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Review Category Equity Portfolio Management (1 & 2)

Done Reviewing

Incorrect

Correct Answer Your Answer

A	X
B	
C	

Confidence Level:

Low

Time Spent:

1 min 15 secs

Difficulty Level:

Expert

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Aleksy Nowacki is a new portfolio manager at Heydon Investments. The firm currently offers a single equity fund, which uses a top-down investment strategy based on fundamentals. Vicky Knight, a junior analyst at Heydon, assists with managing the fund.

Nowacki has been hired to start a second fund, the Heydon Quant Fund, which will use quantitative active equity strategies. Nowacki and Knight meet to discuss distinct characteristics of the quantitative approach to active management, and Knight suggests three such characteristics:

- Characteristic 1** The focus is on factors across a potentially large group of stocks.
- Characteristic 2** The decision-making process is systematic and non-discretionary.
- Characteristic 3** The approach places an emphasis on forecasting the future prospects of underlying companies.

Nowacki states that quantitative investing generally follows a structured and well-defined process. Knight asks Nowacki:

“What is the starting point for the quantitative investment process?”

The new Heydon Quant Fund will use a factor-based strategy. Nowacki assembles a large dataset with monthly standardized scores and monthly returns for the strategy to back-test a new investment strategy and calculates the information coefficient. $FS(t)$ is the factor score for the current month, and $FS(t + 1)$ is the score for the next month. $SR(t)$ is the strategy's holding period return for the current month, and $SR(t + 1)$ is the strategy's holding period return for the next month.

As an additional step in back-testing of the strategy, Nowacki computes historical price/book ratios (P/Bs) and price/earnings ratios (P/Es) using calendar year-end (31 December) stock prices and companies' financial statement data for the same calendar year. He notes that the financial statement data for a given calendar year are not typically published until weeks after the end of that year.

Because the Heydon Quant Fund occasionally performs pairs trading using statistical arbitrage, Nowacki creates three examples of pairs trading candidates, presented in Exhibit 1. Nowacki asks Knight to recommend a suitable pair trade.

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Arbitrage

Stock Pair	Current Price Ratio Compared with Long-Term Average	Historical Price Ratio Relationship	Historical Correlation between Returns
1 and 2	Not significantly different	Mean reverting	High
3 and 4	Significantly different	Mean reverting	High
5 and 6	Significantly different	Not mean reverting	Low

Knight foresees a possible scenario in which the investment universe for the Heydon Quant Fund is unchanged but a new factor is added to its multifactor model. Knight asks Nowacki whether this scenario could affect the fund's investment-style classifications using either the returns-based or holdings-based approaches.

Practice Problem

Q. The *most appropriate* response to Knight's question regarding the potential future scenario for the Heydon Quant Fund is:

- A. only the returns-based approach.
- B. only the holdings-based approach.
- C. both the returns-based approach and the holdings-based approach.

Solution

C is correct. Because the Heydon Quant Fund would be changing its factor model by adding a new factor, the correlations of the fund's returns with the factors would likely change and the returns-based style would change. Even though the investment universe is unchanged, the portfolio holdings would likely change and the holdings-based style classification would also will be affected.

Active Equity Investing: Strategies Learning Outcome

- i. Discuss equity investment style classifications

Incorrect

Correct Answer Your Answer

A	X
B	
C	

Confidence Level:
Low

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1 min 15 secs

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Expert

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QD both will be affected. But Return-based will be more slowly. This says a new factor, but it does not indicate whether this is a strong factor or a weak factor.

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WG why answer c, who can tell me

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Answer

X

