### FinQuiz.com – 1st Mock Exam 2020 (AM Session)

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<td><strong>Total</strong></td>
<td><strong>180</strong></td>
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Questions 1 through 6 relate to Ethical and Professional Standards

Sullivan Taka, Ida Young and Paul Singh Case Scenario

Sullivan Taka, Ida Young and Paul Singh are members of an investment club, which offers financial advisory and asset management services to their acquaintances. Club meetings are held over the weekend so as not to disrupt their employment responsibilities.

Taka works at Frank-Walsh, an asset management firm; Young is a research analyst at Victor & Sun, an economic and market research firm; Singh is a trader at Doyle, a broker-dealer.

The members rely on a risk-return forecasting model to make investment recommendations. The model employs simulation techniques to integrate and project the impact of macroeconomic and unique company-specific financial and non-financial factors on security performance. The model was developed by Young during the time he served as an independent analyst. Subsequently, the model was licensed under Victor & Sun’s name and rights of ownership were transferred accordingly. Young has obtained permission from her employer to use the model to make investment decisions for the club’s clients.

With the consent of Young, Taka introduces the model to his employer by stating, “The model has been developed by a colleague, Ida Young, and is used by the analysts of Victor & Sun to make investment decisions.”

The investment club has accepted their first institutional client, Blackthorn Corp. The club will be responsible for managing the investment portfolio of the client’s defined benefit pension plan’s policy portfolio. Based on the plan’s characteristics, including its long-term horizon, an investment policy is designed categorizing risk tolerance as ‘above average’. The fund manager has expressly prohibited the inclusion of speculative stocks. Taka believes that cyclical stocks will be most suitable for the portfolio’s equity allocation.

A few months pass following the acceptance of Blackthorn as client. The equity allocation of the portfolio generates losses as the economic cycle experiences a downturn. As a result, the plan sponsor reports a deficit on the pension plan. In response to the losses, Singh suggests that the equity allocation be expanded to include venture capital
stocks stating that their high return potential and long holding periods makes them desirable given the long-time horizon of the client.

All three club members have unanimously decided on formalizing a policy with regards to the responsibilities of members to clients. The drafted policy includes the following points:

1. Best execution must be sought at all times even for client directed brokerage arrangements; this is to ensure that optimal investment decisions are made for client accounts.
2. The policy for selecting client accounts to participate in an order must be fair and equitable.
3. Account holdings should be diversified to minimize the risk of loss unless such an action is otherwise contrary to client objectives.

Doyle’s traders rely on research reports, which provide the analysis necessary to assist in making buy and sell decisions for client accounts. Singh’s current task is to purchase emerging market equity index stocks for client accounts. However, he lacks the necessary experience and knowledge and relies on a report published by Taka, who is an expert on emerging markets. The report features a full-length discussion on the principal risks, expected returns, and diversification potential of the index stocks. However, the report does not mention the fact that the specific emerging market index being evaluated comprises of stocks likely to be upgraded to developed equity market index. Singh purchases the stocks after careful consideration of their appropriateness for client accounts. He discloses to his clients and employer that he relied on third party research but does not identify Taka as the author.

1. Has Young violated the CFA Institute Standards of Professional Conduct by allowing Taka to introduce the model at Frank-Walsh?

A. No.
B. Yes, he has violated his duty to his employer only.
C. Yes, he has violated his duty to his employer and misrepresented his position with respect to the model.
2. The most suitable response of the investment professionals to the change in the plan’s funded status would be to:

   A. liquidate existing portfolio holdings.
   B. revise the investment policy statement.
   C. subject future investment decisions to the approval of plan beneficiaries.

3. Singh’s suggestion to include venture capital stocks is most likely:

   A. unsuitable.
   B. suitable as there is potential to improve the plan’s funded status.
   C. suitable considering that the time horizon of the investment will match that of the plan.

4. Is the proposed best execution policy (Policy 1) consistent with the CFA Institute Standards of Professional Conduct?

   A. Yes.
   B. No, there is no requirement to seek best execution if the client expressly states so.
   C. No, seeking best execution is not necessary in client-directed brokerage arrangements.

5. Considering policies 2 and 3, which of the following is most consistent with the CFA Institute Professional Conduct Standards?

   A. Policy 2 only.
   B. Policy 3 only.
   C. Both of the policies.

6. With respect to the purchase of emerging market index stocks, Singh is most likely in violation of the CFA Institute Standards of Professional Conduct concerning:

   A. suitability.
   B. misrepresentation.
   C. diligence and reasonable basis.
Questions 7 through 12 relate to Quantitative Methods

Capital Managers (CAM) Case Scenario

James Diaz is a financial analyst at Capital Managers (CAM), a financial advisory firm operating several branches all over USA. CAM has been established by a group of successful entrepreneurs, each from a different industry. At the firm, Diaz is currently managing the financial portfolio of Bright Education (BED), a foundation providing free education to children less than ten years of age. The portfolio is worth $20 million, and invests both nationally and internationally. In the management of international assets, Diaz is trying to apply statistical techniques to earn abnormal returns. To get a complete understanding of statistical applications in a financial setting, Diaz contacted Jack Thomas, a quantitative expert at the firm. During a discussion with Diaz, Thomas made the following comments:

Statement 1: “The correlation coefficient is a measure of linear association between two variables. Coefficients capture this association numerically and can be computed validly as long as the variances of the two variables and the covariance between them are finite and constant.”

Statement 2: “If the correlation between two variables is -1, then if one variable increases by one unit, the other will always decrease by one unit, regardless of the initial value of the first variable.”

As the discussion continued, Diaz mentioned that he was trying to determine the relationship between U.S. stock market returns and short-term interest rates. For this, he had calculated the correlation coefficient between annual returns to a U.S. market index and annual interest rates using data of the past twenty years. However, when Thomas reviewed his calculations, he made the following comment:

Statement 3: “Your data set includes three observations that can clearly be termed as outliers. Hence, to make sure that the sample correlation is a reliable measure of the true population correlation, you need to recalculate it after removing the effect of the outliers.”
Thomas continued by making the following statement about correlation analysis:

Statement 4: “While determining the relationships between international market returns and the initial dollar investment made, on the one hand, and between initial investment and risk, on the other, I found out that there was a strong positive relationship between return and risk. This shows that investing in high risk investments will yield higher returns.”

Diaz just invested 2% of BED’s portfolio in high-yield U.S. corporate bonds. When Thomas asked him why he did so, Diaz stated there was a high positive and significant correlation between short-term interest rates and bond yields and that U.S. interest rates were expected to decrease. However, when Thomas performed his own calculations, he stated that the correlation, though high and positive, was not significant and hence, the strategy may prove to be unfruitful. Even so, Diaz gathered the following information to estimate the regression equation for the bond yield and interest rates.

### Exhibit 1
Regression analysis with interest rates as the independent variable

<table>
<thead>
<tr>
<th>Covariance between interest rates and bond yields</th>
<th>0.000586</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variance of interest rates</td>
<td>0.000956</td>
</tr>
<tr>
<td>Variance of bond yields</td>
<td>0.000765</td>
</tr>
<tr>
<td>Average short-term interest rate</td>
<td>5.50%</td>
</tr>
<tr>
<td>Average bond yield</td>
<td>6.78%</td>
</tr>
</tbody>
</table>

After estimating the regression equation, Diaz tested the slope coefficient for significance. Although he knew the method of testing, he did not know how changes in the values of key inputs affected the ultimate conclusion. When he asked Thomas about it, he made the following comments:

Statement 5: “If you decrease the level of significance from 5% to 1%, the probability of Type 1 error will decrease and the probability of Type 2 error will increase.”

Statement 6: “Smaller standard errors lead to tighter confidence intervals but if the standard error is incorrectly calculated the probability of Type 1 error will increase.”
7. Thomas is most accurate with respect to:

   A. Statement 1 only.
   B. both statements 1 and 2.
   C. neither Statement 1 nor Statement 2.

8. With respect to statement 3, is Thomas most likely correct?

   A. No.
   B. Yes, because the presence of outliers distorts results.
   C. Yes, because the presence of outliers invalidates the normal distribution assumption.

9. With respect to Statement 4, Thomas’s conclusion is most likely:

   A. correct.
   B. incorrect, because the relationship is spurious.
   C. incorrect, because the result is a data mining error.

10. With respect to his conclusion about the correlation between short-term interest rates and bond yields, Thomas is most likely using a:

    A. smaller sample size than Diaz.
    B. one-tailed test of significance.
    C. lower standard error in his calculations.

11. Using the information provided in Exhibit 1, the values of the intercept and slope coefficients are closest to:

    A. 0.03 and 0.61 respectively.
    B. 0.03 and 0.69 respectively.
    C. 0.02 and 0.80 respectively.

12. Thomas is least accurate with respect to:

    A. Statement 5 only.
    B. Statement 6 only.
    C. neither Statement 5 nor Statement 6.
Questions 13 through 18 relate to Economics

Angel Associates (ANA) Case Scenario

Cynthia Angel is the head of the portfolio management team at the institutional wing of Angel Associates (ANA), an investment firm in Alabama, USA. Angel is currently managing the All Equity Fund (AEF) of the firm, a fund that invests in a diverse set of domestic and international equities. Since the AEF invests internationally, Robert Kelly, a currency overlay manager, has been hired to manage the currency component of each equity investment. Presently, Kelly is determining the rate at which he would be able to convert EUR5 million to Canadian dollars. He has gathered the following information about spot rate quotes in the interbank market.

<table>
<thead>
<tr>
<th>Exhibit 1</th>
<th>Spot Rate Quotes</th>
</tr>
</thead>
<tbody>
<tr>
<td>CAD/USD</td>
<td>1.0133/1.0138</td>
</tr>
<tr>
<td>EUR/USD</td>
<td>0.7894/0.7899</td>
</tr>
<tr>
<td>USD/JPY</td>
<td>0.01257/0.01260</td>
</tr>
</tbody>
</table>

The All Equity Fund has invested 5% of its total worth in a diversified fund of Australian equities. To hedge the risk of a depreciation of the Australian dollar against the USD, Kelly is planning to sell AUD in the forward market. He has gathered the following information for this purpose.

<table>
<thead>
<tr>
<th>Exhibit 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spot USD/AUD</td>
</tr>
<tr>
<td>180-day LIBOR(AUD)</td>
</tr>
<tr>
<td>180-day LIBOR(USD)</td>
</tr>
</tbody>
</table>

In the past, AEF hedged a long exposure to British Pound, worth GBP5 million, at a time when the all-in forward price was 1.0122 USD/GBP. Six months prior to the settlement date, Kelly wants to mark this forward position to market. Exhibit 3 displays the spot and forward rate quotes in the FX market.
13. The bid-offer rate on the CAD/JPY cross rate implied by the interbank market is closest to:

A. 0.01274/0.01276.
B. 0.01240/0.01243.
C. 0.01274/0.01277.

14. If a dealer quoted a bid-offer rate of 0.7780/0.7781 EUR/CAD, then a triangular arbitrage would most likely involve:

A. buying CAD from the dealer and selling CAD in the interbank market.
B. selling CAD to the dealer and buying CAD in the interbank market.
C. buying EUR from the dealer and selling CAD in the interbank market.

15. The forward premium (discount) for a 180-day forward contract for USD/AUD is closest to:

A. -0.01236
B. -0.01220.
C. 1.009

16. If Kelly wants to sell the U.S. dollar three months forward against the GBP using an FX swap, rather than the stated six months, the all-in rate that he will use will be closest to:

A. 1.01274.
B. 1.01297.
C. 1.01302.
17. The mark-to-market for AEF’s forward position used to hedge exposure to the GBP is closest to:

A. −$3,347.
B. −$3,400.
C. −$4,100.

18. Assuming everything else remains constant, if instead of the GBP, AEF hedged a long exposure to the USD worth 5 million, the mark-to-market for AEF’s USD forward position would be closest to GBP:

A. 749.60.
B. 764.84.
C. 1,003.80.
Questions 19 through 24 relate to Corporate Finance.

General Capital Management (GCM) Case Scenario

General Capital Management (GCM) is an investment advisory firm. Bob Morgan has just joined GCM as the head of its corporate finance wing. Synergy Chemicals (SYNC) is one of the firm’s oldest corporate clients, and Morgan has been assigned as its financial consultant. Bryan Grant, the chief executive officer (CEO) at SYNC, invited Morgan over to discuss the optimal capital structure for SYNC. He posed the following questions during the meeting:

Question 1: “Currently, SYNC is an all equity firm with a cost of equity of 12.45%. If we decide to change our debt/equity ratio to 0.5, how will this affect our cost of equity?”

Question 2: “If we issue debt, such that long-term debt is 30% of our company’s current value, how will this affect our firm’s weighted average cost of capital?”

Question 3: “If we issue debt, such that long-term debt is 30% of our company’s new market value, how will this affect our firm’s weighted average cost of capital?”

Question 4: “The financial department at SYNC has indicated that our cost of equity will rise with increased levels of debt from 12.45% (no debt) to 15% (40% debt) to 18% (70% debt). In addition, the marginal cost of borrowing is expected to be 13.5% on 40% debt and 19% on 70% debt. How can this information help us in deciding SYNC’s target capital structure?”

Question 5: “SYNC has paid an annual dividend of $3.5/share for the past three years with an average dividend payout ratio of 55%. During the same period, excavation costs were quite volatile, which, along with changing labor laws, have caused a considerable variability in SYNC’s costs. However, capital budgeting has revealed $6 million in positive NPV projects for SYNC for the current year. If we do not wish to issue debt, what dividend per share should SYNC issue currently on its 5 million shares outstanding?”
To answer Grant’s questions accurately, Morgan has gathered the following information.

### Exhibit 1

<table>
<thead>
<tr>
<th>Earnings before taxes</th>
<th>$345 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax rate</td>
<td>35%</td>
</tr>
<tr>
<td>Interest rate on long-term debt</td>
<td>10%</td>
</tr>
</tbody>
</table>

After the meeting, Grant told Morgan that SYNC is planning to repurchase $1 million shares with the objective of increasing earnings per share. In addition, the company plans to initiate a 3% annual stock dividend. He stated that both these changes are likely to increase shareholder wealth.

19. Using the information in Exhibit 1, according to MM Proposition 2 without taxes, what is the best response to Grant’s first question? The cost of equity will rise by:

A. 0.796%
B. 1.225%
C. 13.675%

20. Using the information provided in Exhibit 1, under MM Proposition 2 with taxes, Morgan’s response to Question 2 should be that the weighted average cost of capital will be closest to:

A. 11.27%.
B. 11.73%.
C. 12.01%.

21. Using the information provided in Exhibit 1, under MM Proposition 2 with taxes, Morgan’s response to Question 3 should be that the weighted average cost of capital will be closest to:

A. 6.5%
B. 11.14%
C. 11.7%

22. Using the information provided by Grant in Question 4, the cost-minimizing capital structure for SYNC is most likely:

A. all equity.
B. 40% debt.
C. 70% debt.

23. Using the information provided in Question 5, if SYNC’s earnings are anticipated to be $34 million, the target payout ratio is 0.55, the adjustment factor is 1, and if SYNC follows a residual dividend payout policy, its annual dividend per share will most likely be:

A. $0.54/share greater than the dividend under a target payout ratio policy.
B. $1.858/share greater than the dividend under a target payout ratio policy.
C. $1.20/share greater than the dividend under a target payout ratio policy.

24. Are SYNC plans to increase shareholder wealth most likely correct?

A. No.
B. Only with respect to share repurchases.
C. Only with respect to stock dividends.
Questions 25 through 30 relate to Financial Reporting and Analysis.

Lucid Enterprises (LUCEN) Case Scenario

Justin Ritter, a chartered financial analyst, works at an equity investment management firm in Minnesota, USA. Ritter is currently analyzing the defined benefit pension plan offered by Lucid Enterprises (LUCEN) to its employees. LUCEN promises to pay its employees pension benefits over a period of 20 years after retirement, with the benefit calculation based on the employee’s final year salary. LUCEN prepares its financial statements in accordance with the IFRS. Exhibits 1 and 2 display some information that Ritter has gathered on LUCEN’s retirement plans.

Exhibit 1
LUCEN Retirement Plan Information for the year 2015 (in millions)

<table>
<thead>
<tr>
<th>Current service costs</th>
<th>$250</th>
</tr>
</thead>
<tbody>
<tr>
<td>Past service costs</td>
<td>$150</td>
</tr>
<tr>
<td>Plan assets at beginning of year</td>
<td>$45,000</td>
</tr>
<tr>
<td>Plan assets at end of year</td>
<td>$47,000</td>
</tr>
<tr>
<td>Benefits paid</td>
<td>($2,000)</td>
</tr>
<tr>
<td>Employer contributions</td>
<td>$1,000</td>
</tr>
<tr>
<td>Actuarial gain/(loss) – PBO related</td>
<td>($700)</td>
</tr>
<tr>
<td>Benefit obligation at beginning of year</td>
<td>$48,000</td>
</tr>
</tbody>
</table>

LUCEN used a discount rate of 6.5% to estimate plan liabilities. In addition, the expected rate of return on plan assets for the year 2015 was 7.0%.

During the evaluation process, Litter determined, that as part of their pension planning, the pension committee at LUCEN often revised the estimates and assumptions needed to calculate the amount of pension liability. Exhibit 2 displays revisions in key assumptions.
Exhibit 2  
Revised Estimates Used for LUCEN’s DB Plan

<table>
<thead>
<tr>
<th>Assumptions</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected rate of return on plan assets</td>
<td>7.45%</td>
<td>7.00%</td>
</tr>
<tr>
<td>Discount rate</td>
<td>6.32%</td>
<td>6.5%</td>
</tr>
<tr>
<td>Life expectancy of beneficiaries</td>
<td>25 years after retirement</td>
<td>20 years after retirement</td>
</tr>
<tr>
<td>Rate of compensation increase</td>
<td>3% per annum</td>
<td>3.5% per annum</td>
</tr>
</tbody>
</table>

25. The actual return on plan assets of LUCEN during the year 2015 was closest to:

A. $1,000 million.  
B. $2,000 million.  
C. $3,000 million.  

26. Assuming that the company’s actual returns on plan assets equal $3,000 million, the amount of periodic pension cost that would be reported in P&L and the cost/loss that would be reported in other comprehensive income in the year 2015 will be closest to:

A. $445 million and $1,625 million respectively.  
B. $595 million and $625 million respectively.  
C. $610 million and $2,850 million respectively.  

27. Assuming LUCEN does not immediately recognize the actuarial loss, there is no amortization of past service costs or actuarial gains and losses, and if instead of the IFRS, financial statements are reported in accordance with the U.S. GAAP, the amount of periodic pension cost that would be reported in the P&L would be closest to:

A. $220 million.  
B. $460 million.  
C. $1,370 million.
28. The benefit obligation at the end of the year 2015 reported by LUCEN will be closest to:

A. $49,220 million.
B. $50,220 million.
C. $50,460 million.

29. Under U.S. GAAP and ignoring past service costs and amortization of actuarial gains and losses, if Ritter makes adjustments to the income statement to truly reflect LUCEN’s operating performance, the:

A. net operating expenses will increase by $30 million, interest expense will increase by $3,120 million, and investment income will increase by $3,150 million.
B. net operating expenses will increase by $30 million, interest expense will increase by $3,120 million, and investment income will increase by $3,000 million.
C. net operating expenses will decrease by $3,120, interest expense will increase by $3,120, and investment income will increase by $2,000 million.

30. Which of the following about the effect of the changes in assumptions on LUCEN’s financial statements is most accurate?

A. The change in the expected rate of return on plan assets will improve the funded status reported on the balance sheet, but will have no effect on the periodic cost reported in the P&L.
B. If LUCEN does not revise its estimate of the discount rate, its reported liabilities will be lower, and its reported net income will be higher.
C. The change in the life expectancy estimate will increase total liabilities and will result in a higher reported periodic pension cost.
Questions 31 through 36 relate to Financial Reporting and Analysis

Julie McDonald Case Scenario

Julie McDonald works as an investment manager at a capital management firm in New York, USA. McDonald is head portfolio manager for the Equix Fund, a fund that invests in equities of large market capitalization firms. One of the firms that McDonald is evaluating for investment is BlueShot Products Incorporated (BLUSH). BLUSH is a U.S.-based multinational firm with a wholly-owned Canadian subsidiary, BluCan. BluCan was incorporated on January 01, 2016 and is an independent entity making autonomous decisions about operations, investing and financing. For her analysis, McDonald gathered BluCan’s financial statements presented in Canadian dollars in addition to the relevant USD/CAD exchange rates. Exhibits 1 and 2 display this information. During the period under analysis, Canada experienced mild inflation.

Exhibit 1
Assets, Liabilities and Net Income of BluCan
as of 2016 (in CAD millions)

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>95</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>156</td>
</tr>
<tr>
<td>Inventory measured at market value</td>
<td>250</td>
</tr>
<tr>
<td>Inventory measured at cost</td>
<td>300</td>
</tr>
<tr>
<td>Property plant and equipment</td>
<td>2130</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>312</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>220</td>
</tr>
<tr>
<td>Long-term notes payable</td>
<td>575</td>
</tr>
<tr>
<td>Capital stock – All issued at start of the year</td>
<td>1,209</td>
</tr>
<tr>
<td>Net Income</td>
<td>650</td>
</tr>
</tbody>
</table>

*BluCan declared dividends of 35 million in 2016

Exhibit 2
Applicable Exchange Rates (USD/CAD)

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>31 December 2015</td>
<td>1.023</td>
</tr>
<tr>
<td>Average rate in 2016</td>
<td>1.078</td>
</tr>
<tr>
<td>31 December 2016</td>
<td>1.119</td>
</tr>
<tr>
<td>15 November when dividends were declared</td>
<td>1.101</td>
</tr>
<tr>
<td>Weighted average rate when inventory was acquired</td>
<td>1.066</td>
</tr>
</tbody>
</table>
After her evaluation, McDonald met with David Bartel, a financial analyst at the firm. During their discussion, McDonald stated that a subsidiary’s inventory accounting method can have a considerable effect on the consolidated financial statements of the parent. Bartel stated that the choice of the subsidiary’s functional currency can affect several of the parent company’s financial ratios.

31. In year 2016, BLUSH’s consolidated financial statements will most likely include a translation gain/loss closest to:

   A. $26 million as part of net income.
   B. $115 million as part of a separate component of equity.
   C. $142 million as part of a separate component of equity.

32. Assuming BluCan’s translated income before translation gain/loss is $850.64 million, if the U.S. dollar were chosen as the functional currency for BluCan in 2016, the translation gain/(loss) included in BLUSH’s consolidated financial statements will be closest to:

   A. ($188.47) million and will be reported in the income statement (I/S).
   B. ($237) million and will be accumulated as a separate component of equity.
   C. ($198.28) million and will be reported in the I/S.

33. Under the temporal method, if BluCan had marketable debt securities as part of its total assets, and accrued expenses and deferred income taxes as part of its total liabilities, which of the following exchange rate(s) will it use to translate them into U.S. dollars?

   A. $1.119/CAD only
   B. $1.119/CAD and $1.03/CAD
   C. $1.078/CAD and $1.119/CAD only
34. If BLUSH wants to report a higher fixed asset turnover in its consolidated financial statements at a time when the Canadian dollar is weakening against the U.S. dollar, BluCan should most likely:

A. choose the Canadian dollar as its functional currency, but this will also result in a higher debt to assets ratio.
B. choose the U.S. dollar as its functional currency, but this will also result in a lower debt to equity ratio.
C. increase the amount of accrued expenses and deferred income taxes reported on its balance sheet.

35. If the USD were chosen as the functional currency for BluCan, which of the following will result in the highest consolidated inventory turnover? (inventory was purchased at the same CAD price throughout the year)

A. LIFO inventory accounting and a depreciating Canadian dollar
B. FIFO inventory accounting and a depreciating Canadian dollar
C. FIFO inventory accounting and an appreciating Canadian dollar

36. If Canada was considered a highly inflationary country, which of the following conditions would result in the same translation results under both IAS 21 and SFAS 52 in the consolidated financial statements?

A. The U.S. and Canadian dollar exchange rate changes by exactly the same percentage amount as the change in the general price index in Canada
B. The U.S. and Canadian dollar exchange rate changes by exactly the same percentage amount as the change in the general price index in the U.S.
C. The percentage appreciation of the U.S. dollar against the Canadian dollar is exactly equal to the inflation differential between the two countries
Questions 37 through 42 relate to Equity Investments

Parachute Investments (PARIN) Case Scenario

Alex Forman is an equity analyst working for Parachute Investments (PARIN), an equity management firm offering investment advisory and management services to institutional as well as private wealth clients. Forman works with Cindy Pon to manage GLOMES fund, an equity fund that invests in domestic as well as global equities. Presently, Forman has asked Pon to use the internal rate of return (IRR) concept to determine a required return estimate for the stock of Vivo Products Inc. (VIVO), a firm operating in the utilities industry. For this purpose, Pon determined that the forecasted dividend for next year is $5.06/share, the current long-term dividend growth rate equals 3.95% and the expected dividend growth rate equals 3.28%. The stock’s current market price is $67.29. She then made the following comments to Forman:

Statement 1:  “I have used the above information to determine a required return estimate of 10.80% for VIVO’s stock. However, my calculation model does not explicitly include an adjustment for risk and the estimate holds true only if the market is efficient.”

Statement 2:  “My method of determining the required return is very similar to the exercise of inferring what the market implies about future growth rates of cash flows, given an independent estimate of required return.”

As their discussion about return estimates continued, Forman stated that an accurate equity risk premium estimate played an essential role in increasing the accuracy of the required return estimate. When Pon asked about whether to use the geometric or arithmetic mean in calculating the risk premium, Forman stated that the major finance models were single period models, so the arithmetic mean was a model-consistent choice. However, he added that compounding forward using the sample arithmetic mean, even when returns are serially uncorrelated, overestimated the expected terminal value of wealth. Pon disagreed, and stated that the geometric mean is the logical choice for estimating a required return in a multi-period context, even when using a single-period required return model. She also stated that risk premium estimates based on the geometric mean have tended to be closer to supply–side and demand –side estimates from economic theory than arithmetic mean estimates.
After their meeting, Forman proceeded with estimating the equity risk premium for U.S. equities using information about a broad-based equity market index. Exhibit 1 displays some data he accumulated for this purpose.

### Exhibit 1
**Data for U.S. Equity Markets**

<table>
<thead>
<tr>
<th>Metric</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>YTM of 20-year maturity T-bonds</td>
<td>5.6%</td>
</tr>
<tr>
<td>YTM of 20-year maturity TIPS</td>
<td>3.01%</td>
</tr>
<tr>
<td>Labor productivity growth</td>
<td>1.1%</td>
</tr>
<tr>
<td>Population growth rate</td>
<td>1.13%</td>
</tr>
<tr>
<td>Increase in labor force participation rate</td>
<td>2.01%</td>
</tr>
<tr>
<td>Expected dividend yield</td>
<td>3.5%</td>
</tr>
<tr>
<td>Reinvestment return</td>
<td>40 bps</td>
</tr>
<tr>
<td>Current long-term corporate bond yield</td>
<td>7.5%</td>
</tr>
</tbody>
</table>

*The U.S. risk-free rate is 4.5%*

In addition, Forman expects the corporate earnings to grow at a rate faster than the growth rate of the overall economy. His estimate of this surplus growth is 1.5%. He also believes that the current P/E level reflects overvaluation of equities and should be adjusted by 2.5%.

Pon is also trying to estimate an appropriate equity risk premium. However, she believes that markets are moving towards perfect integration and that the beta of U.S. stocks relative to the MSCI World Index is 0.9265. She has also estimated the national and global risk-free rates to equal 4.3% and 5.7% respectively. She wonders how her belief will affect her estimate of equity risk premium relative to what Forman just estimated.

After estimating the equity risk premium, Forman is now estimating the beta for Ellen Designs (ELLED), a privately owned clothing outlet. Forman decides to use the beta of a public comparable to estimate the beta of ELLED. He determines the public peer’s beta to be 1.31. When Pon asked Forman about the procedure involved, Forman made the following comments:

Statement 3: “If the public peer has 20% more debt than ELLED, its equity beta will be 20% greater than the estimated beta for ELLED.”
Statement 4: “If ELLED has exactly the same amount of debt in its capital structure as its public peer, its estimated beta will be close to the equity beta of the public peer.”

As the last assignment of the day, Pon has to estimate the required return of a private business. For this, she first estimates an equity risk premium with reference to the S&P 500 index. She then adds the risk-free rate and a beta-adjusted size premium to this estimate, with the size premium estimate based on the lowest market-cap decile.

37. Pon is most accurate with respect to:

A. Statement 1 only.
B. Statement 2 only.
C. both statements 1 and 2.

38. With respect to their comments about the equity risk premium estimates based on the geometric and arithmetic mean, are Forman and Pon most likely correct?

A. Only Forman is correct
B. Only Pon is correct
C. Both Forman and Pon are correct

39. Using the information gathered by Forman, an estimate of the U.S. equity risk premium is closest to:

A. 4.69%.
B. 5.09%.
C. 5.24%.
40. Assuming that the U.S. equity risk premium is 4.75%, Pon will *most likely* use a:

A. 5.127% equity risk premium estimate and a 4.3% risk-free rate to obtain the required return estimate.
B. 5.322% equity risk premium estimate and a 5.7% risk-free rate to obtain the required return estimate.
C. 5.099% equity risk premium estimate and a 4.3% risk-free rate to obtain the required return estimate.

41. Forman is *least* accurate with respect to:

A. Statement 3 only.
B. Statement 4 only.
C. both statements 3 and 4.

42. Pon’s estimate of required return (as part of his last assignment) *most likely* corresponds to the return on a(n):

A. average-systematic-risk micro-cap public equity issue.
B. below-average risk micro-cap public equity issue.
C. above-average-systematic risk micro cap private equity issue.
Questions 43 through 48 relate to Equity Investments

James Blackwell Case Scenario

James Blackwell is an investment analyst at Thornton Securities. Blackwell has been tasked with evaluating the stock of Gratin, a Vietnamese based manufacturer and exporter of frozen food products such as vegetables and meat, for investment. The frozen food industry is a global industry. Blackwell begins his analysis by conducting a Porter’s analysis on the industry summarizing the information in Exhibit 1. He also expresses his concerns regarding the rising inflation in global input prices and forecasts this trend to continue for the next fifteen months. His analysis of the industry and Gratin will be based on the inflation projection.

Exhibit 1

<table>
<thead>
<tr>
<th>Threat of substitutes</th>
<th>Low because Gratin’s food products have the longest shelf life</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intensity of rivalry</td>
<td>Low because Gratin dominates the global industry. There are only three foreign competitors with market shares of 10% each.</td>
</tr>
<tr>
<td>Bargaining power of suppliers</td>
<td>Low because Gratin has access to a large number of cattle ranchers and agriculture producers in Vietnam. Gratin has now started to rely on its own farm to acquire a portion of the necessary input for production. The company plans to expand its farms to fully meet output demand in the near future.</td>
</tr>
<tr>
<td>Bargaining power of customers</td>
<td>Low as the customer base is fragmented including a variety of retail supermarket chains</td>
</tr>
<tr>
<td>Threat of new entrants</td>
<td>Low because of recent specialized frozen technology adopted by industry participants and high leverage structures making it difficult for new players to enter the industry</td>
</tr>
</tbody>
</table>

Next, Blackwell studies the impact of inflation on Gratin’s 2016 sales volume. He designs three alternative scenarios each of which predicts how the company will react to inflationary pressure. Exhibit 2 shows Gratin’s financial results for the most recent financial year (2015) while Exhibit 3 show the estimates of input prices, volume growth and pricing under the three scenarios.
Exhibit 2

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>550,420</td>
</tr>
<tr>
<td>Cost of goods</td>
<td>388,940</td>
</tr>
<tr>
<td>Gross profit</td>
<td>161,480</td>
</tr>
<tr>
<td>Gross profit margin</td>
<td>29.34%</td>
</tr>
</tbody>
</table>

*All non-percentage figures are denominated in the local currency, Vietnam dong (VDN).

Exhibit 3

<table>
<thead>
<tr>
<th></th>
<th>Scenario A</th>
<th>Scenario B</th>
<th>Scenario C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price increases for revenues</td>
<td>0.0%</td>
<td>5.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Volume growth</td>
<td>12.0%</td>
<td>8.0%</td>
<td>-17.0%</td>
</tr>
<tr>
<td>Total revenue growth</td>
<td>12.0%</td>
<td>13.4%</td>
<td>-8.7%</td>
</tr>
<tr>
<td>Input prices increase</td>
<td>10.0%</td>
<td>10.0%</td>
<td>10.0%</td>
</tr>
</tbody>
</table>

Blackwell would also like to estimate the impact on gross profit margin if Gratin is unable to pass on the 10% inflation in input costs to its customers. For his analysis, Blackwell relies on the data in Exhibit 2 and assumes the same financial results hold for 2016.

Blackwell concludes his analysis by comparing Gratin’s operating performance and financial position to its competitors. He decides to rely on return on invested capital (ROIC) and forecasts that the measure will demonstrate a rising trend in the present inflation scenario based on past observations of how this measure reacted to inflation.

43. Based on the information presented in Exhibit 1, Blackwell can conclude that:

A. the ability of Gratin to earn a high ROIC is low.
B. Gratin is in a position to mitigate the impact of increased prices from some of suppliers.
C. Gratin may not be in a position to easily pass price increases to customers.

44. Based on the data in the Exhibit, Blackwell can conclude that Gratin’s ability to:

A. expand operations is unrestricted as Blackwell is the largest seller in the industry.
B. demand lower input prices from suppliers is high.
C. control prices charged to customers is low due to their fragmentation.
45. If Scenario C materializes, the change in gross profit margin from that reported in 2015 is closest to:

   A. – 50%
   B. – 23%
   C. 0%.

46. Considering the data in Exhibit 3, which of the following scenarios most likely assumes that the demand for Gratin’s products is relatively price inelastic? Scenario:

   A. A.
   B. B.
   C. C.

47. Using the data in Exhibit 2, if Gratin is unable to pass on the inflation to its customers, the resulting gross profit margin is equal to:

   A. 22.27%.
   B. 29.34%.
   C. 35.76%.

48. Which of the following reasons most likely supports Blackwell’s preference for the ROIC measure?

   A. The degree of competitive advantage secured by Gratin can be assessed.
   B. Gratin’s degree of financial leverage can be compared to its competitors.
   C. The underlying profitability of companies following different tax regimes can be compared.
Questions 49 through 54 relate to Fixed Income.

Laura Peterson Case Scenario

Laura Peterson is the senior fixed income manager at Tuckhoe Limited, a portfolio management firm. She is attempting to explain to her subordinate, Clark Marshall, how the binomial model can be applied to the valuation of fixed-income securities. Peterson has drawn a list of objectives, which she intends to achieve during the discussion.

Objective 1: Value a 5% annual coupon-paying option-free bond using the binomial model.

Objective 2: Determine the impact of changing volatility on forward rates.

Objective 3: Determine what calibrating an interest rate tree implies for arbitrage profits.

Objective 4: Compare the valuation of a bond issue using spot rates to that performed with a binomial interest rate tree.

Objective 5: Explore Monte Carlo simulation, its statistical accuracy, and the implication of including mean reversion in model estimation.

To achieve the first objective, Peterson constructs a binomial interest rate tree using one-, two-, and three-year spot rates of 3%, 6%, and 8% respectively (Exhibit 1). A 10% volatility assumption is used for the analysis.

After deriving the binomial interest rate tree, Marshall asks his supervisor how the model can be used to value the subject bond. Using the rates in Exhibit 1, Peterson tasks her subordinate with valuing the bond issue (Objective 1). Exhibit 2 summarizes the results of his efforts.

Exhibit 1: Binomial Interest Rate Tree

<table>
<thead>
<tr>
<th>Year 0</th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Node 3-1</td>
<td></td>
</tr>
<tr>
<td>10.254%</td>
<td>Node 3-2</td>
<td>10.413%</td>
</tr>
<tr>
<td>3.000%</td>
<td>8.395%</td>
<td></td>
</tr>
</tbody>
</table>
Exhibit 2: 5% Annual Coupon-Paying Bond Value Derived Using the Binomial Interest Rate Tree

<table>
<thead>
<tr>
<th>Year 0</th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>PV = 90.882</td>
<td>PV = 87.994</td>
<td>PV = 93.153</td>
</tr>
<tr>
<td>Coupon = 5</td>
<td>Coupon = 5</td>
<td>Coupon = 5</td>
</tr>
<tr>
<td>PV = 87.994</td>
<td>PV = 91.962</td>
<td>PV = 95.098</td>
</tr>
<tr>
<td>Coupon = 5</td>
<td>Coupon = 5</td>
<td>Coupon = 5</td>
</tr>
</tbody>
</table>

49. The value of the bond at Node 1-2 (Exhibit 2) is closest to:

A. 86.84.
B. 91.45.
C. 96.45.

50. Without performing any further calculations, an increase in the volatility assumption will cause forward rates to:

A. spread out.
B. remain unaffected.
C. converge to the one year forward rate implied from the current yield curve.

51. The process of interest rate tree calibration will most likely result in the implied opportunities for arbitrage:

A. increasing.
B. decreasing.
C. remaining the same.
52. In contrast to the valuation of option-free bonds using spot rates, the binomial interest rate tree will produce values which are:

A. lower.
B. higher.
C. the same.

53. With respect to Objective 5, mean reversion has the impact of moving interest rates towards:

A. historical average forward rates.
B. spot rates implied from the yield curve.
C. forward rates implied from the yield curve.

54. The rate at Node 3-1 is equal to:

A. 11.508%.
B. 12.718%.
C. 15.534%.

Correct Answer: C

Reference:
*CFA Level 2, Volume 5, Study Session 12, Reading 36, LOS e*

Forward rate (Node 3-1) = $10.413e^{(4 \times 0.10)} = 15.53437\%$ or $15.534\%$
Questions 55 through 60 relate to Derivatives.

F-Line Associates Case Scenario

F-Line Associates is an investment management firm and manages a global equity fund titled Alpha. Benjamin Greene is Alpha’s fund manager. Greene proposes that Alpha’s mandate be revised to include entering in forward contracts for securing arbitrage profits.

As a starting point, Greene works alongside his subordinate, Alicia Jefferson, in drafting a manual which will explain the no-arbitrage principle underlying the pricing and valuation of forward contracts. He begins the manual with the following statement:

Statement 1: “If the cash and forward markets are priced correctly with respect to one another, we cannot secure positive cash flows today without incurring future liabilities.”

Greene then moves on to test the no-arbitrage principle on a hypothetical 3-month equity forward contract. Greene assumes that the underlying stock does not pay dividends. Details concerning the forward contract have been summarized in Exhibit 1.

<table>
<thead>
<tr>
<th>Exhibit 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>$S_0(T)$</td>
</tr>
<tr>
<td>3-month annualized risk-free rate</td>
</tr>
<tr>
<td>Time to expiration</td>
</tr>
<tr>
<td>Current market forward price</td>
</tr>
</tbody>
</table>

Based on the data collected, Greene concludes the manual with the following statement:

Statement 2: “A cash and carry transaction will be profitable.”

Jefferson believes that the manual is incomplete without addressing the impact of a planned decrease in policy rate by the Central Bank on forward prices.
Next, Greene considers the stock of Dexoc, a conglomerate which is headquartered in France. Greene would like to add a €5 million exposure of this stock to Alpha. He explains to Jefferson that there are two ways to acquire exposure:

A. Purchase shares of the stock today
B. Enter into a forward contract to purchase the underlying stock six months from today.

Deciding that option B is the cheaper of the two, Greene collects details required for pricing the equity forward contract in Exhibit 2.

<table>
<thead>
<tr>
<th>Current market price</th>
<th>€20.50</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected annual dividend</td>
<td>€0.75</td>
</tr>
<tr>
<td>Time to dividend payment</td>
<td>2 months</td>
</tr>
<tr>
<td>Annually compounded Euro risk-free rate</td>
<td>3.55%</td>
</tr>
</tbody>
</table>

Greene concludes his analysis of the Dexoc stock with a decision to remove the foreign exchange exposure. He achieves this by selling the euro investment amount forward against the US dollar at a rate of $0.90/€1 today for a period of six months. The annually compounded US risk-free rate is 3%. During the term of the contract, Greene’s primary purpose is to consider the following two scenarios independently:

Scenario A: The impact on the percentage forward premium/discount if the Euro spot market exchange rate rises.

Scenario B: The value of the forward contract if the spot exchange rate one month later is $0.89/€1, while all else is held constant.

55. Considering Statement 1, the approach taken by Greene to price and value the hypothetical forward is based on the:

A. law of one price.
B. assumption that markets are frictional.
C. presumption that the value of any portfolio is less than the sum of the value of each investment held in the portfolio.

56. Is Greene correct with respect to the conclusion derived in Statement 2?

A. Yes.
B. No, an arbitrage strategy will not generate risk-free profits.
C. No, a reverse cash and carry arbitrage will be profitable in the scenario.

57. The most likely impact of a decline in policy rate on the forward price is:

A. neutral.
B. a decrease.
C. an increase.

58. Using the data in Exhibit 2, the no-arbitrage price for the six-month Dexoc equity forward contract is equal to:

A. €19.87.
B. €20.10.
C. €20.86.

59. Considering Scenario A, the percentage currency forward premium/discount will most likely:

A. rise.
B. decline.
C. remain the same.

60. Considering Scenario B, the value of the currency forward contract one month from today is equal to:

A. $37,841.
B. $59,266.
C. €60,000.