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CFA Level III Item-set - **Question**
Study Session 12
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FinQuiz Item-set ID: 17099

Questions 1(*12404*) through 6(*12409*) relate to Reading 25

Jean West Case Scenario

Jean West is a portfolio manager serving Marine Investment Associates, a U.S. based asset management firm. West is responsible for managing two institutional client portfolios; Trent Corp (TC) and Nutro4Life Endowment Fund (NLEF).

TC is a ceramics manufacturer managing its defined benefit pension plan. The plan's investment policy mandates strict adherence to passive equity management. West manages the plan's investment portfolio.

The investment portfolio is currently invested by two equity managers, A and B. West would like to evaluate the relative performance of the two managers for the year ended December 31, 2010. Each benchmark captures the normal risk exposures of the manager in question.

Exhibit 1
Performance of Managers A and B
For the Year Ended December 31, 2010 (in %)

Manager	Portfolio Return	Benchmark Return	Active Risk
A	22	18	3
B	35	36	1

In her report on the investment portfolio's performance, West makes the following conclusion:

Conclusion: Both managers have adhered to the policy's mandate. Manager A has generated superior returns while Manager B has kept tracking risk to a minimum.

It is now one year later and TC has generated a surplus on its investment portfolio. It has instructed West to invest the surplus in a manner consistent with the policy mandate. West has devised three alternative investment strategies.

Strategy 1: Replicate factor exposures of an appropriate benchmark using a limited set of funds.

Strategy 2: Undertake offsetting long and short positions in equity securities of a particular industry.

Strategy 3: Participate in an investment vehicle which will insulate TC from the cost of providing liquidity to markets when investments are redeemed.

NLEF has a high risk-tolerance. The fund's portfolio comprises of a significant proportion of risky investments and the portfolio's equity segment is being managed using a value approach.

The fund's prospectus cites the following justifications for using a value approach:

Justification 1: Potential for earnings multiples to increase in the future as earnings revert to their historical average level.

Justification 2: Fully appreciates the economic reasoning being undervalued stocks.

The equity segment is benchmarked against the Russell 3000 index. West believes the Russell 1000 Value index may be a more suitable benchmark. She has collected benchmark and portfolio (equity segment) returns for the year 2010 (Exhibit 2).

Exhibit 2
Russell 3000, Russell 1000 Value, And Portfolio Returns (2010, in %)

	Portfolio	Russell 3000	Russell 1000 Value
Return	34	20	25

Following an evaluation of portfolio performance, West makes the following comment:

Comment: "61% of the total active return is attributed to style and 39% to security selection."

In order to further enhance portfolio returns, NLEF's sponsor would like to capture alpha on its existing emerging market corporate bond investments in a way that 1) requires no cash and 2) isolates unsystematic risk exposures. However, West's experience is limited to developed market corporate bonds.

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1. Is West's conclusion in compliance with TC's investment policy mandate?

   A. No.
   B. Yes, with respect to both managers.
   C. Yes, with respect to Manager A only.

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2. Strategy 1 *most likely* reflects:

   A. optimization
   B. full replication
   C. stratified sampling

FinQuiz Question ID: 17102

3. Which of the following strategies may not be used to manage TC's portfolio?

    A. Strategy 2 only.
    B. Strategy 3 only.
    C. Strategies 2 and 3.

FinQuiz Question ID: 17103

4. The justifications provided by NLEF are *most likely*:

    A. correct.
    B. incorrect, justification 1 is used by growth investors.
    C. incorrect, value investors misapprehend the cheapness of value stocks.

FinQuiz Question ID: 17104

5. Based on her comment on NLEF's performance, West is *most likely*:

    A. correct.
    B. incorrect, 39% of the total active return is attributed to manager style.
    C. incorrect, 64% of the total active return is attributed to security selection.

FinQuiz Question ID: 17105

6. In context of NLEF's requirements, the *most* appropriate strategy for West is to:

    A. invest in an emerging corporate bond index fund and sell futures on the developed corporate bond index.
    B. short emerging corporate bonds and use the funds to invest in a developed corporate bond index fund.
    C. invest in an ETF tracking the developed corporate bond index and sell futures on an emerging corporate bond index.