CHAPTER 47

INTRODUCTION TO ALTERNATIVE INVESTMENTS

1. (A) smoothing.

Explanation

Appraisal methods used to value real estate tend to produce smoothed return patterns that understate standard deviations of returns. This causes measures of risk-adjusted returns, such as the Sharpe ratio, to be biased upward. Methods used to construct real estate indexes tend to understate the correlation of real estate returns with other asset classes (and thus overstate its diversification benefits).

(Study Session 16, Module 47.4, LOS 47.g)

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2. (B) a request for redemption of shares, within which the fund must fulfill the request.

Explanation

The notice period is the time within which a hedge fund must fulfill a request for redemption of shares. The period during which investors may not redeem shares is called a lockup period. (Study Session 16, Module 47.2, LOS 47.d)

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3. (A) Unique legal structures and tax treatments.

Explanation

Compared to traditional investments, alternative investments have unique legal issues and tax treatments that are related to their legal structure and registrations. They often have lower levels of regulation and are less transparent than traditional asset classes. Alternative investments often employ high levels of leverage in illiquid markets.

(Study Session 16, Module 47.1, LOS 47.a)

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4. (C) clawback.

Explanation

A clawback provision requires the manager to return any periodic incentive fees to investors that would result in investors receiving less than 80% of the profits generated by portfolio investments as a whole.

(Study Session 16, Module 47.3, LOS 47.e)

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5. (A) short position in acquirer, long position in firm being acquired.

Explanation

Merger arbitrage funds typically short the stock of the acquirer and buy the stock of the firm being acquired.

(Study Session 16, Module 47.2, LOS 47.d)

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6. (A) the commodity has a high convenience yield.

Explanation

Backwardation refers to a situation where the futures price is less than the spot price for a commodity. Because commodities have no monetary yield, only a convenience yield greater than the opportunity (interest) cost and storage costs of holding the commodity can lead to backwardation. When a futures market is in backwardation, the roll yield is positive because the futures price moves towards the spot price over the life of the contract.

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7. (B) leveraged.

Explanation

Alternative investments tend to use more leverage and are typically less liquid and less transparent than traditional investments.

(Study Session 16, Module 47.1, LOS 47.a)

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8. (A) mezzanine-stage financing.

Explanation

Mezzanine stage capital prepares a company for and IPO. Angel investing and early-stage financing describe venture capital in a company's formative stages.

(Study Session 16, Module 47.3, LOS 47.e)

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9. (A) **the portfolio company to one of the portfolio company's competitors.**

Explanation

A trade sale involves selling a portfolio company to a competitor or another strategic buyer. An IPO involves selling all or some shares of a portfolio company to the public. A secondary sale involves selling a portfolio company to another private equity firm or a group of investors.

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10. (C) **correlations of fund returns with equity returns to be biased downward.**

Explanation

Infrequent valuation results in downward bias in both standard deviations and correlations.

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11. (B) **Early stage.**

Explanation

The description relates best to the early stage wherein the capital that is supplied helps speed up product development and also helps pay for the beginning of a marketing campaign.

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12. (B) **an event driven strategy.**

Explanation

Event-driven strategies include merger arbitrage, distressed/restructuring, and special situations strategies that involve long or short positions in common equity, preferred equity, or debt of a specific corporation. Macro strategies are based on global economic trends and events, and may involve long or short positions in equities, fixed income, currencies, or commodities. Equity hedge strategies seek to profit from long and short positions in publicly traded equities and derivatives with equities as their underlying assets, but are not based on events such as restructuring or acquisition.

(Study Session 16, Module 47.2, LOS 47.d)

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13. (A) a firm's historical returns are included when it is added to an index.

Explanation

Backfill bias refers to bias introduced by including the previous performance data for firms added to a benchmark index.

(Study Session 16, Module 47.5, LOS 47.i)

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14. (A) in contango.

Explanation

Futures price Spot price (1 + risk-free rate) + storage costs - convenience yield. If the convenience yield is close to zero, it is likely that the futures price exceeds the spot price, i.e., the market for the commodity is in contango.

(Study Session 16, Module 47.4, LOS 47.f)

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15. (A) management fees.

Explanation

Hedge fund fee structures indicate management fees as a percentage of assets under management and incentive fees as a percentage of gains in value. A 3-and-15 fee structure means a fund charges a 3% management fee and a 15% incentive fee.

(Study Session 16, Module 47.1, LOS 47.c)

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16. (B) appraisal index.

Explanation

Appraisal index returns are based on estimates of property values. Because estimating values tends to introduce smoothing into returns data, appraisal index returns are likely to have lower standard deviations than index returns based on repeat sales or trading prices of REIT shares.

(Study Session 16, Module 47.4, LOS 47.g)

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17. (A) can serve as a hedge against inflation.

Explanation

Commodities can serve as a hedge against inflation because commodity prices tend to move with inflation rates. A traditional investment portfolio may gain a diversification benefit from an allocation to commodities because they do not have a strong positive correlation with stock and bond prices. While it is possible for commodity futures markets to change between backwardation and contango, this does not necessarily benefit a commodities investor.

(Study Session 16, Module 47.4, LOS 47.f)

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18. (B) notice period.

Explanation

A notice period, typically 30 to 90 days, is the amount of time a fund has after receiving notice of a redemption request to fulfill the redemption request. A lockup period is a minimum length of time before an investor may redeem shares or make withdrawals.

(Study Session 16, Module 47.2, LOS 47.d)

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19. (B) time-period bias.

Explanation

Index returns for alternative investments are often subject to both backfill and survivorship bias. Time-period bias is a concern in hypothesis testing.

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20. (B) seed stage.

Explanation

In the seed stage of venture capital investing, capital is furnished for product development, marketing, and market research. The angel investing stage is when investment funds are used for business plans and assessing market potential. The early stage refers to investments made to fund initial commercial production and sales.

(Study Session 16, Module 47.3, LOS 47.e)

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21. (A) less than 20% of the increase in value in Year 3 after management fees.

Explanation

Because the fund lost value in Year 2 and has a high water mark, incentive fees for Year 3 will be 20% of only the portion of the Year 3 gain that exceeds the previous highest value.

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22. (B) greenfield infrastructure investments.

Explanation

Greenfield investments are infrastructure assets to be built. Brownfield investments are infrastructure assets that already exist.

(Study Session 16, Module 47.4, LOS 47.h)

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23. (B) decrease portfolio variance only.

Explanation

Unlike most alternative investments, expected returns on commodities are typically less than expected returns on traditional investments. However, because their returns typically have a low correlation with returns on traditional investments, adding commodities to a portfolio of traditional investments can decrease portfolio variance.

(Study Session 16, Module 47.4, LOS 47.f)

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24. (A) Sortino ratio.

Explanation

The Sortino ratio uses downside deviation as its risk measure. The Sharpe ratio uses standard deviation and the Treynor ratio uses beta.

(Study Session 16, Module 47.5, LOS 47.i)

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25. (A) growing revenues and earnings rapidly.

Explanation

Fundamental growth refers to investing in companies that are experiencing high growth and for which the fund managers anticipate significant capital appreciation.

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26. (A) seed stage.

Explanation

Seed stage financing is used for market research and to fund product development and/or marketing and is typically the first stage at which a venture capital fund will invest in a start-up company.

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27. (C) higher fees.

Explanation

A hedge fund typically is more likely to use leverage, is less liquid, and charges higher fees than a traditional mutual fund.

(Study Session 16, Module 47.1, LOS 47.a)

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28. (C) convertible arbitrage.

Explanation

Relative value strategies include convertible arbitrage fixed income, asset-backed fixed income, general fixed income, volatility, and multi-strategy. Market neutral is an equity hedge strategy. Merger arbitrage is an event driven strategy.

(Study Session 16, Module 47.2, LOS 47.d)

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29. (B) to prepare for an initial public offering.

Explanation

Mezzanine-stage venture capital financing provides capital during the period prior to an initial public offering.

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30. (A) stratified sampling.

Explanation

Stratified sampling divides the population according to common characteristics and then selects samples from each subgroup in proportion to the subgroup's representation in the overall population.

(Study Session 16, Module 47.2, LOS 47.d)

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31. (C) **health care facilities.**

Explanation

Health care facilities are categorized as social infrastructure. Waste treatment plants are utility infrastructure. Broadcasting towers are communications infrastructure.

(Study Session 16, Module 47.4, LOS 47.h)

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32. (A) **liquidity risk.**

Explanation

Direct investment in real estate involves liquidity risk because large sums may be invested for long periods before a sale of the property can take place. Market risk exists for both traditional portfolio and real estate investments. Counterparty risk applies mainly to derivative contracts that require a payment from a counterparty, such as swaps and forwards.

(Study Session 16, Module 47.4, LOS 47.g)

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33. (C) **management fee.**

Explanation

"2-and-20" denotes a 2% management fee and a 20% incentive fee. (Study Session 16, Module 47.1, LOS 47.c)

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34. (C) **both increase expected returns and decrease portfolio variance.**

Explanation

For a portfolio of traditional securities, adding alternative investments such as hedge funds can potentially increase the portfolio's expected returns, because these investments often have higher expected returns than traditional investments, and decrease portfolio variance, because returns on these investments are less than perfectly correlated with returns on traditional investments.

(Study Session 16, Module 47.2, LOS 47.d)

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35. (C) short bias strategy.

Explanation

Equity hedge funds with a short bias attempt to profit from short positions in equities they believe to be overvalued. These funds may hold long equity positions but typically have net short exposure to the market. An event driven strategy focuses on companies involved in mergers, in financial distress, or in other special situations. A fundamental value strategy attempts to identify undervalued equities.

(Study Session 16, Module 47.2, LOS 47.d)

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36. (B) soft hurdle rate.

Explanation

With a soft hurdle rate, a hedge fund charges an incentive fee on all profits, but only if the fund's rate of return exceeds a stated benchmark. With a hard hurdle rate, a hedge fund charges an incentive fee only on the portion of returns that exceed a stated benchmark. With a high water mark, a fund's value must exceed its highest previous value before the fund may charge an incentive fee.

(Study Session 16, Module 47.2, LOS 47.d)

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37. (A) private investment in public equity.

Explanation

Private investment in public equities refers to a private equity firm providing equity financing to publicly traded companies. Angel investing refers to financing the formation of a business. Mezzanine-stage financing refers to capital provided to a firm as it prepares for an intial public offering.

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