order to earn the higher variable performance fee.
A is incorrect. While the fixed management fee does guarantee a steady income stream, it is not necessarily the case that the fund manager will always choose it. If the fund's performance is strong and exceeds the hurdle rate, the fund manager could earn a higher income from the variable performance fee. Therefore, the fund manager's choice will depend on the fund's performance, not just the certainty of the fixed management fee.

B is incorrect. While the variable performance fee does have the potential for higher returns, it is not necessarily the case that the fund manager will always choose it. If the fund's performance is poor and does not exceed the hurdle rate, the fund manager would earn nothing from the variable performance fee and would be better off choosing the fixed management fee. Therefore, the fund manager's choice will depend on the fund's performance, not just the potential for higher returns from the variable performance fee.

Q.4355 A small fund with strong performance and capacity constraints is considering its fee structure. The fund manager is aware that larger investors may demand lower fees but is reluctant to reduce the fund's fees. Which of the following actions is the fund manager *most likely* to take?

A. The fund manager will reduce the fund's fees to attract larger investors.

B. The fund manager will increase the fund's fees to compensate for the loss of larger investors.

C. The fund manager will maintain the fund's higher fees and may decline business from larger investors.

The correct answer is **C.**

The fund manager is most likely to maintain the fund's higher fees and may decline business from larger investors. This is because the fund manager is aware of the fund's strong performance and capacity constraints. The fund's strong performance means that it is likely to attract investors even with higher fees. Moreover, the capacity constraints mean that the fund may not be able to accommodate a large number of investors.
Therefore, the fund manager may prefer to maintain the higher fees to maximize the fund's revenue and may decline business from larger investors who demand lower fees. This strategy allows the fund to maintain its profitability while managing its capacity constraints. It also ensures that the fund's performance is not diluted by accommodating a large number of investors. This approach is often adopted by small funds with strong performance and capacity constraints.
A is incorrect. While reducing the fund's fees could attract larger investors, it could also reduce the fund's revenue and profitability. Moreover, the fund's capacity constraints mean that it may not be able to accommodate a large number of investors. Therefore, reducing the fees may not be the best strategy for the fund manager.

B is incorrect. Increasing the fund's fees to compensate for the loss of larger investors is not a viable strategy. Higher fees could deter potential investors and reduce the fund's investor base. Moreover, it could also negatively impact the fund's reputation in the market. Therefore, the fund manager is unlikely to increase the fund's fees.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Q.4400 If the risks associated with the investment lead to a reduction in the IRR versus the initial expectations, what does this *most likely* imply about the investor's compensation for the risk and illiquidity of the investment? The investor:

A. is overcompensated for the risk and illiquidity of the investment.

B. is adequately compensated for the risk and illiquidity of the investment.

C. may not be adequately compensated for the risk and illiquidity of the investment.

The correct answer is **C.**

If the risks associated with the investment lead to a reduction in the Internal Rate of Return (IRR) versus the initial expectations, it implies that the investor may not be adequately compensated for the risk and illiquidity of the investment. The IRR is a measure of the potential return on investment, taking into account the time value of money. It is used to compare the profitability of different investments.

If the IRR is lower than initially expected, it means that the net present value of the future cash inflows from the investment is lower than initially expected. This could be due to higher-than-expected costs, lower-than-expected revenues, or a longer-than-expected time horizon for the investment to pay off. All of these factors increase the risk of the investment. If the investor is not receiving a higher return to compensate for this increased risk, then they may not be adequately compensated for the risk and illiquidity of the investment.

A is incorrect. If the IRR is lower than initially expected, it does not mean that the investor is overcompensated for the risk and illiquidity of the investment. On the contrary, it suggests that the investor may not be receiving a high enough return to compensate for the increased risk and illiquidity.

B is incorrect. If the IRR is lower than initially expected, it does not necessarily mean that the investor is adequately compensated for the risk and illiquidity of the investment. The adequacy of the compensation would depend on the investor's risk tolerance and the returns available from other, similar investments. If the IRR is lower than the returns available from other, similar investments, then the investor may not be adequately compensated for the risk and illiquidity of the investment.

CFA Level I, Alternative Investments, Learning Module 2: Alternative Investment: Performance and Returns. LOS (b): Calculate and interpret alternative investment returns both before and after fees.

Learning Module 3: Investments in Private Capital: Equity and Debt

Q.1079 Which of the following is *least likely* a terminology used to identify venture capital investment at different stages of a company's life?

A. Later Stage.

B. Middle Stage.

C. Formative Stage.

The correct answer is **B.**

The term "Middle Stage" is least likely used to identify venture capital investment at different stages of a company's life. Venture capital investments are typically categorized into specific stages that reflect the development phase of the company receiving the investment. These stages are crucial for investors to understand as they indicate the level of risk, the type of involvement, and the potential return on investment associated with each phase.

A is incorrect. "Later Stage" is a commonly used term in venture capital to describe investments made in companies that are more mature than early-stage companies. These companies have typically completed the initial development of their products or services and have proven their business model through successful market entry or revenue generation. Later-stage investments are made to help these companies expand their market reach, increase production, develop new products, or prepare for an initial public offering (IPO). Therefore, "Later Stage" is a recognized and significant phase in the lifecycle of venture capital investment.

C is incorrect. "Formative Stage" is a term used in venture capital to describe the very early phases of a company's life. This stage encompasses activities from the initial concept or idea through to the development of a viable product and the establishment of a business model. The formative stage can be further broken down into sub-stages, such as pre-seed and seed stages, which involve initial funding rounds to support the development of the business concept, product prototype, and market testing. Investments made during the formative stage are characterized by higher risks due to the nascent nature of the companies and their unproven business models. However, these investments also offer the potential for significant returns if the companies successfully navigate to later stages of development and growth. Thus, "Formative Stage" is a critical and recognized phase in the venture capital investment process.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (c): Describe the diversification benefits that private capital.

Q.1081 Which of the following is a private equity exit strategy in which the portfolio company sells all or some shares to another private equity firm or a group of investors?

A. Trade sale.

B. Secondary sale.

C. Initial Public Offering (IPO).

The correct answer is **B.**

Private equity is a type of investment in which funds and investors buy ownership stakes in private companies with the aim of growing their value and ultimately selling their ownership stakes for a profit. Private equity investors typically have a range of exit strategies available to them, including trade sales, secondary sales, and initial public offerings (IPOs).

A is incorrect. A trade sale is another type of private equity exit strategy in which the portfolio company is sold to a strategic buyer, such as a competitor or another company in the same industry.

C is incorrect. Initial Public Offering (IPO) is a private equity exit strategy in which the portfolio company goes public by offering shares of its stock for sale on a public exchange, allowing investors to buy and sell shares freely.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.1232 The term used to describe investors who invest in the 'idea' stage of new companies is *most likely*:

A. Seed investors.

B. Angel investors.

C. Venture capitalists.

The correct answer is **B.**

Angel investors invest in the 'idea' stage of start-up companies for the purpose of deriving business plans and assessing market potential. At this stage, funds are sourced from individuals dominantly made up of family and friends. Note that venture capital (VC) funds are usually not utilized at this point

A is incorrect. This is the stage where VC is used. Seed investors invest to support product development and marketing efforts, including market research.

C is incorrect. A venture capitalist (VC) is a private equity investor that provides capital to companies exhibiting high growth potential in exchange for an equity stake. It umbrellas both angel and seed stage financing.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.1233 Mezzanine stage financing is *most likely* provided to new companies for the purpose of:

A. Developing a prototype.

B. Conducting market research.

C. Covering expenses related to an IPO.

The correct answer is **C.**

In mezzanine-stage financing, the financed company is prepared to go public. The company is thus financed until its IPO is completed or it is sold. Note that the term mezzanine implies that a company is financed as it transitions from a private company to a public company

A and B are incorrect. Formative stage financing provides funds to companies for both developing a prototype and constructing market research.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.1234 Private equity funds that buy the debt of mature companies facing potential default or bankruptcy proceedings are also referred to as:

A. Hedgers.

B. Vulture investors.

C. Venture capitalists.

The correct answer is **B.**

Vulture investors use distressed investing strategies to invest in the debt of potentially defaulting companies.

A is incorrect. Hedgers are primary participants in the futures markets. A hedger is any individual or firm that buys or sells the actual physical commodity.

C is incorrect. A venture capitalist (VC) is a private equity investor that provides capital to companies exhibiting high growth potential in exchange for an equity stake.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.1236 The private equity exit strategy of selling the portfolio company to another private equity firm or group of investors is *most likely* called a/an:

A. Trade sell.

B. Secondary sale.

C. Initial public offering.

The correct answer is **B.**

In a secondary sale, one private equity company sells its portfolio company to another private equity firm or group of investors.

A is incorrect. A trade sale is the sale of a company to a strategic buyer such as a competitor.

C is incorrect. An Initial Public Offering involves selling a company's shares to public investors.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (c): Describe the diversification benefits that private capital can provide.

Q.1774 Which of the following is *least likely* a characteristic of private equity?

A. Private equity is more liquid than public equity.

B. Share price is negotiated between the firm and investors.

C. Private equity has a limited financial disclosure obligation.

The correct answer is **A.**

Private equity falls under the alternative investments class of investing. Private equity securities do not trade in security markets. Instead, they are offered primarily to institutional investors in private placements. The three common strategies used to trade private equity are leveraged buy-outs, venture capital, and private investment in public equity (PIPE).

Characteristics of Private Equity

1. Private equity investors have a long-term time horizon.
2. Private equity is a relatively illiquid investment compared to public equity, which can be attributed to the fact that private equity is offered primarily to institutional investors in private placements, not traded in security markets.
3. Private equity has fewer regulatory requirements making it cheaper for companies to raise money using private equity.
4. Using a strategy like Private Investment in Public Equity, where investors privately buy shares of a public company, investors can negotiate for a favorable share price.
5. Private equity funds fund companies in their early and mezzanine stages and not in their late stages.
6. Private equity investors are more actively involved in the running of the business they fund.

Compared to public equity, private equity is less liquid, its share price is negotiable, and its reporting cost is less due to limited financial disclosure obligations.

B and C are incorrect. They are characteristics of private equity.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.2016 Later-stage financing *most likely*:

A. Refers to capital provided to fund major expansions.

B. Refers to funding for initiation of commercial operations.

C. Finances the step of going public and represents the bridge between expanding the company and the IPO.

The correct answer is **A.**

Later-stage financing refers to capital provided to fund major expansions, such as physical plant expansion, product improvement, or a major marketing campaign.

B is incorrect. Early-stage financing refers to funding for initiation of commercial operations.

C is incorrect. Mezzanine-stage financing finances the steps of going public and represents the bridge between expanding the company and the IPO.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (c): Describe the diversification benefits that private capital can provide.

Q.3274 The financing provided for 'developing business ideas' *most likely* takes place in the:

A. Seed stage.

B. Angel investing phase.

C. Mezzanine-stage financing.

The correct answer is **B.**

The angel investing phase is characterized by investments made early in a firm's life. These funds are often used to develop business ideas and to assess market potential. The source of funds is usually individuals (friends and family), these individuals are commonly referred to as “angels”.

A is incorrect. The seed stage capital supports product development and/or marketing efforts including market research.

C is incorrect. Mezzanine-stage financing prepares a company to go public. It represents the bridge financing needed to fund a private firm until it can complete an IPO or be sold.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.3282 Which of the following statements describes a typical private equity fund structure?

A. Its fund investments are highly regulated.

B. Its most common type of fund structure is 'partnership'.

C. Its general partner (GP) is usually an unlimited liability corporation.

The correct answer is **B.**

The most common type of structure for private equity funds is a partnership.

A is incorrect. Fund investments are either unregulated or less regulated than offerings to the general public.

C is incorrect. Because most investors are unwilling to bear unlimited liability, the GP is usually a limited liability corporation.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.3283 When looking for a leveraged buyout (LBO) target, private equity firms will *most likely* look for companies which:

A. Are inefficiently managed.

B. Have high leverage levels.

C. Have fairly valued stock prices.

The correct answer is **A.**

When looking for LBO targets, private equity firms will look for companies which:

- are inefficiently managed,
- have low leverage levels,
- have an undervalued or depressed stock price,
- have a strong and sustainable cash flow stream, and
- have a significant asset base.

B is incorrect. Suggesting that private equity firms look for companies with high leverage levels is misleading. High leverage indicates that a company already has a significant amount of debt, which can limit the amount of additional debt that can be used to finance the LBO. Moreover, high leverage increases financial risk, making the investment less attractive. Private equity firms typically seek companies with low to moderate leverage levels, providing room to leverage the company's balance sheet as part of the LBO structure. This allows the firm to maximize the potential return on equity through the use of debt financing.

C is incorrect. The assertion that private equity firms primarily target companies with fairly valued stock prices does not align with the typical LBO investment strategy. Instead, these firms often look for companies with undervalued or depressed stock prices. An undervalued company represents an opportunity to acquire a stake at a price lower than its intrinsic value, offering a higher potential for profit upon improving the company's performance and eventually exiting the investment.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.3284 Distressed investing typically involves:

A. Purchasing the debt of financially troubled companies at prices significantly less than the face value.

B. Minority equity investment in mature companies that need capital to expand or restructure their operations.

C. Majority investment in a company by its own management before restructuring it operationally or financially.

The correct answer is **A.**

Distressed investing is an investment strategy that involves taking positions in the debt or equity of companies that are experiencing financial difficulties or distress. The goal of distressed investing is to profit from the potential turnaround of these companies, often through operational or financial restructuring.

One common strategy in distressed investing is to purchase the debt of financially troubled companies at a significant discount to its face value, often in the form of bonds or loans. This allows investors to acquire a large position in the company's debt at a relatively low cost, which can provide a significant return if the company is able to turn its financial situation around.

B is incorrect. Development capital investing is the minority equity investment in mature companies that that are seeking capital to expand or restructure operations, enter new markets, or finance major acquisitions.

C is incorrect. Management buyout is a majority investment in a company by its own management before restructuring it operationally or financially.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.3314 Capital provided to companies which are beginning to operate but have not yet commenced commercial production and sales is classified as:

A. Later-stage finance.

B. Formative-stage financing.

C. Mezzanine-stage financing.

The correct answer is **B.**

Early-stage financing is provided to companies moving toward operation but before commercial production and sales have occurred. Early-stage financing is classified as part of formative-stage financing.

A is incorrect. Later-stage financing is done after commercial production and sales have begun but before any IPO.

C is incorrect. Mezzanine-stage financing is done to prepare a company to go public.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.3315 Which of the following characteristics is unique to the fee structure of private equity funds?

A. Management fees are paid on invested capital.

B. The Genral Partner earns an incentive fee at the same time as investors receive their initial investment back.

C. The clawback provision ensures the safe return of an investor's initial investment as well as his/her right to receive profit.

The correct answer is **C.**

The clawback provision requires the GP to return any funds disturbed as incentive fees until the Limited Partners (LPs) have received back their initial investment and 80% of the total profit. This provision will ensure that investors' initial investments are returned back to them.

A is incorrect. Until the capital invested is not fully drawn down, the management fee is based on committed capital, not invested capital. After the committed capital is fully invested, the fees are paid only on the funds remaining in the investment vehicle.

B is incorrect. Most private equity partnerships include policies that prohibit distributions of incentive fees to the GP until the LPs have received back their initial investment.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.3316 Which of the following characteristics will be considered as desirable by a private equity company seeking a target for an LBO (leveraged buyout)?

A. Inefficient management.

B. An average ability to generate cash flows.

C. Companies perceived as being in favor in the general market.

The correct answer is **A.**

When selecting candidates for an LBO, a private equity firm will prefer companies that are inefficiently managed and that have the potential to perform better in the future. Firms will seek to generate attractive returns on equity by creating value in the companies they buy.

B is incorrect. Companies that generate strong and sustainable cash flows are attractive in LBO transactions because the target company will be taking on a significant amount of dept. Therefore, the company should have cash flows to repay this debt in the future.

C is incorrect. Private equity firms may focus on companies that are out of favor in public markets.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.3320 Investments in private equity are *most suitable* for investors with:

A. High liquidity requirements.

B. With a short-term time horizon.

C. The ability to conduct due diligence.

The correct answer is **C.**

Investing in private equity requires considerable due diligence. Some of the features to investigate include the General Partner's experience and knowledge, the valuation methodology used, the alignment of the GP's incentives with the interests of the Limited Partners and so forth.

A and B are incorrect. Investments in private equity require patience as there is a long time lag between investments in and exits from portfolio companies. Therefore, investors comfortable with long-term commitment of funds as well as liquidity are best suited to selecting asset class.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.3331 A private equity firm is seeking to exit a company using a strategy that will provide a high valuation. However, the firm would like to retain the company's management team because it comprises of highly skilled and creative individuals. The firm would also like to remain one of the largest shareholders in the company. The exit strategy selected by the private equity firm should *most likely* involve selling shares to:

A. Public investors.

B. A strategic buyer.

C. Another private equity firm.

The correct answer is **A.**

The private equity firm should rely on an IPO as an exit strategy. The approach involves the firm selling all or some of the shares to public investors in an IPO. The advantage of an IPO includes the potential to receive the highest price, management approval since they are retained, and the potential to retain future upside potential as the private equity firm may choose to remain a large shareholder.

B is incorrect. Selling shares to a strategic buyer typically involves transferring a significant stake, if not the entire company, to another business entity that operates in the same industry or a related field. While this can also lead to a high valuation, especially if the buyer sees strategic value in the acquisition, it often does not allow the private equity firm to retain a significant stake in the company. Moreover, the existing management team may be at risk of being replaced by the acquiring entity's team, which contradicts the firm's desire to retain the current management.

C is incorrect. Selling to another private equity firm, also known as a secondary buyout, might not achieve the highest possible valuation compared to an IPO. Private equity buyers are typically looking for undervalued companies that they can acquire, improve, and sell for a profit. As such, they may not be willing to pay a premium that reflects the highest possible market valuation. Additionally, while a secondary buyout could potentially allow the private equity firm to retain some stake in the company, it often leads to changes in the management team as the new owners implement their strategies for improving the company's performance.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.3899 Capital provided by Venture Capital (VC) funds to companies that are prepared to go public and that represents a bridge between the expanding company and the IPO is known as:

A. Early stage venture capital.

B. Expansion venture capital.

C. Mezzanine venture capital.

The correct answer is **C.**

Mezzanine-stage financing or mezzanine venture capital is provided to prepare to go public and represents the bridge between the expanding company and the IPO.

A is incorrect. Early-stage financing or early-stage venture capital may be provided to companies to commence commercial production and sales.

B is incorrect. Expansion venture capital is provided after commercial production and sales have begun but before IPO and may be used for initial expansion of a company already producing and selling a production or for major expansions.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.4206 Which of the following private equity strategies *most likely* involves providing funds to more mature companies seeking expansion or restructuring, venturing into new markets, or funding significant acquisitions?

A. Venture capital.

B. Leveraged buyouts.

C. Growth capital.

The correct answer is **C.**

Growth capital is a private equity strategy that provides funding to more mature companies seeking to expand, restructure, or enter new markets. These companies have already achieved a certain level of success and are looking to grow further but may have difficulty obtaining funding from traditional sources such as banks.

Growth capital aims to help these companies achieve their growth objectives and generate a high return on investment when they eventually exit the investment.

A is incorrect. Venture capital is a private equity strategy that focuses on investing in early-stage companies with high growth potential. Venture capitalists typically provide funding to these companies in exchange for an ownership stake and often take an active role in helping the company grow and develop. The goal of venture capital is to generate a high return on investment by helping the company become prosperous and eventually selling the ownership stake for a profit.

C is incorrect. Leveraged buyouts involve using significant debt financing to acquire an established company. Private equity firms use a combination of their capital and borrowed funds to purchase the company, and they often install new management to improve its performance. The goal of a leveraged buyout is to generate a high return on investment by turning around the company's performance and selling it for a profit in the future.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4207 Which of the following is *least likely* a disadvantage of an IPO as an exit strategy for private equity firms? An IPO:

A. involves short lead times.

B. may involve a lockup period.

C. calls for high disclosure requirements

The correct answer is **A.**

An initial public offering (IPO) is usually associated with long lead times. That is, it can take a significant amount of time and effort for a private company to prepare for an initial public offering (IPO). Before a private company can go public and offer its shares, it must prepare and file the necessary paperwork, including financial statements, prospectuses, and regulatory filings.

B is incorrect. A lockup period is a period of time after an IPO where insiders, such as the company's founders or private equity investors, are not allowed to sell their shares. This lockup period can limit the liquidity of the investment, which can be a disadvantage for private equity firms looking to exit the investment quickly.

C is incorrect. An IPO also calls for high disclosure requirements, which can be a significant disadvantage for private equity firms. Public companies are subject to various regulatory requirements, including financial reporting and disclosure requirements regarding important events or risks that may affect the company's performance.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.4208 Which of the following type(s) of leverage buyout *most likely* involves the current management of the acquired company in the acquisition?

A. Management buyouts

B. Management buy-ins.

C. Both management buyouts and management buy-ins.

The correct answer is **A.**

In a management buyout, the existing management team of the company being acquired, along with outside investors such as a private equity firm, pool their resources to buy out the company's existing owners. The management team typically takes a significant stake in the company and plays a key role in its management and operations going forward.

B is incorrect. A management buy-in (MBI) involves a new management team, typically recruited from outside the company, acquiring a significant stake in the company. This is often done with the backing of private equity firms or other investors.

C is incorrect. It implies that both management buyouts and management buy-ins involve the current management team of the acquired company in the acquisition. Instead, it is only in management buyouts involving the acquired company's existing management team.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.4209 Which of the following is *most likely* correct regarding leverage buyout? In leverage buyouts the:

A. Target company's assets act as collateral for the debt.

B. Target company's cashflows serve as collateral for the debt.

C. Equity firms develop buyout funds to acquire only public companies.

The correct answer is **A.**

In a leverage buyout (LBO), a private equity firm acquires a company using a significant amount of debt financing, often with the target company's assets acting as collateral. The private equity firm uses a combination of equity and debt to fund the purchase and then uses the target company's assets, such as property, inventory, or accounts receivable, as collateral for the debt portion of the financing.

The goal is to use the target company's assets to secure financing and then use the cash flows from the acquired company to pay off the debt.

B is incorrect. Although cash flows can be used to pay off the debt, they are not typically used as collateral for the debt in an LBO.

C is incorrect. Private equity firms can develop buyout funds to acquire public or establish private companies.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.4210 Which of the following private equity exit strategies is the *most likely* cost-effective and efficient, and why?

A. Trade sale because it typically involves lower transaction costs and higher confidentiality.

B. Initial public offering (IPO) because it provides the potential for the highest price and publicity for the private equity firm.

C. Special purpose acquisition company (SPAC) because it offers extended time for public disclosure on company prospects to build investor interest.

The correct answer is **A.**

Trade sale involves selling the company to another business in the same industry or a related one. The benefits of this exit strategy include lower transaction costs compared to an IPO and higher confidentiality because the sale is not public. Trade sales also typically close more quickly than IPOs, allowing private equity firms to receive their payout sooner.

B is incorrect. An IPO involves listing the company on a public stock exchange, which allows for the potential for the highest price and the most publicity for the private equity firm. It provides the potential for the highest price and publicity for the private equity firm but involves high transaction costs and long lead times.

C is incorrect. SPAC involves a "blank-check" company raising capital through an IPO and using those funds to acquire a private company. SPACs offer an extended time for public disclosure of company prospects, which can build investor interest. Additionally, SPACs provide the option for a partial exit, allowing private equity firms to sell some of their shares while retaining ownership of the remaining portion.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (c): Describe the diversification benefits that private capital can provide.

Q.4211 Which of the following is *most likely* true about direct lending in private debt?

A. Payments are received on a variable schedule.

B. The debt itself is typically junior and unsecured.

C. It is provided by a small number of investors to private and sometimes public companies

The correct answer is **C.**

Direct lending involves private debt investors providing capital directly to borrowers and receiving interest, the original principal, and possibly other payments in exchange for their investment.

A and B are incorrect. In direct lending, lenders receive payments on a fixed schedule, and the debt is typically senior and secured, not junior and unsecured. Direct lending is provided by a small number of investors to private and sometimes public entities and differs from traditional debt instruments, such as bonds, which can be issued to many participants and be publicly traded.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4212 Which of the following is *most likely* true regarding mezzanine debt in private debt? Mezzanine debt is:

A. typically senior and secured.

B. used to finance only LBOs.

C. riskier than senior secured debt.

The correct answer is **C.**

Mezzanine debt is private credit subordinated to senior secured debt but senior to equity in the borrower's capital structure. Because of its typically junior ranking and usually unsecured status, mezzanine debt is riskier than senior secured debt.

A is incorrect. Mezzanine debt is private credit subordinated to senior secured debt but senior to equity in the borrower's capital structure.
B is incorrect. Mezzanine debt is a pool of additional capital available to borrowers beyond senior secured debt, often used to finance not only LBOs but also recapitalizations and corporate acquisitions.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4213 Which of the following is *most likely* true about venture debt? Venture debt is:

A. Always secured by substantial assets.

B. Typically provided to mature companies.

C. Used to complement existing equity financing.

The correct answer is **C.**

Investors usually seek venture debt, mainly in the form of a line of credit or term loan, as a form of additional investing without further diluting shareholder ownership. As such, venture debt can complement existing equity financing, allowing the existing shareholders to maintain ownership and control for a more extended period of time.

A is incorrect. Venture debt is private debt funding that provides venture capital backing to start-up or early-stage companies that have little or negative cash flow. As such, the companies lack substantial assets that can be used as collateral.

B is incorrect. Venture debt is typically provided to start-up or early-stage companies.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4329 A company in its mature life cycle stage is seeking capital for investment. The company is currently publicly owned but is considering transitioning to private ownership. The company's management is also considering making significant changes to its business strategy, including reorganizing certain lines of business to increase profitability over the next few years. Based on this scenario, which form of capital would be *most likely* appropriate for the company to pursue?

A. Public Equity.

B. Private Equity.

C. Venture Capital.

The correct answer is **B.**

The most appropriate form of capital for the company to pursue, given the scenario, is Private Equity. Private equity is a type of investment that involves the purchase of shares in a company that is not publicly traded. It is often used by companies in their mature life cycle stage that are seeking to make significant changes to their business strategy, such as the company in this scenario. Private equity investors typically take an active role in the management of the companies in which they invest, providing not only capital but also strategic guidance and operational expertise.

This can be particularly beneficial for a company that is planning to reorganize its lines of business to increase profitability. Furthermore, the transition from public to private ownership can provide the company with greater flexibility to implement its strategic changes without the scrutiny and short-term performance pressures of public markets.

A is incorrect. Public equity is a form of capital that involves the sale of shares to the public through a stock exchange. While it can provide a significant source of capital, it may not be the most appropriate form of capital for a company that is considering transitioning to private ownership and making significant changes to its business strategy. Public equity investors typically have less involvement in the management of the companies in which they invest, and the company would remain subject to the scrutiny and short-term performance pressures of public markets.

C is incorrect. Venture capital is typically used by early-stage companies that are seeking capital to fund their growth and development. It is not typically used by mature companies that are seeking to make significant changes to their business strategy.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.4338 Which of the following statements *most likely* describes the primary reason why a private equity firm might set up a limited partnership for its investment structure?

A. To ensure that the firm's profits are distributed equally among all partners.

B. To limit the liability of the firm's partners and protect them from personal financial risk

C. To maximize flexibility in the investment structure, allocate business risk and return, and distribute special responsibilities between investors and managers.

The correct answer is **C.**

The primary reason why a private equity firm might set up a limited partnership for its investment structure is to maximize flexibility in the investment structure, allocate business risk and return, and distribute special responsibilities between investors and managers. A limited partnership allows the firm to structure the partnership in a way that best suits its investment strategy and the needs of its investors.

It provides a flexible framework for allocating profits and losses and for distributing responsibilities between the general partner (who manages the partnership and assumes unlimited liability) and the limited partners (who provide capital and have limited liability). This structure also allows the firm to allocate business risk and return in a way that aligns with its investment strategy and the risk tolerance of its investors. By distributing special responsibilities between investors and managers, the firm can ensure that the partnership is managed effectively and that the interests of all parties are protected.

A is incorrect. The distribution of profits in a limited partnership is not necessarily equal among all partners. The distribution of profits is determined by the partnership agreement, which can be structured to allocate profits in a way that aligns with the firm's investment strategy and the risk tolerance of its investors. Therefore, ensuring equal distribution of profits is not the primary reason for setting up a limited partnership.

B is incorrect. While limiting the liability of the firm's partners and protecting them from personal financial risk is an important benefit of the limited partnership structure, it is not the primary reason why a private equity firm might choose this structure. The primary reason is to maximize flexibility, allocate business risk and return, and distribute special responsibilities.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.4357 Which of the following private equity strategies would *most likely* involve the target company's assets serving as collateral for the debt and its cash flows being used to service the debt?

A. Venture Capital.

B. Growth Capital.

C. Leveraged Buyout.

The correct answer is **C.**

In a Leveraged Buyout (LBO) strategy, the target company's assets serve as collateral for the debt, and its cash flows are expected to be sufficient to service the debt. This is because, in an LBO, a significant portion of the purchase price is financed through debt. The acquired company's assets are used as collateral for the borrowed capital, which is why this strategy is often used for established companies with stable and predictable cash flows.
The expectation is that the company's future cash flows will be sufficient to pay off the debt over time. This strategy is often used when the private equity firm believes that the company's assets are undervalued or that the company can be run more efficiently under new management. The goal of an LBO is to eventually sell the company or take it public, using the proceeds to pay off the remaining debt and generate a return for the investors.
A is incorrect. Venture Capital (VC) does not involve the target company's assets serving as collateral for the debt, nor are its cash flows expected to be sufficient to service the debt. VC is a private equity investment strategy involving investing in startups or small companies with high growth potential.
These companies are often in the early stages of development and do not have the established assets or cash flows to serve as collateral or service debt. Instead, VC firms invest in these companies in exchange for equity, expecting the company to grow rapidly and provide a high return on investment.

B is incorrect. Growth Capital does not involve the target company's assets serving as collateral for the debt, nor are its cash flows expected to be sufficient to service the debt. Growth capital is a type of private equity investment that involves investing in more mature companies that are looking for capital to expand or restructure operations, enter new markets, or finance a significant acquisition.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4358 Which of the following statements is *most likely* accurate about private equity investment?

A. Does not require any specialized knowledge specific to the industry and sector the firm is in.

B. Allows less direct control over decisions than public equity due to insignificant shareholdings.

C. Allows more direct control over decisions than public equity due to significant shareholdings and requires specialized knowledge specific to the industry.

The correct answer is **C.**

Private equity investment allows more direct control over decisions than public equity due to significant shareholdings and requires specialized knowledge specific to the industry and sector the firm is in. Private equity investors typically acquire a significant, if not controlling, stake in the companies they invest in. This gives them a high degree of influence over the company's strategic decisions, which is not usually the case with public equity investors who hold a smaller proportion of shares.

Furthermore, private equity investment often involves investing in specific industries or sectors and, therefore, requires a deep understanding of the specific industry or sector the firm operates in. This specialized knowledge is crucial for making informed investment decisions and effectively overseeing the company's operations and strategy.

A is incorrect. Private equity investment does require specialized knowledge specific to the industry and sector the firm is in. This is because private equity investors often play an active role in managing and overseeing the companies they invest in, which requires a deep understanding of the specific industry or sector the firm operates in.

B is incorrect. Private equity investment does not allow less direct control over decisions than public equity due to insignificant shareholdings. On the contrary, private equity investors typically acquire a significant, if not controlling, stake in the companies they invest in, which gives them a high degree of influence over the company's strategic decisions.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.4359 Which of the following is *most likely* the potential payoff for equity investors and the downside risk they face?

A. Limited upside with the downside unlimited.

B. Unlimited upside with the downside also unlimited.

C. Unlimited upside with the downside limited to the amount invested.

The correct answer is **C.**

The potential payoff for equity investors is unlimited upside, with the downside limited to the amount invested. Equity investors have the potential to earn unlimited returns if the company's stock price appreciates significantly. This is because there is no upper limit to how high a company's stock price can go.
On the other hand, the downside risk for equity investors is limited to the amount they have invested in the company's stock. This is because a stock's price cannot go below zero, so the most an investor can lose is the amount they initially invested.
A is incorrect. The potential payoff for equity investors is not limited upside, with the downside unlimited. This statement is incorrect because the upside potential for equity investors is unlimited, not limited. Additionally, the downside risk for equity investors is not unlimited but is instead limited to the amount they have invested.

B is incorrect. The potential payoff for equity investors is not unlimited upside with the downside also unlimited. This statement is incorrect because while the upside potential for equity investors is indeed unlimited, the downside risk is not. The downside risk for equity investors is limited to the amount they have invested, not unlimited.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.4361 A venture capitalist is considering investing in a promising startup. The startup is in its early stages and requires funds for product development and initial growth. Which of the following statements is *most accurate* regarding the reasons for a venture capitalist to offer debt financing to a startup company?

A. Generate income from the interest payments.

B. Dilute the equity stake of the startup's founders and gain more control over the company.

C. Gain control of the startup's assets in a bankruptcy situation and provide more protection than equity does.

The correct answer is **C.**

A venture capitalist may offer debt financing to a startup company primarily to gain control of the startup's assets in a bankruptcy situation and to provide more protection than equity does. In the event of bankruptcy, debt holders have a higher claim on the assets of the company than equity holders. This means that if the startup fails, the venture capitalist as a debt holder would be paid before the equity holders.
This provides a level of protection for the venture capitalist's investment. Additionally, the venture capitalist may also have the ability to convert the debt into equity at a later stage, giving them potential upside if the startup is successful. This combination of protection and potential upside makes debt financing an attractive option for venture capitalists when investing in startups.
A is incorrect. While the venture capitalist would indeed receive interest payments from the startup, this is not the primary reason for offering debt financing. Venture capitalists typically invest in startups for the potential of high returns, not for the steady income stream that interest payments would provide. Furthermore, startups in their early stages often have little to no revenue, making it difficult for them to make regular interest payments.

B is incorrect. While debt financing can indeed dilute the equity stake of the startup's founders, this is not the primary reason for a venture capitalist to offer debt financing. The main goal of a venture capitalist is to maximize their return on investment, not to gain control over the company. Furthermore, diluting the equity stake of the founders could potentially demotivate them, which could be detrimental to the success of the startup.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4362 A venture capitalist is considering investing in a biotech startup. The venture capitalist is looking for an investment option that provides an incentive alignment between the entrepreneurs in the startup and the investor. Which of the following investment options *best* fits the venture capitalist's requirements?

A. Common Shares.

B. Convertible Preferred Shares.

C. Minority Equity Interest.

The correct answer is **B.**

Convertible Preferred Shares best fit the venture capitalist's requirements. Convertible Preferred Shares are a type of investment that provides an investor with a fixed dividend but also the option to convert the shares into a fixed number of common shares after a predetermined date. This aligns the interests of the entrepreneur and the investor, as the investor has the potential to benefit from the company's success if they choose to convert their shares.
The conversion feature provides an upside potential, while the preferred status provides downside protection in the form of a fixed dividend and priority over common shareholders in the event of liquidation. This type of investment is particularly attractive to venture capitalists who are investing in startups with high growth potential but also high risk. The convertible feature provides an incentive for the entrepreneur to perform, as the conversion would dilute their ownership stake.
A is incorrect. Common Shares do not provide the same level of protection as Convertible Preferred Shares. While they do provide the holder with a claim on the company's earnings and assets, they do not offer a fixed dividend or priority in the event of liquidation. Furthermore, they do not include a conversion feature that aligns the interests of the entrepreneur and the investor.

C is incorrect. Minority Equity Interest refers to a stake in a company that is less than 50%, meaning the investor does not have a controlling interest. While this type of investment does provide the investor with a share of the company's earnings, it does not offer the same level of protection or incentive alignment as Convertible Preferred Shares. The investor would not have the same level of influence over the company's operations and would not have the option to convert their investment into common shares.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4363 A struggling retail company is looking for an investment that can help streamline its operations and sell off underperforming assets to increase the company's value. The company is considering different types of investments that focus on increasing the value of the core business by adaptively changing the overall business strategy. Which of the following types of investments *best* fits the company's requirements?

A. Private Equity.

B. Mezzanine-Stage Financing.

C. Convertible Preferred Shares.

The correct answer is **A.**

Private equity firms invest in companies with the aim of increasing their value over time. They do this by implementing strategic changes, improving operations, and providing capital for growth and restructuring. In the case of a struggling retail company, a private equity firm could help streamline operations, sell off underperforming assets, and implement a new business strategy.
This could involve a range of activities, from cost-cutting measures to strategic acquisitions. The goal of a private equity investment is to increase the value of the company and then sell it for a profit, either through a sale to another company or through an initial public offering (IPO). Therefore, private equity is the best fit for a company looking to increase its value through strategic changes and operational improvements.
B is incorrect. Mezzanine-stage financing is a type of hybrid debt issue that is subordinated to another debt issue from the same issuer. It is often used to finance acquisitions and buyouts, where it can be used to fill a financing gap between senior debt and equity. While it could provide the company with needed capital, it does not inherently involve the strategic changes and operational improvements that the company is seeking.

C is incorrect. Convertible preferred shares are a type of equity security that can be converted into a predetermined number of common shares at certain times during their life, usually at the discretion of the shareholder. While this type of investment could provide the company with needed capital, it does not inherently involve the strategic changes and operational improvements that the company is seeking.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.4364 A private equity firm is considering an exit strategy for a portfolio company that it has held for five years. The firm has successfully streamlined the company's operations and improved its performance. The portfolio company operates in a dynamic industry, and the economic cycle is currently favorable. Which of the following would be the *most appropriate* exit strategy for the private equity firm in this scenario?

A. Trade sale to a larger company in the same industry.

B. Public listing through an Initial Public Offering (IPO).

C. Hold the investment for a longer period to further enhance its value.

The correct answer is **B.**

Given the favorable economic cycle, improved company performance, and dynamic industry, a public listing through an Initial Public Offering (IPO) would be the most appropriate exit strategy for the private equity firm in this scenario. An IPO allows the firm to capitalize on the company's improved performance and favorable market conditions to potentially achieve a higher exit valuation.
Furthermore, an IPO can provide the company with access to a larger pool of capital for future growth and expansion. The dynamic nature of the industry suggests that there may be significant investor interest in the company, which could further enhance the success of the IPO.
A is incorrect. A trade sale to a larger company in the same industry could be a viable exit strategy, but it may not maximize the firm's return on investment. While a trade sale can provide a quick and certain exit, the sale price may be lower than what could be achieved through an IPO, especially given the favorable market conditions and the company's improved performance.

C is incorrect. Holding the investment for a longer period to further enhance its value could potentially yield higher returns, but it also involves additional risks. The economic cycle and industry dynamics could change, potentially negatively affecting the company's performance and valuation. Furthermore, holding the investment for a longer period ties up the firm's capital, which could be used for other investment opportunities.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.4365 A private equity firm is planning to exit a tech startup it has invested in. The firm aims to maximize its investment return aggressively. Which of the following strategies would the firm *most likely* use to achieve this goal?

A. Sell the startup to the highest bidder.

B. Hold the startup for a longer period to increase its value.

C. Invest more capital in the startup to boost its growth.

The correct answer is **A.**

A private equity firm that is planning to exit a tech startup it has invested in and aims to maximize its investment return aggressively would most likely sell the startup to the highest bidder. This strategy is known as a trade sale and is one of the most common exit strategies used by private equity firms. The firm would typically engage an investment bank to run an auction process to solicit bids from potential buyers, which could include other private equity firms, strategic buyers such as other companies in the same industry, or financial buyers such as hedge funds.
The goal of the auction process is to generate competitive tension among the bidders and drive up the sale price. This strategy allows the private equity firm to realize a significant return on its investment in a relatively short period of time, which is consistent with its aggressive return objective.
B is incorrect. Holding the startup for a longer period to increase its value may not be the best strategy for a private equity firm that wants to maximize its return aggressively. While this strategy could potentially result in a higher sale price in the future, it also involves additional risks, including market risk, operational risk, and the risk that the startup's growth may slow or stall. Moreover, holding the investment for a longer period would delay the realization of the return and reduce the firm's internal rate of return (IRR), which is a key performance measure for private equity investments.

C is incorrect. Investing more capital in the startup to boost its growth is a strategy that could potentially increase the value of the startup and hence the return on the private equity firm's investment. However, this strategy also involves significant risks, including the risk that the additional capital may not result in the expected growth and the risk of dilution of the firm's ownership stake in the startup. Moreover, this strategy would require the firm to tie up more capital in the investment, which could reduce its ability to pursue other investment opportunities.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.4366 Consider a scenario where a private company specializing in renewable energy technology is considering a trade sale of one of its divisions to a larger corporation in the same industry. The larger corporation is interested in this acquisition to expand its business scale and scope.
Which of the following could be a potential challenge that the larger corporation might *most likely* face during this trade sale?

A. Financial challenges due to the high cost of the acquisition.

B. Resistance from its own employees who are not in favor of the acquisition.

C. Regulatory scrutiny and approval due to the potential impact on the competitive environment.

The correct answer is **C.**

The larger corporation might face regulatory scrutiny and approval due to the potential impact on the competitive environment. In many jurisdictions, mergers and acquisitions that could potentially impact the competitive environment are subject to regulatory scrutiny. This is to ensure that the transaction does not result in a monopoly or a significant reduction in competition, which could harm consumers.
The regulatory approval process can be lengthy and complex, involving detailed reviews of the companies' operations, market positions, and the potential impact of the transaction on competition. The larger corporation would need to demonstrate that the acquisition would not harm competition or that any potential harm would be outweighed by the benefits of the transaction, such as increased efficiency or innovation. This could be a significant challenge for the larger corporation, particularly if the renewable energy technology industry is already highly concentrated.
A is incorrect. While the high cost of the acquisition could indeed pose a financial challenge for the larger corporation, this is not a challenge that is specific to the context of a trade sale of a division of a private company to a larger corporation in the same industry. The cost of an acquisition is a factor in any merger or acquisition transaction, regardless of the specific circumstances.

B is incorrect. While it is possible that the larger corporation might face resistance from its own employees who are not in favor of the acquisition, this is not a challenge that is specific to the context of a trade sale of a division of a private company to a larger corporation in the same industry. Employee resistance can occur in any type of organizational change, not just in mergers and acquisitions.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (c): Describe the diversification benefits that private capital can provide.

Q.4367 Which of the following statements best describes the potential advantages of choosing a trade sale over an IPO for a private equity exit strategy?

A. A trade sale involves higher transaction costs and a longer execution time compared to an IPO.

B. A trade sale provides a higher level of confidentiality due to the involvement of a larger number of parties compared to an IPO.

C. A trade sale could potentially be executed faster and provide a higher level of confidentiality due to the limited number of parties involved compared to an IPO.

The correct answer is **C.**

A trade sale could potentially be executed faster, incur lower transaction costs, and provide a higher level of confidentiality due to the limited number of parties involved compared to an IPO. In a trade sale, the transaction is typically between two parties: the buyer and the seller. This can lead to a faster execution time as there are fewer parties involved in the negotiation and decision-making process. Additionally, the transaction costs associated with a trade sale are often lower than those of an IPO, which can involve significant costs for underwriting, legal fees, and other expenses.

Furthermore, a trade sale can offer a higher level of confidentiality as the details of the transaction are not required to be disclosed to the public, unlike an IPO, where extensive disclosure is required. This can be particularly advantageous in a competitive industry where the corporation may not want to reveal its strategic plans to competitors.

A is incorrect. A trade sale would not likely involve higher transaction costs and a longer execution time compared to an IPO. As mentioned above, a trade sale typically involves fewer parties and, therefore can often be executed more quickly and at a lower cost than an IPO.

B is incorrect. While a trade sale does provide a higher level of confidentiality due to the involvement of fewer parties, it is not because of the involvement of a larger number of parties, as stated in this option. In fact, the opposite is true: the limited number of parties involved in a trade sale is what contributes to its higher level of confidentiality compared to an IPO.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (c): Describe the diversification benefits that private capital can provide.

Q.4368 Which of the following is *least likely* potential disadvantage of a trade sale?

A. Increased competition due to a larger universe of trade buyers leads to higher sale prices.

B. Resistance from employees due to the potential for a higher sale price through a public listing.

C. Resistance from existing management due to concerns about job security and potential ownership by a competitor.

The correct answer is **A.**

Increased competition due to a larger universe of trade buyers, leading to higher sale prices, is not a potential disadvantage of a trade sale. In fact, it is a potential advantage. A larger universe of trade buyers can increase competition for the company being sold, which can drive up the sale price. This can be beneficial for the shareholders of the company being sold, as they can potentially realize a higher return on their investment.
Furthermore, increased competition can also lead to better terms and conditions for the sale, such as a higher valuation, better payment terms, and more favorable post-sale arrangements. Therefore, increased competition due to a larger universe of trade buyers is not a disadvantage but rather a potential advantage of a trade sale.
B is incorrect. Resistance from employees due to the potential for a higher sale price through a public listing is also a potential disadvantage of a trade sale. Employees, especially those with equity in the company, may believe that a public listing could result in a higher sale price and, therefore, a higher return on their investment. This belief can lead to resistance to a trade sale, which can create challenges in executing the transaction.

C is incorrect. Resistance from existing management due to concerns about job security and potential ownership by a competitor is indeed a potential disadvantage of a trade sale. The existing management team may be concerned about their future role in the company, their job security, and the potential changes in the company's strategic direction under the new ownership. These concerns can lead to resistance to the sale, which can complicate the transaction and potentially reduce the sale price.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (c): Describe the diversification benefits that private capital can provide.

Q.4369 A private equity firm is considering taking one of its portfolio companies public. The company operates in a currently unpopular industry and has a limited operating history. The firm is also concerned about high transaction fees and the potential for stock market volatility. Which method of public listing might be *most likely* suitable for the company and why?

A. Initial Public Offering (IPO), because it can potentially realize the highest price for the company and increase its visibility.

B. Direct Listing because it reduces the complexity and cost of the transaction and does not involve underwriters.

C. Special Acquisition Company (SPAC), because it allows the company to go public without the need for a traditional IPO process.

The correct answer is **B.**

Given the circumstances, Direct Listing might be the most suitable method of public listing for the company. In a Direct Listing, the company sells shares directly to the public without the involvement of underwriters. This reduces the complexity and cost of the transaction, which can be beneficial for a company with a limited operating history and concerns about high transaction fees.
Furthermore, direct listing allows the company to avoid the traditional IPO process, which can be time-consuming and costly. It also allows the company to bypass the traditional roadshow process, which can be challenging for a company operating in an unpopular industry. In a Direct Listing, the market determines the price of the shares, which can be beneficial in a volatile stock market environment. Therefore, given the company's circumstances, direct listing might be the most suitable method of public listing.
A is incorrect. An Initial Public Offering (IPO) might not be the most suitable method of public listing for the company. While an IPO can potentially realize the highest price for the company and increase its visibility, it also involves a complex and costly process. This includes underwriting fees, legal fees, and other transaction costs. Furthermore, the traditional roadshow process can be challenging for a company operating in an unpopular industry. Therefore, given the company's circumstances, an IPO might not be the most suitable method of public listing.

C is incorrect. A Special Acquisition Company (SPAC) might not be the most suitable method of public listing for the company. While a SPAC allows the company to go public without the need for a traditional IPO process, it also involves a complex and costly process. This includes underwriting fees, legal fees, and other transaction costs. Furthermore, a SPAC involves a merger with a blank check company, which can be challenging for a company with a limited operating history. Therefore, given the company's circumstances, a SPAC might not be the most suitable method of public listing.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (c): Describe the diversification benefits that private capital can provide.

Q.4370 Which of the following is *most likely* primary purpose of a SPAC and why it might be an attractive option for certain companies?

A. To raise capital through an IPO for the purpose of acquiring an existing company, offering a quicker and less complicated route to public listing.

B. To provide a platform for companies to merge or consolidate, thereby increasing their market share and competitive advantage.

C. To facilitate the liquidation of assets for companies facing bankruptcy, providing a means for investors to recover their investments.

The correct answer is **A.**

The primary purpose of a Special Acquisition Company (SPAC) is to raise capital through an Initial Public Offering (IPO) for the purpose of acquiring an existing company. This offers a quicker and less complicated route to public listing. SPACs are essentially shell companies with no operations or assets other than the money raised in their IPO. They are created by a group of investors, known as sponsors, with the sole purpose of acquiring a private company and taking it public.

B is incorrect. While SPACs can potentially provide a platform for companies to merge or consolidate, this is not their primary purpose. The main goal of a SPAC is to acquire a private company and take it public, not to facilitate mergers or consolidations between existing public companies.

C is incorrect. SPACs are not designed to facilitate the liquidation of assets for companies facing bankruptcy. While a SPAC could potentially acquire a company in financial distress, its primary purpose is to take private companies public, not to provide a means for investors to recover their investments in failing companies.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.4371 A tech startup is considering going public and is evaluating different methods to do so. The startup has innovative products and strong growth potential but also carries a significant amount of debt. The company is also keen on providing detailed information about its future prospects to attract investors. Which of the following methods of going public would *best* suit the company's context and why?

A. Direct listing because it allows the company to bypass the underwriting process and avoid dilution of shares.

B. Traditional Initial Public Offering (IPO) because it allows the company to set a flexible share price based on market conditions.

C. Special Purpose Acquisition Company (SPAC), because it offers flexibility of transaction structure and the ability to provide more forward formal guidance on the company's prospects.

The correct answer is **C.**

SPACs are essentially shell companies that raise funds through an IPO with the sole purpose of acquiring a private company, thereby taking it public. The key advantage of a SPAC for the startup is that it offers extended time for public disclosure, flexibility of transaction structure, and the ability to provide more forward formal guidance on the company's prospects.
SPAC would be particularly beneficial for the startup as it has innovative products and strong growth potential but also carries a significant amount of debt. By going public through a SPAC, the startup can provide detailed information about its future prospects to attract investors while also having the flexibility to structure the transaction in a way that best manages its debt. Furthermore, the SPAC process is typically faster and less costly than a traditional IPO, which could be another advantage for the startup.
A is incorrect. A Direct Listing allows the company to bypass the underwriting process and avoid dilution of shares, which could be beneficial for the startup. However, it does not provide the same level of public disclosure, transaction structure flexibility, and forward guidance as a SPAC. Furthermore, a Direct Listing does not raise any new capital, which may not be ideal for a startup with significant debt.

B is incorrect. While a traditional Initial Public Offering (IPO) does allow the company to set a flexible share price based on market conditions, it also involves a lengthy and costly process, which may not be ideal for a startup with significant debt. Furthermore, the IPO process may not provide the same level of flexibility in terms of transaction structure and forward guidance as a SPAC.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4372 Which of the following statements *most likely describes the primary purpose of recapitalization?*

A. To reduce the firm's control over the company.

B. To completely exit the investment by selling the company.

C. To extract money from the company to pay its investors and improve its IRR.

The correct answer is ***C.***

The primary purpose of recapitalization is to extract money from the company to pay its investors and improve its IRR. In private equity, recapitalization is often used as a way to generate a return on investment without selling the company. By introducing or increasing leverage, the private equity firm can extract cash from the company in the form of a dividend, which can then be distributed to its investors.
Recapitalization can improve the firm's IRR, which is a key measure of the performance of a private equity investment. The firm typically maintains control over the company after the recapitalization, which allows it to continue to influence the company's strategy and operations. This strategy is often used when the firm believes that there is still value to be realized from the company, but it wants to provide a return to its investors in the meantime.
B is incorrect. *Recapitalization is not a true exit strategy. While it allows the private equity firm to generate a return on its investment, it does not involve selling the company. The firm typically maintains control over the company after the recapitalization, which allows it to continue to influence the company's strategy and operations.*

A is incorrect. *Recapitalization does not reduce the firm's control over the company. In fact, the firm typically maintains control over the company after the recapitalization. This allows it to continue to influence the company's strategy and operations and to benefit from any future increases in the company's value.*

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.4373 Which of the following statements is *most likely* accurate about secondary sales as an exit strategy in private equity investments? An exit strategy where a private equity firm sells a company to:

A. a public entity.

B. the original owners.

C. another private equity firm or a group of financial buyers.

The correct answer is **C.**

A secondary sale is indeed an exit strategy where a private equity firm sells a company to another private equity firm or a group of financial buyers. This strategy is often used when the original private equity firm has maximized the value of the company and is ready to realize its investment. The buying private equity firm or group of financial buyers then takes over the company with the aim of further increasing its value before eventually selling it again.

A is incorrect. A secondary sale is not an exit strategy where a private equity firm sells a company to a public entity. This would be more accurately described as an initial public offering (IPO), which is another common exit strategy in private equity. In an IPO, a private company is listed on a public stock exchange, allowing the private equity firm to sell its shares to the public.

B is incorrect. A secondary sale is not an exit strategy where a private equity firm sells a company back to the original owners. This would be more accurately described as a buyback or a management buyout, where the original owners or the management team of the company buy back the shares from the private equity firm.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (a): Explain features of private equity and its investment characteristics.

Q.4374 Which of the following is *most likely* the primary reason for a private equity firm to adjust its reported returns to account for the exclusion of failed investments from return indexes?

A. To inflate the firm's performance and attract more investors.

B. To comply with regulatory requirements for financial reporting.

C. To reduce the impact of survivorship bias and provide a more accurate measure of the firm's performance.

The correct answer is **C.**

Private equity firms adjust their reported returns to account for the exclusion of failed investments from return indexes primarily to mitigate the effects of survivorship bias. Survivorship bias can lead to an overestimation of returns by only considering investments that have succeeded while ignoring those that have failed. By making this adjustment, a private equity firm can provide a more realistic and accurate representation of its performance. This is vital for investors who rely on these performance measures to make informed investment decisions. Furthermore, this adjustment enhances the firm's credibility and transparency, which is crucial in building trust with investors and other stakeholders.

A is incorrect: While regulatory compliance is essential in financial reporting, the adjustment of reported returns to account for the exclusion of failed investments from return indexes is not primarily done to comply with regulatory requirements. Instead, it is aimed at providing a more accurate measure of performance. However, it is important to note that regulatory bodies do encourage practices that enhance transparency and accuracy in financial reporting.

B is incorrect: Adjusting reported returns is not intended to inflate the firm's performance or attract more investors. In fact, it can lead to a more accurate and potentially lower reported performance. However, this adjustment is viewed positively as it enhances transparency and credibility.

Q.4375 A company is planning to acquire another company and is seeking a type of private debt that combines elements of debt and equity financing. Which type of private debt investment would *best* serve the company's needs?

A. Venture debt.

B. Mezzanine loans.

C. Direct lending.

The correct answer is **B.**

Mezzanine financing is a hybrid of debt and equity financing that gives the lender the right to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full. It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies, but it is senior to the common stock or venture capital of an equity investor.
Mezzanine loans are often used by companies seeking to finance acquisitions, leveraged buyouts, expansions or recapitalizations. They are attractive to borrowers because they often come with lower interest rates and longer repayment terms than traditional loans, and to lenders because they offer the potential for higher returns through the conversion to equity.
A is incorrect. Venture debt is a type of debt financing provided to venture-backed companies by specialized banks or non-bank lenders to fund working capital or capital expenses, such as purchasing equipment. Venture debt can complement venture capital and provide companies with additional runway or milestone achievement, but it does not combine elements of debt and equity financing like mezzanine loans do.

C is incorrect. Direct lending is a form of corporate debt provision in which lenders other than banks make loans to companies without intermediaries such as an investment bank, a broker or a private equity firm. In direct lending, the borrowers are usually smaller or mid-sized companies, also called small and medium enterprises, rather than large, listed companies, and the lenders may be wealthy individuals or asset management firms. While direct lending can provide companies with the capital they need, it does not combine elements of debt and equity financing like mezzanine loans do.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4376 An investor is interested in buying the debt of companies that are in financial distress or bankruptcy, with the hope that the company will recover and be able to repay the debt. Which type of private debt investment is the investor *most likely* considering?

A. Venture debt.

B. Direct lending.

C. Distressed debt.

The correct answer is **C.**

The type of private debt investment that an investor is considering when buying the debt of companies that are in financial distress or bankruptcy, with the hope that the company will recover and be able to repay the debt, is known as Distressed Debt. Distressed debt investing involves purchasing the bonds of firms that are either in bankruptcy or have a high likelihood of filing for bankruptcy. The goal of distressed debt investing is to profit from a rise in bond prices if the company's financial situation improves.

This type of investment is considered high risk because it involves companies that are in financial distress. However, the potential returns can be substantial if the company is able to turn around its financial situation and meet its debt obligations. Therefore, distressed debt investing requires a deep understanding of the company's financial situation and the factors that could influence its ability to repay its debt.

A is incorrect. Venture debt is a type of debt financing provided to venture-backed companies by specialized banks or non-bank lenders to fund working capital or capital expenses, such as purchasing equipment. Venture debt can be a cost-effective way for start-ups to gain capital, but it does not involve buying the debt of companies in financial distress or bankruptcy.

B is incorrect. Direct lending refers to non-bank entities lending to small and medium-sized enterprises. This type of lending is typically done by private debt funds or other non-bank financial institutions. It does not involve buying the debt of companies in financial distress or bankruptcy.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4377 A financial analyst is advising a client on the potential benefits and drawbacks of investing in private debt. The client is particularly interested in distressed debt and is willing to accept a higher level of risk for the potential of higher returns. The analyst needs to explain the key considerations involved in this type of investment. Which of the following is *least likely* a key consideration that the analyst should explain to the client?

A. The company's current stock price.

B. The need for thorough due diligence and risk management.

C. The potential for less liquidity compared to traditional debt investing.

The correct answer is **A.**

The company's current stock price is not a key consideration when investing in distressed debt. Distressed debt investing involves purchasing the debt of companies that are in financial distress or have already filed for bankruptcy. The goal is to profit from a turnaround in the company's fortunes or from the liquidation of its assets. The focus is on the company's debt and its ability to service that debt, not on its stock price.

The stock price may reflect the market's assessment of the company's prospects, but it is not a direct factor in the valuation or potential return of distressed debt. The key considerations in distressed debt investing are the company's financial health, the quality of its assets, the prospects for a turnaround or liquidation, and the legal and regulatory environment. These factors require thorough due diligence and risk management, and they can result in less liquidity compared to traditional debt investing.

B is incorrect. Thorough due diligence and risk management are indeed key considerations when investing in distressed debt. Due to the high-risk nature of these investments, it is crucial to thoroughly understand the company's financial situation and the potential risks involved.

C is incorrect. The potential for less liquidity compared to traditional debt investing is also a key consideration. Distressed debt can be harder to sell than other types of debt, especially if the company's financial situation worsens. This can make it more difficult to exit the investment and can increase the risk.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4378 An investor is considering diversifying their portfolio by investing in private debt. They are evaluating two approaches: direct and indirect private debt investment. Which of the following statements is *most likely* true about these two approaches to private debt investment?

A. The direct approach offers higher diversification than the indirect approach.

B. The indirect approach involves lending directly to a specific operating company.

C. The indirect approach allows the investor to spread their risk across multiple operating companies.

The correct answer is **C.**

The indirect approach to private debt investment allows the investor to spread their risk across multiple operating companies. This is because, in the indirect approach, the investor buys into a fund that pools contributions from various investors to invest in the debt of a set of operating companies. This is similar to buying into a mutual fund that invests in the debt of several companies.
By investing in such a fund, the investor is able to diversify their investment across multiple companies, thereby spreading their risk. This is a key advantage of the indirect approach to private debt investment, as it reduces the investor's exposure to any single company's performance. This approach also allows the investor to benefit from the expertise of the fund manager, who is responsible for selecting the companies in which to invest and managing the fund's portfolio.
A is incorrect. The direct approach does not offer higher diversification than the indirect approach. In fact, it offers less diversification because the investor is lending directly to a specific operating company. This means that the investor's risk is concentrated in that one company rather than being spread across multiple companies as in the indirect approach.

B is incorrect. The indirect approach does not involve lending directly to a specific operating company. Instead, it involves buying into a fund that invests in the debt of multiple operating companies. The direct approach is the one that involves lending directly to a specific operating company.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4379 Which of the following *best* describes the potential benefits and features of venture debt for the entrepreneur's tech startup?

A. Venture debt complements existing equity financing, allowing current shareholders to maintain ownership.

B. Venture debt allows for additional financing without diluting shareholder ownership, but it does not complement existing equity financing.

C. Venture debt can complement existing equity financing and allows current shareholders to maintain ownership for a longer period, however, it does not compensate the investor/lender for the increased risk of default.

The correct answer is **A.**

Venture debt can complement existing equity financing, allowing current shareholders to maintain ownership for a longer period. This is because, unlike equity financing, venture debt does not dilute shareholder ownership.
Furthermore, venture debt often carries additional features that compensate the investor/lender for the increased risk of default. These features may include warrants or the right to purchase equity at a future date, which can provide the lender with additional upside potential. Venture debt can be a valuable tool for entrepreneurs, providing them with the capital they need to grow their business while preserving equity and control.
B is incorrect. While it is true that venture debt allows for additional financing without diluting shareholder ownership, it is incorrect to say that it does not complement existing equity financing. In fact, venture debt is often used in conjunction with equity financing to provide a more balanced and flexible financing solution for startups.

C is incorrect. While venture debt can complement existing equity financing and allows current shareholders to maintain ownership for a longer period, it is incorrect to say that it does not carry any additional features to compensate the investor/lender for the increased risk of default. As mentioned above, venture debt often includes features such as warrants or the right to purchase equity at a future date, which can provide the lender with additional upside potential.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4380 Which of the following is *most likely* the primary motivation for investors to participate in direct lending of private equity?

A. Reduce their portfolio's risk.

B. Gain ownership of the borrowing company.

C. Earn higher yields on their investment.

The correct answer is **C.**

Direct lending is a form of private debt investment where investors lend capital directly to borrowers, typically companies, in return for interest payments, the repayment of the original principal, and possibly other payments. The primary motivation for investors to participate in direct lending is the potential for higher yields compared to traditional fixed-income investments. Direct lending typically involves lending to companies that may not have access to traditional bank financing or capital markets and, therefore, may be willing to pay higher interest rates. Additionally, direct lending often involves senior and secured debt, which provides investors with a higher level of protection in the event of default.
A is incorrect. Direct lending involves taking on more risk but for a higher return. It allows investors to spread their risk across different types of investments. However, the primary motivation is the potential for higher yields.

B is incorrect. Gaining ownership of the borrowing company is not the primary motivation for investors to participate in direct lending. While it is possible that an investor could end up owning a portion of the company in the event of a default, this is not the primary goal of direct lending. The main goal is to earn a return on the investment through interest payments and the repayment of the principal.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4381 Which of the following is *most likely* to be a benefit that investors would demand in exchange for investing in mezzanine debt?

A. Lower interest rates compared to senior secured debt.

B. Options for equity participation and higher interest rates.

C. Guaranteed return of principal at the end of the loan term.

The correct answer is **B.**

Investors in mezzanine debt often demand options for equity participation and higher interest rates. Mezzanine debt is a hybrid form of financing that combines elements of debt and equity. It is subordinated to senior secured debt in the capital structure, which means it carries a higher risk. To compensate for this increased risk, investors in mezzanine debt typically demand a higher interest rate than that offered on senior secured debt.

In addition, they often require the option to convert their debt into equity in the borrower's company. This gives them the potential to participate in the upside if the company performs well, further compensating for the risk they are taking on. The combination of higher interest rates and equity participation options makes the mezzanine debt an attractive investment for those willing to take on a higher level of risk for potentially higher returns.

A is incorrect. Mezzanine debt is riskier than senior secured debt, so investors would not demand lower interest rates. Instead, they would demand higher interest rates to compensate for the increased risk.

C is incorrect. While investors in mezzanine debt would certainly prefer a guaranteed return of principal at the end of the loan term, this is not typically a benefit they can demand. Given the riskier nature of mezzanine debt, there is no guarantee that the principal will be returned at the end of the loan term. This is one of the risks that investors in mezzanine debt must accept.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4382 Which of the following is *most likely* the main advantage of a unitranche loan for the borrower? It allows the borrower to:

A. avoid having to provide collateral for the loan.

B. take on more debt than they would be able to with a traditional loan.

C. have a single loan with a blended interest rate, simplifying the repayment process.

The correct answer is **C.**

A unitranche loan combines different tranches of secured and unsecured debt into a single loan. This means that instead of having multiple loans with different interest rates and repayment schedules, the borrower only has to manage one loan.
This simplifies the repayment process and can make it easier for the borrower to manage their debt. The blended interest rate is typically lower than the rate on the unsecured tranche but higher than the rate on the secured tranche, providing a balance between cost and risk for the borrower. The unitranche loan structure can also provide more flexibility for the borrower, as it can be tailored to their specific needs and circumstances.
A is incorrect. A unitranche loan does not allow the borrower to avoid providing collateral. In fact, a unitranche loan typically includes both secured and unsecured tranches of debt. The secured tranche is backed by collateral, while the unsecured tranche is not. The inclusion of a secured tranche can help to lower the overall cost of the loan for the borrower, but it does not eliminate the need for collateral.

B is incorrect. While a unitranche loan may allow a borrower to take on more debt than a traditional loan, this is not its main advantage. The primary benefit of a unitranche loan is the simplification of the repayment process through the combination of different tranches of debt into a single loan with a blended interest rate.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4383 A private debt investor is assessing a potential investment opportunity. The interest rate of the private debt is expressed relative to the Secured Overnight Financing Rate (SOFR) plus a certain number of basis points. If the SOFR is 2% and the private debt offers SOFR + 200 basis points, the interest rate on the private debt is *closest to:*

A. 2%

B. 4%

C. 6%

The correct answer is **B.**

The interest rate on the private debt would be 4%. This is because the interest rate of the private debt is expressed relative to the SecFR (Secured Overnight Financing Rate) plus a certain number of basis points. In this case, the SOFR is 2%, and the private debt offers SOFR + 200 basis points. A basis point is one-hundredth of a percentage point (0.01%). Therefore, 200 basis points is equivalent to 2%. Adding this to the SOFR of 2% gives an interest rate of 4% on the private debt.

This type of interest rate structure is common in private debt and other types of floating-rate instruments, where the interest rate is set relative to a reference rate (in this case, the SOFR) plus a fixed spread (in this case, 200 basis points). This allows the interest rate on the debt to adjust to changes in market conditions while also providing a fixed return above the reference rate to compensate the investor for the risk of the investment.

A is incorrect. 2% is the SOFR, not the interest rate on the private debt. The interest rate on the private debt is the SOFR plus 200 basis points, which equals 4%.

C is incorrect. 6% is not the correct interest rate on the private debt. The interest rate on the private debt is the SOFR plus 200 basis points, which equals 4%. 6% would be the interest rate if the private debt offered SOFR + 400 basis points, not 200 basis points.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.4384 Which of the following statements is most likely accurate about the performance of private debt and equity compared to public debt and equity?

A. Private debt and equity always outperform public debt and equity due to their higher risk.

B. Public debt and equity are always a safer investment choice than private debt and equity.

C. Comparing the performance of private debt and equity with public debt and equity may not be suitable due to differences in the company life cycle, performance, and risk.

The correct answer is **C.**

Comparing the performance of private debt and equity with public debt and equity may not be suitable due to differences in the company life cycle, performance, and risk. Private and public investments have different risk and return characteristics, and their performance can vary significantly depending on a variety of factors. Private investments, such as in start-ups or companies in declining industries, can be riskier and may not yield positive returns over longer time horizons.

On the other hand, the performance risk of continuous investment in public equity and debt can be easily hedged. Therefore, it is not appropriate to make a blanket statement about the performance of private versus public investments. Each investment should be evaluated on its own merits, taking into account the specific risk and return characteristics, the investor's risk tolerance and investment objectives, and the overall market conditions.

A is incorrect. It is not accurate to say that private debt and equity always outperform public debt and equity due to their higher risk. While it is true that higher risk can potentially lead to higher returns, it can also lead to higher losses. The performance of private investments can be highly variable and is influenced by a wide range of factors, including the quality of the management team, the competitiveness of the industry, and the overall economic conditions.

B is incorrect. Public debt and equity are not always a safer investment choice than private debt and equity. While public investments can be more liquid and their performance risk can be more easily hedged, they are also subject to market risk, interest rate risk, and other types of risk. Furthermore, the performance of public investments can be influenced by a wide range of factors, including economic conditions, interest rates, and market sentiment.

CFA Level I, Alternative Investments, Learning Module 3: Investments in Private Capital: Equity and Debt. LOS (b): Explain features of private debt and its investment characteristics.

Q.30 Which of these statements regarding Real Estate Investment Trusts (REITs) is *least likely* accurate?

A. REITs are traded on the major exchanges.

B. REITs keep the majority of their cash flows to acquire additional properties.

C. Most REIT revenues come principally from the rental income their properties generate.

The correct answer is **B.**

REITs are companies that own or finance income-generating real estate properties. They are designed to provide investors with a way to invest in real estate without having to buy or manage the properties themselves.

REITs typically distribute most of their cash flows as dividends to shareholders, rather than using the cash flows to acquire additional properties. This is because REITs are required by law to distribute at least 90% of their taxable income to shareholders in the form of dividends. While some REITs may use a portion of their cash flows to acquire new properties, it is not typical for them to keep the majority of their cash flows for this purpose.

A is incorrect. REITs are traded on major exchanges, such as the New York Stock Exchange, and can be bought and sold like other publicly traded stocks.

C is incorrect. Most REITs generate their revenues from the rental income that their properties generate. By law, REITs are required to distribute at least 90% of their taxable income to shareholders as dividends, which means that they usually keep only a small portion of their cash flows to acquire additional properties.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.1083 Which of the following forms of real estate investments are *most likely* to be publicly traded?

A. Residential property.

B. Commercial real estate.

C. Real estate investment trusts (REITs).

The correct answer is **C.**

Real estate investment trusts (REITs) are companies that own and manage income-generating real estate properties. They are designed to provide investors with a way to invest in real estate without having to buy or manage the properties themselves. REITs are most commonly publicly traded, which means that investors can buy and sell shares of a REIT on a public stock exchange, just like other publicly traded stocks.

A is incorrect. Residential property refers to investment in residential real estates, such as single-family homes or multi-family apartment buildings. These properties are typically privately owned and not publicly traded.

B is incorrect. Commercial real estate refers to investment in non-residential real estate, such as office buildings, shopping centers, and industrial properties. While some commercial real estate investments may be publicly traded, such as real estate investment trusts (REITs) that focus on commercial properties, many commercial real estate investments are privately owned.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.1085 Direct commercial real estate ownership is *least likely* to include investment in:

A. Illiquid assets.

B. Large amounts.

C. A short time horizon.

The correct answer is **C.**

Commercial real estate is typically considered a long-term investment due to its illiquid nature, large amounts of capital required, and the time it takes to generate returns. Investors who choose to invest in commercial real estate usually do so with a long-term view, often holding the property for many years in order to benefit from appreciation and rental income. Short-term investments are typically more suited for liquid assets such as stocks or bonds.

A is incorrect. Direct commercial real estate ownership inherently involves illiquid assets. Real estate properties cannot be quickly sold or converted into cash without a significant loss in value. This illiquidity stems from the unique characteristics of each property, the smaller number of potential buyers, and the longer time frames required for transaction completion. Illiquidity is a defining feature of direct real estate investment, contrasting with more liquid investments like stocks or bonds that can be sold rapidly in public markets.

B is incorrect. Investing in direct commercial real estate typically requires large amounts of capital. The high entry costs are due to the substantial value of real estate properties and the expenses associated with purchasing, maintaining, and managing such assets. This characteristic distinguishes direct real estate investment from other types of investments that may allow for smaller initial capital outlays. The requirement for significant investment not only limits access to wealthy individuals or institutional investors but also reflects the scale and potential for substantial returns that direct real estate investments can offer over time.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.1217 Richard Depp is a fund manager for MZJ Investments, a hedge fund investing in blue-chip stocks. What should Depp *most likely* include in his portfolio in order to decrease the portfolio's risk?

A. Real estate.

B. Tech firm equities.

C. Hospitality sector equities.

The correct answer is **A.**

To decrease the portfolio's risk, Depp should most likely include Real estate in his portfolio. Investing in real estate can provide diversification benefits as it has a low correlation with other asset classes such as stocks and bonds. Real estate investments can also provide a hedge against inflation and generate a steady income through rental payments. These benefits make real estate a suitable addition to a portfolio focused on blue-chip stocks, as it can help to reduce overall portfolio risk.

On the other hand, including tech firm equities or hospitality sector equities may increase the portfolio's risk due to their high volatility and sensitivity to market changes.

B is incorrect. Suggesting that tech firm equities would decrease the portfolio's risk overlooks the inherent volatility associated with the technology sector. Tech firms, especially those at the forefront of innovation, can be highly sensitive to market sentiment, regulatory changes, and technological advancements. This sensitivity can lead to significant price swings, potentially increasing the portfolio's overall risk rather than mitigating it. While tech equities can offer substantial growth opportunities, they do not typically serve as a risk-reducing component in a portfolio.

C is incorrect. Including hospitality sector equities in the portfolio to decrease risk is misguided due to the cyclical nature of the hospitality industry. The performance of hospitality companies, including hotels, restaurants, and leisure facilities, is closely tied to the health of the economy. During economic downturns or periods of reduced consumer spending, these companies can experience significant declines in revenue, leading to decreased stock prices. Additionally, the hospitality sector can be highly susceptible to external shocks, such as natural disasters or pandemics, further increasing its volatility. Therefore, adding hospitality sector equities to a portfolio primarily composed of blue-chip stocks would likely increase the portfolio's exposure to risk rather than diminish it.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.1240 A real estate index that is based on changes in price of properties that are sold for multiple times is *most likely* known as a/an:

A. REITs index.

B. Appraisal index.

C. Repeat sale index.

The correct answer is **C.**

A repeat sale index is an index that is based on changes in the prices of properties that are sold multiple times. The index tracks the changes in prices of individual properties that have been sold at least twice, allowing for a more accurate measurement of changes in the underlying value of the real estate. By focusing on the price changes of individual properties, a repeat sale index can help to eliminate the effects of factors such as changes in the mix of properties that are being sold, which can distort the results of other real estate indices.

A is incorrect. REITs (Real Estate Investment Trusts) are companies that own or finance income-producing real estate properties, and a REIT index would track the performance of a portfolio of these companies.

B is incorrect. An appraisal index is an index that is based on the values assigned to properties by real estate appraisers, which may not reflect the actual market value of the properties. Therefore, a repeat sale index is the most likely option based on the description given.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (a): Explain features and characteristics of real estate.

Q.3276 Which of the following *most accurately* describes a feature of the direct form of real estate investment?

A. Transaction costs are low.

B. The underlying property can be managed actively.

C. They represent a public form of real estate investment.

The correct answer is **B.**

Direct real estate investments involve purchasing and owning physical real estate assets such as residential, commercial, or industrial properties. Unlike indirect real estate investments, such as real estate investment trusts (REITs) or real estate mutual funds, direct real estate investments provide the investor with the ability to manage the underlying property actively.

Investors can decide how to improve and manage the property, such as by making repairs, renovations, and upgrades to increase its value, as well as by setting rental rates, screening tenants, and managing property maintenance. This active management can potentially increase the return on investment for the investor, although it also requires more effort and expertise than passive investment options.

A and C are incorrect. Transaction costs for direct real estate investments tend to be relatively high compared to indirect investment options, as investors must cover expenses such as property taxes, insurance, maintenance, and potentially financing costs if the property is purchased with a mortgage. Direct real estate investments are also typically not publicly traded, meaning that they are not a public form of real estate investment.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.3285 Debt-based real estate investments *most likely* include:

A. real estate limited partnerships.

B. shares in real estate corporations.

C. collateralized mortgage obligations.

The correct answer is **C.**

Debt-based real estate investments include mortgage-backed securities (residential and commercial), collateralized mortgage obligations, mortgages, and construction lending.

Equity based real estate investments include direct ownership of real estate (through sole ownership, joint ventures, or real estate limited partnerships) , indirect ownership via real estate funds, shares in real estate development corporations and shares in REITs.

A is incorrect. Real estate limited partnerships (RELPs) are primarily equity-based investments. In a RELP, investors pool their money to invest in real estate projects. The partnership owns the property directly, and investors benefit from rental income, property appreciation, and tax advantages. While debt may be used to finance the acquisition or development of the property, the investment itself represents an ownership stake rather than a loan to the property, distinguishing it from debt-based investments.

B is incorrect. Shares in real estate corporations represent equity investments in companies that own, develop, or manage real estate. Investors who purchase these shares become part-owners of the corporation and its assets. Their return on investment comes from dividends, which are a share of the company's profits, and from any appreciation in the value of the shares. This contrasts with debt-based investments, where returns are generated from interest payments on loans secured by real estate.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.3290 Bob Hagman has a stock and bond portfolio worth $400,000. For diversification purposes, Hagman plans to invest in real estate as part of his 'alternative investments' portfolio. Hagman does not know much about investing in this market, so he has decided to invest only a limited amount of money initially. The *most appropriate* investment vehicle for Hagman will be:

A. REITs.

B. Real estate limited partnerships.

C. Commercial mortgage-backed securities.

The correct answer is **A.**

REITs issue shares that are typically publicly traded. They give investors access to a diversified real estate property portfolio and professional management. Most REITs also do not have a minimum investment requirement.

B is incorrect. Real estate limited partnerships fall under direct ownership of real estate. These have high initial purchase costs including legal expenses, survey costs, engineering/environmental studies, and valuation (appraisal fees).

C is incorrect. Commercial mortgage-backed securities would require a degree of specialization.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.3305 The adjusted funds of operating (AFFO) in Real Estate Investment Trusts (REITs) valuation *most likely* adjusts the funds from operations for:

A. Recurring capital expenditures.

B. Non-recurring gains and losses.

C. Non-recurring developmental expenditures.

The correct answer is **A.**

AFFO is a financial metric used in the valuation of REITs. It is a measure of the cash generated by a REIT's operating activities after taking into account recurring capital expenditures required to maintain the property portfolio.

Funds from operations (FFO) is a commonly used financial metric in REIT analysis, but it does not account for recurring capital expenditures that are necessary to keep the properties in good condition. AFFO adjusts FFO for recurring capital expenditures, such as repairs and maintenance, that are needed to maintain the property portfolio's value. This adjustment gives a more accurate picture of a REIT's ability to generate cash flow over the long term.

B and C are incorrect. Non-recurring gains and losses and Non-recurring developmental expenditures may also be important considerations in REIT valuation, but they are not typically accounted for in the calculation of AFFO. Non-recurring gains and losses can include one-time events such as the sale of a property, which may not be reflective of a REIT's ongoing operating performance. Non-recurring developmental expenditures can include capital expenditures related to new property acquisitions or development projects, which are not recurring and may not be representative of a REIT's ongoing operations.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.3306 Which of the following is *least likely* a reason to invest in real estate?

A. To benefit from wider market trends.

B. To lessen the cash flow impact from economic shocks.

C. To get both income generation and capital appreciation.

The correct answer is **A.**

Real estate investments provide diversification benefits by providing less than perfect correlation with the overall market trends. Other reason for investing in real estate include potential for competitive long-term total returns driven by both income generation and capital appreciation, prospect that multiple-year leases with fixed rents for some property types may lessen cash flow effects from economic shocks, potential to provide an inflation hedge if rents can be adjusted quickly for inflation.

B is incorrect. Real estate investments can indeed lessen the cash flow impact from economic shocks. This is particularly true for certain types of properties that have long-term leases with fixed rents, which can provide stable income streams even during economic downturns. Additionally, the tangible nature of real estate and the potential for physical improvements can provide a level of control and stability not found in more volatile asset classes.

C is incorrect. One of the primary reasons investors are attracted to real estate is the dual benefit of income generation through rents and capital appreciation over time. These two factors contribute to the competitive long-term total returns that can be achieved through real estate investments. Income generation provides a steady cash flow, while capital appreciation offers the potential for significant gains upon the sale of the property. Together, they form a compelling reason for investing in real estate, contrary to the suggestion that this is a less likely reason.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.3317 Which of the following risks is *least likely* specific to investments in real estate property?

A. Fluctuating interest rates.

B. Uncertain impact of environment regulation.

C. 100% loss of equity on individual investments.

The correct answer is **C.**

Although equity-investment real estate funds are subject to the risk of loss in value because they employ a high degree of financial leverage, they are unlikely to pose the risk of a 100% loss of equity on individual investments. For illiquid investments such as private equity or venture capital, there is a real possibility of a 100% loss of equity on individual investments.

A is incorrect. Property values are subject to fluctuations in interest rates, and so this is a valid concern.

B is incorrect. Investments in property development are subject to risks such as regulatory issues. These issues include the impact of environmental regulation.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.3322 The shares of a real estate investment trust (REIT) frequently trade at prices which:

A. Is equal to its NAV per share.

B. Differs from its NAV per share.

C. Is equal to its capitalized value per share.

The correct answer is **B.**

The shares of a real estate investment trust (REIT) frequently trade at prices that differ from its NAV (Net Asset Value) per share. The NAV per share is calculated by dividing the total value of the REIT's assets by the total number of outstanding shares.

The market price of a REIT share is determined by supply and demand factors in the market and may be influenced by a variety of factors such as investor sentiment, interest rates, economic conditions, and the perceived quality of the REIT's management team and investment portfolio. As a result, the market price of a REIT share may fluctuate above or below its NAV per share.

When a REIT's market price is higher than its NAV per share, it is said to be trading at a premium. Conversely, when a REIT's market price is lower than its NAV per share, it is said to be trading at a discount. The degree of premium or discount can vary depending on a variety of factors, such as the strength of the REIT's investment portfolio, the level of investor demand for real estate assets, and prevailing interest rates in the market.

A is incorrect. While the NAV per share provides a fundamental valuation metric, the actual trading price of REIT shares is subject to the forces of supply and demand in the market, which can cause prices to deviate from the NAV.

C is incorrect. It implies that REIT shares trade at a price equal to their capitalized value per share. Capitalized value is a different valuation metric that involves estimating the present value of future income streams, such as rental income from properties owned by the REIT. While this can be one of the factors influencing a REIT's market price, it does not directly equate to the trading price of REIT shares. The market price is influenced by broader market dynamics and investor sentiment, which can lead to prices that differ from both the NAV and the capitalized value per share.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.3324 Which of the following statements *most accurately* compares the fee structure for real estate investment trust (REIT) funds to other alternative investment classes?

A. Management fee is charged based on committed capital.

B. Incentive fees are calculated based on profit before management.

C. Fee structures are subject to high water marks similar to hedge funds.

The correct answer is **A.**

The fee structure for REITs investment funds is similar to private equity with management fees being charged based on committed or invested capital.

C is incorrect. Fee structures for REITs are not subject to high water marks.

B is incorrect. Similar to private equity, incentive fees are only paid to the GP after the initial capital is returned back to LPs.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.3332 Which of the following is *not* a valid reason for investing in real estate?

A. Inflation hedging potential.

B. Likelihood of diversification benefits.

C. Limited involvement in the operational management of properties.

The correct answer is **C.**

Real estate property typically requires operational management. Therefore, this is one of the drawbacks to investing in real estate.

A is incorrect. Real estate has the potential to provide an inflation hedge if rents can be adjusted quickly for inflation.

B is incorrect. Another benefit of investing in real estate is that diversification benefits may be provided by less than perfect correlation with other asset classes.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4214 Which of the following is *least likely* correct regarding real estate investing?

A. Real estate is mainly used for income generation.

B. A real estate deed represents real estate property ownership.

C. Real estate historically has low correlations with other asset types.

The correct answer is **A.**

Real estate can also be used for personal use, such as a primary residence or a vacation home. In fact, many real estate investors buy properties for personal use or as a second home rather than for income generation.

B is incorrect. A real estate deed (title) represents real estate property ownership. The title can be purchased, leased, sold, mortgaged, or transferred together or separately in whole or in part.

C is incorrect. Historically, real estate has low correlations with other asset types, such as stocks and bonds, making it a valuable tool for diversification in an investment portfolio. As such, when other asset classes perform poorly, real estate may still perform well, which can help to mitigate overall portfolio risk.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4217 Which of the following is *most likely* true regarding REITs?

A. REITs eliminate the need for double corporate taxation.

B. Publicly traded REITs are less liquid than private real estate investments

C. Mortgage REITs have the same characteristics as direct leveraged equity investments in real estate.

The correct answer is **A.**

The correct answer is A. REITs can remove the need for double corporate taxation by distributing dividends equal to 90% or 100% of their taxable net rental income.

B is incorrect. Publicly traded REITs are typically more liquid and transparent than private real estate investments.

C is incorrect. Mortgage REITs invest in mortgages and mortgage-backed securities, which have characteristics similar to fixed-income investments such as bonds and not direct leveraged equity investments in real estate.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4218 Which of the following is *most likely* true regarding forms of real estate ownership?d

A. Private equity funds are typically organized into finite-life closed-end funds.

B. Listed real estate investment trusts (REITs) is an example of private debt.

C. Residential mortgages can only be secured and listed on the financial market for indirect debt investment.

The correct answer is **A.**

Private equity funds are typically organized into finite-life closed-end funds, meaning they have a specific investment period and a set amount of capital. These funds are designed to invest in private companies or acquire distressed assets, and they typically have a long-term investment horizon of several years.

In a closed-end fund, investors pool their capital together, and then the fund manager deploys the capital according to the fund's investment strategy. Once the investment period is over, the fund is closed, and the fund manager liquidates the investments and distributes the proceeds to the investors.

B is incorrect. Listed REITs are an example of public equity, not private debt. REITs own and operate income-generating real estate assets and distribute income to their shareholders through dividends.

C is incorrect. Residential mortgages can be secured and listed for direct and indirect debt investment on the financial market. The securities created from these mortgages are called mortgage-backed securities, and they can be purchased by investors either directly or through mutual funds or exchange-traded funds.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4219 Which of the following is *least likely* a characteristic of infrastructure investments?

A. Short-term cashflows.

B. Monopolistic and regulated.

C. Highly leveraged financial structure.

The correct answer is **A.**

Infrastructure investments are typically associated with long-term cashflows, involving long-term assets expected to generate revenue over many years or even decades. In contrast, short-term cashflows are more typical of investments in assets such as stocks or bonds.

B is incorrect. Infrastructure investments are often monopolistic and regulated, particularly in sectors such as utilities or transportation, where limited competition and government oversight may exist.

C is incorrect. Infrastructure investments are associated with highly leveraged financial structures as these projects can require significant upfront capital investment. Financing these investments through debt can allow for greater leverage and potentially higher returns, but it also carries higher risk.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (d): Explain the investment characteristics of infrastructure investments.

Q.4220 Which type of infrastructure asset is *most likely* an economic infrastructure?

A. Education facilities.

B. Healthcare facilities.

C. Transportation assets.

The correct answer is **C.**

Economic infrastructure refers to assets that support economic activity and growth, such as transportation networks, communication systems, and energy infrastructure. Transportation assets, such as highways, airports, and ports, are critical components of economic infrastructure as they facilitate the movement of goods, people, and services and can significantly impact economic development and productivity.

A and B are incorrect. Education facilities and healthcare facilities are essential types of social infrastructure. Social infrastructure includes assets primarily focused on meeting the needs of individuals and communities rather than on driving economic growth.

Education facilities, such as schools and universities, provide education and training to individuals and can contribute to broader social and economic development by developing the skills and knowledge of individuals.

Healthcare facilities, such as hospitals and clinics, provide medical care and support to individuals and are critical for maintaining public health and well-being.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (c): Explain features and characteristics of infrastructure.

Q.4221 Which of the following *most likely* differentiates between greenfield and brownfield infrastructure investments?

A. Greenfield investment is used for investing in existing infrastructure assets, while brownfield investments are investments in infrastructure assets yet to be built.

B. Greenfield investment involves vast capital investment and attracts concentration and liquidity risks, while brownfield investment provides oversight.

C. Greenfield investment is used for investing in infrastructure funds and company shares, while brownfield investment invests directly in the underlying assets.

The correct answer is **B.**

Greenfield investments refer to investments in new infrastructure projects or assets that are yet to be built, such as a new airport or a new toll road. These projects often require significant capital investment and entail higher risk due to uncertainty around construction timelines, regulatory approvals, and market demand.

A is incorrect. Greenfield investments are for new projects or assets that are yet to be built, not for investing in existing infrastructure assets. Conversely, brownfield investments refer to investments in existing infrastructure assets that are already operational, not investments in assets yet to be built. This misunderstanding of the fundamental distinction between greenfield and brownfield investments leads to a misinterpretation of their associated risks and opportunities.

C is incorrect. This option mischaracterizes greenfield and brownfield investments by suggesting that greenfield investment is limited to investing in infrastructure funds and company shares, while brownfield investment involves direct investment in underlying assets. In reality, both greenfield and brownfield investments can involve direct investment in physical assets or indirect investment through funds and shares. The key difference lies in the stage of development of the assets being invested in, not the method of investment. Greenfield projects involve developing new assets, while brownfield projects involve investing in and potentially upgrading existing operational assets.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (c): Explain features and characteristics of infrastructure.

Q.4222 Which of the following forms of infrastructure investments *most likely* involves investment vehicles such as infrastructure funds and company shares?

A. Direct investment.

B. Indirect investment.

C. Greenfield investment.

The correct answer is **B.**

Indirect investment involves investing in infrastructure through intermediaries, such as infrastructure funds or company shares, rather than investing directly in infrastructure projects. Infrastructure funds pool together capital from multiple investors and invest in infrastructure projects on their behalf. Company shares, on the other hand, provide investors with an ownership stake in a company that operates in the infrastructure sector.

A and C are incorrect. Direct investment, on the other hand, involves investing directly in infrastructure projects, such as building a toll road or a power plant. Greenfield investment refers to investments made in new infrastructure projects that are being built from scratch, as opposed to investments in existing infrastructure projects (brownfield investments).

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (d): Explain the investment characteristics of infrastructure investments.

Q.4223 Which of the following is most likely a risk in infrastructure investments that can be managed by entering into fixed-price time-certain contracts with credible and competent contractors?

A. Regulatory risk.

B. Construction risk.

C. Demand/volume risk..

The correct answer is **B.**

Construction risk refers to the risk of cost overruns, delays, or quality issues during the construction or development phase of an infrastructure project. This risk can be significant, particularly for large and complex projects, leading to increased costs and reduced investor returns.

By entering into fixed-price time-certain contracts with credible and competent contractors, investors can mitigate this risk by ensuring the construction process is completed on time, on budget, and to the required standards.

A is incorrect. Regulatory risk refers to the risk of changes in laws or regulations that can impact the operation or profitability of the infrastructure asset and can also be challenging to manage as it is influenced by government policies and decisions.

C is incorrect. Demand/volume risk, on the other hand, refers to the risk of lower-than-expected demand or usage of the infrastructure asset, which can impact its revenue and profitability. This risk can be more challenging to manage, as it is often influenced by external factors such as economic changes, demographics, or market trends.

Q.4330 An investor is looking to invest in a publicly traded form of real asset that generates cash flows primarily from rents or mortgage payments by households. Which type of investment would *most likely* suit the investor's needs?

A. Commodities.

B. Real Estate Investment Trusts (REITs).

C. Public-Private Partnership (PPP) Infrastructure.

The correct answer is **B.**

Real Estate Investment Trusts (REITs) would best suit the investor's needs. REITs are companies that own, operate or finance income-generating real estate. They provide a way for individual investors to earn a share of the income produced through commercial real estate ownership without actually having to go out and buy commercial real estate. The income generated by REITs comes primarily from rents or mortgage payments, which aligns with the investor's needs.
REITs are required by law to distribute at least 90% of their taxable income to shareholders annually in the form of dividends, making them an attractive investment for income-focused investors. Furthermore, REITs are publicly traded on major stock exchanges, providing liquidity and transparency for investors.
A is incorrect. Commodities are basic goods used in commerce that are interchangeable with other goods of the same type. Commodities do not generate cash flows from rents or mortgage payments by households. Instead, their value is derived from supply and demand dynamics in the market.

C is incorrect. Public-Private Partnership (PPP) Infrastructure is a cooperative arrangement between two or more public and private sectors, typically of a long-term nature. While they can generate cash flows, they are not primarily from rents or mortgage payments by households. Instead, they are often from government payments or user fees.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (c): Explain features and characteristics of infrastructure.

Q.4385 In the context of forms of real estate investments, which of the following statements is *most likely*correct?

A. Publicly traded real estate investments cannot be held privately.

B. Equity investment in real estate always provides a fixed cash flow.

C. Mortgage-backed securities (MBS) are a form of debt investment in real estate.

The correct answer is **C.**

Mortgage-backed securities (MBS) are indeed a form of debt investment in real estate. MBS are financial instruments that are secured by a mortgage or collection of mortgages. Investors in MBS receive periodic payments derived from the underlying mortgages' interest and principal payments. This makes MBS a form of debt investment in real estate, as the investor is essentially lending money to the mortgage borrower through the purchase of the MBS.
The investor's return is dependent on the repayment of the mortgage loans, making it a form of fixed-income investment. MBS offers investors the opportunity to benefit from the mortgage market without having to directly lend to borrowers, providing a way to diversify their portfolio and potentially earn higher returns than other fixed-income investments.
A is incorrect. Publicly traded real estate investments can indeed be held privately. Publicly traded real estate investments refer to investments in real estate companies or trusts that are listed on a public exchange. While these investments are available to the public, they can be purchased and held by private investors. The term "publicly traded" simply refers to the availability of the investment, not the ownership structure.

B is incorrect. Equity investment in real estate does not always provide a fixed cash flow. While some forms of equity investment, such as rental properties, can provide a steady, fixed cash flow, others, such as property development or flipping, can provide variable cash flows. The cash flow from an equity investment in real estate is dependent on a variety of factors, including the type of property, the market conditions, and the strategy of the investor.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4386 In the context of real estate investments, which of the following statements is *least likely* correct?

A. REITs can only be publicly traded.

B. REITs are a form of equity investment in real estate.

C. REITs can provide either fixed or variable cash flows, depending on the property investment.

The correct answer is **A.**

The statement that REITs can only be publicly traded is incorrect. REITs can be both publicly traded and privately held. Publicly traded REITs are listed on a stock exchange and can be bought and sold like any other publicly traded security. They offer the benefits of liquidity, transparency, and the ability to invest in real estate without the need for direct property ownership.
On the other hand, private REITs are not listed on a stock exchange and are typically sold to institutional investors. They offer the potential for higher returns but also come with higher risk and less liquidity. Therefore, the assertion that REITs can only be publicly traded is incorrect as it overlooks the existence and characteristics of private REITs.
B is incorrect. The statement that REITs are a form of equity investment in real estate is correct. REITs represent ownership in a portfolio of real estate assets. When investors buy shares of a REIT, they are essentially buying a piece of the real estate assets that the REIT owns. This is similar to buying shares of a company, where the investor becomes a partial owner of the company. Therefore, REITs are indeed a form of equity investment in real estate.

C is incorrect. The statement that REITs can provide either fixed or variable cash flows, depending on the property investment, is correct. The cash flows from REITs can be either fixed or variable, depending on the type of properties the REIT invests in and the rental agreements in place. For example, a REIT that invests in properties with long-term leases may provide more stable and predictable cash flows, while a REIT that invests in properties with short-term leases or variable rents may provide more variable cash flows.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4387 Which of the following statements is *most accurate* about real estate investments?

A. All real estate properties are identical and offer the same investment opportunities.

B. Private market indexes replicating the performance of real estate are directly investable.

C. In private real estate markets, transaction activity may be limited due to supply or demand conditions.

The correct answer is **C.**

Real estate investments are indeed characterized by high transaction costs and potentially limited transaction activity due to supply or demand conditions. This is primarily due to the unique and distinct features of real estate properties, which can vary greatly depending on a variety of factors. The process of buying and selling real estate involves numerous costs, including but not limited to, legal fees, agent commissions, inspection costs, and taxes.
These costs can be substantial and can significantly impact the net return on a real estate investment. Additionally, the market for real estate properties can be illiquid, meaning that it can be difficult to buy or sell properties quickly without affecting the price. This can be due to a variety of factors, including market conditions, the unique characteristics of the property, and the relatively large size of real estate transactions. Therefore, transaction activity in private real estate markets may be limited due to supply or demand conditions.
A is incorrect. It is not accurate to say that all real estate properties are identical and offer the same investment opportunities. As mentioned earlier, real estate properties are characterized by their unique and distinct features, which can vary greatly depending on factors such as location, age, tenant credit mix, lease term, and market demographics. This heterogeneity can make diversification across different types of real estate investment alternatives challenging.

B is incorrect. Private market indexes replicating the performance of real estate are not directly investable. These indexes are typically based on appraisal values and transaction prices of properties, and they are used to track the performance of the real estate market as a whole or specific segments of the market. However, they do not represent actual investment vehicles that investors can buy into. Instead, investors can gain exposure to real estate through various investment vehicles, such as real estate investment trusts (REITs), real estate mutual funds, and direct property ownership.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4388 In the context of investment portfolios, real estate markets present a unique set of challenges and considerations due to their inherent characteristics. Which of the following factors is *least likely* a consideration for a real estate investor but is more relevant to a stock or bond investor?

A. Zoning laws.

B. Local market conditions.

C. Company's financial health

The correct answer is **C.**

The company's financial health is not typically a consideration for a real estate investor but is more relevant to a stock or bond investor. Real estate investors are primarily concerned with the property itself and the factors that can influence its value, such as location, zoning laws, local market conditions, and the condition of the property. While the financial health of a property's owner or developer can be a consideration, it is not typically a primary factor in the investment decision.

On the other hand, the financial health of a company is a key consideration for stock and bond investors. They need to assess the company's profitability, liquidity, solvency, and overall financial stability to determine the potential risks and returns of their investment. This involves analyzing the company's financial statements, ratios, and other financial indicators.

A is incorrect. Zoning laws are a key consideration for real estate investors. They determine what types of buildings and activities are allowed in a particular area, which can significantly impact the value and potential uses of a property.

B is incorrect. Local market conditions are also a crucial factor for real estate investors. They need to understand the supply and demand dynamics in the local market, the level of competition, the economic and demographic trends, and other factors that can influence property values.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4389 Which of the following is *least likely* a potential disadvantage that the investor should consider when making a direct real estate investment?

A. The investor may need to dedicate significant time to manage the property, including understanding local market characteristics and city regulations.

B. The investor may need to have access to a potentially significant amount of debt and equity capital due to the large initial capital outlay needed for real estate investments.

C. The investor can reduce their taxable income using non-cash property depreciation expenses and tax-deductible interest expenses.

The correct answer is **C.**

Choice C is not a potential disadvantage of making a direct real estate investment. In fact, it is a potential advantage. The ability to reduce taxable income using non-cash property depreciation expenses and tax-deductible interest expenses is one of the key benefits of investing in real estate.

This is because the IRS allows investors to deduct these expenses from their taxable income, thereby reducing their overall tax liability. This can significantly enhance the after-tax returns from a real estate investment, making it an attractive option for investors seeking tax-efficient investment opportunities.

A is incorrect. The need to dedicate significant time to manage the property, including understanding local market characteristics and city regulations, is indeed a potential disadvantage of making a direct real estate investment. Managing a property can be time-consuming and complex, requiring a deep understanding of the local real estate market and regulatory environment. This can be a significant drawback for investors who do not have the time or expertise to effectively manage a property.

B is incorrect. The need to have access to a potentially significant amount of debt and equity capital due to the large initial capital outlay needed for real estate investments is also a potential disadvantage. Real estate investments typically require a large initial capital outlay, which can be a barrier to entry for many investors. Furthermore, the use of debt to finance a real estate investment can increase the risk of the investment, particularly in a rising interest rate environment or if property values decline.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4390 Which of the following is *least likely* a potential advantage that the investor should consider when making a direct real estate investment?

A. It is typically difficult to quickly buy or sell direct investments in real estate, and transaction costs are typically high.

B. The investor has the sole decision-making power on when to buy or sell, when and how much to spend on capital projects, whom to select as tenants based on credit quality preference and tenant mix, and what types of lease terms to offer.

C. Real estate has historically exhibited a low correlation with other asset classes, and adding real estate to a portfolio has been demonstrated to increase portfolio diversification and reduce portfolio risk.

The correct answer is **A.**

Choice A is not a potential advantage of making a direct real estate investment. In fact, it is a disadvantage. Direct investments in real estate are typically illiquid, meaning they cannot be quickly bought or sold. This lack of liquidity can be a significant drawback for investors who need to access their capital quickly. Additionally, transaction costs for buying and selling real estate are typically high, which can eat into the potential returns from the investment.
These costs can include commissions, legal fees, and taxes, among others. Therefore, while direct real estate investments can offer several potential benefits, such as control over decision-making and diversification benefits, they also come with certain drawbacks, including illiquidity and high transaction costs.
B is incorrect. Real estate has historically exhibited low correlation with other asset classes, and adding real estate to a portfolio has been demonstrated to increase portfolio diversification and reduce portfolio risk. This is another potential advantage of direct real estate investment. Diversification can help to reduce the overall risk of a portfolio by spreading investments across different asset classes that are not perfectly correlated.

C is incorrect. Having the sole decision-making power on when to buy or sell, when and how much to spend on capital projects, whom to select as tenants based on credit quality preference and tenant mix, and what types of lease terms to offer is indeed a potential advantage of direct real estate investment. This level of control can allow the investor to tailor their investment strategy to their specific needs and preferences.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4391 Which of the following statements is *most likely* correct in regard to the types of REIT in the real estate market?

A. All types of REITs invest in properties outright or through partnerships and joint ventures and underwrite loans to real estate or invest in Mortgage-Backed Securities (MBS).

B. Equity REITs underwrite loans to real estate or invest in Mortgage-Backed Securities (MBS), Mortgage REITs invest in properties outright or through partnerships and joint ventures, and Hybrid REITs invest in both these types.

C. Equity REITs invest in properties outright or through partnerships and joint ventures, Mortgage REITs underwrite loans to real estate or invest in Mortgage-Backed Securities (MBS), and Hybrid REITs invest in both of these types.

The correct answer is **C.**

Equity REITs, Mortgage REITs, and Hybrid REITs each have distinct investment strategies in the real estate market. Equity REITs primarily invest in and own properties, and their revenues come principally from their properties' rents. They invest in properties outright or through partnerships and joint ventures. Mortgage REITs, on the other hand, lend money to real estate owners and operators either directly through mortgages and loans or indirectly through the acquisition of mortgage-backed securities.
Their revenues are generated primarily by the interest that they earn on mortgage loans. Hybrid REITs are a combination of the two, and they invest in both properties and mortgages. Therefore, the statement in Choice A accurately describes the investment strategies of the three types of REITs.
A is incorrect. This choice incorrectly suggests that all types of REITs have the same investment strategy. While it is true that Hybrid REITs invest in both properties and mortgages, Equity REITs and Mortgage REITs have distinct investment strategies. Equity REITs primarily invest in properties, while Mortgage REITs primarily invest in mortgages and mortgage-backed securities.

B is incorrect. This choice incorrectly swaps the investment strategies of Equity REITs and Mortgage REITs. Equity REITs primarily invest in properties, not in mortgages or mortgage-backed securities. Conversely, Mortgage REITs primarily invest in mortgages and mortgage-backed securities, not in properties.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4392 Consider an investor who is contemplating between investing in private real estate and publicly traded Real Estate Investment Trusts (REITs). Which of the following statements *accurately* reflects the advantages and/or disadvantages of investing in publicly traded REITs?

A. Publicly traded REITs offer greater transparency and ease of transactions by buying or selling REIT shares, but investors are forced to sell the company's underlying real estate during mass redemptions and have a higher correlation with public equity markets.

B. Publicly traded REITs offer greater transparency and ease of transactions by buying or selling REIT shares; investors are not forced to sell the company's underlying real estate during mass redemptions and REITs have the expertise to manage properties effectively.

C. Publicly traded REITs offer greater transparency and ease of transactions by buying or selling REIT shares; investors are forced to sell the company's underlying real estate during mass redemptions, but REITs have a lower correlation with public equity markets.

The correct answer is **B.**

Publicly traded Real Estate Investment Trusts (REITs) offer greater transparency and ease of transactions by buying or selling REIT shares, investors are not forced to sell the company's underlying real estate during mass redemptions, and REITs have the expertise to manage properties effectively. However, they have a higher correlation with public equity markets. REITs are required by law to distribute at least 90% of their taxable income to shareholders annually in the form of dividends, which provides a steady income stream for investors.

They also offer the advantage of professional management, which can be particularly beneficial for investors who do not have the time or expertise to manage properties themselves. However, one of the main disadvantages of REITs is their correlation with the broader equity market. Because REIT shares are traded on major exchanges, they are subject to the same market forces as other publicly traded companies, which can lead to increased volatility and risk.

A is incorrect. While publicly traded REITs do offer greater transparency and ease of transactions, investors are not forced to sell the company's underlying real estate during mass redemptions. This is a misconception. In fact, REITs have the ability to manage their capital structures and liquidity positions to avoid such situations.

C is incorrect. Publicly traded REITs do have a higher correlation with public equity markets, not a lower one. This is due to the fact that they are traded on the same exchanges and are subject to the same market forces. Additionally, while they do offer greater transparency and ease of transactions, investors are not forced to sell the company's underlying real estate during mass redemptions.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4394 An investor is considering various investment strategies to diversify his portfolio and is particularly interested in real estate. If the investor decides to invest in an open-end fund that owns a portfolio of high-quality office buildings in major cities, what can he primarily expect to earn his returns from?

A. Appreciation for the value of the properties.

B. Income generated by selling these properties.

C. Rental income income generated by the properties.

The correct answer is **C.**

An investor who invests in an open-end fund that owns a portfolio of high-quality office buildings in major cities can primarily expect to earn returns from the rental income these properties generate. Open-end funds that invest in real estate, also known as real estate investment trusts (REITs), typically generate income through renting out the properties they own. This rental income is then distributed to the investors as dividends.

The steady stream of rental income provides a stable and predictable return, which is one of the main attractions of investing in real estate through open-end funds. While these funds can also generate returns through the appreciation in the value of the properties, this is usually a secondary source of returns and is more unpredictable. Therefore, the primary source of returns for an investor in such a fund would be the rental income.

A is incorrect. While the appreciation in the value of the properties can contribute to the returns of an open-end fund, it is not the primary source of returns. The value of real estate properties can fluctuate due to various factors, including market conditions, location, and the quality of the properties, making it a less reliable source of returns compared to rental income.

B is incorrect. The income generated by selling these properties is not the primary source of returns for an open-end fund. These funds typically hold onto their properties for the long term to generate rental income and only sell properties when they believe it is advantageous to do so. Therefore, the income from selling properties is not a regular or predictable source of returns for investors.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4395 An investor is seeking higher returns and is willing to accept additional risks. They are considering investing in a closed-end fund that is planning to redevelop a run-down shopping center, with the expectation of earning a high return once the project is completed and the property is leased to new tenants. This type of investment strategy is *most likely* considered to be?

A. A value investment strategy.

B. A conservative investment strategy.

C. An opportunistic investment strategy.

The correct answer is **C.**

An investor who is seeking higher returns is willing to accept additional risks and is considering investing in a closed-end fund that is planning to redevelop a run-down shopping center, with the expectation of earning a high return once the project is completed and the property is leased to new tenants, is engaging in an Opportunistic Investment Strategy.

This strategy involves seeking out investment opportunities where the potential for high returns is greater due to higher risk. In this case, the investor is taking on the risk that the redevelopment project may not be successful or that the property may not be leased to new tenants as expected. However, if the project is successful, the investor stands to earn a high return on their investment. This strategy requires a high level of expertise and understanding of the market, as well as a willingness to take on significant risk.

A is incorrect. A value investment strategy involves investing in stocks that are believed to be undervalued by the market. While this strategy can potentially yield high returns, it is not the same as the opportunistic investment strategy described in the question. The value investment strategy focuses on finding undervalued stocks, not on high-risk, high-return projects like the redevelopment of a run-down shopping center.

B is incorrect. A conservative investment strategy is one that prioritizes the preservation of capital over high returns. This strategy typically involves investing in low-risk, low-return assets such as government bonds or blue-chip stocks. It is not consistent with the investor's goal of seeking higher returns and accepting additional risks.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4396 Consider an investor who is looking to diversify his portfolio by investing in real estate. He is considering two options: investing in a commercial building in a bustling city or purchasing a plot of land in a rapidly developing area. The commercial building can generate income through leasing out office spaces, while the plot of land has the potential for significant capital appreciation. However, both investments come with their own set of risks and returns.
Which of the following statements *best* describes the risk and return spectrum for these two types of real estate investments?

A. Both the commercial building and the plot of land are high-risk investments that can produce speculative returns from price appreciation.

B. The commercial building investment is a high-risk direct investment that relies on the timely receipt of lease payments, while the plot of land is a lower-risk investment that can produce speculative returns from price appreciation.

C. The commercial building investment is a low-risk direct investment that relies on the timely receipt of lease payments, while the plot of land is a higher-risk investment that can produce speculative returns from price appreciation.

The correct answer is **C.**

The commercial building investment is a low-risk direct investment that relies on the timely receipt of lease payments, while the plot of land is a higher-risk investment that can produce speculative returns from price appreciation. The commercial building investment is considered a low-risk direct investment because it generates a steady stream of income through lease payments. The risk associated with this type of investment is relatively low because the income is predictable and stable, assuming the building is fully leased and tenants are reliable.
On the other hand, investing in a plot of land in a rapidly developing area is considered a higher-risk investment. This is because the return on this type of investment is speculative and depends on the price appreciation of the land, which can be influenced by various factors such as market conditions, zoning laws, and development plans. Therefore, while the potential returns can be significant, the risk is also higher because the returns are uncertain and can even result in losses if the price of the land decreases.
A is incorrect. Both the commercial building and the plot of land are not high-risk investments that can produce speculative returns from price appreciation. The commercial building investment is a low-risk direct investment that generates a steady stream of income through lease payments, while the plot of land is a higher-risk investment that can produce speculative returns from price appreciation.

B is incorrect. The commercial building investment is not a high-risk direct investment. While it does rely on the timely receipt of lease payments, the risk associated with this type of investment is relatively low because the income is predictable and stable, assuming the building is fully leased and tenants are reliable.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4397 Consider a scenario where you are an investor looking to invest in Real Estate Investment Trusts (REITs). You are particularly interested in core, stable income-producing REITs that invest in properties yielding steady cash flows. These cash flows are typically generated from properties with long-term leases and multiple lessors or from sale-leaseback transactions.
Given this information, which of the following statements *best* describes the nature of returns you can expect from such an investment and the potential risks associated with it?

A. The returns are relatively lower compared to low-risk senior debt and are not subject to real estate market conditions.

B. The returns are relatively higher compared to low-risk senior debt and are not subject to real estate market conditions.

C. The returns are relatively higher compared to low-risk senior debt and are generally bond-like, but they are also subject to real estate market conditions.

The correct answer is **C.**

The returns from core, stable income-producing REITs are relatively higher compared to low-risk senior debt and are generally bond-like, but they are also subject to real estate market conditions. This is because REITs, by their nature, invest in real estate properties and derive their income from the rents and leases of these properties. Therefore, the returns from these investments are subject to the conditions of the real estate market. If the real estate market is doing well, the returns from these investments will be high.
Conversely, if the real estate market is not doing well, the returns from these investments will be low. Furthermore, the returns from these investments are generally higher than those from low-risk senior debt because they involve more risk. The risk comes from the fact that the income from these investments depends on the ability of the tenants to pay their rents and leases. If the tenants default on their payments, the income from these investments will be affected. Therefore, while these investments offer higher returns, they also come with higher risks.
A is incorrect. The returns from these types of investments are not relatively lower compared to low-risk senior debt. As mentioned above, these investments offer higher returns because they involve more risk. Furthermore, these investments are subject to real estate market conditions, contrary to what is stated in this option.

B is incorrect. While it is true that the returns from these types of investments are relatively higher compared to low-risk senior debt, it is not correct to say that they are not subject to real estate market conditions. As explained above, the returns from these investments are directly influenced by the conditions of the real estate market.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4398 Consider an investor who is looking to diversify his portfolio by investing in real estate. He is considering three types of investments: investing in a startup company, core-plus holdings, and value-add real estate. Based on this information, which of the following statements is *most accurate* about the source of returns for these types of investments?

> A. The main source of return for investing in a startup company and core-plus holdings is derived from leases, while the returns from value-add real estate investments are more dependent on the increase in the property's value over time.
>
> B. The main source of return for core-plus holdings is derived from leases, while the returns from investing in a startup company and value-add real estate investments are more dependent on the increase in the property's value over time.
>
> C. The main source of return for investing in a startup company is derived from leases, while the returns from core-plus holdings and value-add real estate investments are more dependent on the increase in the property's value over time.

The correct answer is **B.**

The main source of return for core-plus holdings is derived from leases, while the returns from investing in a startup company and value-add real estate investments are more dependent on the increase in the property's value over time. Core-plus real estate investments are typically stable properties that generate steady cash flows from leases, with a smaller portion of returns expected from capital appreciation.
These properties may require some form of enhancement or value-added element to achieve optimal returns, but the primary source of income is still the lease payments. On the other hand, investing in a startup company and value-add real estate investments are riskier, and their returns are less predictable. The returns from these investments are largely dependent on the appreciation of the property value or the success of the startup company rather than steady cash flows from leases.

A is incorrect. The main source of return for investing in a startup company is not derived from leases. Startups are typically not involved in real estate and do not generate income from leases. Instead, their returns are dependent on the success of the company's business model and its ability to generate profits.

C is incorrect. The main source of return for investing in a startup company is not derived from leases. As mentioned earlier, startups are typically not involved in real estate and do not generate income from leases. Furthermore, while value-add real estate investments do depend on property value appreciation for returns, core-plus holdings primarily generate returns from leases, not property value appreciation.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4399 Which of the following is *most likely* the primary reason that opportunistic real estate investments carry a higher level of risk compared to other types of real estate investments?

A. They involve a longer time horizon for returns.

B. They are typically located in less desirable locations.

C. They involve properties that are financially unstable or require significant development.

The correct answer is **C.**

Opportunistic real estate investments carry a higher level of risk primarily because they involve properties that are financially unstable or require significant development. These types of investments often involve distressed properties, such as those that are in poor condition or have been foreclosed on. These properties often require significant capital investment for renovations or development before they can be sold or rented out for a profit. This can involve a range of risks, including construction risks, regulatory risks, and market risks.

For example, construction costs may exceed initial estimates, regulatory approvals may be delayed or denied, or the real estate market may decline during the development period. Furthermore, these properties may not generate any income during the development period, increasing the financial risk for the investor. Therefore, while opportunistic real estate investments can offer high potential returns, they also carry a high level of risk due to the financial instability of the properties and the significant development required.

A is incorrect. While it is true that opportunistic real estate investments often involve a longer time horizon for returns, this is not the primary reason they carry a higher level of risk. The primary risk comes from the financial instability of the properties and the significant development required, not the length of the investment period.

B is incorrect. Opportunistic real estate investments do not necessarily involve properties in less desirable locations. In fact, these investments often involve properties in prime locations that are in poor condition or have been foreclosed on. The location of the property is not the primary factor that makes these investments riskier; it is the financial instability of the properties and the significant development required.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4401 In the context of real estate investments, which of the following statements is most accurate regarding the use of leverage?

A. Using leverage in real estate investments always leads to higher returns.

B. The performance of real estate investments is solely dependent on the market conditions at the time of purchase.

C. Leverage can amplify both gains and losses in real estate investments, and the returns can be influenced by factors such as management effectiveness and market conditions.

The correct answer is **C.**

Leverage can indeed amplify both gains and losses in real estate investments, and the returns can be influenced by factors such as management effectiveness and market conditions. This statement accurately reflects the complexity and risk associated with real estate investments. Leverage, or the use of borrowed capital to finance an investment, can increase the potential return on an investment, but it can also magnify losses if the investment does not perform as expected.

The performance of real estate investments is not solely dependent on market conditions at the time of purchase but also on a variety of other factors, including the effectiveness of the management of the property, the location of the property, the condition of the property, and the overall economic environment. Therefore, while leverage can enhance returns, it also increases risk, and successful real estate investing requires careful management and consideration of a variety of factors.

A is incorrect. While leverage can potentially increase the returns on real estate investments, it does not always lead to higher returns. Leverage also increases the risk of the investment, and if the investment does not perform as expected, the losses can be magnified. Therefore, the use of leverage must be carefully considered and managed.

B is incorrect. The performance of real estate investments is not solely dependent on the market conditions at the time of purchase. While market conditions can certainly influence the performance of real estate investments, there are many other factors that can also have a significant impact, including the location of the property, the condition of the property, the effectiveness of the management of the property, and the overall economic environment. Therefore, this statement is overly simplistic and does not accurately reflect the complexity of real estate investing.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4402 A property owner is considering a lease agreement that includes a clause for annual rent increases tied to the inflation rate. In this context, which of the following statements is *most accurate*:

A. Real estate always offers protection against inflation regardless of the lease agreement terms.

B. The ability of real estate to hedge against inflation is solely dependent on the terms of the lease agreement.

C. The ability of real estate to hedge against inflation can be influenced by factors such as the terms of the lease agreement, geographic location, market segment, and time period.

The correct answer is **C.**

The ability of real estate to hedge against inflation can indeed be influenced by a variety of factors, including the terms of the lease agreement, geographic location, market segment, and time period. While the terms of the lease agreement can play a significant role in determining the extent to which a property can serve as a hedge against inflation, they are not the only factor. For instance, properties in certain geographic locations or market segments may be more or less susceptible to inflationary pressures.
Similarly, the effectiveness of real estate as an inflation hedge can vary over different time periods, depending on macroeconomic conditions and other factors. Therefore, while lease terms are important, they are just one of several factors that can influence the ability of real estate to serve as a hedge against inflation.
A is incorrect. It is not accurate to say that real estate always offers protection against inflation regardless of the lease agreement terms. While real estate can often serve as a hedge against inflation, this is not always the case. The effectiveness of real estate as an inflation hedge can vary depending on a variety of factors, including the terms of the lease agreement, geographic location, market segment, and time period.

B is incorrect. The ability of real estate to hedge against inflation is not solely dependent on the terms of the lease agreement. While the lease terms can play a significant role, other factors such as geographic location, market segment, and time period can also influence the effectiveness of real estate as an inflation hedge. Therefore, it is not accurate to say that the lease terms are the only factor that matters.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4403 Which of the following is the *most accurate* statement regarding infrastructure investments?

A. Infrastructure investments are solely financed by the government and do not provide any return to private investors.

B. Infrastructure investments are simple and straightforward, requiring minimal understanding of market dynamics.

C. Infrastructure investments require a deep understanding of market dynamics and have seen a shift from public to private funding.

The correct answer is **C.**

Infrastructure investments can indeed be complex, requiring a deep understanding of market dynamics, and have seen a shift from public to private funding, offering new opportunities for investors. Infrastructure investments encompass a wide range of sectors, including public transportation, utilities, and information networks.

The financing of these investments has seen a significant shift from private corporations to government funding and more recently, back to private funding. This transition has created new opportunities for investors. However, these investments can be complex and require a deep understanding of market dynamics. Therefore, investors need to have a comprehensive understanding of the market, the specific sector, and the individual project to make informed investment decisions.

A is incorrect. Infrastructure investments are not solely financed by the government. While it is true that the government plays a significant role in infrastructure financing, private corporations and investors also contribute significantly. Moreover, infrastructure investments do provide returns to private investors. These returns can come in the form of dividends, interest payments, or capital gains, depending on the nature of the investment.

B is incorrect. Infrastructure investments are not simple and straightforward. They require a deep understanding of market dynamics, the specific sector, and the individual project. The complexity of these investments can be attributed to various factors, including the long-term nature of the projects, the involvement of multiple stakeholders, regulatory considerations, and the impact of economic and political factors.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (d): Explain the investment characteristics of infrastructure investments.

Q.4404 Which of the following is *most likely* the potential intentions of infrastructure investors in a public-private partnership (PPP)?

A. Immediately sell the assets back to the government after construction.

B. Hold the assets indefinitely without any intention of selling or leasing them back to the government.

C. Lease the assets back to the government, sell newly constructed assets to the government, or hold and operate the assets until they reach operational maturity.

The correct answer is **C.**

Infrastructure investors in a public-private partnership (PPP) typically have the intention to lease the assets back to the government, sell newly constructed assets to the government, or hold and operate the assets until they reach operational maturity. This is because infrastructure investments are long-term, capital-intensive projects that require significant upfront investment. The private sector partner in a PPP typically provides the necessary capital and expertise to design, build, and operate the infrastructure asset.

In return, they receive a return on their investment through a combination of user fees, lease payments, or the sale of the asset to the government. This allows the public sector to benefit from the private sector's efficiency and innovation while the private sector benefits from a stable, long-term revenue stream. Therefore, the intentions of infrastructure investors in a PPP are aligned with the long-term nature of these projects and the need for a return on their investment.

A is incorrect. Infrastructure investors in a PPP do not typically intend to immediately sell the assets back to the government after construction. This is because the return on investment in infrastructure projects is typically realized over a long period of time through user fees, lease payments, or the eventual sale of the asset. Selling the asset immediately after construction would not allow the investor to recoup their initial investment or earn a return.

B is incorrect. While some infrastructure investors may choose to hold the assets indefinitely, this is not typically the intention in a PPP. The private sector partner in a PPP usually intends to recoup their investment and earn a return through user fees, lease payments, or the sale of the asset to the government. Holding the assets indefinitely without any intention of selling or leasing them back to the government would not provide a return on investment.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4405 In the context of infrastructure investments, which of the following is *most likely* the role of development finance institutions? They:

A. Provide risk capital for economic development projects on a non-commercial basis.

B. Provide loans to governments for infrastructure projects at commercial interest rates.

C. Act as intermediaries between the government and private investors, facilitating the sale of infrastructure assets.

The correct answer is **A.**

Development finance institutions (DFIs) play a crucial role in infrastructure investments. They provide risk capital for economic development projects on a non-commercial basis. DFIs are usually government-controlled and aim to promote economic growth and development, particularly in developing countries. They do this by providing finance for projects that are considered too risky or unprofitable for commercial lenders.
These projects often involve infrastructure development, such as building roads, bridges, hospitals, and schools. By providing risk capital, DFIs help to attract additional private sector investment, thereby leveraging their own resources. They also help to mitigate risks associated with these projects, making them more attractive to private investors. DFIs play a crucial role in bridging the gap between public and private finance, and their involvement can be a key factor in the success of infrastructure projects.
B is incorrect. While DFIs do provide loans for infrastructure projects, they do not typically do so at commercial interest rates. Instead, they offer more favorable terms, including lower interest rates and longer repayment periods, to make these projects more feasible.

C is incorrect. DFIs do not act as intermediaries between the government and private investors, facilitating the sale of infrastructure assets. Their role is more focused on providing finance and mitigating risks, rather than facilitating transactions.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (c): Explain features and characteristics of infrastructure.

Q.4406 Economic infrastructure investments play a crucial role in the functioning of an economy. They encompass a wide range of assets, each with its unique characteristics and risks. Consider the following scenarios:
Scenario 1: A toll road operator whose income is dependent on the number of vehicles using the road.
Scenario 2: A data center owner who earns revenue by providing storage and transmission services.
Scenario 3: A utility company that generates power and provides potable water with a "take-or-pay" arrangement with its buyers.
Which of these scenarios *most likely* susceptible to market risk in the context of economic infrastructure investments?

A. Scenario 1.

B. Scenario 2.

C. Scenario 3.

The correct answer is **A.**

Market risk, also known as systematic risk, is the risk that the value of an investment will decrease due to changes in market factors. In the context of economic infrastructure investments, market risk can be illustrated by the toll road operator scenario. The toll road operator's income is directly dependent on the number of vehicles using the road.
This means that any changes in the market, such as economic downturns, changes in consumer behavior, or competition from other transport routes, can significantly impact the operator's revenue. For example, during an economic downturn, people might choose to travel less or use alternative routes to save money, leading to a decrease in the toll road operator's income. This scenario best illustrates the concept of market risk because it shows how changes in the market can directly impact the revenue of an infrastructure investment.
B is incorrect. While the data center owner also faces market risk, it is not as directly impacted by changes in the market as the toll road operator. The demand for data storage and transmission services is less likely to fluctuate with changes in the market, making this scenario less illustrative of market risk.

C is incorrect. The utility company scenario does not illustrate market risk well because it has a "take-or-pay" arrangement with its buyers. This means that the buyers are obligated to pay for a certain amount of power and water, regardless of whether they use it or not. This arrangement shields the utility company from market fluctuations, reducing its exposure to market risk.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (c): Explain features and characteristics of infrastructure.

Q.4407 Which of the following are *most likely* the factors on which the income from social infrastructure investments depends?

A. Number of facilities and the type of services provided by the public authority.

B. Private service providers contracted by the public authority and the type of public infrastructure.

C. Availability payments and the management and maintenance of the asset according to predefined standards.

The correct answer is **C.**

The income from social infrastructure investments typically depends on the availability of payments and the management and maintenance of the asset according to predefined standards. Availability payments are a type of lease payment that is made by a public authority to a private entity to make a facility available for public use. These payments are typically made on a regular basis, such as monthly or annually, and are contingent on the facility being available for use and maintained to a certain standard.

The income from social infrastructure investments is, therefore, directly linked to the availability of the facility and the quality of its management and maintenance. This model provides a steady and predictable income stream for investors while also incentivizing the private entity to maintain the facility to a high standard. It also aligns the interests of the public and private sectors, as both benefit from the successful operation of the facility.

A is incorrect. While the number of facilities and the type of services provided by the public authority may influence the overall level of investment in social infrastructure, they do not directly determine the income from individual investments. The income from each investment is primarily determined by the availability of payments and the management and maintenance of the asset, as explained above.

B is incorrect. The private service provider contracted by the public authority and the type of public infrastructure may influence the terms of the contract and the level of investment required, but they do not directly determine the income from the investment. The income is primarily determined by the availability of payments and the management and maintenance of the asset.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (d): Explain the investment characteristics of infrastructure investments.

Q.4408 Which of the following *best* describes a scenario where a company decides to invest in the construction of a new railway line on a previously undeveloped land?

A. Brownfield investment.

B. Secondary-stage investment.

C. Greenfield investment.

The correct answer is **C.**

The scenario where a company decides to invest in the construction of a new railway line on previously undeveloped land is best described as a greenfield investment. Greenfield investments refer to the development of new infrastructure on unused land. In this case, the company is investing in the construction of a new railway line, which is a new infrastructure, and the land on which the railway line is being constructed is previously undeveloped, which means it is unused land.

Therefore, this scenario fits the definition of a greenfield investment. Greenfield investments are often associated with higher risks and potential returns than other types of infrastructure investments, as they involve the development of new infrastructure from scratch and may face uncertainties related to construction, regulatory approvals, and market demand.

A is incorrect. A brownfield investment refers to the redevelopment or further development of existing infrastructure on a site that has been previously used. In this scenario, the company is not redeveloping or further developing existing infrastructure but rather constructing new infrastructure on previously undeveloped land. Therefore, this scenario does not fit the definition of a brownfield investment.

B is incorrect. Secondary-stage investments involve the expansion or upgrading of existing infrastructure. In this scenario, the company is not expanding or upgrading existing infrastructure but rather constructing new infrastructure on previously undeveloped land. Therefore, this scenario does not fit the definition of a secondary-stage investment.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (c): Explain features and characteristics of infrastructure.

Q.4409 A multinational corporation is considering an investment opportunity in a developing country. The investment involves the expansion of an existing power plant. The corporation is attracted to this opportunity due to the shorter investment period, immediate cash flows, and the availability of the asset's financial and operating history.
Which of the following is *most likely* the type of investment that the corporation is considering?

A. Greenfield Investment.

B. Brownfield Investment.

C. Bluefield Investment.

The correct answer is **B.**

The type of investment the corporation is considering is a Brownfield Investment. Brownfield investments are those where a company or government entity purchases or leases existing production facilities to launch a new production activity. This is faster and cheaper than a Greenfield investment, which involves building new facilities. In this case, the corporation is considering expanding an existing power plant, which is a classic example of a brownfield investment. The immediate cash flows and the availability of the asset's financial and operating history are key advantages of brownfield investments. These investments are often sought after by strategic investors who specialize in operating the assets and financial investors who are focused on long-term, stable returns. Brownfield investments also carry less risk than greenfield investments because they involve using established facilities and operations.
A is incorrect. A Greenfield Investment is a type of foreign direct investment where a parent company builds its operations in a foreign country from the ground up. In addition to the construction of new production facilities, these projects can also include the building of new distribution hubs, offices, and living quarters. This is not the case in the scenario described in the question, where the corporation is considering expanding an existing power plant.

C is incorrect. There is no such thing as a Bluefield Investment in the context of international business or finance. The term does not exist and is, therefore, not the correct answer.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (b): Explain the investment characteristics of real estate investments.

Q.4410 A company is considering investing in an infrastructure project. They are evaluating the risks and rewards associated with different stages of infrastructure development. If the company is willing to take on higher risks due to uncertainties in construction and commissioning in exchange for potentially higher returns, which type of investment should it consider?

A. Brownfield investments.

B. Greenfield investment in a new project.

C. Secondary-stage investment in an operational asset.

The correct answer is **B.**

Greenfield investment in a new project is the correct choice for a company willing to take on higher risks due to uncertainties in construction and commissioning in exchange for potentially higher returns. Greenfield investments involve the construction of new infrastructure from scratch, which inherently carries a higher level of risk due to uncertainties in construction, commissioning, and initial operation. These uncertainties can include cost overruns, delays, technical problems, and regulatory hurdles, among others. However, if these risks are successfully managed, Greenfield investments can offer higher returns due to the value created through the development and operation of new infrastructure. This type of investment is typically suited for investors with a higher risk tolerance and a long-term investment horizon.

A is incorrect. Brownfield investments involve the expansion of existing facilities and may involve the privatization of public assets or a sale-leaseback of completed greenfield projects. For example, a company might invest in expanding an existing airport or upgrading a power plant. These investments are characterized by a shorter investment period with immediate cash flows and an operating history. brownfield investments may be sought after by both strategic investors specializing in operating the assets and financial investors focused on long-term, stable returns, especially with privatizations.

C is incorrect. Secondary-stage investment in an operational asset is typically associated with lower risks and potentially lower returns. This is because the infrastructure is already built and operational, and the risks associated with construction and commissioning have been largely eliminated. The returns from this type of investment are typically derived from the stable cash flows generated by the operational asset, rather than the value creation associated with new development.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (d): Explain the investment characteristics of infrastructure investments.

Q.4411 A private investor is interested in infrastructure investments but is concerned about liquidity and diversification. He is also looking for benefits such as reasonable fees, transparent governance, observable market prices, and transparent pricing. Which type of infrastructure investment would be *most suitable* for this investor?

A. Master Limited Partnerships.

B. Direct Infrastructure Investment.

C. Publicly Traded Infrastructure Securities.

The correct answer is **C.**

Publicly Traded Infrastructure Securities would be the most suitable type of infrastructure investment for this private investor. These securities offer a high degree of liquidity and diversification, as they are traded on public exchanges and represent a broad range of infrastructure assets. They also offer transparent governance and observable market prices, as they are subject to the same regulatory oversight and disclosure requirements as other publicly traded securities.
The fees associated with investing in publicly traded infrastructure securities are typically lower than those for direct infrastructure investments or Master Limited Partnerships, as they do not involve the same level of management and operational complexity. Furthermore, the pricing of these securities is transparent, as it is determined by the market rather than by a private valuation process. Therefore, publicly traded infrastructure securities meet all of the investor's criteria and would be the most suitable choice.
B is incorrect. Master Limited Partnerships (MLPs) are a type of investment vehicle that invests in energy infrastructure assets. While MLPs offer some benefits, such as tax advantages and high-income potential, they also have significant drawbacks. These include illiquidity, lack of diversification, high fees, complex governance structures, and opaque pricing. Therefore, they would not be suitable for this investor.

A is incorrect. Direct Infrastructure Investment involves investing directly in infrastructure assets, such as toll roads, airports, or utilities. While this can offer high potential returns, it also involves significant risks and challenges, including illiquidity, lack of diversification, high fees, and complex governance and pricing structures. Therefore, it would not be suitable for this investor.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (d): Explain the investment characteristics of infrastructure investments.

Q.4412 Consider a scenario where you are an investment advisor for a multinational corporation looking to invest in infrastructure projects in developing economies. If the corporation is considering building a new port in a rapidly growing coastal city, what could be the potential return opportunity for this investment?

A. Minimal as the city's trade may not increase significantly over time.

B. Substantial as the city's trade is expected to increase over time, yielding significant returns.

C. Moderate as the city's trade may increase, but not enough to yield significant returns.

The correct answer is **B.**

The potential return opportunity for this investment could be substantial as the city's trade is expected to increase over time, yielding significant returns. Infrastructure projects, particularly greenfield projects like building a new port, are long-term investments that can yield substantial returns over time. The rapidly growing coastal city is likely to see an increase in trade over time, which would increase the usage of the port and, consequently, the revenues generated from it.
The growth in trade could be driven by factors such as economic development, population growth, and increased connectivity with other regions. The port could also stimulate further economic activity in the city, creating a virtuous cycle of growth and increasing returns. However, it's important to note that while the potential returns are substantial, so are the risks. These could include construction risks, regulatory risks, and demand risks, among others. Therefore, a thorough risk assessment and due diligence are crucial before making such an investment.
A is incorrect. The assumption that the city's trade may not increase significantly over time is not consistent with the scenario of a rapidly growing coastal city. Rapid growth typically implies increasing economic activity, which would likely include trade. Therefore, the return opportunity is unlikely to be minimal.

C is incorrect. While it's possible that the city's trade may increase but not enough to yield significant returns, this is less likely in the context of a rapidly growing city. Rapid growth typically implies a high rate of economic development, which would likely lead to a substantial increase in trade and, consequently, significant returns from the port investment.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (d): Explain the investment characteristics of infrastructure investments.

Q.4413 If an investor is seeking the most stable returns from infrastructure funds, which type of investment is *most likely* appropriate?

A. Bonds issued by utility companies.

B. Direct equity ownership in a privately-held toll road company.

C. Assets backed by stable long-term concession arrangements, such as a toll road with a 30-year operating license

The correct answer is **C.**

Assets backed by stable long-term concession arrangements, such as a toll road with a 30-year operating license, are the most suitable for an investor seeking the most stable returns from infrastructure funds. These types of investments offer a predictable and stable cash flow over a long period of time, which can provide a steady return on investment.
The long-term concession arrangements provide a degree of certainty about the future income stream, which reduces the risk associated with the investment. Furthermore, these types of investments are often regulated, which can provide additional protection for investors. The stability of these investments makes them an attractive option for investors seeking stable returns from infrastructure funds.
A is incorrect. Bonds issued by utility companies are more liquid and less risky, but they offer lower potential returns. While these types of investments can provide a steady income stream, the returns are typically lower than those offered by other types of infrastructure investments. Therefore, they may not be the best choice for an investor seeking the most stable returns from infrastructure funds.

B is incorrect. Direct equity ownership in a privately held toll road company can offer high returns, but it also carries significant risk due to its illiquidity. This type of investment is less liquid and more risky, which makes it less suitable for an investor seeking stable returns.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (d): Explain the investment characteristics of infrastructure investments.

Q.4415 Based on the characteristics of infrastructure investments, which of the following statements is *most accurate*?

A. Infrastructure investments offer no protection against changes in GDP growth and inflation.

B. Infrastructure investments typically have a high correlation with public market equities and are highly susceptible to economic downturns.

C. Infrastructure investments offer a lower correlation with public market equities and the broader economy, provide some protection for changes in GDP growth, and offer some protection against inflation.

The correct answer is **C.**

Infrastructure investments offer a lower correlation with public market equities and the broader economy, provide some protection for changes in GDP growth, and offer some protection against inflation. Infrastructure investments are typically long-term, illiquid assets that provide essential services, such as transportation, utilities, and telecommunications. These assets often have stable, predictable cash flows that are less susceptible to short-term market fluctuations and economic downturns.

Furthermore, many infrastructure assets have pricing mechanisms that are linked to inflation, providing some protection against inflation risk. Additionally, the demand for these services is often relatively inelastic, meaning it does not change significantly with changes in GDP growth. Therefore, infrastructure investments can provide a degree of diversification and risk mitigation in an investment portfolio.

A is incorrect. While infrastructure investments are not completely immune to economic downturns or market fluctuations, they typically have a lower correlation with public market equities and the broader economy than other types of investments. This is due to the stable, predictable cash flows and essential nature of the services provided by infrastructure assets.

B is incorrect. Infrastructure investments do offer some protection against changes in GDP growth and inflation. The demand for the services provided by infrastructure assets is often relatively inelastic, providing some protection against changes in GDP growth. Furthermore, many infrastructure assets have pricing mechanisms that are linked to inflation, providing some protection against inflation risk.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (d): Explain the investment characteristics of infrastructure investments.

Q.4416 Which of the following statements about infrastructure debt is *most accurate*?

A. Highly subject to fluctuation over the economic cycle.

B. Experiences higher default rates and lower recovery than similar fixed-income instruments.

C. Experiences lower default rates and higher recovery than similar fixed-income instruments, and it is less subject to fluctuation over the economic cycle.

The correct answer is **C.**

Infrastructure debt tends to experience lower default rates and higher recovery than similar fixed-income instruments, and it is less subject to fluctuation over the economic cycle. Infrastructure debt is a type of investment that involves lending money to companies or governments for the construction or maintenance of infrastructure projects such as roads, bridges, airports, utilities, and telecommunications systems. These projects typically have long lifespans and generate stable, predictable cash flows, which makes them attractive to investors like pension funds that have long-term liabilities.

Furthermore, infrastructure projects are often backed by government or regulatory support, which reduces the risk of default. Even in the event of a default, the recovery rates for infrastructure debt are typically higher than for other types of fixed-income instruments because the underlying assets have intrinsic value. Finally, the cash flows from infrastructure projects are less subject to fluctuation over the economic cycle because they provide essential services that are in demand regardless of the state of the economy.

A is incorrect. Infrastructure debt is not highly subject to fluctuation over the economic cycle. The cash flows from infrastructure projects are relatively stable and predictable, and the demand for the services they provide is not highly sensitive to changes in the economy.

B is incorrect. Infrastructure debt does not tend to experience higher default rates and lower recovery than similar fixed-income instruments. As explained above, the nature of infrastructure projects and the regulatory support they often receive make them less risky and more resilient than other types of investments.

CFA Level I, Alternative Investments, Learning Module 4: Real Estate and Infrastructure. LOS (d): Explain the investment characteristics of infrastructure investments.

Learning Module 5: Natural Resources

Q.1084 The sources of commodities futures return can be *best* described to be from:

A. Roll yield only.

B. Roll yield and collateral yield.

C. Roll yield, collateral yield, and change in spot prices.

The correct answer is **C.**

The three sources of commodities futures returns are roll yield, collateral yield, and change in spot prices.

Roll yield refers to the difference between a commodity’s spot price and the price specified by its futures contract. The collateral yield component of commodity index returns is the interest earned on the collateral posted as a good-faith deposit for the futures contracts. The change in spot prices is the relationship between current supply and demand.

A is incorrect. It suggests that roll yield is the only source of commodities futures return. While roll yield is a significant factor, it does not account for the other critical components like collateral yield and changes in spot prices, which can also significantly impact the overall return on a commodities futures investment.

B is incorrect. It includes roll yield and collateral yield but omits the change in spot prices as a source of return. This overlooks a fundamental aspect of commodities trading, where price movements based on supply and demand dynamics are a primary driver of profitability. By not considering the change in spot prices, this option fails to capture the full spectrum of factors that contribute to the returns from commodities futures.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (b): Describe features of commodities and their investment characteristics.

Q.1248 Having physical commodities for use over the period of futures contracts is *most likely* called:

A. Backwardation.

B. Convenience yield.

C. Commodities yield.

The correct answer is **B.**

Convenience yield is the return or benefit derived from holding physical commodities in the short term, which includes the availability of the commodity when it is needed, storage convenience, and other factors that make holding the physical commodity more advantageous than holding a futures contract. This is in contrast to backwardation, which is a situation where the futures price is lower than the spot price, typically indicating a shortage in the market, and commodities yield, which is not a widely used term in commodity markets.

A is incorrect. Backwardation is a term used in futures markets to describe a situation where the futures price of a commodity is lower than the spot price. This typically occurs when there is a current shortage of the commodity in the market, leading to higher demand for the available physical product and, as a result, a higher spot price than the futures price.

C is incorrect. Commodities yield is not a commonly used term in commodity markets, and it is not a concept that is widely recognized or defined in the context of commodity trading.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (b): Describe features of commodities and their investment characteristics.

Q.1249 A situation where futures prices are lower than the spot prices because of high convenience yields is *most likely* called:

A. Roll yield.

B. Contango.

C. Backwardation.

The correct answer is **C.**

In backwardation, the convenience yield is high, and futures prices are lower than the spot prices.

A is incorrect. Roll yield refers to the difference between a commodity's spot price and the price specified by its futures contract or the difference between two futures contracts with different expiration dates.

B is incorrect. Contango is when futures prices are higher than the spot price.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (b): Describe features of commodities and their investment characteristics.

Q.3277 An analyst is writing a report on timberlands and farmlands. He includes the following statements in his report: Statement 1: "Unlike timberlands, the primary return driver of farmlands is land price changes only." Statement 2: "A portfolio manager seeking to diversify his portfolio should seek to avoid timberlands." Is the analyst correct?

A. No.

B. Only with respect to Statement 1.

C. Only with respect to Statement 2.

The correct answer is **A.**

The analyst is incorrect with respect to both statements. Both timberlands and farmlands have three primary return drivers: harvest quantities,commodity prices, and land price changes.

A portfolio manager seeking to diversify his portfolio should consider timberland as this asset class is not highly correlated with other asset classes.

B is incorrect. The primary return drivers for both timberlands and farmlands include more than just land price changes. For timberlands, the returns can be attributed to biological growth, timber prices, and land value appreciation. Biological growth increases the volume of timber available for harvest, which can lead to higher revenue when the timber is sold. Timber prices can fluctuate based on supply and demand dynamics in the market, affecting the revenue from timber sales. Land value appreciation can occur due to various factors, including changes in land use or improvements made to the land. Similarly, farmlands also benefit from crop yield (analogous to biological growth in timberlands), commodity prices, and land value appreciation. Crop yield depends on the farm's productivity, while commodity prices are influenced by global supply and demand for agricultural products. Therefore, stating that the primary return driver for farmlands is only land price changes overlooks the significant impact of crop yields and commodity prices on returns.

C is incorrect. Avoiding timberlands for portfolio diversification purposes is not advisable. Timberlands have been shown to have a low correlation with traditional financial assets like stocks and bonds, making them an excellent choice for diversification. The unique characteristics of timberlands, such as biological growth and the ability to delay harvests until market conditions are favorable, provide a hedge against inflation and market volatility. Including timberlands in a diversified portfolio can reduce overall risk and improve returns over the long term. The analyst's recommendation to avoid timberlands disregards the benefits they can offer in terms of diversification and risk management.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (c): Analyze sources of risk, return, and diversification among natural resource investments.

Q.3279 An investor with a small asset base and moderate financial wealth would like to invest in an alternative asset class which is liquid, provides opportunities for diversification, and requires minimal active involvement. The investor will *most likely* select a:

A. Hedge fund.

B. Private equity fund.

C. Commodity-producing company's stocks.

The correct answer is **C.**

The investor will most likely select the common stock of a commodity-producing company for investment. Commodity investments provide the opportunity for diversification. Investments in commodity-producing companies allow small investors to invest little to moderate amounts of funds in these stocks. Furthermore, commodities are effective for portfolio diversification due to their low correlation with other asset classes. Also, publically traded common stocks can easily be sold and are relatively liquid.

A is incorrect. Hedge funds generally impose restrictions on redemptions. Investors may be required to keep their money in the hedge fund for a minimum period (lockup period) and may be charged a fee to redeem their shares. This makes hedge fund investments a relatively illiquid form of investment. Furthermore, hedge funds are restricted to large, wealthy investors who can invest substantial sums of money.

B is incorrect. Private equity funds require their investors to be patient. Private equity requires a long-term commitment from limited partners because of the long time lag between investments in and exits from portfolio companies. Thus, this is not a suitable investment alternative for investors averse to illiquidity.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (b): Describe features of commodities and their investment characteristics.

Q.3900 When a future price is below the expected spot price for a particular commodity, the market is *most likely* in:

A. Contango.

B. Backwardation.

C. Premium buying.

The correct answer is **B.**

Backwardation is a term used in futures trading to describe a market where the price of a futures contract is trading below the expected spot price of the underlying asset at the contract's expiration date. This situation can occur when the market anticipates a shortage of the underlying asset in the future, causing the futures price to be bid up relative to the spot price. As a result, buyers of futures contracts are willing to pay a premium for the ability to lock in the lower price, rather than paying the expected higher spot price at a later date.

A is incorrect. Contango is the opposite of backwardation and occurs when the futures price of a commodity is higher than the expected spot price at the contract's expiration date. This situation can occur when the market expects an oversupply of the underlying asset in the future, causing the futures price to be bid down relative to the spot price.

C is incorrect. Premium buying is a term used in options trading to describe a situation where an investor purchases an option contract at a premium price in anticipation of a favorable price move in the underlying asset. It is not directly related to futures market conditions like backwardation or contango.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (b): Describe features of commodities and their investment characteristics.

Q.4229 Returns from investing in commodities *most likely* arise from which of the following?

A. Price changes.

B. Regular income from interests and dividends.

C. Price changes and periodic income from interests and dividends.

The correct answer is **A.**

Returns from investing in commodities mainly come from the price changes of the commodity. Commodities are physical goods that have intrinsic value based on supply and demand dynamics, which can be affected by factors such as economic growth, geopolitical events, weather conditions, and technological advancements.

Investors buy commodities in the hope that the price will increase over time, allowing them to sell the commodity at a higher price than they bought it for and earn a profit.

B and C are incorrect. Unlike stocks or bonds, commodities typically do not generate regular income through interest or dividends. Commodities are physical assets that do not generate cash flows like interest or dividends, and therefore, investors in commodities do not usually receive regular income from holding commodities.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (b): Describe features of commodities and their investment characteristics.

Q.4465 An investor is considering diversifying their portfolio by investing in land assets. They are particularly interested in timberland and are considering the United States, Central and Eastern Europe, Latin America, Australia, and New Zealand as potential locations. The investor is aware that these investments are unique and illiquid, and that the value of the resource is significantly influenced by its geographic location and features. However, they lack the specialized knowledge and understanding required to manage a forest over its life cycle.
Which of the following would be the *most likely* course of action for the investor?

A. Invest in a real estate property instead, as it offers a wide variety of financing alternatives and is not as illiquid as land assets.

B. Invest directly in timberland in the United States, as it is estimated that nearly half of private investable timberland globally is located there.

C. Rely on a timberland investment management organization (TIMO) to manage their investments in timberland and acquire suitable timberland holdings.

The correct answer is **C.**

Given the investor's lack of specialized knowledge and understanding required to manage a forest over its life cycle, the most suitable course of action would be to rely on a Timberland Investment Management Organization (TIMO). TIMOs are professional organizations that serve as intermediaries between institutional investors and the timberland market. They provide a range of services, including acquisition and disposition of timberland assets, forest management, and marketing of forest products.

By investing through a TIMO, the investor can leverage the organization's expertise in managing timberland assets and navigating the complexities of the timberland market. This can help the investor achieve their investment objectives while mitigating the risks associated with direct ownership of timberland assets. Furthermore, TIMOs can provide access to a diversified portfolio of timberland assets across different geographic locations, further enhancing the risk-return profile of the investment.

A is incorrect. While it is true that the United States holds a significant portion of private investable timberland globally, direct investment in timberland requires specialized knowledge and understanding of forest management, which the investor lacks. Therefore, direct investment in timberland, regardless of the location, may not be the most suitable course of action for the investor.

B is incorrect. While real estate property may offer a wide variety of financing alternatives and may not be as illiquid as land assets, it does not meet the investor's interest in diversifying their portfolio by investing in land assets, specifically timberland. Therefore, investing in a real estate property may not align with the investor's investment objectives.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (c): Analyze sources of risk, return, and diversification among natural resource investments.

Q.4466 In the context of various aspects of farmland and timberland investments, which of the following statements is *least likely* true?

A. Farmland is immune to unexpected weather changes and climate developments, and these factors do not have any significant impact on the crop yield or revenue.

B. Farmland and timberland investments generate returns from selling crops and timber, and the value of the land may also change over time, contributing to the return on these investments.

C. Smaller investors typically invest in timber and farmland through investment funds, such as real estate investment trusts (REITs) in the United States, or administered privately through limited partnerships.

The correct answer is **A.**

The statement that "Farmland is immune to unexpected weather changes and climate developments, and these factors do not have any significant impact on the crop yield or revenue" is not true. Farmland and timberland investments are indeed subject to a variety of risks, and one of the most significant among them is the risk associated with weather changes and climate developments. Weather conditions and climate changes can have a profound impact on the yield of crops and timber, which in turn affects the revenue and returns from these investments.

Drought, floods, storms, and other extreme weather events can damage crops and timber, reducing their yield and quality. Changes in climate can also affect the suitability of land for certain types of crops or timber, potentially reducing its value. Therefore, investors in farmland and timberland need to carefully consider these risks and take appropriate measures to manage them.

B is incorrect. The statement that "Farmland and timberland investments generate returns from selling crops and timber, and the value of the land may also change over time, contributing to the return on these investments" is true. These investments generate income from the sale of crops and timber, and the value of the land can also appreciate over time, providing capital gains.

C is incorrect. The statement that "Smaller investors typically invest in timber and farmland through investment funds, such as real estate investment trusts (REITs) in the United States, or administered privately through limited partnerships" is also true. These investment vehicles provide a way for smaller investors to gain exposure to these asset classes without having to directly own and manage farmland or timberland.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (c): Analyze sources of risk, return, and diversification among natural resource investments.

Q.4467 An investor is considering investing in commodities, and he is particularly interested in gold. In order to profit from this investment, the investor should wait for the gold's price to:

A. depreciate, which should ideally exceed the cost of carry.

B. appreciate, which should ideally exceed the cost of carry.

C. appreciate, which should ideally be less than the cost of carry.

The correct answer is **B.**

The investor should primarily aim for the gold's price to appreciate, which should ideally exceed the cost of carry. Investing in commodities, such as gold, is fundamentally different from investing in traditional assets like stocks and bonds. Commodities do not generate cash flows, and instead, they often incur costs associated with transportation, storage, and insurance. These costs are collectively referred to as the cost of carry. To profit from investing in commodities, an investor must hope for the price of the commodity to appreciate over time.

This price appreciation should ideally be greater than the cost of carry., as the cost of carry. represents a drain on the investor's potential returns. If the price appreciation is less than the cost of carry, the investor would incur a net loss on the investment. Therefore, the primary aim of an investor in commodities should be for the price of the commodity to appreciate by an amount that exceeds the cost of carry.

A is incorrect. If the investor aims for the gold's price to depreciate, they would incur a loss on their investment. This is because the investor would be selling the gold for less than what they initially paid for it, which is not a profitable strategy.

B is incorrect. If the gold's price appreciation is less than the cost of carry, the investor would not make a profit. The cost of carry represents a drain on the investor's potential returns, and if the price appreciation does not exceed this cost, the investor would incur a net loss on the investment.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (b): Describe features of commodities and their investment characteristics.

Q.4468 Governments worldwide are implementing environmental safeguards to meet climate objectives and control activities with significant climate impacts, such as mining, agriculture, and energy extraction and production. The policy objective of reducing reliance on fossil fuels has led to a shift in focus towards electric vehicles and advances in battery technology.
Which of the following is the *most likely* potential impact of this shift on the demand for certain minerals and metals?

A. Lower demand for minerals and metals such as lithium, cobalt, and nickel.

B. Higher demand for minerals and metals such as lithium, cobalt, and nickel.

C. No effect on the demand for minerals and metals such as lithium, cobalt, and nickel.

The correct answer is **B.**

The shift towards electric vehicles and advances in battery technology can lead to higher demand for minerals and metals such as lithium, cobalt, and nickel. These minerals and metals are key components in the production of batteries for electric vehicles. Lithium is used in the production of lithium-ion batteries, which are commonly used in electric vehicles due to their high energy density and long life span. Cobalt and nickel are also used in these batteries to improve their performance and safety.
A is incorrect. The shift towards electric vehicles and advances in battery technology is not expected to lead to lower demand for minerals and metals such as lithium, cobalt, and nickel. On the contrary, as explained above, this shift is expected to increase the demand for these resources.

C is incorrect. The shift towards electric vehicles and advances in battery technology is expected to have a significant impact on the demand for minerals and metals such as lithium, cobalt, and nickel. As explained above, these resources are key components in the production of batteries for electric vehicles, and as such, their demand is expected to increase as the demand for electric vehicles increases.

Q.4469 Which of the following statements is most likely true regarding exchange-traded products (ETPs), commodity trading advisers (CTAs), and specialized funds as alternative methods of gaining commodity exposure?

A. Exchange-traded products (ETPs) cannot invest in commodities or commodity futures and do not charge fees included in their expense ratios.

B. Specialized funds investing involves direct or indirect claims to physical assets themselves and not claims on residual (equity) or fixed (debt) cash flows. This indirect approach comes with the added risks from financing and operations and, when privately held, the impact of additional illiquidity.

C. Commodity trading advisers (CTAs) are managed futures funds that make directional investments primarily in futures markets based on technical and fundamental strategies. Individual investors cannot establish accounts that are managed in accordance with their specific investment preferences and risk tolerance.

The correct answer is **B.**

Specialized funds investing in specific commodity sectors, such as private energy partnerships, enable institutional exposure to the energy sector. These investments usually involve direct or indirect claims to physical assets themselves and not claims on residual (equity) or fixed (debt) cash flows. However, this indirect approach comes with the added risks from financing and operations and, when privately held, the impact of additional illiquidity.
This statement is true because specialized funds allow investors to gain exposure to specific sectors of the commodity market. These funds often invest in physical assets, which can provide a more direct exposure to the commodity market. However, this approach also comes with additional risks, including financing and operational risks, as well as the risk of illiquidity, especially for privately held investments.

A is incorrect. Exchange-traded products (ETPs) can indeed invest in commodities or commodity futures. ETPs such as Exchange-Traded Funds (ETFs) and Exchange-Traded Notes (ETNs) can provide exposure to a wide range of asset classes, including commodities. They also charge fees, which are included in their expense ratios. Therefore, the statement is incorrect.

C is incorrect. Commodity trading advisers (CTAs) are managed futures funds that make directional investments primarily in futures markets based on technical and fundamental strategies. However, it is not true that individual investors cannot establish accounts that are managed in accordance with their specific investment preferences and risk tolerance. Many CTAs offer managed accounts, which can be tailored to the individual investor's risk tolerance and investment objectives. Therefore, this statement is incorrect.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (b): Describe features of commodities and their investment characteristics.

Q.4470 An investor is considering investing in commodities using derivative instruments. They are particularly interested in a futures contract for gold, expecting the price of gold to rise in the future. If the investor expects a high convenience yield due to a preference for holding the physical commodity, how would this *most likely* impact the forward price?

A. No impact on the forward price.

B. Forward price would decrease.

C. Forward price would increase.

The correct answer is **B.**

The forward price would decrease due to the high convenience yield. The convenience yield is the non-monetary advantage or benefit that a holder of the physical commodity, in this case, gold, derives from the direct ownership of the commodity. It could be due to factors such as the ability to meet unexpected demand, avoiding costs of storage, or ensuring supply during times of shortages. The convenience yield represents the benefits of holding the physical commodity, which is foregone when holding a futures contract instead. Therefore, a higher convenience yield makes the futures contract less attractive, leading to a lower forward price.

A is incorrect. The convenience yield does have an impact on the forward price. It is a component of the formula for the forward price and represents the benefits of holding the physical commodity, which are foregone when holding a futures contract. Therefore, a change in the convenience yield would affect the forward price.

C is incorrect. The forward price would not increase due to the high convenience yield. As explained above, the convenience yield is subtracted from the risk-free rate in the formula for the forward price. Therefore, an increase in the convenience yield would decrease, not increase, the forward price.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (b): Describe features of commodities and their investment characteristics.

Q.4471 Which of the following *best* describes the difference between soft and hard commodities?

A. Soft commodities are less volatile in price than hard commodities.

B. Soft commodities are traded more frequently than hard commodities.

C. Soft commodities are agricultural products, while hard commodities include energy and minerals.

The correct answer is **C.**

Soft commodities specifically refer to agricultural products such as crops and livestock, known for being grown and harvested. In contrast, hard commodities include mined or extracted resources like oil, gas, and metals. This fundamental difference in nature and source is what primarily distinguishes the two categories, with soft commodities being renewable and hard commodities generally being non-renewable.

B is incorrect. The trading frequency of commodities is not the primary factor distinguishing soft and hard commodities. Instead, it's their nature and source that set them apart.

A is incorrect. While price volatility can vary between soft and hard commodities, it's not the defining characteristic that differentiates them. Both categories can experience significant price fluctuations based on market conditions.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (b): Describe features of commodities and their investment characteristics.

Q.4472 Which of the following is *most likely* a benefit of farmland investment?

A. High liquidity and low return.

B. Suitable for speculative purposes rather than a long-term investment.

C. There is a potential for regular income through crop sales and lease payments.

The correct answer is **C.**

Farmland can be a valuable component of an investment portfolio, particularly due to its potential for regular income generation. This income can come from the sale of crops grown on the land or through lease payments from farmers. Additionally, farmland can appreciate in value over time, potentially offering capital gains. The nature of farmland as a tangible asset with a fundamental role in food production can make it a stable investment, especially during times of economic uncertainty.

A is incorrect. Farmland investments are typically illiquid, meaning they cannot be quickly converted into cash without a significant loss in value. They are also seen as long-term investments rather than quick, high-return opportunities.

B is incorrect. While all investments carry some level of speculation, farmland is often valued for its long-term investment potential rather than for speculative trading.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (c): Analyze sources of risk, return, and diversification among natural resource investments.

Q.4473 Which of the following is *most likely* a unique characteristic of timberland as an investment?

A. Offer immediate returns due to the fast growth of trees.

B. Timberland is primarily valued for its underlying land rather than the timber it produces.

C. Timberland functions as both a production site and storage, allowing for harvest timing based on market conditions.

The correct answer is **C.**

One of the unique features of timberland as an investment is its dual role as both a production site and a form of storage. The growth of trees, a biological process, continues regardless of market conditions, giving investors the flexibility to harvest timber when prices are favorable. This characteristic can help stabilize returns over time and reduce the impact of short-term market fluctuations. It makes timberland an attractive option for investors seeking long-term, stable returns.

A is incorrect. Timberland investments do not typically offer immediate returns, as the growth of trees is a long-term process.

B is incorrect. While the value of the underlying land is a factor, the timber produced on timberland is a significant source of its value.

Q.4474 In the context of farmland and timberland investments, which of the following is *most likely* a feature that is considered a primary risk factor?

A. Fixed returns on investment.

B. Weather patterns and climate change.

C. Guaranteed price appreciation over time.

The correct answer is **B.**

One of the primary risks in farmland and timberland investments is the impact of weather patterns and climate change, which can significantly affect crop yields and timber growth. These environmental factors are unpredictable and can lead to variability in investment returns. For instance, adverse weather conditions can damage crops or slow timber growth, leading to reduced yields and financial losses.

A is incorrect. Farmland and timberland investments do not typically offer fixed returns; instead, their returns can fluctuate based on a variety of factors, including environmental conditions.

C is incorrect. Price appreciation in farmland and timberland is not guaranteed and can be influenced by a range of market and environmental factors.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (c): Analyze sources of risk, return, and diversification among natural resource investments.

Q.4475 Which of the following *most likely* outlines the importance of Timberland Investment Management Organizations (TIMOs) to institutional investors?

A. TIMOs provide immediate liquidity in timberland investments.

B. TIMOs primarily focus on residential development on timberland.

C. They offer forest investment expertise for managing timberland portfolios.

The correct answer is **C.**

TIMOs are crucial for institutional investors because they provide the necessary forest investment expertise to manage timberland portfolios effectively. This includes selecting appropriate timberland properties, managing them for sustainable yield, and making informed decisions about when to harvest or sell the timber. Their expertise is vital for maximizing the returns from timberland investments.

A is incorrect. TIMOs do not typically provide immediate liquidity in timberland investments, which are generally considered long-term investments.

B is incorrect. TIMOs do not primarily focus on residential development; their main focus is on timberland investment and management.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (c): Analyze sources of risk, return, and diversification among natural resource investments.

Q.4476 Which of the following is *most likely* an investment characteristic of farmland and timberland?

A. They offer guaranteed returns with minimal risk.

B. They investments are highly liquid and easily tradable.

C. The requirement for high technical knowledge for investment.

The correct answer is **C.**

A significant challenge in direct investments in farmland and timberland is the requirement for high technical knowledge and expertise. Investors need to understand the nuances of agricultural and timber markets, soil quality, environmental factors, and sustainable land management practices. This complexity can be a barrier for investors who lack the necessary expertise.

A is incorrect. Direct investments in farmland and timberland do not offer guaranteed returns and can carry significant risks.

B is incorrect. These assets are typically illiquid and not easily tradable, unlike more conventional investment assets like stocks and bonds.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (c): Analyze sources of risk, return, and diversification among natural resource investments.

Q.4477 Which of the following statements is *most likely* accurate about the factors influencing the returns and cycles of a portfolio that includes commodities, farmland, and timberland?

A. Commodity prices, farmland returns, and timberland returns are all primarily driven by global supply and demand dynamics.

B. Commodity prices, farmland returns, and timberland returns each have distinct factors influencing their returns and cycles.

C. Farmland returns are primarily influenced by global supply and demand dynamics, while timberland returns are driven by geopolitical events.

The correct answer is **B.**

Commodity prices, farmland returns, and timberland returns each have distinct factors influencing their returns and cycles. While there may be some overlap in the factors that influence these asset classes, each has unique drivers and cycles.

Commodity prices are influenced by global supply and demand dynamics, geopolitical events, and currency fluctuations. Farmland returns are influenced by factors such as crop yields, land value appreciation, and government policies.

Timberland returns can be impacted by timber growth rates, timber prices, and land value appreciation. Therefore, it is not accurate to say that all three asset classes are primarily driven by the same factors or that only two of the asset classes are influenced by the same factors. Understanding the unique drivers and cycles of each asset class can help investors make informed decisions about portfolio diversification and risk management.

A is incorrect. While global supply and demand dynamics can influence commodity prices, farmland returns, and timberland returns, they are not the primary driver for all three asset classes. As mentioned above, farmland returns and timberland returns are influenced by a variety of other factors, including crop yields, land value appreciation, government policies, timber growth rates, and timber prices.

C is incorrect. This statement incorrectly suggests that farmland returns are primarily influenced by global supply and demand dynamics and that timberland returns are driven by geopolitical events. While these factors can influence the returns of these asset classes, they are not the primary drivers. Farmland returns are influenced by factors such as crop yields, land value appreciation, and government policies, while timberland returns can be impacted by timber growth rates, timber prices, and land value appreciation.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (c): Analyze sources of risk, return, and diversification among natural resource investments.

Q.4478 Which of the following statements is *most likely* accurate about the pricing mechanisms for commodities and land?

A. Land prices fluctuate more rapidly throughout the trading day than commodity prices.

B. Commodities and land are both priced on a second-by-second basis on public exchanges.

C. Commodity prices are constantly changing on public exchanges, while land prices are updated less frequently.

The correct answer is **C.**

Commodity prices are constantly changing on public exchanges, while land prices are updated less frequently. Commodities like crude oil are traded on public exchanges, where their prices can fluctuate rapidly throughout the trading day. This is due to the high liquidity and high volume of trading in commodity markets.

On the other hand, assets like farmland have an infrequent pricing mechanism, with prices only updated when a transaction occurs. This is because land is an illiquid asset, and transactions occur less frequently. Therefore, the pricing mechanism for land is less dynamic and more infrequent compared to commodities. This difference in pricing mechanisms reflects the different characteristics of these asset classes, including their liquidity, transaction frequency, and market structure.

A is incorrect. Land prices do not fluctuate more rapidly throughout the trading day than commodity prices. In fact, the opposite is true. Commodity prices fluctuate more rapidly due to the high liquidity and high volume of trading in commodity markets, while land prices are updated less frequently due to the infrequent nature of land transactions.

B is incorrect. Commodities and land are not both priced on a second-by-second basis on public exchanges. While commodities are traded on public exchanges and their prices can fluctuate rapidly, land is not traded on public exchanges and its prices are updated less frequently.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (b): Describe features of commodities and their investment characteristics.

Q.4479 Which of the following is *most likely* a potential advantage of investing in commodities and a potential disadvantage of investing in farmland and timberland?

A. Commodities offer stable cash flows and potential for value appreciation, while farmland and timberland offer high liquidity and price transparency.

B. Commodities offer high liquidity and price transparency, while farmland and timberland can be illiquid and subject to various risks, such as changes in government policies.

C. Commodities are subject to various risks, such as weather events and changes in government policies, while farmland and timberland offer high liquidity and price transparency.

The correct answer is **B.**

Commodities, such as gold, oil, and agricultural products, are traded on global exchanges and offer high liquidity and price transparency. This means that investors can easily buy and sell these assets at any time, and the prices are readily available and updated in real time. This is a significant advantage for investors who need flexibility and want to be able to react quickly to market changes.
On the other hand, farmland and timberland are real assets that can be illiquid, meaning they can be difficult to sell quickly without potentially incurring a significant loss. They are also subject to various risks, such as weather events and changes in government policies. For example, a severe drought or a change in agricultural subsidies could significantly impact the value of these assets. Therefore, while they can provide diversification benefits and potential for long-term returns, they also come with certain challenges that investors need to consider.

A is incorrect. Commodities do not typically offer stable cash flows as their prices can be highly volatile and influenced by a wide range of factors, including supply and demand dynamics, geopolitical events, and macroeconomic conditions. On the other hand, farmland and timberland do not generally offer high liquidity and price transparency. These assets are not traded on exchanges, and their prices can be difficult to determine, especially in the absence of recent comparable sales.

C is incorrect. While it is true that commodities are subject to various risks, such as weather events and changes in government policies, these are not advantages but rather challenges associated with investing in these assets. Similarly, farmland and timberland do not typically offer high liquidity and price transparency, which are considered disadvantages rather than benefits of investing in these assets.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (b): Describe features of commodities and their investment characteristics.

Q.4480 Consider a scenario where you are an investor looking to diversify your portfolio. You decide to invest in commodities, specifically wheat, due to its potential for returns and inflation protection. Given this information, which of the following actions would *most likely* show you that there is an imminent increase in the price of wheat in the short term?

A. A large number of investors buy wheat futures contracts.

B. There is an unexpected increase in the production of wheat due to favorable weather conditions.

C. There is a sudden decrease in the demand for wheat from bakeries and food processing companies.

The correct answer is **A.**

When a large number of investors decide to buy wheat futures contracts, it is likely to increase the price of wheat in the short term. When investors buy futures contracts, they are essentially betting that the price of the commodity will rise in the future.

This increased demand for futures contracts can drive up the price of the underlying commodity, in this case, wheat. This is due to the fact that futures prices are often used as a benchmark for spot prices in the physical market.

B is incorrect. An unexpected increase in the production of wheat due to favorable weather conditions would most likely lead to a decrease in the price of wheat, not an increase. This is because when the supply of a commodity increases, its price tends to fall, assuming that demand remains constant. This is yet another basic principle of supply and demand.

C is incorrect. A sudden decrease in the demand for wheat from bakeries and food processing companies would most likely lead to a decrease in the price of wheat, not an increase. This is because when demand for a commodity decreases, its price tends to fall, assuming that supply remains constant. This is another basic principle of supply and demand.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (b): Describe features of commodities and their investment characteristics.

Q.4481 Which of the following events would *most likely* lead to the worst performance for both global stocks and commodities?

A. A global economic recovery following a financial crisis.

B. A global financial crisis leading to economic uncertainty.

C. A sudden increase in the demand for oil outpacing supply.

The correct answer is **B.**

A global financial crisis leading to economic uncertainty would most likely lead to the worst performance for both global stocks and commodities. During a financial crisis, investors tend to move away from riskier assets such as stocks and commodities and towards safer assets such as government bonds. This can lead to a decrease in the prices of both stocks and commodities.
Furthermore, a financial crisis often leads to a decrease in economic activity, which can reduce the demand for commodities, leading to a further decrease in their prices. In addition, during times of economic uncertainty, companies may cut back on their production and investment activities, which can lead to a decrease in their stock prices.

A is incorrect. A global economic recovery following a financial crisis would likely lead to an increase in the prices of both global stocks and commodities. During an economic recovery, companies' earnings typically increase, which can lead to an increase in their stock prices. Furthermore, an economic recovery often leads to an increase in demand for commodities, which can lead to an increase in their prices.

C is incorrect. A sudden increase in the demand for oil outpacing supply would likely lead to an increase in the price of oil, a commodity. This could potentially have a positive impact on the performance of commodities as an asset class. However, the impact on global stocks is less clear. While companies in the oil and gas sector may benefit from higher oil prices, companies in other sectors may face higher costs, which could negatively impact their earnings and stock prices.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (b): Describe features of commodities and their investment characteristics.

Q.4482 Which of the following statements is *most likely* accurate regarding the relationship between inflation and natural resource performance?

A. Commodities, particularly gold, tend to perform better during periods of high inflation, regardless of other market conditions.

B. In stable inflation environments, commodity returns have generally been low but positive, as the real return on commodities tends to be lower.

C. The investment performance of farmland or timberland significantly varies in different inflation environments due to factors such as weather conditions, supply and demand dynamics, and government policies.

The correct answer is **C.**

The statement that the investment performance of farmland or timberland significantly varies in different inflation environments due to factors such as weather conditions, supply and demand dynamics, and government policies is the most accurate. The performance of these types of commodities is influenced by a variety of factors, including inflation, but also other factors that can have a significant impact on their value.

For example, weather conditions can affect crop yields, which in turn can affect the price of farmland. Similarly, supply and demand dynamics can have a significant impact on the price of timberland. Government policies can also play a role, as they can affect the cost of production, the availability of subsidies, and the demand for certain types of commodities. Therefore, while inflation is an important factor to consider when investing in these types of commodities, it is not the only factor that can affect their performance.

A is incorrect. While it is true that commodities, particularly gold, can perform well during periods of high inflation, this is not always the case. The performance of commodities can be influenced by a variety of other factors, including supply and demand dynamics, geopolitical events, and changes in technology. Therefore, it is not accurate to say that commodities always perform better during periods of high inflation, regardless of other market conditions.

B is incorrect. While it is true that commodity returns can be low in stable inflation environments, this is not always the case. The performance of commodities can be influenced by a variety of factors, including supply and demand dynamics, geopolitical events, and changes in technology. Therefore, it is not accurate to say that commodity returns are always low but positive in stable inflation environments.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (c): Analyze sources of risk, return, and diversification among natural resource investments.

Q.4483 Which of the following statements is *most likely* to be correct? Alternative asset classes such as farmland, timberland, and commodities have

A. no correlation with traditional assets like stocks and bonds.

B. high correlations with traditional assets like stocks and bonds.

C. historically shown low correlations with traditional assets like stocks and bonds.

The correct answer is **C.**

Historically, alternative asset classes such as farmland, timberland, and commodities have shown low correlations with traditional assets like stocks and bonds. This is one of the main reasons why financial advisors consider these alternative asset classes for diversification purposes. The low correlation means that these assets do not move in tandem with traditional assets. Therefore, when stocks and bonds are performing poorly, these alternative assets may perform well, and vice versa.

A is incorrect. It is not accurate to say that alternative asset classes such as farmland, timberland, and commodities have no correlation with traditional assets like stocks and bonds. While the correlation is typically low, it is not zero. There can be periods when these asset classes move in the same direction as traditional assets, even if the overall long-term correlation is low.

B is incorrect. Alternative asset classes such as farmland, timberland, and commodities do not have high correlations with traditional assets like stocks and bonds. While there may be periods when these asset classes move in the same direction as traditional assets, over the long term, they have shown low correlations. This is due to the unique factors that drive the returns of these alternative assets, which are different from the factors that drive the returns of stocks and bonds.

CFA Level I, Alternative Investments, Learning Module 5: Natural Resources. LOS (c): Analyze sources of risk, return, and diversification among natural resource investments.

Learning Module 6: Hedge Funds

Q.32 Hedge funds seek absolute return. Absolute return is a:

A. Measure of the gain or loss on an investment portfolio compared to a benchmark index.

B. Measure of the gain or loss on an investment portfolio compared to the amount of risk taken.

C. Measure of the gain or loss on an investment portfolio expressed as a percentage of invested capital.

The correct answer is **C.**

Absolute return is a measure of the actual return achieved by an investment portfolio, expressed as a percentage of the capital invested. It is different from the relative return, which compares the performance of an investment portfolio to a benchmark index or other measures of market performance.

A is incorrect. Benchmark indices are used to measure relative return, not absolute return.

B is incorrect. Risk-adjusted return measures, such as the Sharpe ratio, are used to compare the performance of investment portfolios to the amount of risk taken, not to measure the absolute return.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.1223 Which of the folowing return of a hedge fund is *most likely* stated on an absolute basis?

A. The fund returned 18%.

B. The fund returned 18% above the S&P 500 index.

C. The fund has had an 18% return with a 31% standard deviation.

The correct answer is **A.**

Absolute return measures the actual return earned by an investment over a certain period of time, without comparing it to any benchmark or index.

B is incorrect. It is a relative return, which measures the performance of an investment relative to a benchmark. In this case, the S&P 500 index.

C is incorrect. It is a measure of both return and risk, where the 18% return is accompanied by a 31% standard deviation, which represents the volatility of the returns. While this does not compare the fund's performance to a benchmark, it is not solely a measure of absolute return, as it takes into account the level of risk associated with achieving that return.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (a): Explain investment features of hedge funds and contrast them with other asset classes.

Q.1227 The strategy of purchasing the stocks of the company being acquired and short selling the stock of the acquiring company is *most likely* a/an:

A. Merger arbitrage.

B. Opportunist strategy.

C. Distressed/restructuring strategy.

The correct answer is **A.**

Merger arbitrage is the strategy of purchasing stocks of the company being acquired and short-selling the stocks of the acquirer. Merger arbitragers speculate on the successful completion of mergers and acquisitions. An investor that employs this strategy is known as an arbitrageur. Risk arbitrage is a type of event-driven investing in that it attempts to exploit pricing inefficiencies caused by a corporate event.

B is incorrect. Opportunistic strategies focus on taking an active role in the financial restructuring of over-leveraged companies by investing primarily in stressed and distressed corporate loans, bonds, claims, and other related securities.

C is incorrect. Distressed strategy is investing in securities of companies in financial difficulty.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.1228 Anna Smith is a hedge fund manager who tries to exploit price discrepancies between convertible bonds and common stocks of companies. The strategy that Smith uses is *most likely* known as:

A. Equity market neutral strategy.

B. Fixed-income arbitrage fixed income.

C. Convertible arbitrage fixed income.

The correct answer is **C.**

Anna Smith's strategy involves exploiting price differences between convertible bonds and common stocks, which is a characteristic of the convertible arbitrage fixed-income strategy. This strategy involves buying convertible bonds and simultaneously short-selling the underlying common stocks, to profit from the price difference between the two securities. This strategy is often used by hedge fund managers and other institutional investors seeking to generate returns while minimizing market risk.

A is incorrect. Equity market neutral strategy involves taking long and short positions in stocks with the goal of creating a portfolio that is market neutral, meaning that it has no net exposure to the overall market. This strategy seeks to profit from differences in the performance of individual stocks rather than from movements in the overall market.

B is incorrect. Corporate arbitrage fixed income involves exploiting price differences between fixed-income securities of companies, such as bonds, and typically involves buying the undervalued security and short-selling the overvalued security in the hope of profiting from the price convergence between the two securities. This strategy seeks to generate returns by exploiting mispricing opportunities in the corporate fixed-income market.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.1229 Which of the following factor is *most likely* not considered when selecting a hedge fund?

A. Longevity.

B. Investment process.

C. Public financial data.

The correct answer is **C.**

Since the hedge funds are not required by law to publish its financial data publicly, it is difficult to consider the financial data of hedge funds. Factors to consider when selecting a hedge fund include investment strategy, investment process, competitive advantage, track record, size and longevity, management style, key person risk, reputation, investor relations, plans for growth, and risk management systems.

A is incorrect. Longevity is an important factor considered when selecting a hedge fund. It refers to the duration for which the hedge fund has been operational. A fund with a longer history can provide more data on its performance across different market conditions, which helps in assessing its stability and the effectiveness of its investment strategy. Longevity can also indicate the fund's ability to survive market volatility, making it a crucial consideration for investors.

B is incorrect. The investment process is another critical factor considered when selecting a hedge fund. It encompasses the methods and strategies the fund uses to select investments, manage risk, and achieve its objectives. Understanding a hedge fund's investment process helps investors gauge how the fund aims to generate returns and whether its approach aligns with their risk tolerance and investment goals. The clarity, discipline, and uniqueness of the investment process are often scrutinized to determine the fund's potential for success.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.1259 Which of the following hedge fund strategies *most likely* incorporates a top-down analysis approach based on global macro factors?

A. Macro hedge.

B. Equity hedge.

C. Global analysis.

The correct answer is **A.**

Macro hedge funds use a top-down approach to identify and exploit global macroeconomic trends and events. They analyze a wide range of macroeconomic factors, such as interest rates, inflation, and geopolitical events, to make investment decisions across multiple asset classes, including currencies, commodities, fixed income, and equities. The goal of macro hedge funds is to generate returns by taking advantage of global economic imbalances and market inefficiencies.

B is incorrect. Equity hedge funds, on the other hand, typically focus on investing in individual stocks, using bottom-up analysis to identify companies that are undervalued or have growth potential.

C is incorrect. Global analysis is not a hedge fund strategy, but rather a term that describes the practice of analyzing global economic and market trends to make investment decisions.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.1262 The University of Bursa wants to establish a dedicated fund to provide financial support for the ongoing expansion of its artificial intelligence research center building. Which of the following is the *most* appropriate fund for the project?

A. Hedge fund.

B. Foundation fund.

C. Endowment fund.

The correct answer is **C.**

Endowment funds are set to provide financial support for ongoing programs. They are funds of non-profit institutions that help the institutions provide designated services. Their main objective is to maintain the real (inflation-adjusted) capital value of the fund while generating income to fund the objectives of the institution.

B is incorrect. Foundation funds are funds for grant making entities.

A is incorrect. Hedge funds are private investment vehicles that typically use leverage, derivatives, and long and short investment strategies. They typically require a high minimum investment and often have restricted liquidity by allowing only periodic withdrawals or having a long fixed-term commitment.

Q.2002 A hedge fund that engages primarily in distressed debt investing and merger arbitrage is *most likely* a/an:

A. Long/short fund.

B. Event-driven fund.

C. Global macro fund.

The correct answer is **B.**

Event-driven funds attempt to capitalize on unique opportunities such as distressed debt investing and merger arbitrage.

A is incorrect. A long-short fund is a mutual fund that holds investments long and in addition it sells securities it does not own (short). The goal of a long-short fund is to find investments anticipated to go up, and find investments anticipated to go down, and invest in both in an attempt to increase returns.

C is incorrect. Global macro hedge funds are actively managed funds that attempt to profit from broad market swings caused by political or economic events.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.2004 The leverage employed by a typical hedge fund may *least likely*:

A. Be legally unlimited since the typical fund is domiciled offshore.

B. Include margin borrowed from brokers and from external sources.

C. Be increased by using derivatives rather than the underlying securities.

The correct answer is **A.**

Hedge funds' limited liability agreements, which are legally binding, typically specify the degree of leverage the funds may employ. Hedge funds create leverage by borrowing from external sources, trading in margin accounts with brokers and using derivatives that can be traded on margin instead of their underlying securities when those securities cannot be margined.

B is incorrect. Hedge funds commonly employ leverage through borrowing from brokers and external sources. This statement is accurate and reflects a standard practice among hedge funds to enhance their investment capacity and potential returns. Leverage can amplify both gains and losses, and borrowing is a primary method by which hedge funds achieve their desired leverage levels.

C is incorrect. Increasing leverage by using derivatives instead of underlying securities is a common strategy among hedge funds. Derivatives, such as options and futures, can provide significant leverage with a lower capital outlay compared to purchasing the underlying securities outright. This leverage amplifies potential returns but also increases risk.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.2006 The effect of the survivorship bias on hedge fund risk and returns from historical results is to:

A. Overstate both risk and expected returns.

B. Overstate expected returns and understate risk.

C. Overstate risk and understate expected returns.

The correct answer is **B.**

Survivorship bias tends to overstate the average returns of hedge funds because failed funds are not included in the analysis, so successful funds appear to have higher returns. On the other hand, survivorship bias tends to underestimate the average risk of hedge funds because the failed funds, which would have had a higher risk, are excluded from the analysis.

Therefore, survivorship bias creates a bias towards higher returns and lower risk, which means that it overstates the expected returns and underestimates the expected risk of hedge funds.

A is incorrect. While survivorship bias does indeed lead to an overestimation of expected returns, it has the opposite effect on risk, leading to an underestimation. The exclusion of failed funds, which likely had higher risk profiles, results in a perceived lower average risk among the surviving funds.

C is incorrect. It posits that survivorship bias overstates risk and understates expected returns. This interpretation is the opposite of the actual impact of survivorship bias on hedge fund performance metrics. Failed or closed funds, which are excluded due to survivorship bias, typically would exhibit higher risk and lower returns, not the other way around. Therefore, their exclusion results in an overestimation of returns and an underestimation of risk, not an overestimation of risk.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.2009 The creation and redemption of “in-kind” shares by authorized participants is a feature that is unique to which of the following types of securities?

A. ETFs.

B. Hedge funds.

C. Closed-end funds.

The correct answer is **A.**

Many ETFs require authorized participants to create and redeem shares in-kind - that is, to exchange ETF shares for a basket of securities, rather than cash. This allows the ETF to avoid selling securities to raise cash to meet redemptions, and thereby also prevents capital gains distributions. Additionally, when redeeming in-kind, an ETF can provide the authorized participant with the underlying securities with the lowest cost basis, further reducing the ETF's tax burden.

B is incorrect. Hedge funds do not typically engage in the creation and redemption of shares in-kind. Hedge funds are investment vehicles that pool capital from accredited investors or institutional investors and invest in a variety of assets, often with complex strategies including leverage, derivatives, and short selling. Unlike ETFs, hedge funds do not offer daily liquidity or the same level of transparency in terms of holdings. The process of entering or exiting a hedge fund investment usually involves cash transactions, and the terms are often subject to lock-up periods and redemption notices.

C is incorrect. Closed-end funds (CEFs) also do not engage in the creation and redemption of shares in-kind in the same manner as ETFs. CEFs issue a fixed number of shares through an initial public offering (IPO), and after the IPO, these shares are traded on the open market. The price of CEF shares is determined by supply and demand in the market and can trade at a premium or discount to the net asset value (NAV) of the fund's underlying assets. Unlike ETFs, CEFs do not allow for the daily creation and redemption of shares based on the NAV, and investors looking to buy or sell shares of a CEF must do so through the market.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.2014 ETFs are *most likely* to charge:

A. Back-end, but not front-end loads.

B. Front-end, but not back-end loads.

C. Neither back-end nor front-end loads.

The correct answer is **C.**

In contrast to mutual funds, ETFs do not charge a load. However, they are traded on exchanges and subject to brokerage commissions. A load is a sales charge or commission charged to an investor when buying or redeeming shares in a mutual fund.

A is incorrect. ETFs, by their nature, do not typically charge either type of load. Their structure is designed to avoid these fees, making them more cost-effective for investors. Instead, the primary costs associated with ETFs come from brokerage commissions and the expense ratios of the funds, which cover the management and operational expenses.

B is incorrect. This option suggests that ETFs charge front-end loads but not back-end loads. They are designed to be traded on exchanges without the traditional load fees that mutual funds may impose. The absence of front-end and back-end loads in ETFs is one of their key advantages, offering investors a more straightforward and potentially less costly investment option. However, investors should still be mindful of other costs, such as brokerage fees and the fund's expense ratio, which can impact the overall investment return.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.2015 In an open-end fund:

A. Shares are issued and are traded in secondary markets.

B. Investors can redeem their shares at the end of each business day at the net asset value (NAV).

C. Investors cannot redeem shares for a certain number of years that are specified at the initiation of the contract.

The correct answer is **B.**

In an open-end fund, investors can redeem their shares at the end of each business day at the net asset value (NAV). The net asset value is the value of mutual fund that is reached by deducting the fund's liabilities from the market value of all of its shares and then dividing by the number of issued shares. In addition, it will accept new investment money and issue additional shares at a value equal to the net asset value of the fund at the time of investment.

A is incorrect. Unlike closed-end funds, whose shares are traded on stock exchanges similarly to stocks, open-end fund shares are not traded in secondary markets. Instead, transactions of open-end fund shares occur directly between investors and the fund. Investors buy shares from the fund at the NAV and can sell them back to the fund at the NAV, ensuring that the trading does not affect the share price beyond the daily valuation based on the fund's assets.

C is incorrect. This option misrepresents the nature of open-end funds by suggesting that investors cannot redeem shares for a certain number of years specified at the initiation of the contract. In reality, one of the defining characteristics of open-end funds is the ability of investors to redeem their shares at any time (typically at the end of each business day) at the current NAV. This liquidity is a key feature that differentiates open-end funds from other investment vehicles, such as closed-end funds or certain types of annuities, which may have restrictions on when investors can redeem their shares.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.3280 A hedge fund manager made the following statements regarding hedge fund fee structures. Statement 1: “The management fee is paid regardless of the firm's performance.” Statement 2: “If a fund generates negative returns, it implies a zero incentive fee.” Is he *most likely* correct regarding his statements?

A. He is correct regarding one statement only.

B. Yes, he is correct regarding both statements.

C. No, he is incorrect regarding both statements.

The correct answer is **B.**

Both statements are correct. A management fee is a fixed percentage of assets under management (AUM) charged by a hedge fund to cover operating costs, regardless of the fund's performance. This fee is usually charged annually or monthly and can range from 1% to 2% of AUM.

An incentive fee is a performance-based fee that is charged by a hedge fund based on the fund's returns. This fee is usually a percentage of the fund's profits and is charged in addition to the management fee. If the fund generates negative returns, it is not subject to an incentive fee, as there are no profits to charge the fee on.

A is incorrect. It suggests that only one of the statements is correct. However, as explained, both statements accurately describe standard practices in hedge fund fee structures. The management fee is indeed paid regardless of performance, and the incentive fee is only applicable when the fund generates positive returns.

C is incorrect. It suggests that both statements are incorrect. On the contrary, both statements are accurate representations of common hedge fund fee structures. The management fee is a fixed charge not contingent on the fund's performance, and the incentive fee is directly tied to the fund's profitability, not applicable in scenarios of negative returns.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.3296 Which of the following is *least likely* an example of an equity hedge strategy?

A. Short bias.

B. Merger arbitrage.

C. Fundamental value.

The correct answer is **B.**

Merger arbitrage is an example of an event driven strategy. It involves going long (buying) the stock of the company being acquired and going short (selling) the stock of the acquiring company when the merger or acquisition is announced.

A is incorrect. Short bias is an equity hedge strategy that use quantitative (technical) and/or fundamental analysis to identify overvalued equity securities.

C is incorrect. Fundamental value is an equity hedge strategy that uses fundamental analysis to identify companies that are undervalued. The hedge fund then takes long positions in identified companies.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.3298 Which of the following hedge fund strategies is the public equivalent of private equity investing?

A. Activist.

B. Distressed debt.

C. Merger arbitrage.

The correct answer is **A.**

Activist hedge funds are very similar to private equity investing. The difference is that these funds operate in the public equity market. Activist is a short for activist shareholder. These strategies focus on the purchase of sufficient equity in order to influence a company's policies or direction.

B is incorrect. Distressed debt is a strategy that focuses on the securities of companies either in bankruptcy or perceived to be near to bankruptcy.

C is incorrect. Merger arbitrage is a strategy that involves going long (buying) the stock of the company being acquired and going short (selling) the stock of the acquiring company when the merger or acquisition is announced.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.3299 Which of the following is *least likely* a characteristic of hedge funds?

A. Active portfolio management.

B. Narrow manager specialization.

C. High diversification of investments.

The correct answer is **C.**

Hedge funds are characterized by low diversification of investments. They often have a focused investment strategy that allows for concentrated positions in specific assets, which can lead to high returns but also higher risks. Hedge funds may also invest a portion of their assets under management (AUM) without strict limitations, differentiating them from more regulated investment vehicles.

A is incorrect. Active portfolio management is a key characteristic of hedge funds, as managers actively seek to generate high returns through various strategies.

B is incorrect. Narrow manager specialization is common in hedge funds, where managers often focus on specific strategies or market niches to leverage their expertise and achieve higher returns.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.3301 Which of the following is *most likely* a drawback of the fund of funds investing?

A. Dilution of investor returns.

B. Less favorable redemptions terms.

C. FOF managers lose money fast when hedge funds start to perform poorly.

The correct answer is **A.**

Fund of funds (FOF) investing is a strategy that involves investing in a portfolio of other investment funds, rather than investing directly in individual securities or assets. The goal of FOF investing is to achieve greater diversification and access to a wider range of investment strategies and asset classes.

However, one potential drawback of FOF investing is the dilution of investor returns. FOFs typically charge fees for managing the portfolio of funds, in addition to the fees charged by the underlying funds in which they invest. These fees can add up and reduce the overall returns for investors.

B is incorrect. Less favorable redemption terms, may not be a significant drawback of FOF investing, as FOFs typically have more favorable redemption terms than the individual funds in which they invest.

C is incorrect. Funds of funds managers losing money fast when hedge funds start to perform poorly, may not be a significant drawback either, as FOF managers typically have strategies in place to manage risk and minimize losses in their portfolios.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.3302 Hedge Fund Cross and Hedge Fund Arrow Invest are in the same asset class and use a similar investment strategy. The exhibit below displays comparative data of the hedge funds.

Exhibit: Hedge Fund Characteristics

	HF Cross	HF Arrow
Size	$300 million	$650 million
Returns	17%	13%
Fees	1 and 15	2 and 20
Sortino Ratio	1.2	1.9

An investor is likely to invest in:

A. HF Cross because of higher returns.

B. HF Arrow because of a higher Sortino ratio.

C. Neither HF Cross nor HF Arrow because of a lack of accuracy of alternative investment data.

The correct answer is **A.**

The correct justification for an investor to choose HF Cross over HF Arrow is that HF Cross has **higher returns (17%)** compared to HF Arrow (13%). Investors typically seek higher returns, making this a valid reason. HF Cross's 17% return is more attractive than HF Arrow's 13%.

B is incorrect. While HF Arrow does have a higher Sortino Ratio (1.9) compared to HF Cross (1.2), the question specifically asks about where an investor is likely to invest. Investors typically prioritize returns over risk-adjusted metrics like the Sortino Ratio. The Sortino Ratio alone may not be the primary driver of investment decisions.

C is incorrect. There is no information provided in the image suggesting a lack of accuracy of alternative investment data. Therefore, this reason is not relevant to the investor's decision.Without any evidence of data inaccuracy, this option is not applicable.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.3309 Which of the following statements is *most likely* correct regarding hedge funds employing absolute return strategies?

A. The potential for alpha is high.

B. There is no market index to beat.

C. The beta of the strategy is close to 1.0.

The correct answer is **B.**

Theoretically, the beta of absolute return strategies should be close to zero as they seek to generate returns that are independent of market returns. With an absolute return strategy, there is no specific market index to beat.

A is incorrect. While it is true that hedge funds employing absolute return strategies have the potential for alpha, which represents performance above a benchmark, stating that the potential for alpha is high does not directly address the core characteristic of absolute return strategies. Alpha generation is a goal for many investment strategies, not just those seeking absolute returns. The key distinction of absolute return strategies lies in their aim to generate positive returns in any market condition, rather than outperforming a benchmark, which is a secondary outcome.

C is incorrect. The beta of funds using the absolute-return strategy tends to be close to 0.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.3311 An advantage to funds of hedge funds over single-layer hedge funds *most likely* includes:

A. Higher net returns for investors.

B. More stringent redemption terms.

C. Ease of access to funds which may otherwise be closed to direct investments.

The correct answer is **C.**

An advantage of funds of hedge funds over single-layer hedge funds is that they provide access to hedge funds that may be otherwise be closed to direct investments.

A is incorrect. The fee structure of funds of hedge funds is multi-layered. Such a structure has the effect of diluting returns to the investor thereby reducing investor returns.

B is incorrect. Funds of hedge funds offer negotiated redemption terms that are more favorable (for example, a shorter lockup period and/or notice period).

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.3312 When conducting due diligence for investing in hedge funds, an investor will need to consider several factors. Which of the following factors is *most challenging* to fully assess?

A. Size.

B. Track record.

C. Investment strategy and process.

The correct answer is **C.**

When conducting due diligence of hedge funds, the factor which is most challenging to assess is the investment strategy and process. This is because hedge funds may limit disclosure in order to maintain their competitive advantage and not give information away that is considered proprietary.

A is incorrect. The size of a hedge fund, while an important factor to consider, is generally easier to assess than the investment strategy and process. Information on a fund's assets under management (AUM) is typically readily available and can provide investors with insights into the fund's scale, operational efficiency, and potential for negotiating power with service providers. However, size alone does not necessarily indicate the fund's performance or risk level, making it a less challenging aspect to evaluate compared to the intricacies of the fund's investment strategy.

B is incorrect. Although assessing a hedge fund's track record can present its own set of challenges, such as survivorship bias and the potential for performance manipulation, it is generally considered less difficult than evaluating the fund's investment strategy and process. Track records can be analyzed through various performance metrics and benchmarks, providing investors with a historical perspective on the fund's returns, volatility, and risk-adjusted performance. However, past performance is not always indicative of future results, and a thorough due diligence process should not rely solely on track record analysis without a deep understanding of the underlying investment strategy.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.3313 An investor intends to earn an absolute return on an alternative investment category which is highly leveraged, employs long and short positions, and is characterized by low correlations with traditional investments. The investor will *most likely* opt for:

A. Real estate.

B. Hedge funds.

C. Venture capital.

The correct answer is **B.**

The investor will opt for hedge funds. This alternative investment category manages portfolios of derivatives and securities using a variety of strategies. They may employ long and short positions, are often highly leveraged, and aim to deliver a positive absolute return; that is, they aim to generate positive total performance regardless of broad market performance. Venture capital and real estate do not take long and short positions in their strategies.

A is incorrect. Real estate involves investing in physical properties or real estate-related assets. While it can be a valuable part of a diversified investment portfolio, real estate investments typically do not employ the use of leverage, long and short positions in the same manner as hedge funds. Real estate investments are also more illiquid and have a different risk-return profile, focusing on income generation and capital appreciation over longer periods, rather than aiming for absolute returns through active trading strategies.

C is incorrect. Venture capital is a form of private equity and a type of financing that investors provide to startups and small businesses that are believed to have long-term growth potential. Venture capital is not typically associated with the use of leverage, nor does it employ long and short positions as part of its investment strategy. Instead, venture capital focuses on investing equity capital in companies during their early stages of development, with the hope of significant returns as these companies grow. The investment horizon is usually long-term, and the focus is on capital appreciation rather than achieving absolute returns through active trading strategies.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (a): Explain investment features of hedge funds and contrast them with other asset classes.

Q.3325 Which of the following statements correctly describes a fixed income convertible arbitrage hedge fund strategy? This strategy:

A. Seeks beta-positive investment strategies.

B. Seeks to employ a pricing discrepancy between related securities..

C. Involves buying a convertible bond of one issuer and, after some time, selling another issuer's common stock.

The correct answer is **B.**

A fixed income convertible arbitrage strategy is classified as a relative value strategy. Relative value funds seek to profit from a pricing discrepancy between related securities, i.e., mispricing between a convertible bond and its component parts (the underlying bond and the embedded stock option).

A is incorrect. A fixed-income convertible arbitrage strategy is a market-neutral (zero beta portfolio) strategy.

C is incorrect. The fixed-income convertible arbitrage strategy involves buying a convertible bond of one issue and simultaneously selling the issuer's common stock.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.3335 A hedge fund activist strategy focuses on:

A. Using options to go long or short market volatility across a group of asset classes.

B. Securing a dominant position in the company to influence its policies and direction.

C. The repurchase or issuance of securities of companies currently engaged in restructuring activities.

The correct answer is **B.**

A hedge fund activist strategy focuses on the purchase of sufficient equity in order to influence a company's policies or direction.

A is incorrect. A volatility strategy uses options to go long or short market volatility either in a specific asset class or across asset classes.

C is incorrect. A special situations event hedge fund strategy focuses on opportunities in the equity of companies that are currently engaged in restructuring activities other than merger or bankruptcy. These activities include issuance repurchase.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.3336 A portfolio manager is exploring alternative investments to include in his client's investment portfolio, currently dominated by stocks and bonds. Any alternative investment asset class selected will need to incorporate the fact that the client is subject to liquidity constraints. Which of the following alternative asset classes is *least suitable* for the client?

A. Hedge funds.

B. Mortgage-backed securities.

C. Managed futures commodity funds operating as mutual funds.

The correct answer is **A.**

Hedge funds impose long lockup periods on investors thereby making the asset class inappropriate for the investor in question. Lockup periods tie the investor's funds for a stated period thereby reducing the liquidity of the investment.

B is incorrect. Mortgage-backed securities represent publically traded commercial real estate debt and are relatively liquid.

C is incorrect. Managed futures commodity funds represent actively managed investment funds. When these funds operate similarly to mutual funds, their shares are available to the general public. This increases the liquidity of the investor's holdings.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (a): Explain investment features of hedge funds and contrast them with other asset classes.

Q.4224 An investor who wishes to redeem her shares from a hedge fund will *most likely* pay the redemption fee to the:

A. Investors.

B. Hedge fund.

C. Fund manager.

The correct answer is **B.**

The redemption fee is paid to the fund, not the fund manager, to discourage investors from making frequent withdrawals, which can disrupt the fund's investment strategy and reduce returns for other investors. The redemption fee may also help offset the costs of selling securities to meet the investor's redemption request.

A is incorrect. While investors in a hedge fund may pay various fees, such as management fees and performance fees, the redemption fee is typically paid directly to the hedge fund itself.

C is incorrect. While the fund manager plays a role in managing the hedge fund and overseeing the redemption process, it is unlikely that the investor would pay the redemption fee directly to the fund manager. The fund manager typically receives compensation in the form of management and performance fees, which are separate from the redemption fee.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4225 Which of the following is *least likely* a broad hedge fund strategy category?

A. Macro strategy.

B. Equity-driven strategy.

C. Fixed-income-driven strategy.

The correct answer is **C.**

Fixed-income-driven strategy is not a broad hedge fund strategy category. Fixed income falls under the relative value strategy category. Relative strategies are a broad hedge fund strategy that involves identifying and exploiting price discrepancies between related securities, such as bonds and derivatives.

Based on the strategy employed, hedge funds can be broadly classified into four;

1. Macro strategies: These involve making bets on macroeconomic trends and events, such as interest rates, inflation, and global economic growth.
2. Equity-driven strategies: These involve investing in equity securities, such as stocks, and may include long/short equity, sector-specific, or global equity strategies.
3. Relative strategies: Involves identifying and exploiting price discrepancies between related securities, such as bonds and derivatives.
4. Event-driven strategies: These involve investing in securities of companies that are undergoing significant corporate events, such as mergers, acquisitions, spin-offs, or bankruptcies.

A and B are incorrect. Macro and equity-driven strategies are two of the four broad hedge fund strategy categorizations.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4226 Which of the following reasons will *most likely* make an investor prefer to invest in a single hedge instead of a fund of funds?

A. Fee layering.

B. Due diligence expertise.

C. Limited investment funds.

The correct answer is **A.**

A fund of funds is a portfolio of hedge funds. There are two limitations to investing in a fund of funds:

1. Fee layering, whereby each of the hedge funds a fund of funds invests in receives management and incentive fees resulting in an investor paying fees more than once for the management of the same assets.
2. Liquidity constraints, especially in times of crisis where redemption can hurt the overall performance of the fund of funds.

Therefore, fee layering may make an investor choose to invest in a single hedge fund rather than a fund of funds, as fee layering reduces an investor's return.

B is incorrect. Due diligence expertise is a potential advantage of investing in a fund of funds. Fund of funds typically has dedicated teams of professionals who conduct extensive due diligence on the underlying hedge funds and their managers. This can provide investors with access to high-quality hedge funds that may be difficult to identify or access otherwise.

C is incorrect. A fund of funds can provide investors with access to a diversified portfolio of hedge funds, which can help to reduce overall risk.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4228 A hedge fund manager uses fundamental analysis to identify investment opportunities in an undervalued company with an identified path to rejuvenation. The hedge fund manager has *most likely* employed which equity hedge strategy?

A. Sector-specific.

B. Fundamental value.

C. Fundamental Long/Short growth.

The correct answer is **B.**

Fundamental value is an equity hedge strategy approach that uses fundamental analysis to identify undervalued companies or companies unloved for corporate performance or sector-driven reasons but with an identified path to corporate rejuvenation. A hedge fund will take long positions in such companies and may hedge the portfolio by taking short positions in overvalued companies.

A is incorrect. The sector-specific strategy exploits manager expertise in a specific sector. It uses fundamental and technical analyses to identify opportunities within that sector.

C is incorrect. Fundamental Long/Short (L/S) growth uses fundamental analysis to identify opportunities in companies expected to depict high growth and capital appreciation.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4349 In the context of margin financing arrangement, which of the following statements is most likely correct about the factors determining the minimum margin required in a margin financing arrangement? The minimum margin required is determined by:

A. The creditworthiness of the hedge fund only.

B. The riskiness of the investment portfolio only.

C. Both the riskiness of the investment portfolio and the creditworthiness of the hedge fund.

The correct answer is **C.**

The minimum margin required in a margin financing arrangement is determined by both the riskiness of the investment portfolio and the creditworthiness of the hedge fund. The riskiness of the investment portfolio is a key factor because the more volatile the portfolio, the higher the potential for losses and, therefore, the higher the margin requirement.
The creditworthiness of the hedge fund is also a key factor because the less creditworthy the hedge fund, the higher the risk that it will default on its obligations and, therefore, the higher the margin requirement.

The prime broker will assess both these factors when determining the minimum margin required. This ensures the broker is adequately protected against the risk of the hedge fund defaulting on its obligations. Therefore, both the riskiness of the investment portfolio and the creditworthiness of the hedge fund are important factors in determining the minimum margin required in a margin financing arrangement.

A is incorrect. While the creditworthiness of the hedge fund is a key factor in determining the minimum margin required, it is not the sole determinant. The riskiness of the investment portfolio is also a key factor. Therefore, the statement that the minimum margin required is solely determined by the creditworthiness of the hedge fund is incorrect.

B is incorrect. While the riskiness of the investment portfolio is a key factor in determining the minimum margin required, it is not the sole determinant. The creditworthiness of the hedge fund is also a key factor. Therefore, the statement that the minimum margin required is solely determined by the riskiness of the investment portfolio is incorrect.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4351 A hedge fund is using a proprietary model to value its complex derivatives. In this context, which of the following statements is *most likely* accurate regarding the valuation of these complex derivatives? The hedge fund should have its proprietary model reviewed by:

A. An independent third party to avoid potential conflicts of interest when applying estimates of value.

B. The fund's internal audit team to avoid potential conflicts of interest when applying estimates of value.

C. The fund's management team to avoid potential conflicts of interest when applying estimates of value.

The correct answer is **A.**

The hedge fund should have its proprietary model reviewed by an independent third party to avoid potential conflicts of interest when applying estimates of value. This is because an independent third party would not have any vested interest in the outcome of the valuation and would, therefore, be able to provide an unbiased assessment of the model.
This is particularly important for Level 3 asset pricing, where the inputs used in the valuation model are not observable in the market and are subject to significant estimation uncertainty. By having the model independently tested, benchmarked, and calibrated to industry-accepted standards, the hedge fund can ensure its consistent and reliable valuation approach, thereby reducing the risk of mispricing and potential disputes with investors or regulators.

B is incorrect. While the fund's internal audit team can play a role in reviewing the proprietary model, they may not be sufficiently independent to avoid potential conflicts of interest. The internal audit team is part of the same organization and may, therefore, be influenced by the same biases or pressures as the team that developed the model.

C is incorrect. Reviewing the proprietary model by the fund's management team would not avoid potential conflicts of interest. It could potentially exacerbate them, as the management team may have a vested interest in the outcome of the valuation. They may be incentivized to overstate the value of the derivatives to boost the fund's performance and attract more investors.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4356 An investor is considering investing in a hedge fund based on the performance of a hedge fund index. The index only includes funds that are currently active and have been successful, excluding those that have failed. The investor believes that this is a surefire way to make money. However, this perception might be misleading due to a certain form of selection bias. What is this bias *most likely* called, and how does it potentially distort the investor's return expectations?

A. Confirmation bias, as it confirms the investor's belief in the profitability of hedge funds by only including successful funds.

B. Selection bias, as it selectively includes only successful funds, leads to a distorted view of the overall hedge fund market.

C. Survivorship bias, as it only includes funds that have survived and excludes those that have failed, leading to overly optimistic return expectations.

The correct answer is **C.**

The bias that the investor is experiencing is called Survivorship Bias. Survivorship bias is a type of selection bias that occurs when the sample used for analysis only includes "survivors" or those that have successfully passed through a selection process. In the context of a hedge fund index, survivorship bias occurs when the index only includes funds that are currently active and have been successful, excluding those that have failed.

This can lead to overly optimistic return expectations because the index does not accurately represent the overall performance of the hedge fund market. The failed funds, which are not included in the index, could have experienced significant losses. By excluding these funds, the index overstates the average returns and understates the risk associated with investing in hedge funds. Therefore, the investor's perception that investing in a hedge fund based on the performance of this index is a surefire way to make money might be misleading.

A is incorrect. Confirmation bias is a cognitive bias where individuals favor information that confirms their existing beliefs and ignore information that contradicts them. While the investor may be experiencing confirmation bias by choosing to invest based on the index, this is not the specific bias that is causing the distortion in the investor's return expectations.

B is incorrect. While the index does selectively include only successful funds, leading to a distorted view of the overall hedge fund market, the specific term for this type of bias in the context of investment performance is survivorship bias, not selection bias. Selection bias is a more general term that refers to the distortion of a statistical analysis due to the method of collecting samples.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4484 Which of the following statements is *most likely* accurate about the primary objective of a hedge fund and the challenges in benchmarking their performance?

A. Generate high returns on a risk-adjusted basis relative to its portfolio-level volatility, and benchmarking their performance against traditional index performance benchmarks is straightforward.

B. Generate moderate returns with minimal risk, and benchmarking their performance against traditional index performance benchmarks is challenging due to their unique strategies.

C. Generate high returns, either in an absolute sense or on a risk-adjusted basis relative to its portfolio-level volatility, and benchmarking their performance against traditional index performance benchmarks is challenging due to their unique strategies.

The correct answer is **C.**

The primary objective of a hedge fund is indeed to generate high returns, either in an absolute sense or on a risk-adjusted basis relative to its portfolio-level volatility. Hedge funds are known for their aggressive investment strategies, which often involve taking on higher levels of risk in pursuit of higher potential returns.

This can include investing in distressed debt, as mentioned in the question, as well as other high-risk strategies such as short selling, leverage, and derivatives trading. However, the unique and complex nature of these strategies makes benchmarking the performance of hedge funds against traditional index performance benchmarks challenging.

A is incorrect. While it is true that hedge funds aim to generate high returns on a risk-adjusted basis relative to their portfolio-level volatility, benchmarking their performance against traditional index performance benchmarks is not straightforward due to the unique and complex nature of their investment strategies.

B is incorrect. The primary objective of a hedge fund is not to generate moderate returns with minimal risk. Rather, hedge funds are known for their aggressive investment strategies, which often involve taking on higher levels of risk in pursuit of higher potential returns.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4485 In this context use of leverage, which of the following statements *most likely* describes the role of leverage in a hedge fund's investment strategy?

A. Reduce the overall risk of the portfolio.

B. Potentially amplify both returns and losses.

C. Hedge risky positions against a market move.

The correct answer is **B.**

Leverage is used to potentially amplify both returns and losses. In the context of a hedge fund's investment strategy, leverage is a tool that can be used to increase the potential returns of an investment. By borrowing money to invest in a stock that the fund believes will increase in value, the fund can potentially earn a higher return than it would have been able to achieve with its own capital alone. However, this srategy also comes with increased risk.

If the stock decreases in value, the losses will also be amplified because the fund will still have to repay the borrowed money, potentially resulting in a loss that is greater than the original investment. Therefore, while leverage can enhance returns, it can also amplify losses, making it a double-edged sword in investment strategy.

A is incorrect. Leverage does not reduce the overall risk of the portfolio. In fact, it increases the risk because it can amplify both potential returns and potential losses. While it can enhance the potential for high returns, it also increases the potential for significant losses, making the portfolio more, not less, risky.

C is incorrect. Leverage is not typically used to hedge risky positions against a market move. Hedging is a strategy used to offset potential losses that may be incurred by a companion investment. While leverage can be part of a hedge fund's overall risk management strategy, it is not in itself a hedging tool.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4486 Consider the following statements about hedge funds and mutual funds.
Statement 1: Both hedge fund and mutual fund managers receive a fixed compensation and may not necessarily invest in the funds they manage.
Statement 2: Hedge fund managers have more freedom to make trading decisions and allocate client funds compared to mutual fund managers.
Statement 3: Mutual funds are available to public investors and are highly regulated, while hedge funds are available only to institutional and accredited investors.
Which of the following is *most likely* correct?

A. Only statement 1 is correct.

B. All the statements are correct.

C. Only statements 2 and 3 are correct.

The correct answer is **C.**

Only Statements 2 and 3 are correct. Hedge fund managers do indeed have more freedom to make trading decisions and allocate client funds compared to mutual fund managers. This is because hedge funds are less regulated than mutual funds, allowing them to engage in a wider range of investment strategies, including short selling, leverage, and derivatives trading. This flexibility can potentially lead to higher returns, but it also comes with higher risk. Mutual funds, on the other hand, are subject to strict regulations that limit their investment strategies to protect retail investors.

Statement 3 is also correct. Mutual funds are available to public investors and are highly regulated, while hedge funds are available only to institutional and accredited investors. This is because hedge funds are considered to be riskier and more complex than mutual funds and therefore are not suitable for all types of investors. Accredited investors are individuals or entities that meet certain income or net worth requirements and are considered to be more sophisticated and able to bear the risks associated with hedge funds.

A is incorrect. Statement 1 is not correct. While it is true that both hedge fund and mutual fund managers receive a fixed compensation, they often also invest in the funds they manage. This is known as having "skin in the game," and it aligns the interests of the fund managers with those of the investors.

B is incorrect. Not all the statements are correct, as explained above. Statement 1 is not correct, while Statements 2 and 3 are correct.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (a): Explain investment features of hedge funds and contrast them with other asset classes.

Q.4487 A financial analyst compares various types of investment funds to determine the most suitable option for a client who prefers private ownership, light regulation, and the ability to invest in multiple asset classes. The client also prefers a shorter time horizon and more liquid assets.
Among the following types of funds, which one would *most likely* meet the client's preferences and why?

A. Mutual Funds.

B. Hedge Funds.

C. Real Estate Investment Trusts (REITs).

The correct answer is **A.**

Mutual funds are investment vehicles that pool together funds from many investors and use those funds to buy a diversified portfolio of stocks, bonds, or other securities. They are managed by professional fund managers and are subject to regulation by financial authorities. Mutual funds offer private ownership, as each investor owns shares in the fund that represent a portion of the holdings. They also offer the ability to invest in multiple asset classes, as there are mutual funds that focus on equities, bonds, commodities, and other asset classes.

Mutual funds also typically have a shorter time horizon and more liquid assets compared to other types of investment funds. Investors can usually buy or sell shares in a mutual fund on any business day, providing a high level of liquidity. Therefore, mutual funds would be the most suitable option for a client who prefers private ownership, light regulation, the ability to invest in multiple asset classes, a shorter time horizon, and more liquid assets.

B is incorrect. Hedge Funds are private investment vehicles that use a variety of strategies to generate returns for their investors. While they offer private ownership and the ability to invest in multiple asset classes, they are typically less regulated than mutual funds and REITs. However, hedge funds usually have a longer time horizon and less liquid assets compared to mutual funds. They also often require a large minimum investment and are not suitable for all investors.

C is incorrect. Real Estate Investment Trusts (REITs) are companies that own, operate, or finance income-producing real estate. While they offer private ownership and the ability to invest in the real estate asset class, they do not offer the same level of liquidity as mutual funds. REITs are also subject to more regulation than mutual funds, and they typically have a longer time horizon due to the nature of real estate investments.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4488 A hedge fund manager is considering using leverage as a core component of their strategy. They plan to take both long and short positions using derivatives. The manager believes that a certain stock will increase in value and another will decrease. If their predictions are correct, they will profit from both positions. However, if their predictions are incorrect, they could suffer losses on both positions.
In this context, what is the most crucial aspect the hedge fund manager needs to continuously monitor to manage the risk associated with their strategy?

A. The value of their exposures.

B. The interest rates set by the central bank.

C. The performance of the stock market as a whole.

The correct answer is **A.**

The most crucial aspect the hedge fund manager needs to continuously monitor to manage the risk associated with their strategy is the value of their exposures. In a leveraged strategy, the hedge fund manager is taking on more risk than they would in an unleveraged strategy. This is because they are borrowing money to invest in more assets, which can amplify both gains and losses.

By doing so, they can quickly adjust their positions if the market moves against them, thereby limiting their potential losses. Furthermore, monitoring the value of their exposures can also help the manager identify opportunities to take profits when the market moves in their favor.

B is incorrect. The interest rates set by the central bank can impact the cost of borrowing for the hedge fund manager, which can in turn impact their profitability. However, this is not the most crucial aspect to monitor. This is because the manager's strategy involves taking both long and short positions, which means they can profit from both rising and falling stock prices, regardless of the level of interest rates.

C is incorrect. While the performance of the stock market as a whole can impact the value of the hedge fund manager's positions, it is not the most crucial aspect to monitor. This is because the manager's strategy involves taking both long and short positions, which means they can profit from both rising and falling stock prices.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4489 An investor is considering investing in a hedge fund and is evaluating different types of hedge fund strategies. He is particularly interested in a strategy that capitalizes on specific events such as mergers, acquisitions, or bankruptcies. He believes that such events can significantly impact the share price of the involved companies and wants to take advantage of these price movements.
Which type of hedge fund strategy is the investor *most likely* considering?

A. Equity Hedge Fund Strategy.

B. Event-Driven Hedge Fund Strategy.

C. Relative Value Hedge Fund Strategy.

The correct answer is **B.**

The investor is most likely considering an Event-Driven Hedge Fund Strategy. This strategy aims to exploit pricing inefficiencies that may occur before or after a corporate event, such as bankruptcy, merger, acquisition, or spinoff. Managers using this strategy will buy securities of companies that are the targets of acquisitions and sell the securities of the acquiring companies, or they may buy the securities of companies emerging from bankruptcy.

The goal is to take advantage of price movements caused by these events. This strategy requires a deep understanding of corporate law, finance, and the specific industries in which the companies operate. It also requires the ability to assess the likelihood of an event occurring and its potential impact on the company's share price.

A is incorrect. An Equity Hedge Fund Strategy involves taking long and short positions in equity and equity derivative securities to exploit perceived mispricing. While this strategy may involve investing in companies involved in corporate events, it is not specifically focused on such events.

C is incorrect. A Relative Value Hedge Fund Strategy involves taking advantage of price differentials between related financial instruments. Traders identify securities that are mispriced relative to each other, then buy the undervalued security and short the overvalued one. While this strategy may involve investing in companies involved in corporate events, it is not specifically focused on such events.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4490 A hedge fund manager is looking to exploit price discrepancies between related financial instruments. Which type of hedge fund strategy is the manager *most likely* planning to employ?

A. Opportunistic Hedge Fund Strategy.

B. Multi-Manager Hedge Fund Strategy.

C. Relative Value Hedge Fund Strategy.

The correct answer is **C.**

The hedge fund manager is planning to employ a Relative Value Hedge Fund Strategy. This strategy seeks to take advantage of price differentials between related financial instruments by buying and selling the different securities simultaneously. The goal is to profit from the relative price change of the two instruments, hence the name "relative value." This strategy is often used in arbitrage situations, where the price discrepancies between related securities are exploited for profit.

The relative value strategy is not dependent on the direction of the markets, which makes it a popular choice among hedge fund managers, especially in volatile or uncertain market conditions. The strategy requires a deep understanding of the financial instruments and markets involved, as well as sophisticated trading systems to execute the trades quickly and efficiently.

A is incorrect. An Opportunistic Hedge Fund Strategy is a type of investment strategy that seeks to exploit market opportunities as they arise without being tied to a specific investment style or asset class. This strategy is more flexible and can involve a wide range of investment tactics, including short selling, leverage, and derivatives trading. However, it does not specifically involve exploiting price discrepancies between related financial instruments.

B is incorrect. A Multi-Manager Hedge Fund Strategy involves investing in a portfolio of different hedge funds, each managed by a different manager. The goal is to diversify risk and generate consistent returns by combining the skills and strategies of multiple managers. This strategy does not involve exploiting price discrepancies between related financial instruments.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4491 A small investor lacks the resources to select individual hedge funds and build a portfolio of them. However, the investor still wants to have diversified exposure to different hedge fund strategies. Which type of investment vehicle would be *most* suitable for this investor?

A. Equity Hedge Funds.

B. Funds of Hedge Funds.

C. Event-Driven Hedge Funds.

The correct answer is **B.**

A Funds of Hedge Funds (FoHF) is the most suitable investment vehicle for a small investor who lacks the resources to select individual hedge funds and build a portfolio of them but still wants to have diversified exposure to different hedge fund strategies. FoHFs are investment vehicles that invest in a portfolio of different hedge funds, thereby providing investors with diversified exposure to a range of hedge fund strategies.

This diversification can help to reduce risk and enhance returns. FoHFs also provide access to hedge funds that may be closed to new investors or have high minimum investment requirements. They also offer professional management and due diligence on the underlying hedge funds. Therefore, FoHFs can be a good choice for small investors who want to invest in hedge funds but lack the resources to do so directly.

A is incorrect. Equity Hedge Funds are a type of hedge fund that invests primarily in equities. While they can provide exposure to equity markets, they do not offer the diversified exposure to different hedge fund strategies that the investor is seeking. Furthermore, investing in a single equity hedge fund can expose the investor to a high level of risk, as the performance of the fund will be heavily dependent on the performance of the equity markets and the specific stocks in which the fund invests.

C is incorrect. Event-driven hedge Funds are a type of hedge fund that seeks to profit from significant corporate events such as mergers and acquisitions, bankruptcies, and restructurings. Like equity hedge funds, they do not offer the diversified exposure to different hedge fund strategies that the investor is seeking. Moreover, event-driven strategies can be complex and risky, making them unsuitable for a small investor who lacks the resources to understand and manage these risks.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4492 A hedge fund manager is considering two different approaches to manage a long/short equity fund. The first approach involves starting with a company-level analysis, followed by an overall industry analysis, and finally an overall market analysis. The second approach involves starting with a global macro analysis, followed by sector/regional analysis, and finally an individual company analysis. The manager wants to balance long and short exposures.
Which of the following strategies *best* describes the two approaches the manager is considering?

A. Market Neutral and Short Biased.

B. Bottom-up and Top-down approach.

C. Fundamental Long/Short and Fundamental Growth.

The correct answer is **B.**

The two approaches the hedge fund manager is considering are best described as the Bottom-up and Top-down approach. The bottom-up approach starts with an individual company analysis, followed by an industry analysis, and finally, an overall market analysis. This approach focuses on the analysis of individual securities, and their selection is based on the strength of the individual company, regardless of the industry or economy.

The top-down approach, on the other hand, starts with a global macro analysis, followed by sector/regional analysis, and finally, an individual company analysis. This approach starts with an analysis of the overall economy, then narrows down to sector/industry analysis, and finally to individual companies within that sector/industry. Both these approaches are used in managing long/short equity funds, with the aim of balancing long and short exposures.

A is incorrect. Market Neutral and Short Biased are also not strategies that describe the two approaches the manager is considering. Market Neutral is a strategy that aims to avoid exposure to systematic risk by balancing long and short positions, while short-based is a strategy that involves taking more short positions than long positions in anticipation of a market decline. Neither of these strategies describes the process of starting with a company-level analysis or a global macro analysis.

C is incorrect. Fundamental Long/Short and Fundamental Growth are not strategies that describe the two approaches the manager is considering. Fundamental Long/Short is a strategy that involves taking long positions in stocks that are expected to increase in value and short positions in stocks that are expected to decrease in value. Fundamental Growth, on the other hand, is a strategy that focuses on investing in companies that are expected to grow at an above-average rate compared to other companies in the market. Neither of these strategies describes the process of starting with a company-level analysis or a global macro analysis.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4493 A hedge fund manager is considering a strategy that involves taking long positions in companies that are trading at inexpensive levels compared to their potential intrinsic value and shorting those that trade in the opposite direction. The aim is to reverse this trade to obtain alpha. The strategy also shorts stocks or an index to reduce the risk. The manager typically maintains a net long exposure but may adjust the amount of net market risk depending on his or her market forecast. Which of the following strategies most likely describes the manager's approach?

A. Fundamental Value.

B. Fundamental Growth.

C. Fundamental Long/Short.

The correct answer is **C.**

The strategy described in the question is known as a Fundamental Long/Short strategy. This strategy involves taking long positions in undervalued stocks (stocks trading at inexpensive levels compared to their potential intrinsic value) and short positions in overvalued stocks (stocks trading at expensive levels compared to their potential intrinsic value).

The aim is to profit from the expected convergence of the stock's price to its intrinsic value. The strategy also involves shorting stocks or an index to hedge against market risk. The manager maintains a net long exposure but may adjust the amount of net market risk depending on his or her market forecast. This strategy is designed to generate alpha, or risk-adjusted returns above the market average, by exploiting mispricing in individual securities. It is a common strategy used by hedge funds.

B is incorrect. A Fundamental Growth strategy involves investing in companies that are expected to grow at an above-average rate compared to other companies. This strategy does not involve short selling and is not designed to hedge against market risk. It is a long only strategy that aims to profit from the capital appreciation of growth stocks.

A is incorrect. A Fundamental Value strategy involves investing in companies that are undervalued by the market. This strategy also does not involve short selling and is not designed to hedge against market risk. It is a long only strategy that aims to profit from the capital appreciation of value stocks. While the manager's approach does involve investing in undervalued stocks, it also involves short-selling overvalued stocks and adjusting the net market risk, which are characteristics of a Fundamental Long/Short strategy, not a Fundamental Value strategy.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4494 A hedge fund manager is considering a strategy that uses quantitative, fundamental, and technical analysis to identify under- and overvalued equity securities. The hedge fund takes long positions in undervalued securities and short positions in overvalued securities. The intent is to profit from the movements of individual securities, undervalued ones rising and overvalued ones falling, while avoiding movements in the overall market.
Which of the following strategies *best* describes the manager's approach?

A. Short Biased.

B. Market Neutral.

C. Fundamental Value.

The correct answer is **B.**

The hedge fund manager's approach is best described as a Market Neutral strategy. A market neutral strategy is a type of investment strategy undertaken by an investor or an investment manager that seeks to profit from both increasing and decreasing prices in one or more markets, while attempting to completely avoid exposure to market risk. This strategy involves taking long positions in undervalued securities and short positions in overvalued securities, with the aim of profiting from the expected price movements of these individual securities, while maintaining a net position that is neutral to movements in the overall market.

This is exactly what the hedge fund manager in the question is doing. The manager is using a combination of quantitative, fundamental, and technical analysis to identify undervalued and overvalued securities, and is taking long and short positions in these securities, respectively, while seeking to maintain a market-neutral net position.

A is incorrect. A Short Biased strategy is one that is primarily focused on taking short positions, with the expectation that the securities will decrease in value. This is not the strategy being used by the hedge fund manager in the question, who is taking both long and short positions in an attempt to profit from price movements in individual securities while maintaining a market-neutral net position.

C is incorrect. A Fundamental Value strategy is one that involves selecting securities based on fundamental analysis, with the aim of investing in securities that are undervalued by the market. While the hedge fund manager in the question is using fundamental analysis as part of his or her strategy, this is not the only analysis being used. The manager is also using quantitative and technical analysis, and is taking both long and short positions, not just investing in undervalued securities. Therefore, the manager's approach is not best described as a Fundamental Value strategy.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4495 Event-driven strategies are a type of investment strategy that seeks to capitalize on significant corporate events that are expected to impact a company's valuation. These strategies can involve a variety of financial instruments, including common and preferred stocks, debt securities, and options.
Based on this information, which of the following *best* describes the primary goal of event-driven strategies?

A. To profit from top-down macroeconomic trends.

B. To profit from long-term growth in a company's stock price.

C. To profit from changes in a company's valuation due to a merger.

The correct answer is **C.**

The primary goal of event-driven strategies is to profit from changes in a company's valuation due to specific corporate events. Event-driven strategies are a type of investment strategy that seeks to capitalize on significant corporate events that are expected to impact a company's valuation. These strategies can involve a variety of financial instruments, including common and preferred stocks, debt securities, and options.

A is incorrect. Profiting from top-down macroeconomic trends is not the primary goal of event-driven strategies. While macroeconomic trends can certainly impact a company's valuation and thus be a factor in an event-driven strategy, they are not the specific corporate events that these strategies seek to capitalize on.

C is incorrect. Profiting from long-term growth in a company's stock price is not the primary goal of event-driven strategies. While long-term growth can certainly be a result of successful event-driven strategies, these strategies are more focused on short-term changes in valuation due to specific corporate events.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4496 Which of the following is *most likely* the primary risk in merger arbitrage and the role of leverage in this strategy?

A. The possibility of the acquiring company's stock price rising instead of falling, and leverage is used to mitigate this risk by increasing the potential returns.

B. The acquiring company overpays for the merger, and leverage is used to hedge against this risk by allowing the fund to short more shares of the acquiring company.

C. The announced merger or acquisition not happening, which can negatively impact the value of the fund holdings before the position can be unwound. Leverage is used to amplify returns but can also increase losses when the strategy fails.

The correct answer is **C.**

The primary risk in merger arbitrage is indeed the announced merger or acquisition not happening. This is because the strategy is based on the expectation that the deal spread will narrow to the closing value of the transaction once it is fully consummated. If the merger or acquisition fails to occur, the value of the fund holdings can be negatively impacted before the position can be unwound.

This risk is inherent in the strategy and cannot be eliminated. Leverage is used in this strategy to amplify returns. However, it is a double-edged sword. While it can increase potential returns when the strategy is successful, it can also magnify losses when the strategy fails.

A is incorrect. The primary risk in merger arbitrage is not the possibility of the acquiring company's stock price rising instead of falling. While this can affect the profitability of the strategy, it is not the main risk. Furthermore, leverage is not used to mitigate this risk. Instead, it is used to amplify potential returns, but it can also increase potential losses.

C is incorrect. The primary risk in merger arbitrage is not the acquiring company overpaying for the merger. While this can affect the profitability of the strategy, it is not the main risk. Furthermore, leverage is not used to hedge against this risk. Instead, it is used to amplify potential returns, but it can also increase potential losses.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4497 Which of the following *best* describes a special situations hedge fund strategy?

A. Investing in a company's equity during a period of stability to benefit from steady growth.

B. Investing in a company's equity during a period of significant change, such as a split or restructuring, to profit from the situation.

C. Investing in a company's debt during a period of financial distress to benefit from high interest rates.

The correct answer is **B.**

Special situations strategies are typically employed by hedge funds to capitalize on unique opportunities presented by companies undergoing significant changes. These strategies involve investing in a company's equity during a period of significant change, such as a split or restructuring, to profit from the situation. This is because such changes often lead to price dislocations, which can provide attractive investment opportunities.

A is incorrect. Investing in a company's equity during a period of stability to benefit from steady growth is not a special situations strategy. While this can be a valid investment strategy, it does not involve the same level of complexity or potential for high returns as a special situations strategy.

C is incorrect. Investing in a company's debt during a period of financial distress to benefit from high interest rates is more accurately described as a distressed debt strategy, not a special situations strategy. While both strategies involve investing in companies undergoing significant changes, a distressed debt strategy focuses on the company's debt, not its equity.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4498 An activist hedge fund manager has secured a significant equity holding in a publicly traded company. Which of the following is *least likely* a strategy that an activist hedge fund manager like this might advocate for, according to the typical practices of such funds in the public equity market?

A. Encouraging the company to invest in private equity funds.

B. Advocating for divestitures to streamline the company's operations.

C. Pushing for a restructuring of the company to improve its financial health.

The correct answer is **A.**

Activist hedge fund managers typically do not encourage the company to invest in private equity funds. Activist hedge funds are investment funds that acquire a significant stake in a company and then use that position to influence the company's policies and direction. Their goal is to implement changes that will increase the value of their investment. This can involve a variety of strategies, including advocating for divestitures to streamline the company's operations, pushing for a restructuring of the company to improve its financial health, or advocating for changes in management or corporate governance.

B is incorrect. Advocating for divestitures to streamline the company's operations is a common strategy used by activist hedge funds. By divesting non-core or underperforming assets, the company can focus on its core operations, which can lead to improved operational efficiency and profitability, thereby increasing the value of the company's shares.

C is incorrect. Pushing for a restructuring of the company to improve its financial health is another common strategy used by activist hedge funds. This can involve a variety of measures, such as reducing costs, improving operational efficiency, or restructuring the company's debt, all of which can improve the company's financial health and increase the value of its shares.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4500 A hedge fund manager is considering various higher-yielding securities for investment, including asset-backed securities, mortgage-backed securities, high-yield loans, and bonds, and their derivatives. Which of the following strategies could the manager *most likely* employ to potentially profit from this situation?

A. Sell the mortgage-backed security and buy the individual mortgages, profiting if the security's price falls or if the mortgages' prices rise.

B. Buy the mortgage-backed security and short the individual mortgages, profiting if the security's price rises or if the mortgages' prices fall.

C. Buy both the mortgage-backed security and the individual mortgages, profiting if both the security's price and the mortgages' prices rise.

The correct answer is **B.**

The hedge fund manager could employ the strategy of buying the mortgage-backed security and shorting the individual mortgages to potentially profit from the situation. This is known as a relative value arbitrage strategy. The manager is exploiting the price discrepancy between the mortgage-backed security and its underlying mortgages. If the mortgage-backed security is trading at a discount to its underlying mortgages, the manager could buy the security at a lower price and simultaneously short sell the individual mortgages at a higher price.

If the price of the mortgage-backed security rises or the prices of the individual mortgages fall, the manager would make a profit. This strategy is based on the assumption that the prices of the mortgage-backed security and its underlying mortgages will converge over time, eliminating the price discrepancy. This strategy is often used by hedge fund managers to exploit mispricing in the market and generate returns.

A is incorrect. Selling the mortgage-backed security and buying the individual mortgages would not be a profitable strategy in this situation. If the mortgage-backed security is trading at a discount to its underlying mortgages, selling the security would result in a loss, and buying the individual mortgages at a higher price would not generate a profit. This strategy would only be profitable if the price of the mortgage-backed security falls further or the prices of the individual mortgages rise significantly, which is not guaranteed.

C is incorrect. Buying both the mortgage-backed security and the individual mortgages would not be a profitable strategy in this situation. This strategy would only be profitable if both the price of the mortgage-backed security and the prices of the individual mortgages rise. However, if the mortgage-backed security is trading at a discount to its underlying mortgages, it is more likely that the prices will converge, not rise simultaneously. This strategy does not take advantage of the price discrepancy between the mortgage-backed security and its underlying mortgages.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4501 In the context of macro hedge fund strategies and managed futures funds, which of the following statements is *most accurate*?

A. Both Macro strategies and Managed futures funds are more likely to profit during periods of higher volatility.

B. Managed futures funds are more likely to profit during periods of higher volatility, while Macro strategies are more likely to profit during periods of strong trending market conditions.

C. Macro strategies are more likely to profit during periods of higher volatility, while Managed futures funds are more likely to profit during periods of strong trending market conditions.

The correct answer is **C.**

Macro strategies are more likely to profit during periods of higher volatility, while Managed futures funds are more likely to profit during periods of strong trending market conditions. Macro strategies use a top-down approach to identify economic trends and make trades based on expected movements in economic variables. These strategies are designed to take advantage of volatility in the market, as they can adjust their positions based on changes in economic indicators and market conditions. Therefore, they are more likely to profit during periods of higher volatility.

On the other hand, Managed futures funds make diversified directional investments primarily in the futures markets based on technical and fundamental strategies. These funds typically profit from strong trending market conditions, as they can take long or short positions in various futures contracts based on their analysis of market trends. Therefore, they are more likely to profit during periods of strong trending market conditions.

A is incorrect. Both Macro strategies and Managed futures funds are not more likely to profit during periods of higher volatility. While Macro strategies can profit from higher volatility, Managed futures funds are more focused on profiting from strong trending market conditions. Therefore, it is not accurate to say that both types of funds are more likely to profit during periods of higher volatility.

B is incorrect. Managed futures funds are not more likely to profit during periods of higher volatility. While these funds can take advantage of volatility to some extent, their primary focus is on identifying and profiting from market trends. Therefore, they are more likely to profit during periods of strong trending market conditions, not during periods of higher volatility.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4503 Which of the following statements is *most likely* to be true about hedge funds?

A. Hedge funds always offer daily liquidity, similar to mutual funds.

B. Hedge funds cannot take concentrated positions in securities or use leverage in their investment strategies.

C. Hedge funds might take a large position in a company's stocks, betting on the company's continued growth and dominance in its sector.

The correct answer is **C.**

Hedge funds might indeed take a large position in a company's stocks, betting on the company's continued growth and dominance in its sector. This is a common strategy used by hedge funds to generate high returns. They often take concentrated positions in securities that offer exposure to credit, volatility, and liquidity risk premiums.

This strategy is often referred to as a "long" position, where the hedge fund buys a large number of shares in a company with the expectation that the price will rise. This strategy can be risky, as it exposes the hedge fund to the potential for large losses if the price of the stock falls. However, it can also generate high returns if the price of the stock rises. The use of leverage can amplify these potential gains (and losses), making this a potentially high-risk, high-reward strategy.

A is incorrect. The statement that hedge funds always offer daily liquidity, similar to mutual funds, is incorrect. Unlike mutual funds, which typically offer daily liquidity, hedge funds often have lock-up periods during which investors cannot withdraw their funds. This is because hedge funds often invest in illiquid assets that cannot be easily sold. Therefore, they need to ensure that they have sufficient funds to meet their investment objectives and to cover potential losses.

B is incorrect. The statement that hedge funds cannot take concentrated positions in securities or use leverage in their investment strategies is incorrect. In fact, hedge funds are known for their aggressive investment styles, which often involve taking concentrated positions in securities and making liberal use of leverage. These strategies can increase the potential for higher returns, but they also increase risk.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4504 Which of the following statements is *most likely* accurate regarding hedge funds?

A. All hedge funds are structured as private investment partnerships and are only offered in tax-advantaged offshore locations.

B. The offering of a hedge fund is not subject to any legal restrictions and can be offered to any number of investors regardless of their income or net worth.

C. In some jurisdictions, the offering of a hedge fund is limited to a certain number of investors who meet specific income and net worth guidelines, typically referred to as accredited investors.

The correct answer is **C.**

In some jurisdictions, the offering of a hedge fund is indeed limited to a certain number of investors who meet specific income and net worth guidelines, typically referred to as accredited investors. For instance, in the US, it is a legal requirement set by the Securities and Exchange Commission (SEC) to protect less sophisticated investors from the potential risks associated with investing in complex and less regulated investment vehicles such as hedge funds.

Accredited investors are considered to be financially sophisticated and have a reduced need for the protection provided by regulatory disclosure filings. They are individuals or entities that meet requirements regarding income, net worth, asset size, governance status, or professional experience.

A is incorrect. Not all hedge funds are structured as private investment partnerships and are only offered in tax-advantaged offshore locations. While many hedge funds are structured this way to take advantage of certain tax benefits, it is not a requirement. Hedge funds can be structured in a variety of ways and can be offered in both onshore and offshore locations, depending on the specific circumstances and objectives of the fund.

B is incorrect. The offering of a hedge fund is indeed subject to legal restrictions and cannot be offered to any number of investors regardless of their income or net worth. As mentioned above, in the United States, hedge funds are typically only offered to accredited investors who meet specific income and net worth guidelines. This is to protect less sophisticated investors from the potential risks associated with these types of investments.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4505 An investor is considering investing in a hedge fund. The fund operates on a "2 and 20" fee structure. What does the "2 and 20" structure typically represent in this context?

A. The management fee and the performance fee are both 2% of the total assets.

B. The management fee is 2% of the total assets, and the performance fee is 20% of the profits.

C. The management fee is 20% of the total assets, and the performance fee is 2% of the profits.

The correct answer is **B.**

The "2 and 20" fee structure typically represents a management fee of 2% of the total assets and a performance fee of 20% of the profits. In the context of hedge funds, this is a common fee structure. The management fee is calculated as a percentage of the total assets under management (AUM), which in this case is 2%. This fee is charged regardless of the performance of the fund and is meant to cover the operational costs of the fund.

A is incorrect. In the "2 and 20" fee structure, the management fee is not 20% of the total assets, and the performance fee is not 2% of the profits. This would be an unusually high management fee and a relatively low-performance fee, which is not typical in the hedge fund industry.

C is incorrect. In the "2 and 20" fee structure, the management fee and the performance fee are not both 2% of the total assets. The management fee is 2% of the total assets, but the performance fee is 20% of the profits, not the total assets. This choice misunderstands the structure of hedge fund fees.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4506 In the context of hedge fund investments, which of the following statements *best* describes the purpose and function of side letters in hedge fund investments?

A. Provide all investors with enhanced information rights and detailed quarterly reports.

B. Change the terms of the private placement memorandum, the partnership agreement, or the articles.

C. Address specific legal, regulatory, tax, operational, and reporting requirements of an investor without changing the main documents of the fund.

The correct answer is **C.**

Side letters are used to address specific legal, regulatory, tax, operational, and reporting requirements of an investor without changing the main documents of the fund. They are essentially private agreements between the hedge fund and an individual investor that may confer certain rights, privileges, or preferences to that investor. These agreements are tailored to the specific needs of the investor and do not affect the terms of the fund's main documents.

A is incorrect. Side letters do not provide all investors with enhanced information rights and detailed quarterly reports. They are individual agreements that apply only to the investor who is party to the side letter. While a side letter may grant enhanced information rights to a specific investor, it does not extend these rights to all investors in the fund.

B is incorrect. Side letters do not change the terms of the private placement memorandum, the partnership agreement, or the articles. They are separate agreements that operate alongside these main documents and do not alter their terms. While a side letter may supersede the terms of the fund's main documents in relation to the specific investor who is a party to the side letter, it does not change the terms of these documents for other investors.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4507 Which of the following statements is *most accurate* regarding separately managed accounts (SMA)?

A. The day-to-day management of the account is retained by the investor.

B. The underlying assets are held and registered in the name of the hedge fund manager.

C. The investor creates their own investment vehicle, and the underlying assets are held in their name, but the day-to-day management is done by the hedge fund manager.

The correct answer is **C.**

In a separately managed account (SMA), the investor creates their own investment vehicle and the underlying assets are held and registered in their name, but the day-to-day management is delegated to the hedge fund manager. This structure provides the investor with a high level of control and transparency, as they have direct ownership of the underlying assets and can monitor the investment strategy and performance closely.

However, they delegate the day-to-day management to the hedge fund manager, who has the expertise and resources to manage the investments effectively. This allows the investor to benefit from the manager's expertise while maintaining control and transparency. The SMA structure is often preferred by large investors who want to maintain control over their investments but do not have the resources or expertise to manage them on a day-to-day basis.

A is incorrect. In SMA, the day-to-day management of the account is not retained by the investor. The investor creates their own investment vehicle, and the underlying assets are held and registered in their name, the day-to-day management is delegated to the hedge fund manager.

B is incorrect. In an SMA, the underlying assets are not held and registered in the name of the hedge fund manager. They are held and registered in the name of the investor. This is one of the key features of an SMA that provides the investor with a high level of control and transparency.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4508 Which of the following strategies could *most likely* increase the fund manager's motivation for investment performance in separately managed accounts (SMA)?

A. Structuring in favor of incentive fees.

B. Increasing the complexity of the SMA structure.

C. Reducing the transparency of the SMA structure.

The correct answer is **A.**

Structuring in favor of incentive fees is a strategy that could be used to mitigate the problem of fund managers not having a stake in the fund investments and potentially increase their motivation for investment performance. Incentive fees are a type of compensation that fund managers receive when the fund's performance exceeds a certain benchmark or hurdle rate. This aligns the interests of the fund managers with those of the investors, as the managers are rewarded for generating superior returns.

B is incorrect. Increasing the complexity of the SMA structure is not a strategy that would necessarily increase the fund manager's motivation for investment performance. In fact, it could potentially have the opposite effect, as it could make the fund more difficult to manage and could distract the managers from their primary task of generating returns.

C is incorrect. Reducing the transparency of the SMA structure is not a strategy that would increase the fund manager's motivation for investment performance. Transparency is a key benefit of SMAs, as it allows investors to see exactly what assets are in their portfolio and how they are being managed. Reducing transparency could potentially undermine investor confidence and could lead to a loss of trust in the fund manager.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4510 Which of the following is *least likely* a motivation behind choosing indirect exposure to hedge funds?

A. Increasing risk exposure.

B. Reducing management costs.

C. Increasing performance transparency.

The correct answer is **A.**

Increasing risk exposure is NOT a motivation behind choosing indirect exposure to hedge funds. Indirect investment in hedge funds, often through funds of funds, is typically chosen by investors who want to diversify their portfolio, reduce management costs, and increase performance transparency. These investors may lack the specialized skills or resources to manage certain asset types directly, or they may want to create multiple and concurrent exposures to different strategies.

However, the goal of this approach is not to increase risk exposure. In fact, one of the main benefits of indirect investment is that it can help to spread risk across a wider range of investments, thereby potentially reducing the overall risk of the portfolio.

B is incorrect. Reducing management costs is indeed a motivation behind choosing indirect exposure to hedge funds. By investing in a fund of funds, investors can gain exposure to a diversified portfolio of hedge funds with a single investment, which can be more cost-effective than investing in each fund individually.

C is incorrect. Increasing performance transparency is also a motivation behind choosing indirect exposure to hedge funds. Funds of funds provide regular and detailed reports on their performance, which can make it easier for investors to monitor their investments and make informed decisions.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4511 Which of the following statements is *most accurate* about the potential impact of fees and liquidation on the investor's returns from the hedge fund?

A. The management and performance fees will not significantly impact the investor's returns if the hedge fund performs well.

B. The investor's returns from the hedge fund will be unaffected by the liquidation of positions if the hedge fund underperforms.

C. The investor's returns from the hedge fund could be significantly reduced due to the management and performance fees and the potential for lower payouts from the liquidation of positions if the hedge fund underperforms.

The correct answer is **C.**

The investor's returns from the hedge fund could be significantly reduced due to the management and performance fees and the potential for lower payouts from the liquidation of positions if the hedge fund underperforms. Hedge funds typically charge a management fee and a performance fee. The management fee is usually a fixed percentage of the fund's net asset value, while the performance fee is a percentage of the fund's profits. These fees can significantly reduce the investor's returns, especially if the fund does not perform well.

Additionally, if the hedge fund underperforms and has to close out due to performance issues, the capital redeemed from liquidated positions may result in a lower payout, further diminishing the total return from the fund. Therefore, the potential impact of fees and liquidation on the investor's returns from the hedge fund can be significant.

A is incorrect. Even if the hedge fund performs well, the management and performance fees can still significantly impact the investor's returns. The management fee is charged regardless of the fund's performance, and the performance fee can take a substantial portion of the fund's profits. Therefore, even if the fund performs well, these fees can still reduce the investor's returns.

B is incorrect. The investor's returns from the hedge fund can be affected by the liquidation of positions if the hedge fund underperforms. If the fund has to close out due to performance issues, the capital redeemed from liquidated positions may result in a lower payout, which can further reduce the investor's returns. Therefore, the statement that the investor's returns will be unaffected by the liquidation of positions if the hedge fund underperforms is not accurate.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4512 Some index providers impose certain requirements on hedge funds for their inclusion in the index. For instance, an index provider may only include funds that have at least $100 million in Assets Under Management (AUM), have been in operation for at least five years, and are currently accepting new investors.
Which biases can *most likely* be introduced by these criteria?

A. Selection bias.

B. Survivorship bias.

C. Self-selection bias.

The correct answer is **B.**

These criteria can introduce Survivorship bias. Survivorship bias is introduced because the index only includes funds that have been in operation for at least five years. This means that funds that have failed or closed within this period are not included in the index, which can lead to an overestimation of the performance of the funds in the index.

A is incorrect. While selection bias could potentially be introduced by the criteria set by the index provider, the specific criteria mentioned do not introduce this bias. Selection bias occurs when the sample is not representative of the population, but in this case, the criteria are not selecting for a particular type of fund but rather setting minimum standards for inclusion in the index.

C is incorrect. Self-selection bias occurs when individuals select themselves into a group, causing a biased sample with nonprobability sampling. This bias is not introduced by the criteria set by the index provider.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4513 Which of the following is *least likely* a factor you would consider when evaluating the potential returns of a hedge fund?

A. The fund's marketing and branding efforts.

B. The fund's historical performance and volatility.

C. The fund manager's investment strategy and track record.

The correct answer is **A.**

The fund's marketing and branding efforts are not a factor to consider when evaluating the potential returns of a hedge fund. While marketing and branding efforts can influence the perception of a hedge fund and potentially attract more investors, they do not directly impact the fund's returns.

The returns of a hedge fund are primarily determined by the fund manager's investment strategy and the performance of the underlying assets, not by how well the fund is marketed or branded. Therefore, as a financial analyst, you would not consider the fund's marketing and branding efforts when evaluating its potential returns.

B is incorrect. The fund's historical performance and volatility are also important factors to consider when evaluating the potential returns of a hedge fund. Historical performance can give you an idea of how the fund has performed in the past, which can be a useful indicator of how it might perform in the future. Volatility, on the other hand, is a measure of the fund's risk, and higher volatility can indicate a higher potential for both gains and losses.

C is incorrect. The fund manager's investment strategy and track record are crucial factors to consider when evaluating the potential returns of a hedge fund. The manager's strategy will determine the types of investments the fund makes and the level of risk it takes, both of which can significantly impact the fund's returns. Additionally, the manager's track record can provide valuable insight into their ability to generate returns and manage risk.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4514 Which of the following strategies would be *most likely* be effective in reducing the impact of survivorship bias in fund indexes?

A. Only include the returns of active funds in the index.

B. Include the returns of both active funds and those that have stopped reporting.

C. Exclude the returns of funds that have stopped reporting due to poor performance.

The correct answer is **B.**

Including the returns of both active funds and those that have stopped reporting is the most effective strategy in reducing the impact of survivorship bias in fund indexes. Survivorship bias arises when funds that have ceased reporting are excluded from the index, which can lead to an overestimation of the index's performance.

By including the returns of funds that have stopped reporting, the index would provide a more accurate representation of the overall performance of the funds. This approach takes into account the performance of all funds, regardless of whether they are currently active or have ceased reporting. It helps to mitigate the impact of survivorship bias by ensuring that the index reflects the true performance of the fund universe rather than just the performance of the surviving funds.

A is incorrect. Only including the returns of active funds in the index would not reduce the impact of survivorship bias. In fact, it would exacerbate the bias because it would exclude the performance of funds that have ceased reporting, which are often the ones that have underperformed. This would lead to an overestimation of the index's performance.

C is incorrect. Excluding the returns of funds that have stopped reporting due to poor performance would not reduce the impact of survivorship bias. On the contrary, it would increase the bias because it would exclude the underperforming funds from the index, leading to an overestimation of the index's performance. This approach would not provide a true representation of the overall performance of the funds.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (b): Describe investment forms and vehicles used in hedge fund investments.

Q.4515 Which of the following statements *best* describes the impact of backfill bias on the performance of the index and the interpretation of the average return of the funds in the index?

A. Inflates the performance of the index and gives a false impression of the average return of the funds in the index.

B. Reduces the performance of the index and gives a true impression of the average return of the funds in the index.

C. It inflates the performance of the index and does not affect the interpretation of the average return of the funds in the index.

The correct answer is **A.**

Backfill bias inflates the performance of the index and gives a false impression of the average return of the funds in the index. This is because the index includes the past performance of a new fund, which has been performing exceptionally well. This practice can lead to an overstatement of the actual performance of the index. The inclusion of the strong past performance of the new fund in the index calculation can make the index appear more successful than it actually is.

B is incorrect. Backfill bias does not reduce the performance of the index. On the contrary, it inflates the performance of the index by including the strong past performance of a new fund. This can give a false impression of the average return of the funds in the index.

C is incorrect. Backfill bias does have an impact on the performance of the index. It inflates the performance of the index and can give a false impression of the average return of the funds in the index. Therefore, it does affect the interpretation of the average return of the funds in the index.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4516 Which of the following statements is *most likely* true regarding the benchmarking of returns for hedge funds?

A. Benchmarking of returns is easier for hedge funds due to their high flexibility of investments.

B. Traditional funds complicate frequent benchmarking of returns due to the systematic market risk they bear.

C. The structure of hedge funds complicates frequent benchmarking of returns due to factors like high flexibility of investments, and minimal disclosure.

The correct answer is **C.**

The structure of hedge funds complicates frequent benchmarking of returns due to factors like high flexibility of investments, minimal disclosure, and relative illiquidity of investments. Hedge funds are known for their flexibility in investment strategies, which can range from long/short equity strategies to global macro strategies, among others. This high degree of flexibility makes it difficult to find a suitable benchmark that accurately reflects the risk and return characteristics of the fund.

Furthermore, hedge funds are not required to disclose their holdings as frequently as traditional funds, making it difficult to assess their performance on a regular basis. Lastly, hedge funds often invest in illiquid assets, which can be hard to value and can therefore distort performance measurements. All these factors make the benchmarking of hedge fund returns a complex task.

A is incorrect. While it is true that hedge funds have a high degree of investment flexibility, this does not make benchmarking easier. On the contrary, the wide range of possible investment strategies and asset classes used by hedge funds makes it difficult to find a suitable benchmark that accurately reflects the risk and return characteristics of the fund.

B is incorrect. Traditional funds do not complicate frequent benchmarking of returns due to the systematic market risk they bear. In fact, the opposite is true. Traditional funds, such as long-only mutual funds and index ETFs, are typically benchmarked against well-known market indices, such as the S&P 500 for U.S. equity funds. This makes the benchmarking process relatively straightforward, as the performance of the fund can be easily compared to the performance of the index.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4517 If you are an investor considering a hedge fund investment, which of the following would you *least likely* consider as a potential risk associated with hedge fund investments?

A. Liquidity risk due to lock-up periods.

B. Operational risk due to lack of transparency.

C. Interest rate risk due to changes in the value of bonds.

The correct answer is **C.**

Interest rate risk due to changes in the value of bonds is not a risk that is specifically associated with hedge fund investments. Interest rate risk is a type of risk that is inherent in any investment that has a fixed income component, such as bonds. It refers to the risk that the value of a bond or other fixed-income investment will decrease due to an increase in interest rates.

While hedge funds may invest in bonds as part of their investment strategy, interest rate risk is not a risk that is unique to hedge funds. Therefore, it would not be considered a potential risk specifically associated with hedge fund investments.

A is incorrect. Liquidity risk due to lock-up periods is indeed a potential risk associated with hedge fund investments. Lock-up periods refer to a period of time during which investors are not allowed to redeem or sell their shares. This can create liquidity risk for the investor, as they may not be able to access their investment when they need to.

B is incorrect. Operational risk due to lack of transparency is also a potential risk associated with hedge fund investments. Hedge funds are often criticized for their lack of transparency, as they are not required to disclose their investment strategies or positions to investors. This can create operational risk for the investor, as they may not fully understand the risks associated with the hedge fund's investment strategy.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4518 Which of the following statements is *most accurate* about the diversification benefits of hedge fund investments?

A. Hedge fund investments always reduce the overall risk of an investment portfolio due to their low correlation with traditional asset classes.

B. Hedge fund investments increase the overall risk of an investment portfolio due to their high volatility and lack of transparency.

C. The diversification benefits of hedge fund investments depend on the specific strategies employed by the hedge fund and the existing composition of the investment portfolio.

The correct answer is **C.**

The diversification benefits of hedge fund investments depend on the specific strategies employed by the hedge fund and the existing composition of the investment portfolio. Hedge funds employ a wide range of strategies, including long/short equity, event-driven, global macro, and many others. Each of these strategies has its own risk-return characteristics and correlation with traditional asset classes. Therefore, the diversification benefits of investing in a hedge fund can vary significantly depending on the specific strategy employed by the fund.

A is incorrect. While it is true that hedge funds often have a low correlation with traditional asset classes, it is not accurate to say that hedge fund investments always reduce the overall risk of an investment portfolio. The risk reduction benefits of hedge fund investments depend on the specific strategies employed by the hedge fund and the existing composition of the investment portfolio.

B is incorrect. While it is true that some hedge funds have high volatility and lack transparency, it is not accurate to say that hedge fund investments always increase the overall risk of an investment portfolio. The impact of hedge fund investments on the overall risk of a portfolio depends on the specific strategies employed by the hedge fund and the existing composition of the investment portfolio.

CFA Level I, Alternative Investments, Learning Module 6: Hedge Funds. LOS (c): Analyze sources of risk, return, and diversification among hedge fund investments.

Q.4519 Which of the following statements is *least likely* true about DLT?

A. Bitcoin, a popular cryptocurrency, uses DLT to record all transactions.

B. DLT networks are fully secure, and there are no possible breaches in privacy and data protection.

C. DLT networks offer potential enhancements in delivering financial services and maintaining financial records.

The correct answer is **B.**

While Distributed Ledger Technology (DLT) offers many potential benefits, it is not accurate to say that DLT networks are fully secure and there are no possible breaches in privacy and data protection. Like any technology, DLT is not immune to security risks. The decentralized nature of DLT can make it more difficult to manage and control, and there are concerns about the potential for hacking, fraud, and other types of cybercrime.

Additionally, the transparency of DLT networks, while a potential advantage in some respects, can also raise privacy concerns. For example, if a DLT network is public, all transactions are visible to all participants in the network, which could potentially expose sensitive information.

A is incorrect. Bitcoin, a popular cryptocurrency, does indeed use DLT to record all transactions. This is a fundamental aspect of how Bitcoin and many other cryptocurrencies operate. The use of DLT allows for a decentralized, transparent, and secure record of all transactions, which is a key feature of these digital currencies.

C is incorrect. DLT networks do indeed offer potential enhancements in delivering financial services and maintaining financial records. This is one of the key potential benefits of DLT, and it is a major reason why this technology is being explored in the financial services industry.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (a): Describe financial applications of distributed ledger technology.

Q.4520 Which of the following *best* describes the role of cryptography in DLT? It is used to:

A. decrypt data, making it usable for unauthorized parties.

B. verify network participant identity and for data decryption.

C. encrypt data, making it unusable for unauthorized parties and to verify network participant identity.

The correct answer is **C.**

Cryptography plays a crucial role in Distributed Ledger Technology (DLT) by encrypting data, making it unusable for unauthorized parties, and verifying the identity of network participants. Cryptography is a method of protecting information by transforming it into an unreadable format. Only those who possess a special key can decrypt and read the information. In the context of DLT, cryptography is used to secure transactions and control the creation of new units.

A is incorrect. Cryptography in DLT is not used to decrypt data, making it usable for unauthorized parties. On the contrary, it is used to encrypt data, making it unusable for unauthorized parties. The purpose of cryptography is to secure data, not to make it accessible to unauthorized parties.

B is incorrect. While it is true that cryptography is used to verify network participant identity, it is not used for data decryption in the context of DLT. Instead, it is used to encrypt data, making it unusable for unauthorized parties. The decryption of data is only possible for authorized parties who possess the correct cryptographic key.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4521 In the context of consensus mechanisms in blockchain technology, which of the following statements is *most likely* true regarding these mechanisms?

A. Proof of Work is more energy-efficient than Proof of Stake.

B. Proof of Stake requires more computational power than Proof of Work.

C. Proof of Stake is generally considered more energy-efficient than Proof of Work.

The correct answer is **C.**

Proof of Stake (PoS) is generally considered more energy-efficient than Proof of Work (PoW). This is because PoS does not require miners to solve complex mathematical problems to validate transactions and create new blocks in the blockchain. Instead, the creator of a new block is chosen based on their stake or ownership of tokens in the network. This process does not require significant computational power or energy, making it more energy-efficient than PoW.

A is incorrect. Proof of Work is not more energy-efficient than Proof of Stake. In fact, one of the main criticisms of PoW is its high energy consumption. PoW requires miners to solve complex mathematical problems, which consumes significant computational power and energy. This is in contrast to PoS, which does not require such intensive computational work and is, therefore, more energy-efficient.

B is incorrect. Proof of Stake does not require more computational power than Proof of Work. In PoS, the creator of a new block is chosen based on their stake or ownership of tokens in the network, not on their ability to solve complex mathematical problems. This means that PoS does not require the same level of computational power as PoW, making it less resource-intensive and more energy-efficient.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4522 Which of the following is *most likely* is the primary function of blockchain technology in the context of Bitcoin transactions?

A. Increase the value of Bitcoin.

B. Provide a platform for Bitcoin mining.

C. Verify and record all Bitcoin transactions

The correct answer is **C.**

The primary function of blockchain technology in the context of Bitcoin transactions is to verify and record all Bitcoin transactions. Blockchain technology is a decentralized ledger that records all transactions across a network of computers. In the case of Bitcoin, every transaction made with the cryptocurrency is recorded on the blockchain. This record is permanent and cannot be altered, providing a transparent and secure method of recording transactions.

A is incorrect. Blockchain technology does not directly increase the value of Bitcoin. The value of Bitcoin is determined by supply and demand dynamics in the market, not by the technology underlying it. While the security and transparency provided by the blockchain may contribute to Bitcoin's appeal and, therefore, its value, this is an indirect effect and not the primary function of the blockchain.

B is incorrect. While blockchain technology does provide the platform for Bitcoin mining, this is not its primary function. Mining is the process of verifying transactions and adding them to the blockchain, but the main purpose of the blockchain itself is to record and verify these transactions. The platform for mining is a byproduct of the blockchain's primary function, not the function itself.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (b): Explain investment features of digital assets and contrast them with other asset classes.

Q.4523 Which of the following is *most likely* the primary purpose of a consensus protocol in a blockchain system?

A. Increase the speed of transactions.

B. Provide a user-friendly interface for users.

C. Dictate how blocks can join the chain and become the immutable "truth".

The correct answer is **C.**

The primary purpose of a consensus protocol in a blockchain system is to dictate how blocks can join the chain and become the immutable "truth." In a blockchain system, the consensus protocol is a set of rules that all participating nodes in the network agree to follow. It ensures that all transactions are recorded in a consistent and secure manner across all nodes in the network. The consensus protocol is designed to resist attempts at malicious manipulation and maintain the integrity and security of the system.

A is incorrect. While increasing the speed of transactions can be a desirable feature of a blockchain system, it is not the primary purpose of the consensus protocol. The consensus protocol is primarily concerned with ensuring the integrity and security of the system, not its speed. In fact, the process of reaching a consensus can sometimes slow down the transaction processing speed, as it requires the agreement of multiple nodes in the network.

B is incorrect. Providing a user-friendly interface for users is not the purpose of a consensus protocol in a blockchain system. The consensus protocol operates at the backend of the system, ensuring the integrity and security of the blockchain. It does not directly interact with users or affect the user interface. The user interface is typically handled by separate software or applications that interact with the blockchain.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (d): Analyze sources of risk, return, and diversification among digital asset investments.

Q.4524 Which of the following statements *best* describes how block creators are chosen in a Proof of Stake (PoS) consensus system?

A. Block creators in PoS are chosen based on the amount of computational power they have.

B. Block creators in PoS are chosen randomly, without considering their stake in the network.

C. Block creators in PoS are chosen randomly, but their selection probability increases with their stake in the network.

The correct answer is **C.**

In a Proof of Stake (PoS) consensus algorithm, the creator of a new block is chosen based on a specific criterion that is deterministic and depends on the creator's stake in the network. The more cryptocurrency a miner owns, the more mining power they have. Therefore, block creators in PoS are chosen randomly, but their selection probability increases with their stake in the network.

This is a key feature of PoS systems, as it incentivizes participants to hold and invest in the network's cryptocurrency, thereby promoting network security and stability. The more stake a participant has, the more likely they are to be chosen to create a new block, and the more they stand to lose if they attempt to undermine the network. This mechanism aligns the interests of the participants with the overall health and success of the network.

A is incorrect. The statement that block creators in PoS are chosen based on the amount of computational power they have is incorrect because this describes the Proof of Work (PoW) consensus algorithm, not PoS. In PoW, miners compete to solve complex mathematical problems, and the first to solve the problem gets to add a new block to the blockchain. This process requires significant computational power and energy consumption.

B is incorrect. The statement that block creators in PoS are chosen randomly, without considering their stake in the network, is also incorrect. In PoS, the selection of block creators is not purely random; it is influenced by the amount of stake a participant has in the network. The more stake a participant has, the higher their chances of being selected to create a new block.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4525 Which of the following statements is *most likely* true regarding the susceptibility to '51% attacks' and energy efficiency in Proof of Work (PoW) and Proof of Stake (PoS) consensus algorithms?

A. PoW is more energy-efficient and less susceptible to '51% attacks' compared to PoS.

B. PoS is more energy-efficient and less susceptible to '51% attacks' compared to PoW.

C. PoW and PoS have the same energy efficiency and susceptibility to '51% attacks'.

The correct answer is **B.**

Proof of Stake (PoS) is indeed more energy-efficient and less susceptible to '51% attacks' compared to Proof of Work (PoW). PoS is a consensus algorithm that achieves network security through the staking of assets. In PoS, the creator of the next block is chosen via various combinations of random selection and wealth or age of staked assets. This makes PoS more energy-efficient as it does not require miners to solve complex mathematical problems, which is a characteristic of PoW that requires significant computational power and energy consumption.

In terms of susceptibility to '51% attacks', PoS is considered less vulnerable. A '51% attack' refers to an attack on a blockchain network by a group of miners controlling more than 50% of the network's mining hash rate or computing power. In PoS, executing a '51% attack' would require ownership of 51% of the cryptocurrency, which is financially disincentivizing, making PoS less susceptible to such attacks.

A is incorrect. Proof of Work (PoW) is not more energy-efficient compared to Proof of Stake (PoS). PoW requires miners to solve complex mathematical problems to add a new block to the blockchain, which requires significant computational power and energy consumption. Also, PoW is more susceptible to '51% attacks' as it allows anyone with enough computational power to take control of the network.

C is incorrect. Proof of Work (PoW) and Proof of Stake (PoS) do not have the same level of susceptibility to '51% attacks'. As explained above, PoS is more energy-efficient and less susceptible to '51% attacks' compared to PoW.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4526 Which of the following statements *best* describes the difference between permissioned and permissionless networks?

A. Both permissioned and permissionless networks restrict who can participate in the network.

B. Permissionless networks are open to all participants, while permissioned networks restrict who can participate in the network.

C. Permissioned networks are open to all participants, while permissionless networks restrict who can participate in the network.

The correct answer is **B.**

Permissionless networks are open to all participants, while permissioned networks restrict who can participate in the network. In the context of blockchain technology, a permissionless network, also known as a public blockchain, is open to anyone who wants to participate. Anyone can join the network, validate transactions, and create new blocks. Bitcoin and Ethereum are examples of permissionless networks.

On the other hand, a permissioned network, also known as a private blockchain, restricts who can participate in the network. Only authorized participants can validate transactions and create new blocks. This type of network is often used by businesses for its increased efficiency and security. The key difference between the two types of networks is the level of access control for participation in the network, which has implications for the network's transparency, security, and speed.

A is incorrect. This statement is not accurate because it suggests that both permissioned and permissionless networks restrict participation, which is not the case. Permissionless networks are open to all participants, not restricted.

C is incorrect. This statement is the opposite of the correct answer. In reality, permissioned networks restrict who can participate in the network, while permissionless networks are open to all participants.

Q.4527 Which of the following statements is *most likely* true regarding permissionless networks?

A. Trust between transacting parties is a requirement in a permissionless network.

B. Permissionless networks require a centralized authority to confirm or deny the validity of transactions.

C. Permissionless networks are independent of a centralized authority to confirm or deny the validity of transactions.

The correct answer is **C.**

Permissionless networks are indeed independent from a centralized authority to confirm or deny the validity of transactions. This is one of the key characteristics of permissionless networks, such as Bitcoin's blockchain. In these networks, the validation of transactions is decentralized and is performed by the network's participants or nodes. This is achieved through a consensus mechanism, such as proof-of-work or proof-of-stake, where nodes compete to validate transactions and add them to the blockchain.

A is incorrect. Permissionless networks do not require a centralized authority to confirm or deny the validity of transactions. This is a characteristic of permissioned networks, where a central authority, such as a bank or a consortium of companies, controls who can participate in the network and validate transactions.

B is incorrect. Trust between transacting parties is not a requirement in a permissionless network. This is because the validity of transactions is ensured by the network's consensus mechanism, not by the trustworthiness of the participants. This is often referred to as "trustless" transaction, as it removes the need for trust in individual participants and instead relies on the trust in the network's protocol and consensus mechanism.***CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.***

Q.4528 Which of the following statements is *most likely* true regarding the consensus mechanism and cost-effectiveness of permissionless and permissioned blockchains?

A. Permissioned blockchains use a consensus protocol that requires significant computational power, making them less cost-effective.

B. Permissionless blockchains use a Proof of Work consensus mechanism and are more cost-effective due to their high level of decentralization.

C. Permissionless blockchains use a Proof of Work consensus mechanism and are less cost-effective due to their high level of decentralization.

The correct answer is **C.**

Permissionless blockchains like Bitcoin use a Proof of Work (PoW) consensus mechanism and are less cost-effective due to their high level of decentralization. In a PoW system, miners compete to solve complex mathematical problems, and the first one to solve the problem gets to add a new block to the blockchain. This process requires a significant amount of computational power and energy, making it less cost-effective.

Furthermore, the high level of decentralization in permissionless blockchains means that every participant in the network must validate and record every transaction, which requires a significant amount of bandwidth and storage capacity. This further adds to the cost and inefficiency of permissionless blockchains. Despite these drawbacks, the high level of decentralization in permissionless blockchains provides a high level of security and transparency, which is one of the main reasons why they are used for cryptocurrencies like Bitcoin.

A is incorrect. Permissioned blockchains like Ripple do not require a significant amount of computational power, which makes them more cost-effective. In permissioned blockchains, only a select group of nodes are allowed to validate and record transactions, which reduces the amount of computational power, energy, bandwidth, and storage capacity required. This makes permissioned blockchains more cost-effective compared to permissionless blockchains.

B is incorrect. While it is true that permissionless blockchains like Bitcoin use a Proof of Work consensus mechanism, they are not more cost-effective due to their high level of decentralization. As explained above, the high level of decentralization in permissionless blockchains requires a significant amount of computational power, energy, bandwidth, and storage capacity, which makes them less cost-effective.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (d): Analyze sources of risk, return, and diversification among digital asset investments.

Q.4529 Which of the following statements is *most likely* true regarding digital assets?

A. They can only take the form of currencies.

B. They require an intermediary for transactions.

C. They allow for near-real-time transactions without the need for an intermediary.

The correct answer is **C.**

Digital assets indeed allow for near-real-time transactions without the need for an intermediary. This is one of the key characteristics of digital assets, particularly cryptocurrencies like Bitcoin. The use of blockchain technology, which underpins many digital assets, enables this direct peer-to-peer transaction capability. Blockchain is a decentralized ledger that records transactions across many computers so that the record cannot be altered retroactively without the alteration of all subsequent blocks.

This technology eliminates the need for a central authority or intermediary, such as a bank or financial institution, to validate and process transactions. This not only speeds up transaction times but also reduces costs and increases security. The ability to transact directly and in near-real-time is a significant advantage of digital assets and is transforming the way financial transactions are conducted globally.

A is incorrect. Digital assets can take various forms, not just currencies. They can represent a wide range of tangible and intangible items, including but not limited to financial assets like stocks and bonds, real estate, and other property rights. Digital assets also include non-financial items like digital art, music, and other intellectual property rights. Therefore, the statement that digital assets can only take the form of currencies is incorrect.

B is incorrect. One of the defining characteristics of digital assets, particularly those based on blockchain technology, is that they do not require an intermediary for transactions. This is a significant departure from traditional financial systems, which rely heavily on intermediaries such as banks and financial institutions to validate and process transactions. Therefore, the statement that digital assets require an intermediary for transactions is incorrect.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (a): Describe financial applications of distributed ledger technology.

Q.4530 Which of the following statements *best* describes the primary purpose of a Central Bank Digital Currency (CBDC)?

A. To create a new form of currency that is not tied to any existing fiat currency.

B. To replace the physical currency with a digital version that is not controlled by any central authority.

C. To create a digital version of the currency issued by the central bank, essentially a digital bank note or coin.

The correct answer is **C.**

The primary purpose of a Central Bank Digital Currency (CBDC) is to create a digital version of the currency issued by the central bank, essentially a digital bank note or coin. CBDCs are a new form of central bank money that is different from balances in traditional reserve or settlement accounts. They are designed to have the same underlying value as the physical currency issued by the central bank and are fully regulated and backed by the central bank.

This means that they offer the same level of security and legal tender status as physical currency. The introduction of CBDCs is seen as a response to the decline in cash usage and the rise of digital payments. They are intended to ensure that central bank money remains accessible to all in a digital world and to provide a safe, efficient, and inclusive payment instrument.

A is incorrect. CBDCs are not intended to create a new form of currency that is not tied to any existing fiat currency. They are a digital form of the existing fiat currency issued by the central bank and are fully backed by that currency. They are not a new, separate currency but a new form of the existing currency.

B is incorrect. CBDCs are not intended to replace the physical currency with a digital version that is not controlled by any central authority. On the contrary, CBDCs are issued and regulated by the central bank, which is a central authority. They are designed to complement, not replace, physical currency and existing digital forms of central bank money.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4531 Which of the following statements *best* describes the primary difference between fungible tokens like cryptocurrencies and non-fungible tokens (NFTs)?

> A. Fungible tokens, like cryptocurrencies, are unique and represent authenticated objects, while NFTs are interchangeable and lack uniqueness.
>
> B. Both fungible tokens and NFTs are unique and represent authenticated objects, but NFTs are more commonly used for trading in digital artwork.
>
> C. Fungible tokens, like cryptocurrencies, are interchangeable and lack uniqueness, while each NFT is unique and represents a unique authenticated object.

The correct answer is **C.**

The primary difference between fungible tokens like cryptocurrencies and non-fungible tokens (NFTs) is that fungible tokens are interchangeable and lack uniqueness, while each NFT is unique and represents a unique authenticated object. Fungible tokens, such as cryptocurrencies like Bitcoin or Ethereum, are identical to each other and can be exchanged on a one-for-one basis. They do not carry unique information and are not linked to a specific asset.

On the other hand, NFTs are unique digital assets that are linked to a specific object or piece of content. Each NFT carries unique information and is linked to a specific asset, which can be a digital artwork, a collectible, a piece of real estate, or any other asset. This uniqueness and the ability to authenticate the asset is what gives NFTs their value and distinguishes them from fungible tokens.

A is incorrect. Fungible tokens, like cryptocurrencies, are not unique and do not represent authenticated objects. They are interchangeable and identical to each other. On the other hand, NFTs are unique and represent authenticated objects. They are not interchangeable.

B is incorrect. While it is true that NFTs are more commonly used for trading in digital artwork, this does not represent the primary difference between fungible tokens and NFTs. The primary difference is that fungible tokens are interchangeable and lack uniqueness, while each NFT is unique and represents a unique authenticated object.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (b): Explain investment features of digital assets and contrast them with other asset classes.

Q.4532 Consider a scenario where you are an active user on a blockchain-based platform. You frequently use this platform for various transactions and services. The platform uses a specific type of token as a medium of exchange for services and transaction fees. These tokens do not pay out dividends but compensate for activities on the network.
Based on your understanding of different types of tokens in a blockchain environment, which type of token is the platform *most likely* using?

A. Equity tokens

B. Utility tokens

C. Security tokens

The correct answer is **B.**

The platform is likely using Utility Tokens. Utility tokens are a type of digital asset that are designed to be spent within a certain blockchain ecosystem. They are not created to be an investment, instead, they provide users with access to a product or service. In this case, the tokens are used as a medium of exchange for services and transaction fees on the platform, which is a characteristic of utility tokens.

These tokens are often used to raise funds in an Initial Coin Offering (ICO), but their primary function is to provide access to a product or service. They are like digital coupons that give holders the right to use a network, and they can also be used to incentivize certain behaviors or actions within the network. Therefore, the tokens described in the scenario are utility tokens because they are used to compensate for activities on the network and do not pay out dividends.

A is incorrect. Equity tokens represent ownership in an underlying asset or company. They are similar to traditional stocks, and holders may have voting rights or be entitled to dividends. In this scenario, the tokens do not pay out dividends and do not represent ownership in an asset or company, so they are not equity tokens.

C is incorrect. Security tokens are a type of token that pay dividends, share profits, pay interest or invest in other tokens or assets to generate profits for the token holders. They are subject to federal securities and regulations. In this scenario, the tokens do not pay out dividends, which is a characteristic of security tokens, so they are not security tokens.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4533 Which statement *best* describes the role of cryptocurrencies in an investment portfolio?

A. Hedge against inflation and are not considered a legitimate asset class.

B. They are considered a traditional asset, similar to stocks and bonds, and are a standard part of any investment portfolio.

C. They are considered an alternative asset, sought after by certain institutional investors for their potential for higher returns and diversification benefits.

The correct answer is **C.**

Cryptocurrencies are indeed considered an alternative asset, sought after by certain institutional investors for their potential for higher returns and diversification benefits. As an alternative asset class, cryptocurrencies are not correlated with traditional asset classes such as stocks and bonds. This lack of correlation can provide diversification benefits to an investment portfolio, potentially reducing risk and enhancing returns.
Furthermore, the high volatility of cryptocurrencies can lead to higher potential returns, albeit at a higher risk. This makes them attractive to certain institutional investors, such as hedge funds, who are willing to take on higher risk in exchange for the potential for higher returns. The example of Tesla's investment in Bitcoin illustrates this trend. Therefore, cryptocurrencies can play a role in an investment portfolio, particularly for investors seeking diversification and higher potential returns.

A is incorrect. While some investors may use cryptocurrencies as a hedge against inflation, this is not their primary role in an investment portfolio. Moreover, the statement that cryptocurrencies are not considered a legitimate asset class is incorrect. As mentioned above, they are increasingly being recognized as a legitimate, albeit alternative, asset class by institutional investors.

B is incorrect. Cryptocurrencies are not considered a traditional asset, similar to stocks and bonds. They are a relatively new type of asset with unique characteristics, such as decentralization and reliance on blockchain technology. Furthermore, they are not a standard part of any investment portfolio. While some investors may choose to include cryptocurrencies in their portfolios, many others do not, due to their high volatility and regulatory uncertainty.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4534 Which of the following services is *least likely* provided by these financial service providers to support the growth and adoption of digital assets?

A. Secure storage of digital assets.

B. Physical delivery of digital assets.

C. Transaction processing of digital assets.

The correct answer is **B.**

Physical delivery of digital assets is not typically provided by financial service providers like Coinbase and BitGo. Digital assets, by their very nature, are intangible and exist only in the digital realm. They are represented by cryptographic tokens that are stored on a blockchain or other form of distributed ledger technology. These tokens can be transferred electronically from one digital wallet to another, but they cannot be physically delivered in the same way that traditional assets like stocks or commodities can be.

A is incorrect. Secure storage of digital assets is one of the primary services provided by financial service providers like Coinbase and BitGo. They provide digital wallets that securely store the cryptographic keys that control access to digital assets. This is a crucial service for the adoption and growth of digital assets, as it provides a safe and secure way for individuals and institutions to store their digital assets.

C is incorrect. Transaction processing of digital assets is another primary service provided by financial service providers like Coinbase and BitGo. They process transactions on the blockchain or other distributed ledger on behalf of their customers, ensuring that the transactions are valid and correctly recorded. This is another crucial service for the adoption and growth of digital assets, as it provides a reliable and efficient way for individuals and institutions to transact with their digital assets.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4535 In the context of digital assets, which statement would be the *most accurate*?

A. Blockchain technology eliminates the volatility in the value of digital assets.

B. Regulatory considerations have no significant impact on the value and usability of digital assets.

C. The value of digital assets is highly volatile, and regulatory considerations can significantly impact their value and usability.

The correct answer is **C.**

The statement that the value of digital assets is highly volatile and regulatory considerations can significantly impact their value and usability is the most accurate. Digital assets, such as cryptocurrencies, are known for their high volatility. This volatility is due to a variety of factors, including market speculation, technological advancements, and regulatory considerations. Regulatory considerations can have a significant impact on the value and usability of digital assets. Different countries have different regulations regarding digital assets.

A is incorrect. Blockchain technology does not eliminate the volatility in the value of digital assets. While blockchain technology does provide a secure and transparent way to record transactions, it does not control the factors that contribute to the volatility of digital assets, such as market speculation, technological advancements, and regulatory considerations.

B is incorrect. The statement that regulatory considerations have no significant impact on the value and usability of digital assets is incorrect. As explained above, regulatory decisions can significantly impact the demand for, and therefore the value of, digital assets. They can also impact the usability of digital assets. Therefore, regulatory considerations are a significant factor that investors in digital assets need to consider.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (d): Analyze sources of risk, return, and diversification among digital asset investments.

Q.4536 Which of the following *least likely* describes digital assets?

A. They are tangible and can be physically owned.

B. They utilize cryptographic techniques for secure transactions.

C. They are mostly decentralized and do not require a central authority for their operation.

The correct answer is **A.**

Digital assets, as the name suggests, are digital in nature and do not have a physical form. This is one of the key characteristics that set them apart from traditional financial assets. Digital assets, such as cryptocurrencies, exist only in electronic form and are stored in digital wallets or on blockchain networks. They cannot be physically owned or held, unlike traditional assets such as cash, stocks, or real estate.

B is incorrect. The use of cryptographic techniques for secure transactions is indeed a distinguishing characteristic of digital assets. Cryptography is used to secure transactions and control the creation of new units of digital assets. This provides a high level of security and helps to prevent fraud and double-spending.

C is incorrect. One of the key characteristics of many digital assets, particularly cryptocurrencies, is that they are decentralized and do not require a central authority for their operation. This is facilitated by blockchain technology, which allows for a distributed ledger system where transactions are verified and recorded by a network of computers rather than a central authority. This decentralization can offer benefits such as increased transparency and reduced reliance on traditional financial intermediaries.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4537 Which statement *accurately* reflects the distinctions between digital assets and traditional financial assets?

A. Digital assets, unlike traditional financial assets, cannot be divided into smaller units.

B. Traditional financial assets, unlike digital assets, do not require regulatory oversight.

C. Digital assets, unlike traditional financial assets, can be transferred without the need for an intermediary.

The correct answer is **C.**

Digital assets, unlike traditional financial assets, can indeed be transferred without the need for an intermediary. This is one of the key characteristics of digital assets and a major factor that differentiates them from traditional financial assets. The transfer of digital assets is facilitated by blockchain technology, which allows for peer-to-peer transactions to occur in a decentralized manner.

A is incorrect. Digital assets, like traditional financial assets, can indeed be divided into smaller units. In fact, one of the advantages of digital assets is their high degree of divisibility. This high degree of divisibility allows for greater flexibility in transactions and can facilitate microtransactions, which are not always feasible with traditional financial assets.

B is incorrect. Traditional financial assets, like digital assets, do require regulatory oversight. In fact, traditional financial assets are typically subject to a high degree of regulation to protect investors, maintain market integrity, and ensure the stability of the financial system. Digital assets are also subject to regulation, although the regulatory framework for digital assets is still evolving and varies widely by jurisdiction.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (a): Describe financial applications of distributed ledger technology.

Q.4538 Which of the following is *most likely* the primary characteristic of an Investible Digital Asset? They are:

A. Digital assets that can only be used for online purchases.

B. Physical assets that have been digitized for ease of trading.

C. Digital representations of value that can be traded, stored, or invested.

The correct answer is **C.**

This option accurately describes the primary characteristic of an investible digital asset. Investible digital assets are digital representations of value that can be traded on various platforms, securely stored in digital wallets, and serve as investment vehicles. This definition encompasses a wide range of assets, including cryptocurrencies, tokenized securities, and other blockchain-based assets.

A is incorrect: This option is too narrow, focusing on digital assets with a specific use case (online purchases). Investible digital assets are broader in scope, encompassing various digital representations of value beyond just those used for online transactions.

B is incorrect: While this option refers to the digitization of physical assets, it doesn't capture the primary characteristic of an investible digital asset. Investible digital assets are typically native to digital environments, often built on blockchain technology, and not necessarily the digitization of physical assets.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (b): Explain investment features of digital assets and contrast them with other asset classes.

Q.4539 Which of the following statements is *most likely* true about smart contracts?

A. Can be altered or changed after they have been executed.

B. Do not provide a trackable and irreversible record of transactions.

C. Automate the execution of agreements and provide a trackable, irreversible record of transactions.

The correct answer is **C.**

Smart contracts automate the execution of agreements and provide a trackable, irreversible record of transactions. This is one of the key features of smart contracts. They are self-executing contracts with the terms of the agreement directly written into code. The code and the agreements contained therein exist across a distributed, decentralized blockchain network. The code controls the execution, and transactions are trackable and irreversible.

Once a smart contract is executed, it cannot be altered or changed, providing a high level of security and trust in the transaction. The automation of the execution process reduces the need for intermediaries and can significantly increase the efficiency of transactions. The trackable and irreversible record of transactions provided by smart contracts is a key feature that enhances transparency and trust in the blockchain network.

A is incorrect. Smart contracts cannot be altered or changed after they have been executed. This is a key feature of smart contracts that enhances their security and trustworthiness. Once a smart contract is executed, the terms of the agreement are enforced automatically by the code, and the transaction is recorded on the blockchain, creating an irreversible record.

B is incorrect. Contrary to this statement, smart contracts do provide a trackable and irreversible record of transactions. This is one of the key features of smart contracts and blockchain technology in general. Every transaction executed through a smart contract is recorded on the blockchain, creating a permanent, unalterable record that can be tracked and verified by all participants in the network.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4540 A trader in Japan is interested in acquiring a tokenized asset from the United States. What potential advantages could the utilization of stablecoins *most likely* offer to the trader?

A. Earn interest on the tokenized asset.

B. Increase the volatility of the tokenized asset.

C. Bypass traditional banking systems and avoid foreign exchange fees.

The correct answer is **C.**

Stablecoins can indeed help the trader to bypass traditional banking systems and avoid foreign exchange fees. In the context of international transactions, stablecoins offer a significant advantage over traditional banking systems. Traditional banking systems often involve multiple intermediaries, each of which may charge fees, and can take several days to process international transactions. In contrast, transactions with stablecoins can be completed almost instantly, with minimal fees, regardless of the geographical location of the parties involved.

A is incorrect. While it is possible for a trader to earn interest on a tokenized asset, this is not a direct benefit of using stablecoins. The ability to earn interest on a tokenized asset depends on the specific terms of the asset, not on the use of stablecoins.

B is incorrect. Stablecoins are designed to minimize volatility, not increase it. The primary purpose of stablecoins is to provide stability in the highly volatile cryptocurrency market. Therefore, using stablecoins would not help the trader to increase the volatility of the tokenized asset.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4541 In the context of cryptocurrency trading, which of the following is *most likely* accurate?

A. Centralized cryptocurrency exchanges operate independently without any central authority, similar to peer-to-peer trading platforms.

B. Decentralized cryptocurrency exchanges function like traditional stock exchanges, with a central authority overseeing transactions.

C. Centralized cryptocurrency exchanges function like traditional stock exchanges, while decentralized exchanges operate like peer-to-peer trading platforms.

The correct answer is **C.**

Centralized cryptocurrency exchanges function like traditional stock exchanges, while decentralized exchanges operate like peer-to-peer trading platforms. Centralized exchanges are operated by a central authority or company that oversees and facilitates transactions, much like a traditional stock exchange. They provide a platform for users to trade cryptocurrencies for other assets, such as conventional fiat money or other digital currencies. Centralized exchanges are often easier to use and offer advanced features like margin trading, stop loss, lending, and others.

On the other hand, decentralized exchanges operate without a central authority. Instead, they run on blockchain technology that enables peer-to-peer trading. This means that transactions are made directly between users without the need for an intermediary. Decentralized exchanges offer increased privacy and control over one's funds, but they can be more difficult to use and may lack some of the features of centralized exchanges.

A is incorrect. Centralized cryptocurrency exchanges do not operate independently without any central authority. They are run by a central authority or company that oversees and facilitates transactions. This is in contrast to decentralized exchanges, which operate without a central authority and enable peer-to-peer trading.

B is incorrect. Decentralized cryptocurrency exchanges do not function like traditional stock exchanges. They do not have a central authority overseeing transactions. Instead, they operate on blockchain technology that enables peer-to-peer trading, allowing transactions to be made directly between users without the need for an intermediary.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4542 Which of the following is *most likely* a possible implementation of the pump-and-dump tactic in the context of cryptocurrency exchanges?

A. Creating a fake cryptocurrency and selling it on the exchange.

B. Hacking into the exchange's system and altering the price of a cryptocurrency.

C. Using social media to artificially inflate the price of a cryptocurrency, then selling off when the price is high.

The correct answer is **C.**

In the context of cryptocurrency exchanges, a pump-and-dump scheme can be implemented by using social media to artificially inflate the price of a cryptocurrency, then selling off when the price is high. This is a form of market manipulation where the manipulators buy a cryptocurrency at a low price, then create hype around it through social media or other platforms to attract other investors. As more people buy the cryptocurrency, its price increases.

Once the price is high enough, the manipulators sell their holdings, causing the price to crash and leaving the other investors with losses. This tactic is similar to the pump-and-dump schemes seen in the stock market and is a major challenge for cryptocurrency exchanges due to the lack of rigorous oversight and regulation.

A is incorrect. Creating a fake cryptocurrency and selling it on the exchange is a form of fraud, not a market manipulation tactic. While it is a serious issue that can harm investors and damage the reputation of the exchange, it is not the same as a pump-and-dump scheme. This tactic involves creating a cryptocurrency that has no real value or utility and selling it to unsuspecting investors, often through deceptive marketing practices.

B is incorrect. Hacking into the exchange's system and altering the price of a cryptocurrency is a form of cybercrime, not a market manipulation tactic. While it is a serious issue that cryptocurrency exchanges need to address, it is not the same as a pump-and-dump scheme.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (d): Analyze sources of risk, return, and diversification among digital asset investments.

Q.4543 Which of the following is *least likely* a characteristic of Direct Digital Asset Investment?

A. Involves the direct purchase of digital assets without the use of intermediaries.

B. Allows investors to have direct ownership and control over their digital assets.

C. Requires the use of a broker or other financial intermediary to facilitate the transaction.

The correct answer is **C.**

Direct Digital Asset Investment does not require the use of a broker or other financial intermediary to facilitate the transaction. This is one of the key characteristics of Direct Digital Asset Investment. It involves the direct purchase of digital assets such as cryptocurrencies, tokens, and other digital securities without the use of intermediaries. This allows investors to have direct ownership and control over their digital assets.

A is incorrect. This statement is actually a characteristic of Direct Digital Asset Investment. It involves the direct purchase of digital assets without the use of intermediaries. This is one of the key features of this form of investment.

B is incorrect. This statement is also a characteristic of Direct Digital Asset Investment. It allows investors to have direct ownership and control over their digital assets. This can offer significant advantages in terms of control and flexibility, but it also comes with its own set of risks and challenges.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (b): Explain investment features of digital assets and contrast them with other asset classes.

Q.4544 Which of the following is *most likely* the unique feature that distinguishes digital asset exchanges from traditional stock exchanges?

A. They are not regulated by any financial authority.

B. They operate 24/7, allowing for continuous trading.

C. They only allow transactions in one specific type of digital asset.

The correct answer is **B.**

Digital asset exchanges, such as Coinbase, Binance, or Kraken, operate 24/7, allowing for continuous trading. This is a unique feature that distinguishes them from traditional stock exchanges. Traditional stock exchanges operate during specific hours, typically five days a week. However, digital asset exchanges operate continuously, allowing investors to trade digital assets at any time of the day or night, regardless of their location.

A is incorrect. While it is true that the regulatory environment for digital assets is less developed than for traditional financial assets, it is not accurate to say that digital asset exchanges are not regulated by any financial authority. Many digital asset exchanges are subject to regulations in the jurisdictions in which they operate.

C is incorrect. Digital asset exchanges typically support transactions in a wide range of digital assets, not just one specific type. These can include cryptocurrencies like Bitcoin and Ethereum, as well as other types of digital assets like utility tokens and security tokens. The range of digital assets supported can vary between exchanges, but it is not accurate to say that they only allow transactions in one specific type of digital asset.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (b): Explain investment features of digital assets and contrast them with other asset classes.

Q.4545 Which of the following would be the *most suitable* strategy for an investor contemplating an investment in cryptocurrencies?

A. Invest only in smaller cryptocurrencies, or altcoins, to avoid the influence of "whales."

B. Invest all their savings in one popular cryptocurrency to maximize potential returns.

C. Conduct thorough research and due diligence before investing, diversify their cryptocurrency portfolio, and securely store their passkeys.

The correct answer is **C.**

Conducting thorough research and due diligence before investing, diversifying their cryptocurrency portfolio, and securely storing their passkeys is the most appropriate strategy for an investor considering investing in cryptocurrencies. This approach mitigates the three main risks associated with cryptocurrency investments. Firstly, by conducting thorough research and due diligence, investors can avoid fraudulent activities such as scam ICOs and pump-and-dump schemes, thereby reducing Fraud Risk.

Secondly, diversifying their cryptocurrency portfolio can help investors spread their risk across different cryptocurrencies, reducing the impact of any single cryptocurrency's performance on their overall portfolio. This can help mitigate Concentration Risk. Lastly, securely storing their passkeys can prevent loss of access to their cryptocurrency holdings, thereby reducing Access Risk. Therefore, this strategy provides a comprehensive approach to managing the risks associated with cryptocurrency investments.

A is incorrect. Investing only in smaller cryptocurrencies, or altcoins, to avoid the influence of "whales" is not an appropriate strategy as it increases the Fraud Risk. Smaller cryptocurrencies are often less regulated and more susceptible to fraudulent activities. Furthermore, this strategy does not address the Access Risk and may not effectively mitigate the Concentration Risk, as "whales" can also exist in smaller cryptocurrencies.

B is incorrect. Investing all their savings in one popular cryptocurrency to maximize potential returns is not an appropriate strategy as it increases the Concentration Risk. If the chosen cryptocurrency performs poorly, the investor could lose a significant portion, if not all, of their investment. Furthermore, this strategy does not address the Fraud Risk and Access Risk associated with cryptocurrency investments.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (d): Analyze sources of risk, return, and diversification among digital asset investments.

Q.4546 Which of the following is *most likely* an example of an indirect digital asset investment?

A. Storing digital assets in a digital wallet.

B. Purchasing Bitcoin directly from a cryptocurrency exchange.

C. Investing in a technology company that develops blockchain solutions.

The correct answer is **C.**

Investing in a technology company that develops blockchain solutions is an example of an indirect digital asset investment. This is because the investor is not directly purchasing a digital asset like Bitcoin or Ethereum, but is instead investing in a company that is involved in the digital asset market. The performance of the investment is linked to the success of the company and its blockchain solutions, which may be influenced by the overall performance of the digital asset market.

A is incorrect. Storing digital assets in a digital wallet is not an investment at all. It is simply a method of storing digital assets that have been purchased. While it is an important aspect of managing digital assets, it does not involve putting money into a financial instrument or company with the expectation of generating a return, which is the definition of an investment.

B is incorrect. Purchasing Bitcoin directly from a cryptocurrency exchange is a direct digital asset investment, not an indirect one. In this case, the investor is directly purchasing and owning a digital asset. The performance of the investment is directly linked to the price of Bitcoin, which can be highly volatile.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4547 Which of the following is *most likely* correct statement regarding trading in cryptocurrency futures contracts?

A. Trading in cryptocurrency futures contracts requires the investor to physically store and secure the cryptocurrency.

B. Trading in cryptocurrency futures contracts is not leveraged, meaning you cannot control a large amount of cryptocurrency with a relatively small amount of capital.

C. The market for cryptocurrency futures may be less liquid and more volatile than more established futures markets, leading to potential large price swings and losses.

The correct answer is **C.**

The market for cryptocurrency futures may indeed be less liquid and more volatile than more established futures markets, leading to potential large price swings and losses. Cryptocurrencies are known for their high volatility, and this extends to their futures contracts as well. The liquidity of a market refers to how easily assets within that market can be bought and sold without affecting the asset's price.

A is incorrect. Trading in cryptocurrency futures contracts does not require the investor to physically store and secure the cryptocurrency. This is because these contracts are typically cash-settled, meaning that no actual cryptocurrency changes hands. Instead, the contract is settled in cash based on the difference between the contract price and the market price of the cryptocurrency at the time of settlement.

B is incorrect. Trading in cryptocurrency futures contracts is indeed leveraged, meaning you can control a large amount of cryptocurrency with a relatively small amount of capital. This is a characteristic of futures trading in general, not just cryptocurrency futures. The leverage comes from the fact that the trader only needs to put up a fraction of the contract's value as a margin to enter the trade. This can amplify potential gains but also potential losses.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (d): Analyze sources of risk, return, and diversification among digital asset investments.

Q.4548 Which of the following statements *accurately* reflects the nature of Cryptocurrency ETFs?

A. They use only cash to gain exposure to the value of cryptocurrencies.

B. They directly invest in cryptocurrencies and hold them in their portfolio.

C. They use cash and cryptocurrency derivatives to gain exposure to the value of cryptocurrencies.

The correct answer is **C.**

Cryptocurrency Exchange-Traded Funds (ETFs), such as the Bitwise 10 Crypto Index Fund (BITW), typically do not directly invest in cryptocurrencies. Instead, they use both cash and cryptocurrency derivatives to gain exposure to the value of cryptocurrencies. This strategy allows them to circumvent the risks and complexities associated with holding cryptocurrencies directly. Cryptocurrency derivatives are financial contracts that derive their value from the performance of the underlying cryptocurrency.

A is incorrect. Cryptocurrency ETFs do not use only cash to gain exposure to the value of cryptocurrencies. While they may use cash as part of their investment strategy, they also use cryptocurrency derivatives to gain exposure to the value of cryptocurrencies. This allows them to replicate the performance of a basket of cryptocurrencies without the need to hold the cryptocurrencies directly.

B is incorrect. Cryptocurrency ETFs typically do not directly invest in cryptocurrencies and hold them in their portfolio. This is because holding cryptocurrencies directly involves significant risks and complexities, including the risk of loss due to hacking, the need for secure storage, and the challenges of managing the private keys that control access to the cryptocurrencies.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4549 Which of the following statements *best* describes the role of hedge funds in the digital asset market?

A. Hedge funds primarily act as intermediaries between cryptocurrency buyers and sellers, facilitating transactions and earning commissions.

B. Hedge funds primarily invest in cryptocurrencies by purchasing them on exchanges and holding them in anticipation of price appreciation.

C. Hedge funds actively participate in the cryptocurrency market through various strategies, including mining for Bitcoin, investing in blockchain technology, and trading digital assets.

The correct answer is **C.**

Hedge funds actively participate in the cryptocurrency market through various strategies, including mining for Bitcoin, investing in blockchain technology, and trading digital assets. Hedge funds, known for their diverse and often complex investment strategies, have been increasingly involved in the digital asset space. They employ a variety of strategies to generate returns, including mining for Bitcoin, investing in blockchain technology, and trading digital assets.

Mining for Bitcoin involves the use of powerful computers to solve complex mathematical problems, thereby validating transactions on the Bitcoin network. The miners are then rewarded with new Bitcoin, which can be sold for a profit. This active participation in the cryptocurrency market allows hedge funds to generate returns in a variety of market conditions and to take advantage of the unique opportunities presented by digital assets.

A is incorrect. While some hedge funds may act as intermediaries between cryptocurrency buyers and sellers, this is not their primary role in the cryptocurrency market. Hedge funds are primarily investment vehicles, not intermediaries. They seek to generate returns for their investors through a variety of investment strategies, including those involving cryptocurrencies.

B is incorrect. While some hedge funds may invest in cryptocurrencies by purchasing them on exchanges and holding them in anticipation of price appreciation, this is not their only strategy in the cryptocurrency market. Hedge funds employ a variety of strategies in the cryptocurrency market, including mining for Bitcoin, investing in blockchain technology, and trading digital assets. Simply buying and holding cryptocurrencies is just one of many strategies that hedge funds may use.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4550 Which of the following is *most likely* the primary advantage of asset-backed tokens?

A. It increases the overall value of the asset.

B. It democratizes access to high-value assets.

C. It allows investors to own a whole high-priced asset.

The correct answer is **B.**

The primary benefit of asset-backed tokens is that they democratize access to high-value assets. This is achieved through the concept of fractional ownership, which allows multiple investors to own a fractional interest in high-priced assets. This means that investors who would not normally be able to afford to invest in such assets due to their high price can now do so.

A is incorrect. While asset-backed tokens can potentially increase the liquidity of an asset, they do not necessarily increase the overall value of the asset. The value of the asset is derived from the underlying physical or financial asset, and the tokenization process does not change this. The value of the tokens will fluctuate based on the value of the underlying asset, but the overall value of the asset remains the same.

C is incorrect. Asset-backed tokens do not allow investors to own a whole high-priced asset. Instead, they allow investors to own a fraction of such an asset. This is a key feature of asset-backed tokens and is what makes them different from traditional forms of investment.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (c): Describe investment forms and vehicles used in digital asset investments.

Q.4551 Which of the following is *most likely* true regarding the investment in cryptocurrencies?

A. Investing in cryptocurrencies is a low-risk strategy due to their recognition as alternative investments.

B. Despite their recognition as alternative investments, cryptocurrencies should be approached with caution due to their high level of risk.

C. The value appreciation of cryptocurrencies is solely due to the introduction of traditional indirect forms of investment into the cryptocurrency market.

The correct answer is **B.**

Despite their recognition as alternative investments, cryptocurrencies should indeed be approached with caution due to their high level of risk. Cryptocurrencies, such as Bitcoin and Ethereum, have seen significant increases in value and have been recognized as alternative investments. However, they are known for their volatility, which can lead to substantial financial losses.

While they offer the potential for high returns, the risk associated with these digital assets is equally high. This is due to a variety of factors, including regulatory uncertainty, technological vulnerabilities, and market manipulation. Therefore, while cryptocurrencies can be a part of a diversified investment portfolio, they should be approached with caution, and investors should be prepared for the possibility of losing their entire investment.

A is incorrect. Investing in cryptocurrencies is not a low-risk strategy due to their recognition as alternative investments. While it is true that cryptocurrencies have gained recognition as alternative investments, this does not mitigate the high level of risk associated with them. Their prices are highly volatile and can fluctuate widely in a very short period of time. Therefore, investing in cryptocurrencies can lead to substantial financial losses.

C is incorrect. The value appreciation of cryptocurrencies is not solely due to the introduction of traditional indirect forms of investment into the cryptocurrency market. While the introduction of traditional indirect forms of investment has certainly contributed to the increase in value of cryptocurrencies, it is not the only factor. Other factors, such as increased acceptance of cryptocurrencies as a form of payment, technological advancements, and regulatory developments, have also played a role in their value appreciation.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (d): Analyze sources of risk, return, and diversification among digital asset investments.

Q.4552 Which of the following *most likely* determines the value of cryptocurrencies?

A. Number of transactions processed through the network.

B. Amount of dividends or interest payments it generates.

C. Scarcity principle that is similar to how the value of precious metals is determined.

The correct answer is **C.**

The value of cryptocurrencies like Bitcoin is primarily determined by the scarcity principle, similar to how the value of precious metals is determined. This principle is based on the economic theory of supply and demand. When the supply of an asset is limited and demand for it is high, its value tends to increase. In the case of Bitcoin, its supply is capped at 21 million, making it a scarce digital asset.

A is incorrect. While the number of transactions processed through the network can influence the perceived utility and hence the demand for a cryptocurrency, it is not the primary determinant of its value. The value of a cryptocurrency is not directly tied to the volume of transactions it processes. A cryptocurrency could process a high volume of transactions, but if the demand for the cryptocurrency is low, its value may not necessarily be high.

B is incorrect. Cryptocurrencies do not generate dividends or interest payments, so their value is not determined by these factors. This is a key difference between cryptocurrencies and traditional assets like stocks and bonds, which derive their value from the underlying cash flows they generate.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (b): Explain investment features of digital assets and contrast them with other asset classes.

Q.4553 Which of the following is *most likely* true about cryptocurrencies in terms of regulatory status and potential risks?

A. Despite the lack of clear legal protection, there is no risk involved in investing in cryptocurrencies due to their digital nature.

B. Cryptocurrencies are fully regulated and protected by law in both the United States and the EU, minimizing the risk for investors.

C. The regulatory uncertainty and lack of legal protection for cryptocurrencies create a significant risk for investors, with potential for fraud and criminal activities.

The correct answer is **C.**

The regulatory uncertainty and lack of legal protection for cryptocurrencies indeed create a significant risk for investors, with the potential for fraud and criminal activities. The legal and regulatory frameworks for cryptocurrencies are still evolving, and this lack of clarity can lead to significant risks. In the United States, cryptocurrencies are treated as digital commodities, but this does not mean they are fully regulated or protected by law.

In the EU, comprehensive regulations are yet to be established. This lack of clear legal protection can expose investors to various risks, including fraud and criminal activities. Cryptocurrencies, due to their digital nature and the anonymity they can provide, have been used in illegal activities, including money laundering and financing of terrorism. Furthermore, the lack of regulation can also lead to market manipulation and volatility, which can result in significant financial losses for investors.

A is incorrect. Cryptocurrencies are not fully regulated and protected by law in both the United States and the EU. While the US treats cryptocurrencies as a digital commodity, this does not equate to full regulation or legal protection. In the EU, comprehensive regulations are yet to be established. Therefore, the statement is inaccurate.

B is incorrect. The statement that there is no risk involved in investing in cryptocurrencies due to their digital nature is incorrect. The digital nature of cryptocurrencies does not eliminate risks; in fact, it can introduce new ones, such as cybersecurity risks. Furthermore, the lack of clear legal protection can expose investors to significant risks, including fraud and criminal activities.

CFA Level I, Alternative Investments, Learning Module 7: Introduction to Digital Assets. LOS (d): Analyze sources of risk, return, and diversification among digital asset investments.