Question #1 of 12

Question ID: 1552398

A portfolio manager has a new client who would like to invest passively in equities and desires low costs and high liquidity. Which of the following investments/approaches would be *least appropriate* for the client?

A) Separately managed equity index-based portfolios. ✓

B) Equity index derivatives. ✗

C) Exchange-traded funds (ETFs). ✗

Explanation

Equity index derivatives (options, futures, swaps) have the advantage of high liquidity since they trade in liquid markets. As well, the transaction costs are generally low (e.g., only a relatively small premium is paid for upfront options, no explicit transaction costs for futures).

ETFs are advantageous in that they are easy to trade (e.g., relatively liquid), have low management fees, and may increase returns through tax efficiency. However, they have transaction costs from commissions and bid-ask spreads (buy at offer and sell at bid prices) as well as potential illiquidity in some ETF secondary markets.

Separately managed equity index-based portfolios hold all of the constituent stocks in the index or a representative sample. They require regularly updated data on the index, sophisticated trading and accounting systems, and compliance systems, all of which would significantly increases costs.

(Module 14.2, LOS 14.c)

Question #2 of 12

Question ID: 1552422

An investor gathers the following data on three index-tracking mutual funds.

Mutual Fund	Number of Stocks Held	Expense Ratio
S&P 500 Index Fund	508	0.02%
Russell 1000 Index Fund	1,010	0.07%
Wilshire 5000 Index Fund	1,731	0.62%

Based on this information, the investor would expect the tracking error to be highest for:

A) the Wilshire 5000 Index Fund.

B) the Russell 1000 Index Fund.

C) the S&P 500 Index Fund.

Explanation

The Wilshire 5000 Index Fund is likely to use a sampling approach, holding a much lower number of constituent stocks compared to the index. In contrast, both the S&P 500 Index Fund and Russell 1000 Index Fund appear to be replicating their respective index. (They are holding slightly more constituents than their respective index, which can happen if buffering is used.) Sampling generally increases tracking error relative to full replication.

In addition, the Wilshire Fund has the highest expense ratio. Higher expense ratios contribute to lower excess returns and higher tracking error.

(Module 14.3, LOS 14.e)

Question #3 of 12

Question ID: 1552368

Stock Q is in a small-capitalization index. Returns on the stock result in an increase in market capitalization, causing it to be reclassified as a mid-capitalization stock. However, only one-half of the portfolio's position in that stock is moved to the mid-capitalization index on the reconstitution date. The technique being utilized is *best* described as:

A) conditional reconstitution.

B) packeting.

C) buffering.

Explanation

Packeting describes the method of reducing stock transactions costs by only transferring a portion of the position from one capitalization category to another on a reconstitution date. Buffering limits migration by establishing a threshold that must be met before moving a stock from one index to another. Conditional reconstitution is not a term used in the reading.

(Module 14.1, LOS 14.a)

Question #4 of 12

Question ID: 1552405

Chandler Gough, CFA, is constructing a passively managed equity portfolio containing a large number of stocks. His primary objective is to minimize tracking error and his secondary objective is to minimize transaction costs. Which of the following construction approaches is *most appropriate* for Gough?

A) Stratified sampling.

B) Full replication.

C) Optimization.

Explanation

Optimization uses the tools of modern portfolio theory to address the problem of minimizing tracking error, which is Gough's primary objective. However, if there are changing historical relationships, then there is the need to maintain the optimization as the data change and that *may* be costly due to transaction costs. Therefore, optimization *may or may not* meet his secondary objective.

Full replication closely matches the index return so it minimizes tracking error, which meets his primary objective. However, because there are a large number of stocks, full replication will *definitely* be costly due to transaction costs and that *will not* meet his secondary objective.

Stratified sampling has higher tracking error due to the large number of stocks and therefore, the need for a larger sample. That does not meet his primary objective. However, the use of a sample means that the transaction costs are lower than for full replication.

(Module 14.2, LOS 14.d)

Question #5 of 12

Question ID: 1552389

An equity analyst makes the following statements about fundamental-weighted equity indexes.

Statement 1:	Investors that use fundamental-weighted indexes as benchmarks believe that equity markets are efficient.
Statement 2:	Fundamental-weighted indexes are generally low cost, transparent, and investable.

Which of the analyst's statements is correct?

A) Both Statement 1 and Statement 2.

B) Statement 1 only.

C) Statement 2 only.

Explanation

Fundamental-weighted portfolios are constructed to exploit pricing inefficiencies. (Market-cap-weighted portfolios are based on the efficient market hypothesis.)

Fundamental-weighted indexes (and market-cap-weighted indexes) are low cost, rules-based, transparent, and investable.

(Module 14.1, LOS 14.b)

Question #6 of 12

Question ID: 1552377

Compared to the FTSE 100 market-cap weighted index, the FTSE 100 equally-weighted index is *most likely* to:

A) be less volatile.

B) require less rebalancing.

C) be less concentrated.

Explanation

Compared to market-cap weighting, equal weighting reduces concentration risk, especially for the large-cap segment where capitalizations vary widely.

Equal weighting produces higher volatility of returns because of its bias toward smaller-cap stocks relative to market-cap weighting.

An equally-weighted index requires frequent rebalancing because portfolio weights are no longer equal as soon as prices change.

(Module 14.1, LOS 14.a)

Question #7 of 12

Question ID: 1552419

Which of the following statements regarding cash drag for an equity index fund and/or its relevant benchmark is correct?

A) Cash drag can have a positive effect on the value of the fund.

B) Both the fund and the benchmark are subject to cash drag.

C) Using derivatives strategies has no impact on cash drag on the fund.

Explanation

When markets are falling, it is better to hold cash and therefore, cash drag actually benefits the fund.

The benchmark is assumed to be fully invested, therefore, it is not subject to cash drag.

The use of futures contracts is an example of a derivatives strategy that can be used to provide equity exposure to a portfolio. That will *avoid or reduce* cash drag compared to if the portfolio were simply invested in cash.

(Module 14.3, LOS 14.e)

Question #8 of 12

Question ID: 1552388

Which of the following statements regarding passive factor-based strategies is most accurate?

A) They usually have lower fees than market-cap-weighted strategies.

B) **They usually have moderate fees because they do not require regular monitoring.**

C) They usually use a single benchmark.

Explanation

Factor-based strategies have moderate fees (i.e. fees are less than those for active management) because they are rules based and that restricts the fees. They usually use *multiple* benchmarks, including a factor-based one and a market-cap weighted one. They also have *higher* management fees and trading commissions than market-cap-weighted strategies.

(Module 14.1, LOS 14.b)

Question #9 of 12

Question ID: 1552435

Which of the following statements regarding investor engagement by passive equity managers is correct?

Statement 1:	Passive equity managers have a fiduciary duty to vote proxies in the best interests of their investors.
Statement 2:	Passive equity managers must research proxy ballots internally because of the importance of this form of shareholder engagement.

A) Both Statement 1 and Statement 2.

B) Statement 2 only.

C) Statement 1 only.

Explanation

Passive managers have a fiduciary duty to their clients to vote proxies in the best interests of investors.

Proxy voting as a form of shareholder engagement is time consuming and costly. Because shareholder engagement is not a primary objective of passive managers, they will frequently use recommendations from a proxy voting service to vote proxies in the best interests of their investors.

(Module 14.3, LOS 14.f)

Question #10 of 12

Question ID: 1552400

An investment analyst states that exchange-traded funds (ETFs) exhibit the following trading characteristics.

Characteristic 1:	Investors can buy and sell ETF shares throughout the trading day.
Characteristic 2:	The fund manager of an ETF acts as the market maker for the trading of the ETF's shares on an exchange.

Is the analyst correct?

A) The analyst is correct regarding Characteristic 2, but incorrect regarding Characteristic 1.

B) Yes.

C) The analyst is correct regarding Characteristic 1, but incorrect regarding Characteristic 2.

Explanation

ETFs are traded throughout the day on an exchange.

An authorized participant acts as the market maker for an ETF's shares. It is also the intermediary between investors and the ETF fund manager for the creation and redemption of the ETF's shares.

(Module 14.2, LOS 14.c)

Question #11 of 12

Question ID: 1552412

A small endowment fund wishes to invest $20 million in a passively managed equity portfolio. Full replication is *most likely* to be an appropriate method of constructing this portfolio when the equity index consists of:

A) 4,500 mid-cap and small-cap stocks, some of which are relatively illiquid.

B) 500 large-cap stocks with high liquidity.

C) 2,000 small-cap stocks with varying degrees of liquidity.

Explanation

Full replication can be costly when the index has a large number of constituents and liquidity is limited.

(Module 14.2, LOS 14.d)

Question #12 of 12

Question ID: 1552427

Which type of analysis is *most* useful in identifying sources of tracking error?

A) Optimization.

B) Attribution analysis.

C) Stratified sampling.

Explanation

The manager of a passively managed equity portfolio needs to understand the sources of return versus the index in order to effectively and efficiently manage a portfolio that replicates its performance. A key tool is attribution analysis, which can help the manager identify the sources of tracking error.

(Module 14.3, LOS 14.f)