



CFA Institute CFA-Level-II Mock Exam

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Question 1

Question Type: MultipleChoice

The board members for Kazmaier Foods have gathered for their quarterly board of directors meeting. Presiding at the meeting is the Chairman and CEO for Kazmaier, Phil Hinesman. The other eight members of the board are also present, including Allen Kazmaier, the brother of Kazmaier's founder; Elaine Randall, Executive Vice President for Emerald Bank, which Kazmaier uses to obtain short-term financing; and Bill Schram, Kazmaier's President and Chief Operating Officer. Each of the directors was elected to serve on the board for a 4-year term. They were elected two at a time over the past three years. With the exception of Hinesman, Allen Kazmaier, Randall, and Schram, board members had no ties to Kazmaier prior to joining the board and had no personal relationships with management. In addition to the regular board meetings, the five independent board members get together annually, in a meeting separate from the regular board meetings, to discuss the company's operations.

Item 1 on the board meeting agenda is a discussion about the importance of corporate governance and how Kazmaier can improve its corporate governance system. Hinesman begins the discussion by saying, "A strong system of corporate governance is important to our shareholders. Studies have shown that, on average, companies with strong corporate governance systems have higher measures of profitability than companies with weak corporate governance systems." Randall adds her comment to the discussion: "The lack of an effective corporate governance system increases risk for our investors. If we do not have the appropriate checks and balances in place, our investors may be exposed to the risk that information used to make decisions about our firm is misleading or incomplete, as well as the risk that mergers or acquisitions the firm enters into will benefit management at the expense of shareholders."

After a lengthy discussion, the board agrees on five separate recommendations that will enhance its current system of corporate governance. One of these recommendations is to change the function and structure of the board's audit committee. Currently the audit committee consists of Matthew Bortz, David Smith, and Ann Williams---three independent directors who each have backgrounds in finance and accounting. The board agrees that one more member should be added to the committee and that the committee should expand its list of responsibilities.

Item 2 on the agenda for the board of directors' meeting is a report from Kazmaier's Chief Financial Officer, Doug Layman. The following information was included in the material that was distributed to each board member before the meeting:

Current share price: \$40.00

Shares outstanding: 56, 250,000

Estimated earnings: \$112.5 million

Planned capital spending: \$150 million

Target debt-to-equity ratio 1 to 1

Cost of equity: 8.0%

Constant growth rate: 5.2%

Layman tells the board that his analysis indicates that, based on a constant-growth dividend discount model, the initiation of an \$0.80 per share dividend would reduce the cost of equity by 1.2% and increase the value of the firm's stock, assuming that earnings, the cost of debt, and the constant growth rate don't change.

Item 3 on the agenda is the sale of Kazmaier's condiment packaging division to Sautter Packaging and Supply Company. Layman believes the sale will net the company \$50 million, payable in cash. After discussing the pros and cons of selling the division, the directors agree that the sale is in the best interests of the company and its shareholders. The directors then move to a vote, and the sale of the condiment packaging division is approved unanimously. The committee then moves on to discuss what to do with the proceeds from the sale. Williams suggests that paying out the \$50 million to shareholders as a special dividend would continue to give the firm flexibility in how it uses its excess cash. Smith tells the board that a share repurchase can be thought of as an alternative to a cash dividend, and that if the tax treatment between the two alternatives is the same, investors should be indifferent between the two. After debating the merits of special dividends and stock repurchases, Kazmaier's board authorizes the proceeds from the sale of the condiment packaging division to be used for the purchase of \$50 million worth of outstanding shares.

An external agency recently included Kazmaier in a review of corporate governance systems to determine whether or not the structure of the board of directors was consistent with corporate governance best practices. The agency scored companies based on the following criteria:

Criterion 1: Composition of the board of directors.

Criterion 2: Chairman of the board of directors.

Criterion 3; Method of electing the board.

Criterion 4: Frequency of separate sessions for independent directors.

Each of the four criteria was weighted equally, with the firm receiving a positive mark for being in compliance with corporate governance best practice.

A month after the board meeting, the price of Kazmaier stock is still at \$40 per share, and the sale of Kazmaier's condiment packaging division does not go through. In order to finance the approved share repurchase, Kazmaier is forced to borrow funds. Schram states, "I am concerned that the cost of the debt used to repurchase shares may cause a reduction in earnings per share."

Jennifer Nagy, a vice president in Kazmaier's finance division, tells Schram not to be concerned about using debt to finance the share repurchase because the rationale behind the repurchase is sound. Nagy then writes down some of the common rationales for share repurchases and hands them to Schram.

Rationale 1: Repurchasing shares can prevent the EPS dilution that comes from the exercise of employee stock options.

Rationale 2: Management can use a share repurchase to alter the company's capital structure by decreasing the percentage of equity.

Rationale 3: Like a dividend increase, a share repurchase is a way to send a signal to investors that Kazmaier's management believes the outlook for the company's future is strong.

Which of the following pairs of recommendations would be best in helping Kazmaier's audit committee comply with corporate governance best practices?

Options:

- A- The internal audit staff of the firm should report directly to the audit committee, and the committee should meet with auditors at least once annually without management present.
- B- At least 75% of the audit committee members should be independent, and all of the committee members should have a background in finance and accounting.
- C- All of the audit committee members should be independent and should meet with management at least annually to discuss findings in internal audits.

Answer:

C

Explanation:

Using a target debt-to-equity ratio of 1:1, the \$150 million in capital spending will be financed with \$75 million in internal equity and \$75 million in debt. The total dividend is the remaining internal equity of $\$112.5 - \$75 = \$37.5$ million, or $\$37.5 / 56.25 = \0.67 per share. (Study Session 8, LOS 29-j)

Question 2

Question Type: MultipleChoice

Marie Williams, CFA, and David Pacious, CFA, are portfolio managers for Stillwell Managers. Williams and Pacious are attending a conference held by Henri Financial Education on the fundamentals of valuation for common stock, preferred stock, and other assets.

During the conference, the presenter uses an example of four different companies to illustrate the valuation of common stock from the perspective of a minority shareholder.

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* Firm A is a noncyclical consumer products firm with a 50 year history. The firm pays a \$1.80 dividend per share and attempts to increase dividends by 4% a year. Earnings and dividends have steadily increased for the past

20 years.

* Firm B is a technology firm. It has never paid a dividend and does not expect to in the near future. Furthermore, due to large investments in new factories and equipment, the firm is not expected to generate positive free cash flow in the foreseeable future.

* Firm C is an industrial firm with currently very little competition and a dividend growth rate of 9% a year. However, the profits in its product market have started to attract competitors and it is expected that Firm C's profits will slowly decline such that the dividend growth steadily falls each year until it reaches a growth rate of 4% a year.

* Firm D is a pharmaceutical firm that is currently enjoying high profits and paying dividends. However, the firm's strongest selling drug is coming off patent in three years. With no other drugs in the pipeline, the firm's dividend growth rate is expected to drop abruptly in three years and settle at a lower growth rate.

The next day, Pacious decides to put what he learned into practice. The stock he is valuing, Maple Goods and Services, currently pays a dividend of \$3.00. The dividend growth rate is 25% and is expected to steadily decline over the next 8 years to a stable rate of 7% thereafter. Given its risk, Pacious estimates that the required return is 5%.

Williams analyzes the value of Mataka Plastics stock. Its dividend is expected to grow at a rate of 18% for the next four years, after which it will grow at 4%. This year's dividend is \$5.00 and Williams estimates the required return at 15%.

From the seminar, Pacious learned that a firm's health can be gauged by the present value of its future investment opportunities (PVGO). Tackling a calculation, he uses the following example for Wood Athletic Supplies:

Stock price \$90.00

Current earnings \$5.50

Expected earnings \$6.00

Required return on stock 15%

Pacious and Williams discuss the characteristics of firms in various stages of growth, where firms experience an initial growth phase, a transitional phase, and a maturity phase in their life. They both agree that the Gordon Growth Model is not always appropriate. Pacious makes the following statements.

Statement I: For firms in the initial growth phase, earnings are rapidly increasing, there are little

or no dividends, and there is heavy reinvestment. The return on equity is, however, higher than the required return on the stock, the free cash flows to equity are positive, and the profit margin is high.

Statement 2: When estimating the terminal value in the three-stage dividend growth model, it can be estimated using the Gordon Growth Model or a price-multiple approach.

Which of the following is closest to the current value for Maple Goods and Services stock?

Options:

- A- \$15.90.
- B- \$49.13.
- C- \$67.13.



Answer:

C

Explanation:

The firm should be valued using an H dividend discount model given that an initially high rate of growth declines linearly over a specified period. The formula is:



$$V_0 = \frac{[D_0 \times (1 + g_L)] + [D_0 \times H(g_S - g_L)]}{r - g_L}$$

where:

$$H = \left(\frac{t}{2}\right) = \text{half-life (in years) of high-growth period}$$

where:

t = length of high growth period

g_S = short-term growth rate

g_L = long-term growth rate

r = required return

Using the figures for Maple:

$$V_0 = \frac{[\$3.00 \times (1 + 0.07)] + \left[\$3.00 \times \left(\frac{8}{2}\right) \times (0.25 - 0.07)\right]}{0.15 - 0.07} = \$67.13$$

(Study Session 11, LOS 40.m)

Question 3

Question Type: MultipleChoice

Martha Garret, CFA, manages fixed income portfolios for Jones Brothers, Inc. (JBI). JBI has been in the portfolio management business for over 23 years and provides investors with access to actively managed equity and fixed-income portfolios. All of JBI's fixed-income portfolios are constructed using U.S. debt instruments. Garret's primary portfolio responsibilities are the Quasar Fund and the Nova Fund, both of which are long fixed-income portfolios consisting of Treasury securities in all maturity ranges. The Quasar Fund holdings as of March 15 are provided in Exhibit 1. A comparison of key rate durations for the Quasar Fund and Nova Fund is provided in Exhibit 2.

Exhibit 1: Quasar Fund

<i>Bond</i>	<i>Maturity (years)</i>	<i>Coupon</i>	<i>Yield</i>	<i>Par Value</i>	<i>Market Value</i>	<i>Duration</i>
A	2	5.0%	5.0%	4,000,000	4,000,000	1.86
B	5	4.5%	6.0%	3,500,000	3,278,851	4.32
C	15	8.0%	7.0%	2,750,000	3,000,468	8.90
D	30	6.5%	4.0%	6,450,000	9,238,340	15.90

Exhibit 2: Key Rate Durations for Quasar Fund & Nova Fund

<i>Fund</i>	<i>Maturity (Years)</i>			
	2	5	15	30
Quasar Fund	0.90	1.20	1.80	6.10
Nova Fund	0.40	2.50	3.40	1.10

Of particular importance to Garret and her colleagues is the degree of interest rate risk exposure unique to each portfolio under JBI's management. Driving the increased awareness of the portfolios' interest rate exposure is the double digit growth in assets under management that JBI's fixed-income portfolios have experienced in the last five years. Interest in the company's fixed-income portfolios continues to grow and as a result, all portfolio managers are required to attend weekly meetings to discuss key portfolio risk factors. At the last meeting, Miranda Walsh, a principal at JBI, made the following comments:

"The variance of daily interest rate changes has been trending higher over the last three months leading us to believe that a period of high volatility is approaching in the next twelve to eighteen months. However, the reliability is questionable since the volatility estimates were derived using an option pricing model, which assumes constant interest rates."

"Also, the Treasury spot rate curve currently has a similar shape to the yield curve on Treasury coupon securities, which, according to the market segmentation theory of interest rate term structure, indicates a relatively high level of demand from investors for intermediate term securities. Overzealous trading by investors unwilling to move into other maturity ranges may create mispricing and opportunities for arbitrage."

After the meeting, Walsh and JBI's other principals met to discuss a new international portfolio opportunity. At Walsh's suggestion, the principals selected Garret as the lead portfolio manager for the new fund, which will be titled the Atlantic Fund. One of the other portfolio managers, Greg Terry, CFA, suggested to Garret that she utilize the LIBOR swap curve as a benchmark for the Atlantic fund rather than using local government yield curves. Terry justifies his suggestion by claiming that "the lack of government regulation in the swap market makes swap rates and curves directly comparable between different countries despite fewer maturity points with which

to construct the curve as compared to a government yield curve. Furthermore, credit risk in the swap curves of various countries is similar, thus avoiding the complications associated with different levels of sovereign risk embedded in government yield curves." Intrigued by the idea of using the swap curve, Garret has her assistant begin gathering a range of current and forward LIBOR rates.

Which option best factors would have the most explanatory power for the historical returns of the Quasar Fund? Changes in the:

Options:

- A- level of interest rates.
- B- slope of the yield curve.
- C- curvature of the yield curve.

Answer:

A

Explanation:

Research conducted by Litterman and Scheinkman indicated that changes in the level of interest rates had the most explanatory power for returns on Treasury securities. Since the Quasar fund is composed of Treasuries of various maturities, Litterman and Scheinkmans research would be applicable. (Study Session 14, LOS 53-b)

Question 4

Question Type: MultipleChoice

A client of Colby Nash, CFA, wants to add an alternative asset class to his portfolio. However, the client is concerned that any investment in hedge funds may be far riskier and generate lower returns than is generally expected. Nash believes the client's attitude toward hedge funds was influenced by negative press coverage regarding fraud perpetrated by a few funds. Nash decided to conduct his own research on the risk/reward characteristics of hedge funds. Nash generated a report (shown in Exhibit 1) comparing several hedge fund strategies and a traditional investment benchmark; the S&P 500 index. Each hedge fund strategy is represented by an individual fund, which is used to measure risk and return over a ten year period. Nash also created a correlation matrix between hedge funds and the S&P 500 index, shown in Exhibit 2.

Exhibit 1: Hedge Fund Comparison

<i>Hedge Fund</i>	<i>Return</i>	<i>St. Dev.</i>	<i>Beta</i>	<i>Maximum Drawdown</i>
Long/Short Equity	14.6%	9.1%	0.1	-10.3%
Fixed Income Arbitrage	6.0%	4.1%	0.0	-14.4%
Equity Market Neutral	8.1%	3.2%	0.6	-9.7%
Distressed Securities	12.1%	5.6%	0.4	-12.8%
S&P 500 index	10.4%	15.5%	—	-44.7%

Exhibit 2: Hedge Fund Correlation Matrix

<i>Correlation Matrix</i>	<i>LSE</i>	<i>FIA</i>	<i>EMN</i>	<i>DS</i>	<i>SP</i>
Long/Short Equity (LSE)	1.00	—	—	—	—
Fixed Income Arbitrage (FIA)	0.07	1.00	—	—	—
Equity Market Neutral (EMN)	0.35	0.07	1.00	—	—
Distressed Securities (DS)	0.58	0.35	0.16	1.00	—
S&P 500 index (SP)	0.66	0.01	0.12	0.39	1.00

In addition to the statistics presented in the exhibits above, Nash created a hedge fund index to evaluate each fund's performance. Nash recognized the fact that several shortcomings exist in creating an adequate hedge fund index. To that end, Nash created an index in which all the hedge funds included in the index agreed to provide data that can be verified by Nash. Nash also set up strict rules for inclusion and removal of hedge funds into and out of the hedge fund index.

As a further improvement to his research, Nash created a positive risk-free rate benchmark to evaluate each hedge fund. However, his review of academic research indicated that the positive risk-free rate benchmark is only appropriate for a limited number of hedge fund strategies. The current risk-free rate is 4%.

Nash conducted a personal interview with the portfolio manager of the Fixed Income Arbitrage hedge fund. The portfolio manager disclosed that he exploited pricing inefficiencies between fixed income securities while hedging exposure to interest rate risk. The portfolio manager utilizes a convergence trading strategy, which assumes that the price difference between two similar assets will narrow in the future. The portfolio manager is willing to invest in illiquid bonds if the opportunity presents itself.

in reviewing the correlation matrix (Exhibit 2), Nash concluded that the Fixed Income Arbitrage

hedge fund would be an ideal addition to his client's current traditional investment portfolio. Nash's rationale was that a low correlation between the hedge fund and the S&P 500 index will assure that the fund's returns will be positive when the returns of the index are negative.

After reviewing Nash's research, the Director of Research at his firm inquired why he did not examine the value at risk (VAR) measure for the various hedge fund strategies. Nash stated that VAR is an ineffective statistical measure of risk when a hedge fund has high turnover or frequent changes in its strategy. In addition, Nash stated his belief that when the only input is historical data, VAR does not provide a reliable estimate of future risk.

Nash is concerned about the impact a major market disruption would have on the performance of the selected hedge funds. Based solely on Exhibit 1, which hedge fund has the greatest risk if a major market disruption were to occur?

Options:

- A- Long/Short Equity
- B- Fixed Income Arbitrage
- C- Distressed Securities

Answer:

B

Explanation:

The risk of long-tail events resulting from major market disruptions should be a key concern of investors. A measure of such long-tail events is maximum drawdown. The maximum drawdown is defined as the largest loss from peak to trough a hedge fund has experienced, which in this case is over a ten year period (Exhibit 1). The larger the maximum drawdown, the greater the market disruption risk associated with the particular hedge fund. In this case, the Fixed Income Arbitrage hedge fund has the largest maximum drawdown (-14.4%). (Study Session 13, LOS 50.b)

Question 5

Question Type: MultipleChoice

Charles Mabry manages a portfolio of equity investments heavily concentrated in the biotech industry. He just returned from an annual meeting among leading biotech analysts in San Francisco. Mabry and other industry experts agree that the latest industry volatility is a result of questionable product safety testing methodologies. While no firms in the industry have escaped

the public attention brought on by the questionable safety testing, one company in particular is expected to receive further attention---Biological Instruments Corporation (BIC), one of several long biotech positions in Mabry's portfolio. Several regulatory agencies as well as public interest groups have heavily criticized the rigor of BIC's product safety testing.

In an effort to manage the risk associated with BIC, Mabry has decided to allocate a portion of his portfolio to options on BIC's common stock. After surveying the derivatives market, Mabry has identified the following European options on BIC common stock:

<i>BIC Call Options</i>				<i>BIC Put Options</i>			
	<i>Strike</i>	<i>Maturity</i>	<i>Premium</i>		<i>Strike</i>	<i>Maturity</i>	<i>Premium</i>
Call A	40	October	3.51	Put D	30	November	2.31
Call B	50	October	1.98	Put E	40	November	4.14
Call C	60	October	1.42	Put F	50	November	9.21

Mabry wants to hedge the large BIC equity position in his portfolio, which closed yesterday (June 1) at \$42 per share. Since Mabry is relatively inexperienced with utilizing derivatives in his portfolios, Mabry enlists the help of an analyst from another firm, James Grimell.

Mabry and Grimell arrange a meeting in Boston where Mabry discusses his expectations regarding the future returns of BIC's equity. Mabry expects BIC equity to make a recovery from the intense market scrutiny but wants to provide his portfolio with a hedge in case BIC has a negative surprise. Grimell makes the following suggestion:

"If you want to avoid selling the BIC position and are willing to earn only the risk-free rate of return, you should sell calls and buy puts on BIC stock with the same market premium. Alternatively, you could buy put options to manage the risk of your portfolio. I recommend waiting until the vega on the options rises, making them less attractive and cheaper to purchase."

Which of the following correctly analyzes Grimell's comments regarding earning the risk-free rate by selling calls and buying puts, and regarding waiting for the option vegas to increase?

Options:

- A- Only Grimeirs statement regarding earning the risk-free rate is correct.
- B- Only Grimell's statement regarding waiting for vega to rise is correct.
- C- Neither of Grimeirs statements is correct.

Answer:

C

Explanation:

Grimcll is incorrect in both of his statements. Using put-call parity, Mabry could create a position in which he would earn the risk-free rate of return but he would need to sell calls and buy puts with the same strike price, not the same premium. As the vega (volatility relative to price) of an option increases, it would become more sensitive to changes in the volatility of the underlying asset. Therefore, the price would likely rise, not fall. (Study Session 17, LOS 60.a)

Question 6

Question Type: MultipleChoice

Ryan Hendricks serves as a security analyst for Investment Management, Inc. (IMI), which employs the Treynor-Black model to evaluate securities and to make portfolio recommendations. IMI uses the capital asset pricing model (CAPM) to determine the degree to which securities may be mispriced relative to IMFs forecasts.

Hendricks evaluates the common shares of Computer Software Associates (CSA), a small company specializing in a unique computer software market niche. Hendricks obtains the following market model results for CSA, using monthly returns for the past 60 months:

$$R_{CSA} = -0.02 + 1.75 R_{S\&P500} + \epsilon_{CSA} \quad (1)$$

where:

R_{CSA} = the return on the CSA stock

$R_{S\&P500}$ = the return on the S&P500 stock market index

ϵ_{CSA} = random regression error term

Hendricks uses the adjusted beta method to derive his forecasts for companies' future betas. In deriving his forecast for any company beta, Hendricks uses the following first-order autoregressive formula:

$$\text{forecast beta} = 0.33 + 0.67 \times (\text{historical beta}) \quad (2)$$

Hendricks derives required returns for individual securities using the CAPM after making appropriate adjustments using his adjusted beta formula in equation (2).

IMI provides Hendricks with the following capital market forecasts to use as inputs for the CAPM.

Exhibit 1: Capital Market Forecasts

<i>Economic Variable</i>	<i>Expected Return</i>
S&P 500	12%
1-year Treasury bill	4%

IMI asks Hendricks to make decisions to take long and short positions in individual securities for IMI's actively managed portfolio, IMI-Active. Specifically, Hendricks is asked to examine CSA and Millennium Drilling (MD), an oil and gas drilling company specializing in deep sea drilling. After a thorough examination of the prospects for each company, Hendricks derives the following alpha forecasts for CSA and MD.

Exhibit 2: Alpha Forecasts

<i>Company</i>	<i>Alpha</i>
CSA	0.04
MD	0.08

Hendricks forecasts that the unsystematic variance (the variance of the market model regression error) for MD will be more than double that of CSA .

After determining the appropriate allocations across securities within the IMI-Active portfolio, Hendricks derives the portfolio predictions shown in Exhibit 3.

Exhibit 3: Forecasts for the IMI-Active Portfolio

<i>Forecast Variable</i>	<i>Forecast Value</i>
Alpha, α	5.33%
Beta, β	1.35%
Total standard deviation, σ	40.00%
Unsystematic standard deviation, $\sigma(\epsilon)$	30.00%

IMI forecasts that the total standard deviation for the S&P500 returns will equal 20%. After examining the historical forecasting abilities of Hendricks, IMI determines that Hendricks has demonstrated perfect forecasting ability in regards to CSA stock, but imperfect forecasting abilities in regards to MD stock. IMI finds that the correlation between the realized alphas for MD and the forecast MD alphas provided by Hendricks equals 0.50.

Referring to the Treynor-Black model, Hendricks makes the following statements:

Statement 1: All else equal, the Treynor-Black model increases the weight to the active portfolio as its unsystematic risk increases.

Statement 2: The Treynor-Black model is based on the premise that only a limited number of stocks should be included in the actively managed portfolio.

To adjust for Hendricks' forecasting record, what alpha forecasts should IMI use for CSA and MD?

Options:

- A- 0.06 for CSA and 0.04 for MD
- B- 0.04 for CSA and 0.04 for MD
- C- 0.04 for CSA and 0.02 for MD

Answer:

C

Explanation:

The formula to adjust alphas for forecasting ability equals

$$\text{adjusted alpha} = R^2 \alpha$$

where R^2

the square of the correlation between past realized alphas and the past forecast alphas derived by Hendricks. A perfect forecaster will have an R^2 equal to 1,

Therefore, there is no adjustment to be made for the CSA alpha because Hendricks has exhibited perfect forecast ability for the CSA stock. An adjustment should be made for the MD stock:

$$\text{adjusted alpha for MD} = (0.50)^2(0.08) = 0.02 = 2\%$$

(Study Session 18, LOS 67.c)

Question 7

Question Type: MultipleChoice

Carl Warner, CFA, has been asked to review the financial information of Global Drug World (GDW) in preparation for a possible takeover bid by rival competitor Consolidated Drugstores International (Consolidated). GDW has produced impressive results since going public via an initial public offering in 1998. Through a program of aggressive growth by acquisition, GDW is currently seen as a major player and a threat to Consolidated's own plans for growth and profitability. In preparation for his analysis, Warner has gathered the following financial data from GDW's year-end statements:

GDW Statement of Income for Year ended May 31, 2008

Sales	<u>4,052,173</u>
Expenses	
Cost of goods sold, general and operating expenses	3,735,397
Noncash charges	56,293
Interest on long-term debt	20,265
Other interest	5,223
	<u>3,817,178</u>
Income before income taxes	234,995
Income taxes	70,499
Net income	<u>164,497</u>
Earnings per share	0.72

Partial GDW Balance Sheet on May 31, 2008**Assets**

Current assets (excluding cash)

Accounts receivable	284,762
Inventories	490,755
Prepaid expenses	<u>23,743</u>

Total current assets (excluding cash)

799,260

Property, plant, and equipment

687,890

Other assets

236,417

Liabilities

Current liabilities (excluding notes payable)

Accounts payable and accrued liabilities	296,564
Other	<u>100,039</u>

Total current liabilities (excluding notes payable)

396,603

Long-term debt

262,981

Other liabilities

15,484

Additional Information

Risk-free rate	4.5%
WACC	7.5%
2008 working capital investment	\$7,325
2008 dividends	\$82,248
Beta	1.10
Investment in fixed capital in 2008	\$143,579
Market risk premium	5%
Total equity May 31, 2007	\$1,019,869
Principal repayment of long-term debt in 2008	\$33,275
Notes payable issued in 2008	\$5,866
2008 change in liabilities	\$27,409
Tax rate	30%

As part of his analysis, Warner needs to forecast the free cash flow to the firm (FCFF) for 2009. The best information he has points to an increase in sales of 6%. The earnings before interest and tax (EBIT) margin is not expected to change from the rate of 6.4% achieved in 2008. Additional fixed capital spending is expected to be \$36,470. Investment in net working capital is expected to be \$24,313. Moreover, Warner notes that the only noncash charge is depreciation, which he estimates will be \$60,000.

Warner has been asked to analyze the effect each of the following corporate events, if taken during 2009, would have on GDW's free cash flow to equity (FCFE):

- * 20% increase in dividends per share.
- * Repurchase of 25% of the firm's outstanding shares using cash.
- * New common share offering that would increase shares outstanding by 30%.
- * New issue of convertible bonds that are not callable for five years and would increase the level of debt by 10%.

By how much (in dollars) does GDW's FCFF exceed its free cash flow to equity (FCFE) in 2008?

Options:

- A- \$9,567.
- B- \$45,251.
- C- \$52,897.

Answer:

B

Explanation:

FCFE can be expressed in terms of FCFF as follows:

$$\text{FCFE} = \text{FCFF} - \text{Int}(I - \text{tax rate}) + \text{net borrowing}$$

Therefore, the amount by which FCFF exceeds FCFE can be written as:

$$\text{FCFF} - \text{FCFE} = \text{Int}(I - \text{tax rate}) - \text{net borrowing}$$

$$\text{Int} - \$25,488$$

$$\text{Net borrowing} = \$5,866 - \$33,275 = -\$27,409 \text{ (additional information)}$$

$$\text{Therefore: } \text{FCFF} - \text{FCFE} = \$25,488(1 - 0.3) - (-\$27,409) = \$45,251 \text{ (Study Session 12, LOS 41.e)}$$

Question 8

Question Type: MultipleChoice

For the past 15 years, Susan Luna, CFA, Kyle Lawson, CFA, and Matt Miller, CFA, have worked together as equity analysts and then equity portfolio managers in the investment management division (BIMCO) of the Broadway Life Insurance Company. For the past five years, the three associates have worked together managing the BIMCO Aggressive Growth Fund (BAGF). During their management tenure the BAGF had excellent performance and was well recognized in the financial press.

Just over one year ago, Broadway Life was acquired by a larger company, Gobble Insurance, and as part of the consolidation process BIMCO was closed. The closure allowed Luna, Lawson and Miller to start their own investment management firm, Trio Investment Management LLC (TIM). TIM focuses on the small capitalization growth equities area. This is the same investment focus as the BAGF, but TIM will have individually managed accounts. Several cases have arisen calling for interpretation as to consistency with CFA Institute Standards of Professional Conduct.

Case 1

TIM markets its investment management services by contracting with small, local bank trust departments. One of the newest bank trust clients for TIM is Shadow Mountain Bank and Trust. Judy Sampson, CFA, the trust officer for Shadow Mountain, has scheduled a meeting with a potential client. When Lawson arrives for the client meeting, he finds that all of the TIM marketing material, including biographies of TIM portfolio managers, has been relabeled by Sampson as the Shadow Mountain Wealth Management Team. Sampson has also added the performance of BAGF into the current TIM Equity Composite Index portfolio and relabeled the resultant combined graph, the Shadow Mountain Equity Composite Index. Sampson states that making such changes

would probably please clients and improve the chances of acquiring additional trust management accounts for Shadow Mountain and TIM. Lawson goes along and makes the presentation to the potential client using the Shadow Mountain marketing material and the relabeled BAGF/TIM equity performance record.

Case 2

Susan Luna of TIM is meeting with Sol Wurtzel, an institutional salesman for Turn Byer, a large national brokerage firm. Luna complains that TIM's technology costs are too high, especially their outside software services costs. TIM currently subscribes to two investment-related software services. The first software vendor is StockCal Software Services (StockCal), which provides valuation and stock charting capabilities TIM uses in their equity research and selection process. The other vendor is Add-Invest Software (Add-Invest), a software program providing account management and performance evaluation reporting which TIM uses in developing monthly reports for all clients. In response to Luna, Wurtzel suggests that Turn Byer has an excellent soft dollar trading desk and would be willing to offer to cover TIM's StockCal and Add-Invest expenses through soft dollar commissions. Luna then reviews TIM's projected commission dollars for the year and decides there are more than enough soft dollars to pay the StockCal, AGF and Add-Invest Software bills combined. Luna believes she can be assured of excellent trade execution from Turn Byer and improved profitability for TIM because of the increased use of soft dollars. Luna then directs that the StockCal and Add-Invest software services be paid for with soft dollar or client brokerage dollars.

Case 3

Sol Wurtzel, the equity salesman for Turn Byer, has referred several clients to TIM over the past year. In fact, Wurtzel referrals currently account for almost 20% of the assets managed by TIM. The principals of TIM decide to reward Wurtzel, either by doubling the commissions paid on trades executed through Turn Byer on Wurtzel's referral accounts, or by paying Wurtzel a cash referral fee for each additional TIM account opened by a Wurtzel referral. The principals agree that any cash referral fee would need to be disclosed to clients in advance.

Case 4

Luna notes that her clients have become increasingly aware of the directed client brokerage / soft dollar commissions issue. At a recent meeting with one of her large pension clients, Service Workers Union Local #1418, the subject of directed commissions came up. Upon learning of the commission dollars available to their account, the Union trustees directed Luna to use their client brokerage of approximately \$25,000 to donate to a think tank called the Hoover Study Center of Unions at Samford University. Service Workers trustees believed the Hoover study will increase the public awareness of the benefits unions offer to their members and increase union membership. Luna concurs with the trustee's judgment on increasing union enrollment as a great goal, and follows the client's instructions and makes the \$25,000 contribution to the Hoover Study Center. Another client, Rosa Lutz, has asked Luna to credit the soft dollar client brokerage proceeds from her personal retirement accounts to Roswell Academy, to update their computer lab. Luna agrees that a new computer lab for Roswell Academy is greatly needed and she allocates 510,000 of Lutz's commission dollars to Roswell Academy.

Is the use of client brokerage to make the \$25,000 educational contribution to the Hoover Study Center of Unions a violation of the CFA Institute Standards of Professional Conduct?

Options:

- A- Yes, because TIM must assure that client brokerage fees are directed to the benefit of the client.
- B- Yes, because client brokerage must only be used to pay for goods and services directly related to the investment decision making process.
- C- No, because the client brokerage has been spent at the specific direction of the client.

Answer:

A

Explanation:

Standard 111(A). In making a \$25,000 contribution to the Hoover Study Center of Unions, Luna has violated Standard 111(A) Duties to Clients - Loyalty, Prudence, and Care, which states that Members and Candidates must act for the benefit of their clients and place their clients' interest before their employer's or their own interest. In relationship with clients, Members and Candidates must determine applicable fiduciary duty and must comply with such duty to persons and interests to whom it is owed. The contribution to the Hoover Study Center of Unions, authorized by the trustees of the union, brings into question acting for the benefit of the client. Despite providing guidance and governance for the union, trustees are not the client of the union fund; rather, the members of the union and their beneficiaries are the clients of the fund. By making a \$25,000 contribution from the client brokerage, Luna and the trustees have used funds that rightly belongs to the members of the union and they have done so without direct compensation to the Union members. Luna should not have authorized the pension account to make the contribution and having done so violated her duty to loyally guard the assets of her clients as a fiduciary. Luna has an obligation to follow not only the Code and Standards, but also adhere to the CFA Institute Soft Dollar Standards, which stress that the client brokerage is property of the client, not the trustee or fiduciary representing the client. (Study Session 1, LOS 2.a)

Question 9

Question Type: MultipleChoice

Rogert Markets is the nation's third largest retail grocery chain, and usually has the largest or second largest market share in every city in which it competes. In its most successful large cities,

Rogert has as much as a 25% market share, although its share is sometimes greater in small cities. Rogert is known for its excellent customer service and has a wide variety of grocery selections in almost every part of its stores. Its profit margins on sales are slightly above industry averages, and its return on assets and return on equity are above average.

Rogert has an equity beta of 0.78 and a debt-to-capital ratio of approximately 50%. Recent economic difficulties, including higher commodity prices and higher unemployment, resulted in lower profit margins for Rogert. Still, Rogert's decline in profit margin was less than for its competitors. Rogert did not experience substantial losses of sales from customers switching to lower-priced competitors as its market share remained substantially constant.

Zephine Markets is one of Rogert's smaller competitors. Zephine operates in roughly 15% of the same cities as Roger. Zephine is publicly traded, and one of the members of Rogert's board of directors has asked the staff to evaluate an acquisition of Zephine. The staff believes that Zephine is slightly underpriced and that it could be acquired for a 20% premium over its current price. In recommending against the acquisition, staff member Pierre Chiraq says:

"I agree that eliminating Zephine as a rival would probably enhance our profit margins. However, I am skeptical about this acquisition. First, because our market share is almost never dominant, much of the benefit of eliminating a smaller rival will be shared by our other rivals. They will free-ride on our investment. Second, if our profit margins do increase, we will eventually attract new rivals into our markets. And finally, our cost of capital should increase substantially because the firm will be diversifying horizontally instead of vertically, increasing the firm's risk."

Over the last several years, grocery industry growth has tended to follow the general economy. The competitors in the industry, like Rogert, compete for market share in a stable industry. The industry's cyclical behavior has shown stable performance in both the ups and downs of the business cycle.

In assessing Rogert's competitive position, Chiraq makes comments about the threat of new entrants:

"My concern about new entrants into our business is low for several reasons. Economies of scale are achievable at a low size of operations relative to that of our firm. Our brand identity is high in the markets in which we compete. And, finally, access to distribution channels is difficult to achieve in the grocery business. While there are many competitive forces that concern me, new entrants is low on my list."

Finally, the staff discusses industry changes that might have a negative effect on Rogert's industry position. Three phenomena are mentioned that could have such an effect. They are:

1. Industry growth rates are low and declining;
2. Several suppliers are sponsoring national television advertisements for their products;
3. The government has approved a new method of extending the shelf life of fruits and vegetables.

Which of Chiraq's reasons for opposing the acquisition of Zephine Markets is least likely to be

correct?

Options:

- A- The free-rider argument.
- B- The risk of new rivals argument.
- C- The cost of capital argument.

Answer:

C

Explanation:

The first two arguments are plausible. If Rogert had a dominant market share, such as 80%, eliminating a smaller rival would cause the benefits to accrue mostly to Rogert. But in this case, much of the benefits would accrue to other rivals (they would be free riders). Increasing the profit margins in some markets would likely attract new rivals in the future. The cost of capital argument is weak. Acquisitions in the grocery business, an industry in which Rogert has considerable competence and success, is not especially risky. A vertical merger (into new and different industries) would be more likely to increase risks and the cost of capital. (Study Session 11, LOS 37.d)

Question 10

Question Type: MultipleChoice

Marsha McDonnell and Frank Lutge are analysts for the private equity firm Thorngate Ventures. Their primary responsibility is to value the equity of private firms in developed global economies. Thorngate's clients consist of wealthy individuals and institutional investors. The firm invests in and subsequently actively manages its portfolio of private firms.

During a discussion with junior analysts at the firm, McDonnell compares the characteristics of private firms with that of public firms and makes the following statements:

Statement 1: Private firms typically have higher risk premiums and required returns than public firms because private firms are usually smaller and thus thought to be riskier. Furthermore, the lack of access to liquid public equity markets can limit a private firm's growth.

Statement 2: Because of their higher risk, private firms may not be able to attract as many qualified applicants for top positions as public firms. Due to the higher risk, the managers they do attract tend to have a shorter-term view of the firm and their tenure at the firm, compared to

public Firm managers. As a result, the private firm may neglect profitable long-term projects.

Due to its considerable success, Thorngate has recently attracted a substantial inflow of capital from investors. To deploy that capital, McDonnell and Lutge are considering the purchase of Albion Biotechnology. Albion is using advances in biotechnology for application in the pharmaceutical field. The analysts are primarily interested in Albion because the firm's research team is developing a drug that Thorngate's current pharmaceutical firm is also working on. McDonnell estimates that combining research teams would result in advances that no pharmaceutical competitor could match for at least two years. The firm is currently owned by its founders, who are familiar to Lutge through previous social contacts. Lutge hopes to avoid a competitive bidding process for the firm, because its founders have not advertised the firm's sale publicly.

McDonnell is also examining the prospects of Balanced Metals, a metal fabrication firm. Thorngate currently does not have any manufacturing firms in its portfolio, and Balanced would provide needed exposure. The growth in sales at Balanced has been impressive recently, but it is expected to slow considerably in the years ahead due to increased competition from overseas firms. The firm's most valuable assets are its equipment and factory, located in a prime industrial area.

Balanced was previously considered for possible purchase by a competitor in the metal fabrication industry. Although the sale was not consummated, McDonnell has learned that the firm estimated that costs could be reduced at Balanced by eliminating redundant overhead expenses. McDonnell has obtained the following financial figures from the Balanced Metals CFO as well as the previously estimated synergistic savings from cost reductions. Capital expenditures will equal depreciation plus approximately 4% of the firm's incremental revenues.

Current revenues \$22,000,000

Revenue growth 7%

Gross profit margin 25%

Depreciation expense as a percent of sales 1%

Working capital as a percent of sales 15%

SG&A expenses \$5,400,000

Synergistic cost savings \$1,200,000

Tax rate 30%

Lutge is valuing a noncontrolling equity interest in Jensen Gear, a small outdoors equipment retailer. Jensen has experienced healthy growth in earnings over the past three years. However, given its size and private status, Lutge does not expect that Jensen can be easily sold. To obtain the appropriate price multiple for the Jensen valuation, he has prepared a database of price multiples from the sale of entire public and private companies over the past ten years, organized by industry classification. Using historical data, Lutge estimates a control premium of 18.7% and

discount for lack of marketability of 24%.

To obtain the cost of capital for Jensen, Lutge uses a cost of capital database that includes public company betas, cost of equity, weighted average cost of capital, and other financial statistics by industry. Given Jensen's small size, Lutge obtains a size premium using the smallest size decile of the database. McDonnell examines Lutge's cost of capital calculations and makes the following statements.

Statement 1: I am concerned about the use of this database. The estimation of the size premium may result in an undervaluation of the Jensen equity interest.

Statement 2: The use of betas and the CAPM from the database may be inappropriate, [f so, Lutge should consider using the build-up method where an industry risk premium is used instead of beta.

Regarding the statements made by McDonnell on the comparison of private firms and public firms, are both statements correct?

Options:

- A- Yes.
- B- No. both statements are incorrect.
- C- No, one statement is correct but the other statement is incorrect.

Answer:

C

Explanation:

Statement 1: McDonnell is correct. Private firms are usually smaller than public firms and thus thought to be riskier. Accordingly, private firms are usually assigned higher risk premiums and required returns than public firms. The lack of access to liquid public equity markets can also limit a private firms growth.

Statement 2: McDonnell is correct that small private firms may not be able to attract as many qualified applicants for top positions as public firms. This may reduce the depth of management, slow growth, and increase risk at private firms. She is, however, incorrect that private firm managers and investors have a shorter-term view. Public firm shareholders often focus on short-term measures such as quarterly earnings and the consistency of such. Public management may therefore take a shorter-term view than they otherwise would. So it is private firms that should be able to take a longer-term view.

Furthermore, in most private firms, management has substantial equity ownership. In this case, external shareholders cannot exert as much control, and the firm may be able to take a longer-

term perspective. (Study Session 12, LOS 44.a)



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