CFA-LEVEL-1 Q&As

CFA Level I Chartered Financial Analyst

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QUESTION 1

Historically, the EPS figure for a stock market series has been less volatile than the earnings multiplier for the same series. Which of the following best characterizes the primary reason for the greater volatility experienced by the earnings multiplier? Choose the best answer.

A. None of these answers is correct.

B. The EPS figure is less volatile due to accounting manipulations and the malleability of international and domestic accounting standards including GAAP.

C. The price-to-earnings figure experiences a tax leveraging effect that is not passed on to the EPS figure.

D. The earnings multiplier is more sensitive to fluctuations in the equity markets than is the EPS figure; i.e. the earnings multiplier is "forward looking."

E. The price-to-earnings ratio is more sensitive to changes in the spread between the required rate of return and the anticipated future growth rate.

F. The earnings multiplier is more sensitive to changes in dividend policies than is the EPS figure.

Correct Answer: E

The greater relative volatility of the earnings multiplier versus the EPS figure is primarily attributable to an increased sensitivity to changes in the spread between the required rate of return "k" and the anticipated growth rate "g." Remember that the equation used to determine the appropriate earnings multiplier for a stock market series is the following:

{P/E = [D/E / (k - g)]}

Where: P/E = the earnings multiplier, or Price-to-Earnings ratio, D/E = the dividend payout ratio at t1, k = the required rate of return, and g = the anticipated growth rate of dividends.

As you can see, changes in the spread between the required rate of return and the anticipated growth rate can have a dramatic effect on the earnings multiplier for a stock market series. While the earnings multiplier is sensitive to changes in the dividend payout ratio, volatility in this figure is not cause for the increased volatility of the earnings multiplier versus the EPS figure.

QUESTION 2

Which of the following may be used as mechanisms to motivate managers to act in the best interest of the stockholders?

I. Managerial compensation

II. Direct stockholder intervention

III. Threat of firing

IV.

Threat of takeover

A.

IV only

B.

I only

C.

I, II, III and IV

D.

III only

E.

I, II and III

F.

II only

Correct Answer: C

Managerial compensation may be designed to not only attract and retain the best managerial talent for a firm, but also to align the management\\'s action with the interest of the shareholders. Direct intervention is another mechanism that may be used to motivate management into acting in the owner\\'s best interest. This in practice is executed with a wide degree of success. The threat of firing may also be used as well as the threat of hostile takeovers. The threat of a hostile takeover is strongest when a company is under performing and/or its stock is undervalued.

QUESTION 3

Andrea Anastasio heads the research wing at HiLo Funds, Ltd., an investment advisory and money management firm. Andrea was recently informed by one of her junior analysts, Marcus Cambus, that the investment recommendation on HotPots food chain stock needed an immediate downgrade from hold to sell. This was based on talks with HotPots\\' management whom revealed that HotPots would be launching an ill-advised expansion plan soon (this information has been discussed in the financial newspapers, too). Andrea checked Marcus\\' analysis and agreed with the conclusions. Deciding to include this in her research newsletter, Andrea informed a few of the portfolio managers about the change. She did warn them that no action on the news should be taken before the newsletter was out for at least 4 days. However, Cotler, one of her subordinates and an AIMR member, inadvertently and prematurely sold off a large chunk of the holdings of Hotpots stock in one of his larger accounts. A month-end review of accounts DID NOT catch the violation. Which of the following is/are true?

I. Andrea has not violated any AIMR code but Cotler has violated Standard III (B) - Duty to Employer.

II. Andrea has violated Standard III (E) - Responsibilities of Supervisors.

III. Cotler has violated Standard V (A) - Prohibition against Use of Non-Public Information.

IV.

Cotler has violated Standard IV (B.3) - Fair Dealing.

A.

III and IV only

B.

II and IV only

C.

I only

D.

II, III and IV only

Correct Answer: B

Since the information has been discussed in the financial newspapers, it certainly is not non-public information and no violation of Standard V (A) - Prohibition against Use of Non-Public Information has occurred. However, by treating one of his larger accounts differently, Cotler has violated Standard IV (B.3)

-Fair Dealing which requires him to treat all of his clients fairly, without bias. By ignoring Andrea\\'s admonitions and committing these violations, he has potentially harmed his employer (this is in breach of Standard II (B) - Professional Misconduct, not Standard III (B) - Duty to Employer, which is quite specific about its scope of activities covered). Andrea, on the other hand, has been negligent in not carrying out her supervisory duties. She should have either not revealed the change in investment recommendation to her employees or if she deemed it necessary to do so, should have takenappropriate steps to ensure that violations of her instructions did not occur. Simple verbal or even written warnings are not good enough to absolve her of violating Standard III (E) - Responsibilities of Supervisors. Further, the fact that a month-end review of accounts did not detect Cotler\\'s irresponsible actions implies that stricter or more efficient monitoring is required of Andrea.

QUESTION 4

Which best describes venture capital?

A. Venture capitalists exert control over the entrepreneur in order to achieve high returns.

B. Venture capital is an extremely risky investment, whose returns are usually negative.

C. Venture capital is method of equity financing whereby the entrepreneur loses majority ownership of his company.

D. Venture capital is a method to take control over a young company.

E. Venture capital is more than just capital, it is a process that fuels the growth of the venture.

Correct Answer: E

Venture capital is the process forces the entrepreneur to hire a management team. The venture capital firms have significant representation on the board of directors and play a major role in shaping the company\\'s growth strategy. The process also forces entrepreneurs to prepare a business plan to describe their objectives and to specify their financial projections. Venture capitalists bring in a broad amount of experience to the venture, thereby improving management\\'s available resources. Ideally, the venture capital process should develop better entrepreneurs and better managers.

QUESTION 5

Which one of the following is not one of the four major determinants of real estate value?

A. the property

B. demand

C. supply

D. the property transfer process

E. none of these answers

Correct Answer: E

Demand, supply, the property and the property transfer process all are determinants of real estate value.