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CFA
LEVEL I

EXPLANATIONS – SAMPLE – CFA LEVEL I

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Explanations - Sample - CFA Level I

Answer 1: Correct answer is C

Both of these items are explicitly listed in the discussion of Standard VI(A), Disclosure of Conflicts.

Answer 2: Correct answer is B

Both violated Standard VII(A) because they committed an act that compromised the validity of the examinations leading to the award of the right to use the CFA designation.

Answer 3: Correct answer is B

Recall the WACC equation:

$$WACC = [w_d \times k_d \times (1 - t)] + (w_{ps} \times k_{ps}) + (w_{ce} \times k_s)$$

The increase in the corporate tax rate will result in a lower cost of debt, resulting in a lower WACC for the company.

Answer 4: Correct answer is A

k_{ps} = \$8 / \$80 = 10%

Answer 5: Correct answer is B

Several studies support the idea that approximately 90% of the variation in a single portfolio's returns can be explained by its target asset allocations, with security selection and tactical variations from the target (market timing) playing a much less significant role. In fact, for actively managed funds, actual portfolio returns are slightly less than those that would have been achieved if the manager strictly maintained the target allocation, thus illustrating the difficultly of improving returns through security selection or market timing.

Answer 6: Correct answer is A

Investor X has a steep indifference curve, indicating that he is risk-averse. Flatter indifference curves, such as those for Investor Y, indicate a less risk-averse investor. The other choices are true. A more risk-averse investor will likely obtain lower returns than a less risk-averse investor.

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Answer 7: Correct answer is B

In order to be considered arbitrage there must be no risk in the trade.

It doesn't matter if commissions are paid as long as the amount of the price discrepancy is enough to offset the amount paid in commissions.

In order to be considered arbitrage there must be no initial investment of one's own capital. One must finance any cash outlay through borrowing.

Answer 8: Correct answer is B

The kink in the diagram of a covered call is always at the exercise price of the option. Therefore, point X is \$80. As the stock price rises above \$80, the stock is called away and the maximum gain is the call premium plus the stock price gain (\$80 − \$70). The maximum gain, then, at point Y is (\$5 + \$10 = \$15).

Answer 9: Correct answer is C

Long/short funds, by definition, are not market-neutral and usually maintain a net positive or net negative market exposure.

Answer 10: Correct answer is B

NOI = rental income × (1 − vacancy rate) − insurance costs − property taxes − utility expense − repair costs
NOI = \$3.80 million × (96.5%) − 250,000 − 400,000 − 120,000 − 200,000 = 2.70 million
Value of building = 2.70 million / 0.08 = 33.75 million

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