

Each Practice Exam covers all Topics in the CAIA curriculum according to their respective weights.

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# EXAM 1 PART 1: MULTIPLE CHOICE

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## Professional Standards and Ethics

1. Which of the following statements concerning knowledge of the law and member actions is **CORRECT**? In the event that there is a conflict between the Standards and the relevant local law:
  - A. the local law applies. In the event that a violation is detected, members are required to report to the appropriate governmental authorities.
  - B. the more strict of the two applies. In the event that a violation is detected, members are required to report to the appropriate governmental authorities.
  - C. the local law applies. In the event that a violation is detected, members are not required to report to governmental authorities, though this may be advisable in some circumstances.
  - D. the more strict of the two applies. In the event that a violation is detected, members are not required to report to governmental authorities, though this may be advisable in some circumstances.
  
2. Which of the following statements is **FALSE** with respect to the determination of investment suitability for a particular client?
  - A. Investments should be suitable given the investor's financial situation.
  - B. Each investment should be evaluated for its suitability on the basis of its total risk.
  - C. Investor information should be updated regularly, no less frequently than annually.
  - D. Investments should be evaluated in the context of the investor's risk and return objectives.
  
3. Wilson Briggs has received an offer from a client to pay him a \$10,000 bonus if certain performance objectives are met. With respect to this offer, which of the following statements is **CORRECT**?
  - A. He cannot accept the offer under any circumstances.
  - B. He can accept the offer if he receives written consent from his employer and the client.
  - C. He can accept the offer without written consent from any party because it is compensation for service.
  - D. He can accept the offer if he receives written consent from his employer, but does not need written consent from the client.

4. After working nearly 20 years on Wall Street, Kevin Gentry decides to leave New York and open his own investment firm on tiny, but wealthy, Turtle Island, located in the Caribbean. Gentry has selected Turtle Island as his new base of operations for the lifestyle it affords as well as the country's securities laws that are much less stringent than the Code of Ethics and the Standards of Professional Conduct that he had operated under while working in the United States. As anticipated, many of his U.S.-based clients have agreed to keep Gentry as their portfolio manager and move their assets to his new firm. After a few months of operations, Gentry has encountered several instances where Turtle Island regulations relieve him of disclosing information to investors that he had been required to disclose while working in New York. According to the Code and Standards, Gentry must adhere to the:
- A. laws of Turtle Island, since it is where his business is conducted.
  - B. Code and Standards because it is "more strict" than the applicable law.
  - C. laws of Turtle Island, but disclose any discrepancies to U.S.-based clients.
  - D. Code and Standards because he must adhere to the Code and Standards under all circumstances.
5. Julie Moore reports directly to Jim Black, who is the president of a mid-sized money management firm. Moore discovers that Black is the subject of several investigations by various authorities regarding alleged trading violations. She has worked closely with him and has observed some possible violations. Which course of action must Moore take in this situation?
- A. Cooperate with the Professional Conduct Program and provide all information requested.
  - B. Immediately resign her position and discontinue all participation in the investigation in order to preserve confidentiality to her former employer and clients.
  - C. Provide information regarding only those clients who have given their written consent.
  - D. Execute a settlement agreement with the money management firm with a confidentiality clause that will relieve her of any obligation to provide information.
6. Jonathan Song has recently been hired as a portfolio manager for a small investment advisory firm that specializes in managing personal trusts. The firm hired Song in preparation for a new marketing campaign aimed at attracting new clients. One of Song's first tasks is to prepare an investment performance presentation for prospective clients that will clearly and accurately represent the firm's track record. Which of the following strategies adheres the closest to the obligations of the Standards of Professional Conduct? The firm should:
- A. include terminated accounts as a part of performance history.
  - B. present a minimum of five years of historical performance data.
  - C. comply with the Global Investment Performance Standards (GIPS).
  - D. present an estimate of returns over the next 12 months, given the current portfolio composition.

7. Rob Carter works for a Wall Street investment banking institution as an analyst for the consumer goods industry. Carter is preparing a research report on Clean Bright, a U.S.-based company that manufactures cleaning products used in the home. Clean Bright was once an industry leader, but has suffered several years of lackluster sales after the death of its founder. After reviewing industry statistics and consulting with several suppliers of Clean Bright, Carter discovers that Clean Bright has become alarmingly slow in meeting its accounts payable obligations. Carter believes that the company may soon face bankruptcy. Before Carter can issue a sell recommendation in his research report, Carter is required to:
- A. take no additional action.
  - B. wait until suppliers contact other analysts about Clean Bright.
  - C. make full disclosure of the conversations with the suppliers to a compliance officer at his firm.
  - D. contact management at Clean Bright to disclose the results of his conversations with suppliers.
8. Two Level 1 CAIA candidates working in the same large investment firm have purchased two different independent review materials to help them prepare for the CAIA exam. Although the materials are copyright protected, the candidates make copies and exchange them with one another. According to the Standards of Professional Conduct:
- A. the candidates have violated the Standards.
  - B. so long as no legal charges are brought, no violation has occurred.
  - C. in the absence of legal copyrights within the candidates' home country, no violation has occurred.
  - D. until at least one of the candidates has completed Level 1, the Standards do not apply.
9. The Northern Saving Trust department has an internally managed, commingled stock fund where all of its smaller client accounts are pooled together. For larger clients, Northern handles the accounts individually, setting up individual portfolios for each customer. The stocks held in the individual accounts are by and large the same as those held in the commingled fund. Northern always trades in the individual accounts first, and in the commingled fund last. This policy is:
- A. in violation of the Standards by failing to deal fairly with all clients.
  - B. in violation of the Standards by inappropriately using the same investment strategy for individual and commingled accounts.
  - C. in violation of the Standards by pooling individual investments into a commonly managed fund.
  - D. acceptable under the Standards.

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# EXAM 1 PART 1 ANSWERS

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Answers to multiple choice Practice Exam questions are explained in detail and include a reference to the associated Learning Objective in the CAIA curriculum.

## Professional Standards and Ethics

1. **D** When there is a conflict between the Standards, local law, regulations, or other rules, the more strict measure applies to member actions. Thus, members can be held to a standard that is higher than the local law. When a violation is detected, members are not necessarily required to report to governmental authorities, but it may be advisable to do so in some circumstances. (LO 1.1.a)
2. **B** An investment should *not* be evaluated on the basis of its total risk. Investments should instead be evaluated in a portfolio context in order to determine suitability. All of the other statements are correct. (LO 1.3.c)
3. **B** The Standard concerning additional compensation arrangements states that such compensation can only be accepted if written consent is obtained from all parties involved. All parties involved would include both the employer and client. (LO 2.1.b)
4. **B** Standard I(A). When applicable law and the Code and Standards have differing requirements, candidates and members must follow the “more strict” of either the local law or the Code and Standards. (LO 1.1a)
5. **A** Standard III(E). Members will not be violating their duty to preserve confidentiality by forwarding confidential information to CFA Institute. (LO 1.3.e)
6. **C** Compliance with the GIPS standards is the best method for members and candidates to meet their obligations under Standard III(D). (LO 1.3.d)
7. **A** Standard II(A). According to Standard II(A), the analyst’s conclusions are covered by the mosaic theory, so no additional disclosure is required. (LO 1.2.a)
8. **A** Standard I(D). Unauthorized copying of copyrighted materials is theft and would be a clear violation of the Standard. (LO 1.1.d)
9. **A** Standard III(B). The policy is consistent but unfair and would be in violation even if disclosed. Standard VI(B) covers trading activity in one’s own account ahead of employers or clients; it does not address putting one client’s interests ahead of another’s. (LO 1.3.b)
10. **C** Standard II(B), Market Manipulation, is not intended to prohibit transactions that are done in order to minimize income taxes or trading strategies that are NOT intended to distort prices or artificially inflate trading volume. Thus, neither Gordon nor Turpin is in violation. (LO 1.2.b)
11. **C** Standard VI(A). Members shall disclose to their clients and prospects all matters that could impair the member’s ability to make objective recommendations. (LO 2.3.a)

Each Practice Exam includes essay questions to prepare candidates for the essay section of the actual CAIA exam.

## EXAM 1 PART 2: ESSAY

### Question 1 (10 Points)

Tom Carter is a portfolio manager for Oleander Associates. Oleander specializes in convertible bond investing. Carter is considering two different convertibles for investment, one issued by Hoke Incorporated and the other issued by Stuart Metals. The data for the convertibles are provided in Figure 1 below.

Figure 1

	<i>Hoke Incorporated</i>	<i>Stuart Metals</i>
Bond maturity in years	8	15
Conversion ratio	18	24
Coupon rate paid on an annual basis	7.00%	7.50%
Current stock price	\$35.00	\$52.00
Face value	\$1,000	\$1,000
Market price of convertible bond	\$996	\$1,284
Yield to maturity on bond	7.10%	8.00%

- A. As an initial step in his investigation of the bonds, Carter calculates the investment value premium and conversion value premium for each of the bonds. Calculate the values for each, assuming that each bond pays its coupon payment annually.

(4 points)

# EXAM 1 PART 2 ANSWERS

Answers to Practice Exam essay questions are explained in detail and include a reference to the associated Topic in the CAIA curriculum.

## Question 1 (Topic 3)

- A. The straight bond value is calculated as the present value of its coupon and principal, which can be solved on your financial calculator for Hoke Incorporated as:

$$FV = 1000; PMT = 70; N = 8; I/Y = 7.1; CPT \rightarrow PV = -994.05.$$

The investment value premium is calculated as:

$$\text{investment value premium} = \frac{\text{convertible price} - \text{straight bond value}}{\text{straight bond value}}$$

$$\text{investment value premium}_{\text{Hoke}} = \frac{\$996.00 - \$994.05}{\$994.05} = 0.20\%$$

For Stuart Metals, the calculations are:

$$FV = 1000; PMT = 75; N = 15; I/Y = 8.0; CPT \rightarrow PV = -957.20.$$

$$\text{investment value premium}_{\text{Stuart}} = \frac{\$1,284.00 - \$957.20}{\$957.20} = 34.14\%$$

The conversion value reflects what the convertible is worth if converted to common stock. This is the conversion ratio times the current stock price. For Hoke Incorporated it is:  $18 \times \$35 = \$630$ .

The conversion value premium is calculated as:

$$\text{conversion value premium} = \frac{\text{convertible price} - \text{conversion value}}{\text{conversion value}}$$

$$\text{conversion value premium} = \frac{\$996.00 - \$630.00}{\$630.00} = 58.10\%$$

For Stuart Metals, the conversion value is:  $24 \times \$52 = \$1,248$ .

$$\text{conversion value premium} = \frac{\$1,284.00 - \$1,248.00}{\$1,248.00} = 2.88\%$$

- B. The delta measures the change in the convertible value relative to a change in the underlying stock price. It also measures the number of shares the arbitrageur should short to establish a hedged position. Gamma measures the change in delta relative to a change in the stock price. Gamma helps refine a dynamic hedge.

The sensitivity of the Stuart Metals bond to the underlying equity is higher as reflected in its higher investment value premium. The higher investment value premium reflects that the convertible is valued primarily for its conversion to common stock, not as a straight bond. Because it is more sensitive to the underlying equity, its delta and gamma will be higher than that for the Hoke Incorporated bond.