

Reading 58: Introduction to Alternative Investments

Question #1 of 48

Question ID: 434450

Yeoman Partners is a private equity fund that raised \$100 million in committed capital at inception with a 2% management fee and 20% incentive fee. In Year 1, Yeoman drew down \$40 million and did not return any capital to investors. The fund's fees in Year 1 are:

- ☐ A) \$8,800,000.
- ☒ B) \$2,000,000.
- ☐ C) \$800,000.

Explanation

Fees in Year 1 are $2\% \times \$100 \text{ million} = \2 million . Private equity funds charge a management fee on the amount of committed capital, regardless of the actual amount deployed. A private equity fund typically does not earn incentive fees until after it has returned the initial capital to investors.

References

Question From: Session 18 > Reading 58 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #2 of 48

Question ID: 416033

An additional risk of direct investment in real estate, which is not typically a significant risk in a portfolio of traditional investments, is:

- ☐ A) counterparty risk.
- ☒ B) liquidity risk.
- ☐ C) market risk.

Explanation

Direct investment in real estate involves liquidity risk because large sums may be invested for long periods before a sale of the property can take place. Market risk exists for both traditional portfolio and real estate investments. Counterparty risk applies mainly to derivative contracts that require a payment from a counterparty, such as swaps and forwards.

References

Question From: Session 18 > Reading 58 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #3 of 48

Question ID: 416052

The component of the return on a futures position that results from interest earned on U.S. Treasury bills deposited to establish the position is called the:

- X **A)** current yield.
- ✓ **B)** collateral yield.
- X **C)** roll yield.

Explanation

Collateral yield is the return earned on the collateral posted to satisfy margin requirements. In most cases, the collateral posted will be U.S. Treasury Bills, in which case the collateral yield is the T-bill yield.

References

Question From: Session 18 > Reading 58 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #4 of 48

Question ID: 614854

Investments in infrastructure assets that will be constructed in the future are *most accurately* described as:

- X **A)** brownfield infrastructure investments.
- ✓ **B)** greenfield infrastructure investments.
- X **C)** openfield infrastructure investments.

Explanation

Greenfield investments are infrastructure assets to be built. Brownfield investments are infrastructure assets that already exist.

References

Question From: Session 18 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #5 of 48

Question ID: 485819

A due diligence factor that is common to analyzing real estate investment trusts, hedge funds, and private equity is (are):

- X **A)** drawdown procedures.
- X **B)** dividend distribution requirement.
- ✓ **C)** variability of manager performance.

Explanation

All of these classifications of alternative investments share variability of manager performance as a due diligence factor. Drawdown procedures are primarily a due diligence factor for analyzing private equity. Dividend distribution requirement is specific to REITs.

References

Question From: Session 18 > Reading 58 > LOS g

Related Material:

- Key Concepts by LOS
-

Question #6 of 48

Question ID: 460709

Victrix is a hedge fund that has a 3-and-15 fee structure. Compared to hedge funds with 2-and-20 fee structures, Victrix charges higher:

- ✓ **A)** management fees.
- X **B)** incentive fees.
- X **C)** load fees.

Explanation

Hedge fund fee structures indicate management fees as a percentage of assets under management and incentive fees as a percentage of gains in value. A 3-and-15 fee structure means a fund charges a 3% management fee and a 15% incentive fee. Sales load is typically associated with mutual funds and is not indicated by hedge fund fee structures.

References

Question From: Session 18 > Reading 58 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #7 of 48

Question ID: 416042

A private equity provision that requires managers to return any periodic incentive fees resulting in investors receiving less than 80% of profits is a:

- X **A)** high water mark.
- X **B)** drawdown.
- ✓ **C)** clawback.

Explanation

A clawback provision requires the manager to return any periodic incentive fees to investors that would result in investors receiving less than 80% of the profits generated by portfolio investments as a whole.

References

Question From: Session 18 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #8 of 48

Question ID: 416057

Springfield Fund of Funds invests in two hedge funds, DXS and REF funds. Springfield initially invested \$50.0 million in DXS and \$100.0 million in REF. After one year, DXS and REF were valued at \$55.5 million and \$104.5 million, respectively, net of both hedge fund management fees and incentive fees. Springfield Fund of Funds charges 1.0% management fee based on assets under management at the beginning of the year and a 10.0% incentive fee independent of management fees. The annual net return for Springfield Fund of Funds is *closest to*:

- ☐ A) 6.0%.
- ☐ B) 5.5%.
- ☒ C) 5.0%.

Explanation

Management fee = $\$150.0 \times 1.0\% = \1.5 million

Net value at end of year after hedge fund fees = $\$55.5 + \$104.5 = \$160.0$ million

Incentive fee = $(\$160.0 - \$150.0) \times 10\% = \$1.0$ million

Total fees = $\$1.5 + \$1.0 = \$2.5$ million

Net of fees: $\$160.0 - \$2.5 = \$157.5$ million

Net return = $(\$157.5 / \$150.0) - 1 = 5.0\%$

References

Question From: Session 18 > Reading 58 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #9 of 48

Question ID: 614856

A hedge fund that charges an incentive fee on all profits, but only if the fund's rate of return exceeds a stated benchmark, is said to have a:

- ☐ A) high water mark.
- ☒ B) soft hurdle rate.
- ☐ C) hard hurdle rate.

Explanation

With a soft hurdle rate, a hedge fund charges an incentive fee on all profits, but only if the fund's rate of return exceeds a stated benchmark. With a hard hurdle rate, a hedge fund charges an incentive fee only on the portion of returns that exceed a stated benchmark. With a high water mark, a fund's value must exceed its highest previous value before the fund may charge an incentive fee.

References

Question From: Session 18 > Reading 58 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #10 of 48

Question ID: 416045

The most prevalent type of private equity fund is:

- X **A)** distressed securities funds.
- ✓ **B)** leveraged buyout funds.
- X **C)** venture capital funds.

Explanation

Leveraged buyout funds comprise the majority of private equity investment funds.

References

Question From: Session 18 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #11 of 48

Question ID: 614852

Return and risk data on alternative investments may be affected by backfill bias if:

- X **A)** data only include currently existing firms.
- ✓ **B)** a firm's historical returns are included when it is added to an index.
- X **C)** the incorrect distribution is used to model volatility.

Explanation

Backfill bias refers to bias introduced by including the previous performance data for firms added to a benchmark index.

References

Question From: Session 18 > Reading 58 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #12 of 48

Question ID: 416044

If a commodity's convenience yield is close to zero, the futures market for that commodity is *most likely*:

- X **A)** in backwardation.
- X **B)** at fair value.
- ✓ **C)** in contango.

Explanation

Futures price \approx Spot price $(1 + \text{risk-free rate}) + \text{storage costs} - \text{convenience yield}$. If the convenience yield is close to zero, it is likely that the futures price exceeds the spot price, i.e., the market for the commodity is in contango.

References

Question From: Session 18 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #13 of 48

Question ID: 434451

Historical data on returns of assets valued with appraisal methods are *most likely* to exhibit:

- ☐ A) downward-biased Sharpe measures.
- ☒ B) smoothing.
- ☐ C) overstated correlations with other asset classes.

Explanation

Appraisal methods tend to produce smoothed return patterns understate standard deviations of returns. This causes correlations with other asset classes to be understated and Sharpe ratios to be biased upward.

References

Question From: Session 18 > Reading 58 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #14 of 48

Question ID: 416061

For which of the following investments is an investor *most likely* to require the greatest liquidity premium?

- ☒ A) Private equity funds.
- ☐ B) Commodity futures.
- ☐ C) Real estate investment trusts.

Explanation

Private equity funds tend to have lockup periods; investors will require liquidity premiums as compensation. REITs and commodity futures are exchange-traded instruments and much more liquid than private equity funds.

References

Question From: Session 18 > Reading 58 > LOS g

Related Material:

- Key Concepts by LOS
-

Question #15 of 48

Question ID: 416059

With respect to risk management for alternative investments, counterparty and liquidity risk are introduced as additional considerations by the use of:

- X **A)** lock-up periods.
- ✓ **B)** derivatives.
- X **C)** foreign currencies.

Explanation

Use of derivatives introduces operational, financial, counterparty, and liquidity risk.

References

Question From: Session 18 > Reading 58 > LOS g

Related Material:

- Key Concepts by LOS
-

Question #16 of 48

Question ID: 614853

Social infrastructure assets *most likely* include:

- X **A)** waste treatment plants.
- ✓ **B)** health care facilities.
- X **C)** broadcasting towers.

Explanation

Health care facilities are categorized as social infrastructure. Waste treatment plants are utility infrastructure. Broadcasting towers are communications infrastructure.

References

Question From: Session 18 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #17 of 48

Question ID: 485818

An example of a relative value hedge fund strategy is:

- ✓ **A)** convertible arbitrage.
- X **B)** merger arbitrage.
- X **C)** market neutral.

Explanation

Relative value strategies include convertible arbitrage fixed income, asset-backed fixed income, general fixed income, volatility, and multi-strategy. Market neutral is an equity hedge strategy. Merger arbitrage is an event driven strategy.

References

Question From: Session 18 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #18 of 48

Question ID: 434452

Real estate and private equity *most likely* share which of the following characteristics?

- ☐ A) Commonly traded on an exchange.
- ☒ B) Biases in historical returns on indexes.
- ☐ C) Low management fees.

Explanation

Private equity index returns may exhibit survivorship bias and backfill bias, while some real estate index returns may exhibit sample selection bias. Neither asset class is considered to have low management fees. Private equity is not typically traded on an exchange.

References

Question From: Session 18 > Reading 58 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #19 of 48

Question ID: 416060

For an investment with negatively skewed returns, the *most appropriate* of the following risk measures is:

- ☐ A) value at risk.
- ☒ B) Sortino ratio.
- ☐ C) shortfall risk.

Explanation

The Sortino ratio uses downside deviation, and therefore will capture the effects of negative skewness better than measures that use standard deviation. Value at risk (VaR) is a downside risk measure that estimates the potential loss from outcomes in the left tail of the distribution of returns but uses standard deviation, as does shortfall risk.

References

Question From: Session 18 > Reading 58 > LOS g

Related Material:

- Key Concepts by LOS

Question #20 of 48

Question ID: 416037

A portfolio manager who adds commodities to a portfolio of traditional investments is *most likely* seeking to:

- ☐ A) both increase expected returns and decrease portfolio variance.
- ☒ B) decrease portfolio variance only.
- ☐ C) increase expected returns only.

Explanation

Unlike most alternative investments, expected returns on commodities are typically less than expected returns on traditional investments. However, because their returns typically have a low correlation with returns on traditional investments, adding commodities to a portfolio of traditional investments can decrease portfolio variance.

References

Question From: Session 18 > Reading 58 > LOS c

Related Material:

- Key Concepts by LOS
-

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Question ID: 416039

A hedge fund strategy that takes positions in shares of firms undergoing restructuring or acquisition is an:

- ☐ A) macro strategy.
- ☒ B) event driven strategy.
- ☐ C) equity hedge strategy.

Explanation

Event-driven strategies include merger arbitrage, distressed/restructuring, and special situations strategies that involve long or short positions in common equity, preferred equity, or debt of a specific corporation. Macro strategies are based on global economic trends and events, and may involve long or short positions in equities, fixed income, currencies, or commodities. Equity hedge strategies seek to profit from long and short positions in publicly traded equities and derivatives with equities as their underlying assets, but are not based on events such as restructuring or acquisition.

References

Question From: Session 18 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #22 of 48

Question ID: 416053

A Canadian hedge fund has a value of C\$100 million at the beginning of the year. The fund charges a 2% management fee based on assets under management at the beginning of the year and a 20% incentive fee with a 10% hard hurdle rate. Incentive

fees are calculated net of management fees. The value at the end of the year before fees is C\$112 million. The net return to investors is *closest to*:

- ☐ A) 9%.
- ☐ B) 8%.
- ☒ C) 10%.

Explanation

Management Fee: $C\$100.0 \times 2.0\% = C\2.0 million

Gross value at end of year (given) = C\$112.0 million

Incentive fee = $[(C\$112.0 - C\$100.0 - C\$2.0 - (C\$100.0 \times 10.0\%)] \times 20\% = C\0

Total fee = C\$2.0 million

Net of fee: $C\$112.0 - C\$2.0 = C\$110.0$ million

Net return = $(C\$110.0 / C\$100.0) - 1 = 10.0\%$

References

Question From: Session 18 > Reading 58 > LOS e

Related Material:

- Key Concepts by LOS

Question #23 of 48

Question ID: 485817

An equity hedge fund strategy that focuses primarily on exploiting overvalued securities is *best* described as a(n):

- ☐ A) event driven strategy.
- ☐ B) fundamental value strategy.
- ☒ C) short bias strategy.

Explanation

Equity hedge funds with a short bias attempt to profit from short positions in equities they believe to be overvalued. These funds may hold long equity positions but typically have net short exposure to the market. An event driven strategy focuses on companies involved in mergers, in financial distress, or in other special situations. A fundamental value strategy attempts to identify undervalued equities.

References

Question From: Session 18 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS

Question #24 of 48

Question ID: 416047

The difference between a hedge fund's trading net asset value and its accounting net asset value is that:

- ☒ A) trading NAV tends to be lower because of illiquid assets.

- X **B)** accounting NAV tends to be lower because of model prices.
- X **C)** accounting NAV tends to be higher because of estimated liabilities.

Explanation

Trading NAV adjusts accounting NAV downward to account for illiquidity of a hedge fund's investments, such as positions that are large relative to trading volume.

References

Question From: Session 18 > Reading 58 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #25 of 48

Question ID: 416058

A Hong Kong hedge fund was valued at HK\$400 million last year. At year's end the value before fees was HK\$480 million. The fund charges 2 and 20. Management fees are calculated on end-of-year values. Incentive fees are independent of management fees and calculated using no hurdle rate. The previous year the fund's net return was 2.5%. The annualized return for the last two years is *closest to*:

- X **A)** 8.1%.
- X **B)** 13.6%.
- ✓ **C)** 7.9%.

Explanation

Management fee is $\text{HK\$}480 \text{ million} \times 0.02 = \text{HK\$}9.6 \text{ million}$.

Incentive fee is $(\text{HK\$}480 \text{ million} - \text{HK\$}400 \text{ million}) \times 0.20 = \text{HK\$}16.0 \text{ million}$.

Total fee is $\text{HK\$}9.6 \text{ million} + \text{HK\$}16.0 \text{ million} = \text{HK\$}25.6 \text{ million}$.

Net of fee: $\text{HK\$}480.0 - \text{HK\$}25.6 = \text{HK\$}454.4 \text{ million}$

Net return: $(\text{HK\$}454.4 / \text{HK\$}400.00) - 1 = 13.6\%$

Two year annualized return is $(1.136 \times 1.025)^{1/2} - 1 = 7.9\%$

References

Question From: Session 18 > Reading 58 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #26 of 48

Question ID: 434453

For a given set of underlying real estate properties, the type of real estate index that is most likely to have the lowest standard deviation is a(n):

- X **A)** repeat sales index.
- ✓ **B)** appraisal index.
- X **C)** REIT trading price index.

Explanation

Appraisal index returns are based on estimates of property values. Because estimating values tends to introduce smoothing into returns data, appraisal index returns are likely to have lower standard deviations than index returns based on repeat sales or trading prices of REIT shares.

References

Question From: Session 18 > Reading 58 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #27 of 48

Question ID: 416046

Which of the following *best* describes why adding a commodities index position to a portfolio of stocks and bonds may be beneficial? Commodities index positions:

- ☐ **A)** benefit from commodity markets oscillating between contango and backwardation.
- ☐ **B)** are positively correlated with stock and bond prices.
- ☒ **C)** serve as a hedge against inflation.

Explanation

The correlation between commodity futures and inflation is positive, while the correlation between inflation and stocks and bonds is negative. Therefore, declining stock and bond prices due to high inflation can be offset by the rising prices of commodities that occur during times of high inflation. While it is possible for commodity futures markets to change between backwardation and contango, this alone is not a reason to add a commodities position to a traditional portfolio.

References

Question From: Session 18 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #28 of 48

Question ID: 416036

Funds that invest in the equity of companies, primarily by using debt financing, are *best* characterized as:

- ☐ **A)** hedge funds.
- ☒ **B)** private equity funds.
- ☐ **C)** real estate investment trusts.

Explanation

Leveraged buyout (LBO) funds, a type of private equity fund, use borrowed money to purchase equity in established companies.

References

Question From: Session 18 > Reading 58 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #29 of 48

Question ID: 416054

A British hedge fund has a value of £100 million at the beginning of the year. The fund charges a 2% management fee based on assets under management at the end of the year and a 20% incentive fee with a soft hurdle rate of LIBOR + 2.5%. Incentive fees are calculated net of management fees. If the relevant LIBOR rate is 2.5% and the fund's value at the end of the year before fees is £120 million, the net return to investors is *closest to*:

- ✓ **A)** 14.1%.
- X **B)** 16.5%.
- X **C)** 17.6%.

Explanation

Management fee = $£120.0 \times 2.0\% = £2.4$ million.

Gross value at end of year (given) = £120.0 million.

Gross return = $(£120.0 / £100.0) - 1 = 20.0\%$. The soft hurdle rate of $2.5\% + 2.5\% = 5.0\%$ was exceeded.

Incentive fee = $(£120.0 - £100.0 - £2.4) \times 20\% = £3.52$ million.

Total fee = $£2.40 + £3.52 = £5.92$ million.

Net of fee: $£120.00 - £5.92 = £114.08$ million.

Net return = $(£114.08 / £100.00) - 1 = 14.1\%$.

References

Question From: Session 18 > Reading 58 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #30 of 48

Question ID: 416050

In the valuation of a real estate investment trust (REIT), subtracting the REIT's liabilities from the value of its real estate assets and dividing by the number of shares outstanding provides an estimate of the REIT's:

- X **A)** adjusted funds from operations.
- ✓ **B)** net asset value.
- X **C)** free cash flow per share.

Explanation

An asset-based approach to valuing a REIT is to estimate its net asset value as the difference between the value of the REIT's real estate assets and its liabilities, divided by the number of shares outstanding.

References

Question From: Session 18 > Reading 58 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #31 of 48

Question ID: 434454

Kettering Incorporated is a successful manufacturer of technology hardware. Kettering is seeking capital to finance additional growth that will position the company for an initial public offering. This stage of financing is *most accurately* described as:

- X **A)** angel investing.
- X **B)** early-stage financing.
- ✓ **C)** mezzanine financing.

Explanation

Mezzanine stage capital prepares a company for and IPO. Angel investing and early-stage financing describe venture capital in a company's formative stages.

References

Question From: Session 18 > Reading 58 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #32 of 48

Question ID: 416043

A form of direct investment in mortgages is:

- ✓ **A)** whole loans.
- X **B)** mortgage real estate investment trusts.
- X **C)** commercial mortgage-backed securities.

Explanation

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

References

Question From: Session 18 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #33 of 48

Question ID: 416055

Bulldog Fund is a hedge fund with a value of £100 million at the beginning of the year. Bulldog Fund charges 1.5% management fee based on assets under management at the end of the year and a 25% incentive fee with no hurdle rate. Incentive fees are calculated independent of management fees. The fund's value at the end of year before fees is £120 million. Compared to a 2 and 20 fee structure, Bulldog Fund's total fees for the year are:

- ✓ **A)** higher.
- X **B)** lower.
- X **C)** the same.

Explanation

	<i>1.5% Management Fee, 25% Incentive Fee</i>	<i>2% Management Fee, 20% Incentive Fee</i>
Management fee	$\text{£}120 \times 1.5\% = \text{£}1.8 \text{ million}$	$\text{£}120 \times 2\% = \text{£}2.4 \text{ million}$
Incentive fee	$(\text{£}120 - \text{£}100) \times 25\% = \text{£}5.0 \text{ million}$	$(\text{£}120 - \text{£}100) \times 20\% = \text{£}4.0 \text{ million}$
Total fees	$\text{£}1.8 + \text{£}5.0 = \text{£}6.8 \text{ million}$	$\text{£}2.4 + \text{£}4.0 = \text{£}6.4 \text{ million}$

References

Question From: Session 18 > Reading 58 > LOS e

Related Material:

- Key Concepts by LOS

Question #34 of 48

Question ID: 416051

Which of the following will result from futures prices for a particular commodity being in contango?

- ✓ **A)** Negative roll yield.
- X **B)** Negative collateral yield.
- X **C)** Positive current yield.

Explanation

A positive roll yield results from a backwardated market, whereas a negative yield is produced in a contango market. In backwardated (contango) markets, futures prices are lower (higher) than spot prices.

References

Question From: Session 18 > Reading 58 > LOS f

Related Material:

- Key Concepts by LOS

Question #35 of 48

Question ID: 496437

To which of the following categories of alternative investments is an investor *most likely* to gain exposure through derivatives?

- X **A)** Hedge funds.
- ✓ **B)** Commodities.
- X **C)** Private equity.

Explanation

For many commodities, liquid markets exist in derivatives such as futures contracts. Derivatives are less likely to be available on hedge funds or private equity.

References

Question From: Session 18 > Reading 58 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #36 of 48

Question ID: 416034

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

- X **A)** transparent.
- X **B)** liquid.
- ✓ **C)** leveraged.

Explanation

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

References

Question From: Session 18 > Reading 58 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #37 of 48

Question ID: 434449

The typical trade used by a merger arbitrage fund is:

- ✓ **A)** short position in acquirer, long position in firm being acquired.
- X **B)** long position in acquirer, short position in firm being acquired.
- X **C)** short positions in both the acquirer and the firm being acquired.

Explanation

Merger arbitrage funds typically short the stock of the acquirer and buy the stock of the firm being acquired.

References

Question From: Session 18 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #38 of 48

Question ID: 416049

The yield from an investment in commodities that results from a difference between the spot price and a futures price is the:

- X **A)** collateral yield.
- X **B)** convenience yield.
- ✓ **C)** roll yield.

Explanation

Roll yield is the yield return due to a difference between the spot price and futures price, or a difference between two futures prices with different expiration dates, and results from futures prices converging to the spot price as futures contracts approach their expiration dates. Roll yield may be positive or negative.

References

Question From: Session 18 > Reading 58 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #39 of 48

Question ID: 416038

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

- ✓ **A)** both increase expected returns and decrease portfolio variance.
- X **B)** decrease portfolio variance only.
- X **C)** increase expected returns only.

Explanation

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

References

Question From: Session 18 > Reading 58 > LOS c

Related Material:

- Key Concepts by LOS
-

Question #40 of 48

Question ID: 416040

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

- X **A)** withdrawal period.
- X **B)** lockup period.
- ✓ **C)** notice period.

Explanation

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

References

Question From: Session 18 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #41 of 48

Question ID: 614851

Which of the following alternative investments is *least likely* classified as investing in commodities?

- ☐ A) Common shares of a copper mining firm.
- ☒ B) Direct ownership of a natural gas distribution pipeline.
- ☐ C) Managed futures fund specializing in livestock.

Explanation

Utility assets such as natural gas distribution pipelines are best classified as infrastructure investments. Managed futures funds and common shares of commodity producers are among the methods for investing in commodities.

References

Question From: Session 18 > Reading 58 > LOS b

Related Material:

- Key Concepts by LOS
-

Question #42 of 48

Question ID: 416041

The formative stage of venture capital investing when capital is furnished for market research and product development is *best* characterized as the:

- ☐ A) early stage.
- ☐ B) angel investing stage.
- ☒ C) seed stage.

Explanation

In the seed stage of venture capital investing, capital is furnished for product development, marketing, and market research. The angel investing stage is when investment funds are used for business plans and assessing market potential. The early stage refers to investments made to fund initial commercial production and sales.

References

Question From: Session 18 > Reading 58 > LOS d

Related Material:

- Key Concepts by LOS
-

Question #43 of 48

Question ID: 416048

Under which approach to valuing real estate properties is an analyst *most likely* to estimate a capitalization rate?

- ☐ A) Comparable sales approach.
- ☒ B) Income approach.
- ☐ C) Cost approach.

Explanation

The income approach estimates values by calculating the present value of expected future cash flows from property ownership or by dividing the net operating income (NOI) for a property by a capitalization rate. The comparable sales approach estimates a property value based on recent sales of similar properties. The cost approach is based on the estimated cost to replace an existing property.

References

Question From: Session 18 > Reading 58 > LOS f

Related Material:

- Key Concepts by LOS
-

Question #44 of 48

Question ID: 639403

An investor made an investment in a hedge fund at the beginning of the year, when the NAV was □80 million. The NAV after fees for Year 1 was □75 million. For Year 2, the end-of-year value before fees is □90 million. The fund has a 2 and 20 fee structure. Management fees are paid independently of incentive fees and are calculated on end-of-year values. Incentive fees are calculated using a high water mark and a soft hurdle rate of 2%. Total fees paid for Year 2 are:

- ☐ A) □5.8 million.
- ☒ B) □3.8 million.
- ☐ C) □4.4 million.

Explanation

Management fee = □90 million × 0.02 = □1.8 million.

Gross return = (□90 / □75) – 1 = 20.0%. The soft hurdle rate was exceeded.

Because of the high water mark, incentive fees are paid only on the increase in NAV above the previous year-end NAV after fees of □80 million.

Incentive fee = (□90 million – □80 million) × 0.20 = □2.0 million.

Total fee: □1.8 million + □2.0 million = □3.8 million.

Note that the new high water mark is □90 million - □3.8 million = □86.2 million.

References

Question From: Session 18 > Reading 58 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #45 of 48

Question ID: 416032

Compared to a traditional mutual fund, a hedge fund is *more likely* to feature:

- ☐ A) lower leverage.
- ☒ B) higher fees.
- ☐ C) higher liquidity.

Explanation

A hedge fund typically is more likely to use leverage, is less liquid, and charges higher fees than a traditional mutual fund.

References

Question From: Session 18 > Reading 58 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #46 of 48

Question ID: 434448

Alternative investments *most likely* have which of the following characteristics compared to traditional investments?

- ☐ A) Lower leverage and higher liquidity.
- ☒ B) Unique legal structures and tax treatments.
- ☐ C) Higher levels of regulation and transparency.

Explanation

Compared to traditional investments, alternative investments have unique legal issues and tax treatments that are related to their legal structure and registrations. They often have lower levels of regulation and are less transparent than traditional asset classes. Alternative investments often employ high levels of leverage in illiquid markets.

References

Question From: Session 18 > Reading 58 > LOS a

Related Material:

- Key Concepts by LOS
-

Question #47 of 48

Question ID: 614855

In a 2-and-20 hedge fund fee structure, the "2" refers to a hedge fund's

- ☐ A) redemption fee.
- ☐ B) incentive fee.

✓ **C)** management fee.

Explanation

"2-and-20" denotes a 2% management fee and a 20% incentive fee.

References

Question From: Session 18 > Reading 58 > LOS e

Related Material:

- Key Concepts by LOS
-

Question #48 of 48

Question ID: 416035

Categories of alternative investments *least likely* include:

- X **A)** hedge funds.
- ✓ **B)** currencies.
- X **C)** real estate.

Explanation

Categories of alternative investments include hedge funds, private equity, real estate, commodities, and other non-traditional assets such as collectibles or patents.

References

Question From: Session 18 > Reading 58 > LOS b

Related Material:

- Key Concepts by LOS