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.
