

## Sample Level II CFA Program

### Item-Set Questions

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TOPIC: ETHICAL AND PROFESSIONAL STANDARDS

TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS

Edgar Somer, CFA, was recently hired as a portfolio manager at Karibe Investment Management. Somer previously worked at a rival firm where he produced an average annual return of 11% using a small-cap value strategy.

On his first day at Karibe, the firm asks Somer to approve marketing materials that present the following performance disclosures.

- Text which states: "Somer has generated average annual returns of 11%"
- The 3-year performance of a composite of Karibe client accounts that follow a similar small-cap value strategy
- A disclosure that the assumptions and calculations underlying the returns presented are publicly available on Karibe's public website

To maintain relationships with clients and to attract prospective clients, Somer is active on social media. He posts a link to a news story about a famous athlete who recently paid substantial tax penalties after failing to properly report investment gains. In addition to the link Somer writes the comment: "A client of mine had similar gains, but because I kept proper records he faced no penalties. #HireAProfessional". Some responses to the post suggest that readers mistakenly believe the athlete is Somer's client. Somer does not post a clarifying comment.

Somer develops a new quantitative investment strategy that he describes in marketing materials. The description states that "the strategy is based on eight proven fundamental and technical factors, including well-known factors such as value and momentum as well as certain proprietary factors that have been back-tested. The strategy includes a dynamic weighting component to adjust the amount allocated to each factor based on prevailing market conditions." The materials also highlight risks such as "the possibility that the model or its underlying factors may not work out of sample," and "because the weight placed on various factors is dynamic, it may not be suitable for clients who seek steady exposure to certain factors." One of Somer's clients agrees to use this strategy. When preparing the first performance report for this client, Somer discovers a coding error that reversed the client's weightings assigned to the value and momentum factors.

Prior to joining Karibe, Somer purchased shares in a small-cap technology firm for his personal portfolio. When he started his new role Somer disclosed the position, which had quadrupled in value since the initial purchase and represented more than 5% of his personal holdings. He had

no intention to sell the shares and he recommended them to clients at Karibe, to whom he disclosed his ownership. After the successful launch of a new product resulted in additional large gains in the shares, Somer now recommends that clients place limit orders when purchasing the shares. Though he remains bullish on the stock he is concerned about the size of his personal position, which is now more than 15% of his portfolio. One of his clients recently placed a limit order at \$50 per share, which represents the highest bid in the market. The lowest offer is \$52. Somer considers filling the client's order with some of his own shares at the \$50 bid price.

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1. To *best* comply with the CFA Institute Standards of Professional Conduct (the Standards) related to performance presentation, Somer should modify the:
  - A. text regarding Somer's investment returns.
  - B. presentation of the performance for Karibe's representative composite.
  - C. content of the disclosure statement related to assumptions and calculations.
2. Does Somer's social media post result in a violation of the Standards?
  - A. No.
  - B. Yes, he violates the standard related to preservation of confidentiality.
  - C. Yes, he violates the standard related to communication with clients and prospective clients.
3. When preparing the marketing materials for the quantitative strategy, did Somer comply with the standard related to communication with clients and prospective clients?
  - A. Yes.
  - B. No, because he did not identify the risk of coding errors.
  - C. No, because he did not describe the investment process in detail.
4. If he fills the client's order for shares of the technology firm, would Somer violate the standard related to priority of transactions?
  - A. No.
  - B. Yes, because the client would be disadvantaged by the trade.
  - C. Yes, because he would benefit personally from a trade undertaken for a client.

TOPIC: FINANCIAL STATEMENT ANALYSIS  
TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS

Paris Rousseau, a wealth manager at a US-based investment management firm, is meeting with a new client. The client has asked Rousseau to make recommendations regarding his portfolio's exposure to liquid alternative investments, specifically publicly traded real estate investments and commodity futures.

### Publicly Traded Real Estate

Rousseau believes that the client should increase his portfolio's allocation to publicly traded real estate through equity REITs. She collects financial information for the three office REITs presented in Exhibit 1.

**Exhibit 1**

|                                                               | <b>Autier REIT</b> | <b>Bissorte REIT</b> | <b>Chambon REIT</b> |
|---------------------------------------------------------------|--------------------|----------------------|---------------------|
| Current market price per share (\$)                           | 161.58             | 137.86               | 42.20               |
| Last 12-months net operating income (NOI in \$ millions)      | 1,085.80           | 1,826.12             | 431.79              |
| Last 12-months funds from operations (FFO in \$ millions)     | 877.42             | 1,085.84             | 328.79              |
| Cash and equivalents (\$ millions)                            | 80.38              | 140.63               | 4.25                |
| Accounts receivable and prepaid/other assets (\$ millions)    | 109.30             | 504.32               | 11.35               |
| Non-cash (straight-line) rent adjustment (\$ millions)        | 20.55              | 0.00                 | 5.45                |
| Recurring maintenance-type capital expenditures (\$ millions) | 54.52              | 75.85                | 8.75                |
| Leasing costs & tenant improvement allowances (\$ millions)   | 19.34              | 29.23                | 13.34               |
| Total debt outstanding and other liabilities (\$ millions)    | 7,049.29           | 12,236.03            | 2,222.97            |
| Shares outstanding (millions)                                 | 115.15             | 154.62               | 146.76              |
| Office sub-sector forecast 12-month growth in NOI and FFO     | 1.50%              |                      |                     |
| Office sub-sector average capitalization rate                 | 5.75%              |                      |                     |
| Office sub-sector average P/FFO multiple                      | 20x                |                      |                     |

Rousseau computes adjusted funds from operations (AFFO) per share and net asset value per share (NAVPS) for each REIT in Exhibit 1.

Rousseau also considers recommending OceanFront Partners, a condominium developer operating as a publicly-traded real estate operating company (REOC), for inclusion in the client's portfolio. In a recent analyst conference call, the CEO of OceanFront announced plans

to significantly increase the firm's retention ratio to fund several new acquisitions and development projects. Specifically, the CEO explained that OceanFront recently purchased several vacant lots in a popular beach-front community following a zoning change which allows for construction of high-rise condominiums.

### Commodity Futures

Rousseau notes that the client's portfolio currently has a futures position in gold. The client's gold futures contracts are nearing expiration. Rousseau notes that gold futures are currently in contango, and she recommends rolling forward the client's position while maintaining the same dollar exposure in gold futures.

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5. The AFFO per share for Autier REIT over the last 12-months is *closest* to:
  - A. \$6.80.
  - B. \$7.16.
  - C. \$8.43.
  
6. The NAVPS for Bissorte REIT is *closest* to:
  - A. \$129.34.
  - B. \$130.43.
  - C. \$133.51.
  
7. The *most* appropriate method for estimating the intrinsic value of OceanFront is based on:
  - A. P/AFFO.
  - B. net asset value.
  - C. discounted cash flow.
  
8. If the client implements Rousseau's recommendation, the number of gold futures contracts in his portfolio will *most likely*:
  - A. decrease.
  - B. stay the same.
  - C. increase.

## Answers to Sample Level II Item-Set Questions

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1. To *best* comply with the CFA Institute Standards of Professional Conduct (the Standards) related to performance presentation, Somer should modify the:
- A. text regarding Somer's investment returns.
  - B. presentation of the performance for Karibe's representative composite.
  - C. content of the disclosure statement related to assumptions and calculations.

**Answer: A**

A is correct because Somer's returns are not clearly explained as being generated at his prior firm. If a firm is not claiming GIPS compliance, "Members and candidates can also meet their obligations under Standard III(D) by including disclosures that fully explain the performance being reported."

B is incorrect because the marketing materials present the performance of a composite of similar portfolios.

C is incorrect because the materials direct prospective clients to the website where a full disclosure of the assumptions and calculations are available

2. Does Somer's social media post result in a violation of the Standards?
- A. No.
  - B. Yes, he violates the standard related to preservation of confidentiality.
  - C. Yes, he violates the standard related to communication with clients and prospective clients.

**Answer: A**

A is correct because Somer did not reveal the identity of his client (Standard III(E)). The context of the comment (he helped his client avoid penalties) contradicts the mistaken conclusion of the readers of the social media post (the athlete in question had to pay penalties so obviously was not his client). He also does not violate the standard related to communication (Standard V(B)) because it applies to 1) disclosure of the format and general principles of the investment process; 2) significant limitations and risks of the investment process; 3) identifying important factors for their analysis and recommendations; and 4) distinguishing between fact and opinion in investment analyses and recommendations. His post did not relate to any of these and thus is not a potential violation of the standard.

B is incorrect because Somer does not violate the standard related to confidentiality because the athlete in the news story is not his client, and the information that he helped his own client

avoid tax penalties by keeping good records does not provide enough information to disclose the client's identity.

C is incorrect because Somer does not violate the standard related to communication (Standard V(B)) because it applies to 1) disclosure of the format and general principles of the investment process; 2) significant limitations and risks of the investment process; 3) identifying important factors for their analysis and recommendations; and 4) distinguishing between fact and opinion in investment analyses and recommendations. His post did not relate to any of these and thus is not a potential violation of the standard, but certain candidates and/or exam team writers who think that communications with clients includes a duty to correct everyone who misunderstands you may choose this answer.

3. When preparing the marketing materials for the quantitative strategy, did Somer comply with the standard related to communication with clients and prospective clients?
  - A. Yes.
  - B. No, because he did not identify the risk of coding errors.
  - C. No, because he did not describe the investment process in detail.

**Answer: A**

A is correct because he did not violate Standard V(B). With respect to informing clients of the investment process, the guidance stipulates that when explaining the process one "need not describe the investment system in detail... but must inform clients of (the) basic process and logic." The explanation of Somer's process as factor-based with weights dynamically allocated meets this criterion. Regarding risk identification, "members and candidates cannot be expected to disclose risks they are unaware of at the time.... Having no knowledge of a risk or limitation that subsequently triggers a loss may reveal a deficiency in the diligence and reasonable basis... but may not reveal a breach of Standard V(B)."

B is incorrect because "members and candidates cannot be expected to disclose risks they are unaware of at the time.... Having no knowledge of a risk or limitation that subsequently triggers a loss may reveal a deficiency in the diligence and reasonable basis... but may not reveal a breach of Standard V(B)."

C is incorrect because when explaining the process one "need not describe the investment system in detail... but must inform clients of (the) basic process and logic." (Example 1 p. 141) The explanation of Somer's process as factor-based with weights dynamically allocated meets this criterion.

4. If he fills the client's order for shares of the technology firm, would Somer violate the standard related to priority of transactions?
  - A. No.

- B. Yes, because the client would be disadvantaged by the trade.
- C. Yes, because he would benefit personally from a trade undertaken for a client.

**Answer: C**

C is correct because the guidance for Standard VI(B) specifies that “nothing is inherently unethical about... making money from personal investments as long as (1) the client is not disadvantaged by the trade, (2) the investment professional does not personally benefit from trades undertaken for clients, and (3) the investment professional complies with applicable regulatory requirements.” In this case, Somer would personally benefit from a trade undertaken for a client by realizing a large gain and reducing the portfolio risk arising from his large position, which results in several potential conflicts of interest. At a minimum he would need to disclose to the client that he was filling the order from his own account and seek permission from Karibe to do so.

A is incorrect because Somer would personally benefit from a trade undertaken for a client by realizing a large gain and reducing the portfolio risk arising from his large position, which results in several potential conflicts of interest. At a minimum he would need to disclose to the client that he was filling the order from his own account and seek permission from Karibe to do so.

B is incorrect because the client is not disadvantaged by the trade (and in fact gets the order filled at a discount to the prevailing market price).

5. The AFFO per share for Autier REIT over the last 12-months is *closest* to:

- A. \$6.80.
- B. \$7.16.
- C. \$8.43

**Answer: A**

A is correct because "AFFO is most often defined as FFO adjusted to remove any non-cash rent and to subtract maintenance-type capital expenditures and leasing costs (including leasing agent's commissions and tenants' improvement allowances)" The computation for Autier REIT is as follows:

|                                            |                  |
|--------------------------------------------|------------------|
| Last 12-Months Funds From Operations (FFO) | \$877.42 million |
| Less: Non-Cash Rents                       | 20.55 million    |
| Less: Recurring CapEx (Maintenance)        | 54.52 million    |
| Less: Leasing Cost & Tenant Allowances     | 19.34 million    |

|                                       |                  |
|---------------------------------------|------------------|
| Adjusted Funds From Operations (AFFO) | \$783.01 million |
|---------------------------------------|------------------|

To arrive at Adjusted Funds From Operations (AFFO) per share, divide AFFO by the number of shares outstanding (115.15 million).

Correct AFFO per share =  $\$783.01 / 115.15 = \$6.7999 \approx \$6.80$

B is incorrect. In this case non-cash rents get added to FFO instead of subtracting them.

C is incorrect. In this case the adjustments are added instead of subtracted.

6. The NAVPS for Bissorte REIT is closest to:

- A. \$129.34.
- B. \$130.43.
- C. \$133.51.

**Answer: C**

C is correct because "NAVPS is the difference between a real estate company's assets and its liabilities, all taken at current market values instead of accounting book values, divided by the number of shares outstanding" The Net Asset Value (NAV) for Bissorte REIT is correctly computed as:

|                                          |                     |
|------------------------------------------|---------------------|
| Net Operating Income (Last 12 Months)    | \$1,826.12 million  |
| Less: Non-Cash Rents                     | 0.00 million        |
| Times: (1+ Forecast growth in NOI)       | x 1.015             |
| Estimated Next 12-Months Cash NOI        | \$1,853.51 million  |
| Divide: Capitalization Rate              | / 0.0575            |
| Estimated Value of Operating Real Estate | \$32,234.99 million |
| Plus: Cash and Equivalents               | 140.63 million      |
| Plus: A/R and Prepaids/Other Assets      | 504.32 million      |
| Less: Total Debt & Other Liabilities     | 12,236.03 million   |
| Net Asset Value (NAV)                    | \$20,643.91 million |

The candidate then divides the NAV computed above by the number of shares Bissorte REIT has outstanding (154.62) to arrive at the correct NAVPS.

Correct NAVPS =  $\$20,643.91 / 154.62 = \$133.51$

A is incorrect. In this case the current assets of "Cash and Equivalents" and "Accounts Receivable and Prepaid/Other Assets" in the computation of NAV are not added back.

B is incorrect. In this case NAV is computed using the next 12-months forecast NOI, not last 12-months NOI as presented in the exhibit.

7. The most appropriate method for estimating the intrinsic value of OceanFront is based on:

- A. P/AFFO.
- B. net asset value.
- C. Discounted cash flow.

**Answer: B**

B is correct because net asset value (NAV) explicitly considers "land held for future development" and is not affected by changes in dividends. As noted in the case, "In a recent analyst conference call the CEO of OceanFront announced plans to increase the firm's retention ratio to fund several new acquisitions and development projects. Specifically, he explained that OceanFront recently acquired several vacant lots in a popular beach-front community following a zoning change which allows for construction of high-rise condominiums." Thus, OceanFront has recently acquired "land held for future development" and the transactions are recent. This combined with the fact that dividends are being lowered to begin development of these properties makes NAV the best choice for estimating OceanFront's intrinsic value.

A is incorrect because "applying a multiple to FFO or AFFO may not capture the intrinsic value of all real estate assets held by the REIT or REOC; for example, land parcels and empty buildings may not currently produce income and hence do not contribute to FFO (and AFFO) but have value".

C is incorrect because the discounted cash flow (DCF) approach is most appropriate and applicable when REITs and REOCs "return a significant portion of their income to their investors." In this case, "In a recent analyst conference call the CEO of OceanFront announced plans to significantly increase the firm's retention ratio to fund several new acquisitions and development projects".

8. If the client implements Rousseau's recommendation, the number of gold futures contracts in his portfolio will most likely:

- A. decrease.
- B. stay the same.
- C. increase.

**Answer: A**

A is correct because "gold futures are currently in contango" and will require buying fewer contracts to meet Rousseau's goal of "maintaining the same dollar exposure in gold futures." In the readings: "A portfolio may require buying more far contracts than the near contracts being sold. Investors can observe this scenario if backwardation is driving the shape of the commodity futures price curve." In the opposite case, if the futures price curve shape is being driven by contango—with a higher futures price in the far contract—this scenario will require the purchase of fewer commodity contracts than in the near position.

B is incorrect because "gold futures are currently in contango" and will require buying fewer contracts to meet Rousseau's goal of "maintaining the same dollar exposure in gold futures." The number of required contracts would only remain the same if the price of the expiring near contract is equal to the price of the far contract the investor is rolling into.

C is incorrect because "gold futures are currently in contango" and will require buying fewer contracts to meet Rousseau's goal of "maintaining the same dollar exposure in gold futures," not more contracts. The number of required contracts would only increase if the futures market was in backwardation.