



## Question #1 of 17

Question ID: 1485414

When an investor is faced with a limited opportunity set of investment options, it is most likely caused by:

- A) incomplete markets. 
- B) financial innovations. 
- C) moral hazards. 
- D) information asymmetries. 

### Explanation

Incomplete markets refer to markets where limited investment opportunities fail to satisfy the exact investment options that participants seek.





(LO 2.1.7)

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## Question #2 of 17

Question ID: 1404873

The risk of *moral hazard* may occur when:

- A) a bank sells its mortgages to a third party and subsequently no longer closely monitors the risk of the loans. 
- B) a firm's managers possess information about the firm's performance that outside investors do not. 
- C) a hedge fund investment is said to contain a 3% complexity premium. 
- D) an investor is unable to make a profitable investment in an insurance opportunity due to high costs. 

### Explanation

Moral hazard describes a scenario where one party takes actions that disadvantage another party. When a bank has less incentive to closely monitor mortgages sold to a third party, credit and other risks may rise on the mortgages. When managers possess superior information about firm performance, and when alternative investments contain a complexity premium (to compensate an investor's time and expertise in analyzing it), these are examples of information asymmetries. When an investor cannot earn profit due to high costs and fees, this is an example of incomplete markets.





(LO 2.1.7)

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### Question #3 of 17

Question ID: 1485413

An analyst at a university endowment must calculate the return for the endowment's private equity positions. The methodology that is most appropriate is the:

- A) internal rate of return. 
- B) holding period return using notional principal for position size. 
- C) geometric mean of daily returns. 
- D) holding period return. 

#### Explanation

Private equity involves cash flows that occur over time including capital calls and payouts. Because of this, the internal rate of return methodology is often used to calculate the return of a private equity investment.





(LO 2.1.6)

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### Question #4 of 17

Question ID: 1404877

Absolute return standards evaluate the returns of an investment relative to:

- A) a benchmark portfolio. 
- B) a standard of zero or the risk-free rate. 
- C) the market. 
- D) a peer group of portfolio managers. 

#### Explanation

Absolute return products attempt to earn return regardless of the market environment. Absolute return standards evaluate investment returns against a standard of zero or the risk-free rate. Relative return standards evaluate the returns of a portfolio relative to a benchmark.

(LO 2.1.8)

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### Question #5 of 17

Question ID: 1485412

The alternative asset investments class is least associated with which of the following characteristics?

- A) Efficient pricing. 
- B) Illiquidity. 
- C) Diversification. 
- D) Non-normal returns. 

**Explanation**

Alternative assets are most often characterized by inefficient pricing, providing potential abnormal returns or alpha returns.

(LO 2.1.5)

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**Question #6 of 17**

Question ID: 1404864

Equity investments made for the launch, early development, or expansion of a business are known as:

- A) venture capital. 
- B) incubators. 
- C) Initial public offerings. 
- D) Angels investments. 

**Explanation**

Equity financing associated with the early development of a business is called venture capital.

(LO 2.1.2)

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**Question #7 of 17**

Question ID: 1404863

Privately held Midsight Company issued convertible notes and warrants to fund its research and development. This is an example of:

- A) venture capital. 
- B) mezzanine financing. 
- C) leveraged buyouts. 

D) distressed debt investing.



### Explanation

Mezzanine financing is a blend of private debt and equity financing.





(LO 2.1.2)

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### Question #8 of 17

Question ID: 1485409

Which of the following best describes collateralized debt obligations?

- A) The private debt of a firm with seniority between that of senior debt and equity. 
- B) The debt of a firm that is likely to or has already filed for bankruptcy protection. 
- C) Assets with contingent payoffs linked to the credit risk of underlying reference assets. 
- D) Tranched securities with varying levels of risk and seniority that are backed by an underlying portfolio. 

### Explanation

Collateralized debt obligations (CDOs) are tranched securities backed by a collateral portfolio. The risk and return of the securities depends upon the tranche to which the securities belong. Distressed debt includes the debt of a firm that is likely to or has already filed for bankruptcy protection. Mezzanine debt is the private debt of a firm with seniority between that of senior debt and equity. Credit derivatives are derivatives with contingent payoffs tied to the credit risk of underlying assets.


(LO 2.1.2)

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### Question #9 of 17

Question ID: 1485408

Which of the following categories of assets is most likely classified as an alternative asset?

- A) Cash. 
- B) Convertible bonds. 
- C) Preferred stocks. 
- D) Real assets. 

### Explanation

Traditional investments include cash, bonds, and stocks. Alternative investments include four major categories: real assets, hedge funds, private equity, and structured products. While convertible bonds are often used within an alternative investment strategy (e.g., convertible arbitrage), convertible securities are unlikely to be considered an alternative asset.

(LO 2.1.2)

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### Question #10 of 17

Question ID: 1485407

Which of the following are most likely considered traditional investments?

- A) Long positions in bonds, publicly traded stocks, commodities, and currencies. ✘
- B) Long and short positions in bonds, publicly traded stocks, commodities, and currencies. ✘
- C) Long and short positions in cash, bonds, and publicly traded stocks. ✘
- D) Long positions in cash, bonds, and publicly traded stocks. ✔

#### Explanation

Traditional investments include long positions in cash, bonds, and publicly traded stocks. Alternative investments are sometimes defined as any investment that is nontraditional.

(LO 2.1.1)

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### Question #11 of 17

Question ID: 1404875

A fixed income analyst wishes to divide a firm's assets into a fixed stream for debtholders and a residual stream for equity holders. What is the correct term for this process of dividing cash streams into two or more streams that are different in terms of risk, timing, and taxation?

- A) Structuring cash flows. ✔
- B) Segmenting cash flows. ✘
- C) Migrating cash flows. ✘
- D) Calibrating cash flows. ✘

#### Explanation

Structuring of cash flows occurs when a cash flow stream is divided into multiple streams, which vary with respect to variables including risk and timing. An example of this is the corporate capital structure. In its simplest form, the structure will include equity and debt securities. The cash flows of the firm are divided into two streams: the guaranteed debt payments and the residual dividend payments.

(LO 2.1.7)

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### Question #12 of 17

Question ID: 1404871

Alternative investments can be distinguished from traditional investments by methods of analysis applicable to:

- A) return computation, statistics, valuation, and portfolio management.
- B) statistics, valuation, and portfolio management.
- C) return computation, and portfolio management.
- D) statistics and valuation.

#### Explanation

Four types of methods may be used to analyze alternative investment returns: return computation, statistical, valuation, and portfolio management.

(LO 2.1.6)

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### Question #13 of 17

Question ID: 1404868

Ann Tenner, an analyst with TWJ Securities, is analyzing the return distributions of alternative investments. She has discovered that they are often not normal. Which of the following structures are most likely the source of the non-normal return distributions?

- A) Trading and regulatory structures.
- B) Regulatory and securities structures.
- C) Regulatory structures only.
- D) Trading and securities structures.

#### Explanation

For long time intervals (i.e., medium- and long-term), the return distributions for many alternative investments are not normal. The non-normality may result from sources such as trading structures or security structures. Many alternative investments trade infrequently, requiring returns to be calculated over longer time intervals. In addition, active trading strategies that dynamically adjust long and short positions can cause returns to be non-normal. Other structures that influence investments include regulatory, compensation, and institutional structures.

(LO 2.1.5)

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### Question #14 of 17

Question ID: 1404876

The additional risk undertaken by a portfolio manager in order to deviate from the benchmark return is the:

- A) absolute risk. 
- B) active risk. 
- C) return diversification. 
- D) relative risk. 

#### Explanation

Active management seeks to generate better risk and return combinations through actively buying and selling portfolio assets. Active risk is the additional risk undertaken to earn that additional return.


(LO 2.1.8)

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### Question #15 of 17

Question ID: 1485411

Which of the following structures is least likely to distinguish hedge funds from mutual funds?

- A) Securities. 
- B) Regulatory. 
- C) Trading. 
- D) Compensation. 

#### Explanation

Hedge funds and mutual funds both invest in the same types of traditional assets, so the securities structures of hedge funds do not distinguish them from mutual funds. Hedge funds are distinguished by lower regulation, specialized trading strategies, and performance based compensation.





(LO 2.1.3)

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### Question #16 of 17

Question ID: 1404867

Alternative assets have return distributions that exhibit non-normality over medium and long-term intervals. The structures that result in non-normality for alternative assets include:

- A) only the trading structure. 
- B) only the securities structure. 
- C) both the trading and securities structure. 
- D) neither the trading nor the securities structure. 

#### Explanation

Both the trading structures and securities structures of alternative assets can lead to non-normality of returns. The trading structures can lead to non-normality through infrequent trading and/or dynamic trading strategies. The securities structures of an alternative asset can lead to non-normality through investments in underlying securities that have non-linear payoffs (e.g., derivatives).


(LO 2.1.5)

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### Question #17 of 17

Question ID: 1485410

Which of the following investment structures most likely belongs to the category of securities structures?

- A) Public stock exchange listing. 
- B) Taxation. 
- C) Investor composition. 
- D) A CDO's cash flow waterfall. 

#### Explanation

Securities structures include the methods used in securitization. A CDO's cash flow waterfall describes the structure of how cash flows are repaid to the CDO tranches.

Taxation is part of regulatory structures. Investor composition and public stock exchange listing are part of institutional structures.

(LO 2.1.3)