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Review Category Equity Portfolio Management (1 & 2)

Done Reviewing

Correct

Correct Answer Your Answer

A	
B	✓
C	

Confidence Level:

Not Selected

Time Spent:

1 min 49 secs

Difficulty Level:

Difficult

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### The Epsilon Institute Case Scenario

The Epsilon Institute of Theoretical Physics is a non-profit corporation initially funded from government and private sources. Mitch Lazare is the chairman of the Investment Committee, which oversees the institute's endowment fund, of which about \$750 million is currently under active management. He is currently tasked with finding two additional investment managers to manage a portion of the actively managed funds and, along with his assistant, Brian Warrack, is reviewing the presentations made by several applicants.

John Fraser's performance is the first that Lazare and Warrack review. Fraser's fund is constructed with a discretionary approach using the four Fama–French factors; he uses the Russell 1000 Value Index as his benchmark. The most recent 10 years of performance data for both the fund and the benchmark are shown in Exhibit 1.

#### Exhibit 1

Fraser Fund and Benchmark Average Monthly Performance over the Past 10 years

	Russell 1000 Value Index	The Fraser Fund	Factor Performance
<b>Monthly performance in excess of the risk-free rate</b>	0.72%	0.55%	
	<b>β to specified factor</b>		
<b>Market</b>	0.90	0.91	0.61%
<b>Size</b>	-0.27	0.15	0.17%
<b>Value</b>	0.38	0.60	0.18%
<b>Momentum</b>	0.15	0.08	0.72%
<b>Average monthly risk-free rate</b>	0.33%		

As part of his evaluation of the applicants, Warrack compiles a record of the Active Share and active risk of the funds that they manage. He observes that the Mattley Fund has relatively high Active Share but relatively low active risk.

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volatility.

- The active risk attributed to Active Share will be smaller in more diversified portfolios.
- If the factor exposure is fully neutralized, the Active Share will be entirely attributed to the active risk.

The manager of the Western Fund focuses on smaller companies in the Russell 1000 Value Index and uses the following constraints:

- Size: The capitalization of the average company is \$1.8 billion. On average, companies of this size trade 0.90% of their capitalization every day.
- Liquidity: Positions can be no larger than 7% of average daily trading volume.
- Allocation: Positions can be no larger than 1.75% of total assets under management.
- Diversification: The portfolio must contain at least 60 securities.

If the manager of the Western Fund is hired by Epsilon, she will have \$100 million of Epsilon's funds to manage.

Lazare and Warrack turn their attention to the manager of the Herrick Fund, which is the only fund that involves substantial international exposure. Lazare believes that current political events in Country A may result in greater risk exposure than might be appropriate and wishes to investigate further.

The Herrick Fund manager provides them with the information in Exhibit 2, which they use to carry out a risk attribution analysis.

**Exhibit 2**

**The Herrick Fund—Risk Analysis**

Country	Country Weight (%)	Standard Deviation (%)	Correlation		
			Country A	Country B	Country C
A	30	25	1.0	0.4	0.3
B	50	15	0.4	1.0	0.2
C	20	9	0.3	0.2	1.0
Portfolio	100	13.2			

  

Country	Covariance		
	Country A	Country B	Country C
Country A	0.062500	0.015000	0.006750
Country B	0.015000	0.022500	0.002700

**Correct**

Correct Answer Your Answer

A	
B	✓
C	

Confidence Level:

Not Selected

Time Spent:

1 min 49 secs

Difficulty Level:

Difficult

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<b>Country</b>	0.006750	0.002700	0.008100
<b>C</b>			
<b>Portfolio</b>	0.0276	0.01629	0.004995

**Q.** In Lazare and Warrack's comments about Active Share and active risk, the comment that is *least* accurate is the one concerning:

- A. portfolio diversification.
- B. neutralizing factor exposure.
- C. increasing idiosyncratic volatility.

**Solution**

**B is correct.** The comment concerning neutralizing factor exposure is incorrect: In a single-factor model, if the factor exposure is neutralized, the active risk will be entirely attributable to the Active Share—a consequence of the manager deviating from benchmark weights. The active risk attributed to Active Share will be smaller for more diversified portfolios with lower idiosyncratic risk. Active risk does rise with an increase in factor and idiosyncratic volatility.

A is incorrect. The active risk attributed to Active Share will be smaller for more diversified portfolios with lower idiosyncratic risk.

C is incorrect. Active risk does rise with an increase in factor and idiosyncratic volatility.

**Active Equity Portfolio Construction Learning Outcome**

- c. Distinguish between Active Share and active risk and discuss how each measure relates to a manager's investment strategy

Correct

Correct Answer Your Answer

A	
B	✓
C	

Confidence Level:  
Not Selected

Time Spent:  
1 min 49 secs

Difficulty Level:  
Difficult

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SF "Wrong answers" constructed by taking a correct answer permutating words are poor practice. Your brain is wired to autocorrect such things. Tahs't wyh yuo'er albe to erad tihs stenece.

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JL This is english test not CFA test. It want us know what is different between attribute and contribute.  
 the active risk will be entirely attributable to the Active Share -- which is B attribute to A

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YZ So A is incorrect as well? As The active risk attributed to Active Share should be LARGER for more diversified portfolios with lower idiosyncratic risk.

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XL Don't catch the answer

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CY Still don't understand the explanation for choice B. Is it wrong because it says "Active Share will be entirely attributed to the active risk" instead of Active RISK will be entirely attributed to the active share?

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JP You're correct: cause and effect are inverted in the answer

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