R61 INAI

Number of questions: 65

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Question		Q-Code: L1-AI-INAI-001
1	Alternative investment funds are *most likely* managed: A) passively. B) to generate positive beta return. C) to generate a positive alpha return.	
Answer	**C)** to generate a positive alpha return.	
Explanation	C is correct. Most alternative investment funds are actively managed and seek to generate positive alpha returns.	

Question		Q-Code: L1-AI-INAI-002
2	Compared with traditional investments, alternative investments are *more likely* to be characterized by higher: A) transparency. B) liquidity. C) expected returns.	
Answer	**C)** expected returns.	
Explanation	C is correct. Alternative investments are typically less transparent and less liquid compared to traditional investments.	

Question		Q-Code: L1-AI-INAI-003
3	Relative to traditional investments, alternative investments are *less likely* to be characterized by: A) low correlation with traditional investments. B) high level of regulation. C) unique legal and tax consideration.	
Answer	**B)** high level of regulation.	
Explanation	B is correct. Relative to traditional investments, alternative investments are characterized by low correlation with traditional investments, low level of regulation, and unique legal and tax considerations.	

Question		Q-Code: L1-AI-INAI-004
4	Which of the following factors is *most likely* to be a characteristic of alternative investments? A) Narrow manager specialization. B) High regulation. C) High transparency.	
Answer	**A)** Narrow manager specialization.	
Explanation	A is correct. General characteristics of alternative investments include: illiquidity of underlying investments, narrow manager specialization, low correlation with traditional investments, low level of regulation and less transparency, limited and potentially problematic historical risk and return data, unique legal and tax considerations.	

Question		Q-Code: L1-AI-INAI-005
5	Alternative investments are *least likely* to be characterized by higher: A) fees. B) illiquidity. C) transparency.	
Answer	**C)** transparency.	
Explanation	C is correct. Alternative investments are often characterized by higher fees and illiquidity.	

Question		Q-Code: L1-AI-INAI-006
6	Which of the following is *least likely* to be considered an alternative investment?	

A) Hedge funds.
B) Real estate.
C) Long-only stock funds.

Answer	**C)** Long-only stock funds.
Explanation	C is correct. Long-only stock funds are typically considered traditional investments and hedge funds and real estate are typically classified as alternative investments.

Question	Q-Code: L1-AI-INAI-007
7	Which of the following is *most likely* to be correct about return? A) Beta, a measure of sensitivity, relative to a particular market index, is a measure of unsystematic risk. B) Owing to existing inefficiencies, a positive return can be earned through exploitation and after adjustment of beta risk. This is defined as alpha return. C) Alpha returns are correlated with beta returns and are presumably the result of managers' special skills in capturing non-systematic opportunities.
Answer	**B)** Owing to existing inefficiencies, a positive return can be earned through exploitation and after adjustment of beta risk. This is defined as alpha return.
Explanation	B is correct. A is incorrect because beta is a measure of systematic risk. C is incorrect because alpha returns are not correlated with beta returns.

Question	Q-Code: L1-AI-INAI-008
8	An investor is *most likely* to consider adding alternative investments to a traditional investment portfolio because of their: A) low sharp ratio. B) high correlation with traditional investments. C) diversifying potential.
Answer	**C)** diversifying potential.
Explanation	C is correct. A key motivation for investing in alternative investments is their diversifying potential when combined with a traditional portfolio.

Question	Q-Code: L1-AI-INAI-009
9	Which of the following is *least likely* to be based on realized profits for a funds' structure? A) Incentive fee. B) Management fee. C) Performance fee.
Answer	**B)** Management fee.
Explanation	B is correct. The management fee, also called the base fee, is based on assets under management.

Question	Q-Code: L1-AI-INAI-010
10	Which of the following is *least likely* to be a characteristic of a hedge fund? A) It is an aggressively managed portfolio of investments across asset classes. B) Investors may be required to keep their money in the hedge fund for a minimum period known as a lock-up period. C) It is an investment opportunity available to the public and requires hefty investment.
Answer	**C)** It is an investment opportunity available to the public and requires hefty investment.
Explanation	C is correct. Hedge funds are set up as a private investment open to a limited number of investors willing and able to make a large initial investment.

Question	Q-Code: L1-AI-INAI-011
11	Which of the following statements is *most likely* to be correct about funds of funds? Statement I: Funds of funds are funds that hold a portfolio of hedge funds. Statement II: Funds of funds presumably have some expertise in conducting due diligence on hedge funds. Statement III: Funds of funds may be able to negotiate better redemption. A) Statements I and II. B) Statements I and III.

	C) Statements I, II, and III.
Answer	**C)** Statements I, II, and III.
Explanation	C is correct. All three statements regarding funds of funds are correct.
Question	Q-Code: L1-AI-INAI-012
12	Which of the following is *least likely* to be a hedge fund strategy? A) Event driven. B) Micro. C) Relative value.
Answer	**B)** Micro.
Explanation	B is correct. Macro, and not micro, is a hedge fund strategy.
Question	Q-Code: L1-AI-INAI-013
13	A type of private equity fund that invests in established profitable and cash generative companies with solid customer bases, proven products, and high quality management is *most likely* described as a (an): A) venture capital. B) angel investing. C) leveraged buyout.
Answer	**C)** leveraged buyout.
Explanation	C is correct. A type of private equity fund that invests in established profitable and cash generative companies with solid customer bases, proven products, and high quality management is most likely described as a leveraged buyout.
Question	Q-Code: L1-AI-INAI-014
14	An investor may prefer a fund of funds to a single hedge fund if she: A) seeks better redemption terms. B) is concerned about extra layer fee structure. C) is willing and able to make a large initial investment.
Answer	**A)** seeks better redemption terms.
Explanation	A is correct. Funds of funds presumably have some expertise in conducting due diligence on hedge funds and may be able to negotiate more favorable redemption terms than could an individual investor in a single hedge fund.
Question	Q-Code: L1-AI-INAI-015
15	Analyst 1: The management fee for a private equity fund is based on assets under management. Analyst 2: The management fee for a private equity fund is based on committed capital. Which analyst's statement is *most likely* correct? A) Analyst 1. B) Analyst 2. C) Neither of them.
Answer	**B)** Analyst 2.
Explanation	B is correct. The management fee for private equity funds is based on committed capital whereas for hedge funds the management fees are based on assets under management.
Question	Q-Code: L1-AI-INAI-016
16	Which of the following investments is *most* suitable for an investor looking for competitive long-term total return driven by both income generation and capital appreciation? A) Hedge funds. B) Real estate. C) Commodities.
Answer	**B)** Real estate.
Explanation	B is correct. One of the key reasons for investing in real estate is the potential for competitive long-term total returns driven by both income generation and capital appreciation.

Question		Q-Code: L1-AI-INAI-017
17	If capital is provided to companies moving towards operations but before commercial production and sales have occurred, then it is *most likely*: A) angel investing. B) seed-stage financing. C) early stage financing.	
Answer	**C)** early stage financing.	
Explanation	C is correct. Early stage financing (early stage venture capital) is provided to companies moving toward operation but before commercial production and sales have occurred.	

Question		Q-Code: L1-AI-INAI-018
18	Venture capital entails investing in: A) struggling public companies. B) well established private companies with stable cash flows. C) private companies with high growth potential.	
Answer	**C)** private companies with high growth potential.	
Explanation	C is correct. Venture capital entails investing in private companies with high growth potential.	

Question		Q-Code: L1-AI-INAI-019
19	Which of the following is *least likely* the characteristic of an attractive target company for a leveraged buyout? A) Company is not being run efficiently. B) Company's stock is depressed. C) Company's cash flow is volatile.	
Answer	**C)** Company's cash flow is volatile.	
Explanation	C is correct. Characteristics of an attractive target company for LBOs include: undervalued or depressed stock price, willing management, inefficient companies, strong and sustainable cash flows, low leverage, and significant amount of physical assets.	

Question		Q-Code: L1-AI-INAI-020
20	Which of the following is the *most accurate* description of contango? A) A situation where the spot price exceeds the forward or futures price. B) A situation where the forward or futures price exceeds the spot price. C) A situation where the forward or futures price is equivalent to the spot price.	
Answer	**B)** A situation where the forward or futures price exceeds the spot price.	
Explanation	B is correct. Backwardation is a situation where the spot price exceeds the forward or futures price. The opposite is true for contango.	

Question		Q-Code: L1-AI-INAI-021
21	Which of the following is *least likely* a form of real estate investment? A) Mortgage-backed securities. B) Real estate limited partnerships. C) Leveraged buyouts.	
Answer	**C)** Leveraged buyouts.	
Explanation	C is correct. Leveraged buyouts are highly leveraged transactions where private equity firms establish buyout funds to acquire public companies or established private companies with significant proportion of the purchase price financed through debt. It is a form of private equity investment rather than real estate investment. Securitization of retail and commercial mortgages such as in mortgage-backed securities and real estate limited partnerships are forms of real estate investment.	

Question		Q-Code: L1-AI-INAI-022
22	Investors are *least likely* to gain exposure to commodities because: A) they want to trade in a physical product. B) commodity prices have historically been correlated with inflation. C) commodity prices are linked to economic growth.	
Answer	**A)** they want to trade in a physical product.	
Explanation	A is correct. Only a small group of investors trades in physical commodities while most investors invest in commodities using	

commodity derivatives rather than the physical good itself.

Question		Q-Code: L1-AI-INAI-023
23	Which of the following is *least likely* a method for investing in commodities? A) Commodity index futures. B) Options contracts on commodities. C) Direct investment in commodities.	
Answer	**C)** Direct investment in commodities.	
Explanation	C is correct. The majority of commodities investing is implemented through derivatives.	

Question		Q-Code: L1-AI-INAI-025
24	Which of the following is *least likely* a private equity strategy? A) Buyout funds. B) Venture capital. C) Merger arbitrage.	
Answer	**C)** Merger arbitrage.	
Explanation	C is correct. Buyout funds and venture capital (VC) funds are collectively referred to as private equity.	

Question		Q-Code: L1-AI-INAI-026
25	If the price of a commodity futures contract is below the spot price, it is *most likely* that the: A) roll yield is negative. B) convenience yield exceeds the cost of carry. C) storage costs exceed convenience yield.	
Answer	**B)** convenience yield exceeds the cost of carry.	
Explanation	B is correct. Since the futures price is less than the spot price, the market is in backwardation. The convenience yield must be more than the cost of carry to arrive at a futures price below the spot price because the futures price is approximately equal to: spot price * (1 + r) + storage cost – convenience yield. The cost of carry is defined as interest cost plus storage cost. When the market is backwardation the roll yield for the long party is positive.	

Question		Q-Code: L1-AI-INAI-027
26	Which of the following is the *most* liquid alternative investment? A) Hedge funds. B) Private equity. C) Exchanged traded funds.	
Answer	**C)** Exchanged traded funds.	
Explanation	C is correct. Exchanged traded funds are publically traded and thus provide liquidity.	

Question		Q-Code: L1-AI-INAI-028
27	Which of the following hedge fund strategies is *least likely* categorized as an event-driven strategy? A) Distressed debt. B) Merger arbitrage. C) Fixed income arbitrage.	
Answer	**C)** Fixed income arbitrage.	
Explanation	C is correct. Distressed debt and merger arbitrage are event driven strategies.	

Question		Q-Code: L1-AI-INAI-029
28	Which of the following characteristics of a target company is *most likely* attractive for a leveraged buyout? A) High leverage. B) Economic environment. C) Strong and sustainable cash flows.	
Answer	**C)** Strong and sustainable cash flows.	
Explanation	C is correct. Strong and sustainable cash flow is an attractive feature of a target company in a leveraged buyout.	

Question		Q-Code: L1-AI-INAI-030

29	The futures price of wheat is higher than the spot price. This is most likely to be referred to as: A) backwardation. B) arbitrage. C) contango.
Answer	**C)** contango.
Explanation	C is correct. Contango is when the futures price of a commodity is above the spot price.
Question	Q-Code: L1-AI-INAI-031
30	Which of the following is most likely to be correct for commodities? A) Investors deal in commodity derivatives because holding commodities in physical form incurs costs for transportation and storage. B) Commodity derivatives are attractive because of potential profits, but are not effective hedges against inflation. C) Commodity derivatives can only be traded on exchanges and include obligations.
Answer	**A)** Investors deal in commodity derivatives because holding commodities in physical form incurs costs for transportation and storage.
Explanation	A is correct. B is incorrect because commodity derivatives are effective hedges against inflation. C is incorrect because commodity derivatives can be traded over the counter. Furthermore, commodity derivatives include options and swaps.
Question	Q-Code: L1-AI-INAI-032
31	When future prices are higher than the spot price, the commodity forward curve is: A) upward sloping and prices are referred to as being in contango. B) downward sloping and prices are referred to as being in contango. C) downward sloping and prices are referred to as being in backwardation.
Answer	**A)** upward sloping and prices are referred to as being in contango.
Explanation	A is correct. A downward sloping curve occurs when the futures prices are lower than the spot price. This condition is called backwardation.
Question	Q-Code: L1-AI-INAI-033
32	The difference between the spot price of a commodity and the price specified by its futures contract: A) Convenience yield. B) Collateral yield. C) Roll yield.
Answer	**C)** Roll yield.
Explanation	C is correct. Roll yield refers to the difference between the spot price of a commodity and the price specified by its futures contract.
Question	Q-Code: L1-AI-INAI-034
33	Which of the following is *least likely* to be a characteristic associated with alternative investments? A) Asymmetric risk and return profiles. B) Illiquidity. C) Unlimited portfolio transparency.
Answer	**C)** Unlimited portfolio transparency.
Explanation	C is correct. Alternative investments are associated with limited portfolio transparency.
Question	Q-Code: L1-AI-INAI-035
34	Which of the following is *least likely* to be correct about hedge fund valuation? A) A common practice is to use the average of bid and ask for market quotes and prices. B) Ask prices are used for long and bid prices are used for shorts. C) Liquidity discounts are deemed necessary to reflect fair value and are also known as haircuts
Answer	**B)** Ask prices are used for long and bid prices are used for shorts.
Explanation	B is correct. Bid prices are used for long and ask prices are used for shorts.
Question	Q-Code: L1-AI-INAI-036
35	A minority equity investment in more mature companies looking to enter new markets is *most likely* to be known as: A) Development capital.

B) Distressed investing.
C) Venture capital

Answer	**A)** Development capital.
Explanation	A is correct. Development capital refers to minority equity investment in more mature companies looking to enter new markets

Question	Q-Code: L1-AI-INAI-037
36	A company is *least likely* to be attractive as a leverage buyout target if: A) the company is inefficient and has the potential to perform better. B) the company has low leverage and sustainable cash flows. C) the market value of the company exceeds its perceived intrinsic value.
Answer	**C)** the market value of the company exceeds its perceived intrinsic value.
Explanation	C is correct. A company is an attractive leverage buyout target if the perceived intrinsic value of the company exceeds the market value.

Question	Q-Code: L1-AI-INAI-038
37	Imperial Tiles is a company moving towards operation but has not yet started commercial production. Which of the following financing stages is *most likely* to suit the needs of Imperial Tiles? A) Early-stage financing. B) Seed-stage financing. C) Mezzanine-stage financing.
Answer	**A)** Early-stage financing.
Explanation	A is correct. Early stage financing is provided to companies moving toward operation but before commercial production and sales have occurred.

Question	Q-Code: L1-AI-INAI-039
38	Which of the following is *least likely* to be correct about exit strategies for private equity portfolio managers? A) A trade sale can be conducted through an auction process or by private negotiation. B) An advantage of an initial public offering is that it can be conducted quickly. C) Under recapitalization, the private equity firm maintains control, but allows the private equity investor to extract money from the company.
Answer	**B)** An advantage of an initial public offering is that it can be conducted quickly.
Explanation	B is correct. A disadvantage of an initial public offering is that the lead times are long.

Question	Q-Code: L1-AI-INAI-040
39	Which of the following is *least likely* to be a key reason for investing in real estate? A) Potential to avoid government regulations. B) Potential for competitive long term total returns. C) Potential to provide an inflation hedge.
Answer	**A)** Potential to avoid government regulations.
Explanation	A is correct. A concern for real estate is that it is subject to government regulations affecting what can be done to modify the existing property and how it can be transferred.

Question	Q-Code: L1-AI-INAI-042
40	Collateralized mortgage obligations are *most likely* to be an example of: A) private debt. B) public debt. C) public equity.
Answer	**B)** public debt.
Explanation	B is correct. Collateralized mortgage debt is an example of public debt.

Question	Q-Code: L1-AI-INAI-043
41	Which of the following is *least likely* to be a portfolio company valuation approach? A) Asset based approach. B) Comparable sales approach.

	C) Discounted cash flow approach.
Answer	**B)** Comparable sales approach.
Explanation	B is correct. A comparable sales approach is used to value real estate.

Question	Q-Code: L1-AI-INAI-044
42	Zee Capital, a hedge fund with an initial investment capital of $200 million had a 40% return in its first year. At year end, a 4% management fee is charged based on the assets under management and a 10% incentive fee is charged. The management fee is calculated using end-of-period valuation. Which of the following is *most likely* to be the incentive fees earned? A) $8 million. B) $20 million. C) $28 million.
Answer	**A)** $8 million.
Explanation	A is correct. Incentive Fee = (200*1.4 - 200)*0.1 = $8 million.

Question	Q-Code: L1-AI-INAI-045
43	Zee Capital, a hedge fund with an initial investment capital of $200 million had a 40% return in its first year. At year end, a 4% management fee is charged based on the assets under management and a 10% incentive fee is charged. The management fee is calculated using end-of-period valuation. Which of the following is *most likely* to be the effective return for the investor? A) 30.4%. B) 34.4%. C) 36.0%.
Answer	**A)** 30.4%.
Explanation	A is correct. Effective Return = (Investment - Initial Capital - Total fees) / Initial Capital Total fees = Incentive fee + Management fee + \$8 + (200*1.4*0.04) = \$19.2 Effective Return = (280 - 200 - 19.2) / 200 = 30.4%

Question	Q-Code: L1-AI-INAI-046
44	Zee Capital, a hedge fund with an initial investment capital of $200 million had a 40% return in its first year. At year end, a 4% management fee is charged based on the assets under management and a 10% incentive fee is charged. The management fee is calculated using end-of-period valuation. Given that the incentive fee is calculated based on return net of management fee, which of the following is *most likely* to be the total fees earned by Zee Capital? A) $6.88 million. B) $18.08 million. C) $20.48 million.
Answer	**B)** $18.08 million.
Explanation	B is correct. Management fee = 200*1.4*0.04 = 11.2 Incentive fee = (200*1.4 - 200 -11.2) * 10% = 6.88 Total fee = 11.2 + 6.88 = $18.08

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Question	Q-Code: L1-AI-INAI-047
45	Zee Capital, a hedge fund with an initial investment capital of $200 million had a 40% return in its first year. At year end, a 4%

management fee is charged based on the assets under management and a 10% incentive fee is charged. The management fee is calculated using end-of-period valuation.

Assume that the fee structure specifies a hurdle rate of 5% and the incentive fee is based on returns in excess of the hurdle rate. Furthermore, the performance fee is calculated net of the management fee. Which of the following is *most likely* to be the investor's net return given this fee structure?

A) 26.21%.
B) 28.51%.
C) 31.46%.

Answer	**C)** 31.46%.
Explanation	C is correct. Management fee = 200*1.4*0.04 = 11.2 Hurdle = 200*5% = 10 Effective Return = (280 - 200 - 11.2 - 5.88) / 200 = 31.46%

Question	Q-Code: L1-AI-INAI-048
46	Zee Capital, a hedge fund with an initial investment capital of $200 million had a 40% return in its first year. At year end, a 4% management fee is charged based on the assets under management and a 10% incentive fee is charged. The management fee is calculated using end-of-period valuation. The fund value declines to $250 million in the second year. Assuming the fee structure is the same as given in the information above but is inclusive of a high water mark, which of the following is *most likely* to be the fees earned by Zee Capital in the second year? A) $10 million. B) $25 million. C) $35 million.
Answer	**A)** $10 million.
Explanation	A is correct. Management fee = 250*0.04 = 10 Because the fund declined in value, there will be no incentive fee.

Question	Q-Code: L1-AI-INAI-049
47	Cole Hedge Funds had an invested capital of $100 million. It earned a return of 25% in the first year. Given that it follows a 4 and 20 fee structure, and calculates the incentive and management fees independently, the net return for the investors is *closest* to: A) 8%. B) 15%. C) 20%.
Answer	**B)** 15%.
Explanation	B is correct. Management fee = 100*1.25*0.04 = 5 million Incentive fee = (100*1.25 - 100)*0.2 = 5 Return = (100*1.25 - 100 - 10) / 10 + 15%

Question	Q-Code: L1-AI-INAI-050
48	The management fee for hedge funds is based on: A) initial investment. B) committed capital. C) assets under management.
Answer	**C)** assets under management.
Explanation	C is correct. The management fee for hedge funds is based on assets under management.

Question	Q-Code: L1-AI-INAI-051

49	IFT Capital is a hedge fund with PKR 100 million of initial investment capital. IFT charges a 2% management fee based on assets under management at year end and a 20% incentive fee. The hurdle rate is 10% and the incentive fee is based on returns in excess of the hurdle rate. The incentive and management fees are calculated independently. The fund has a return of 30% for the first year. What is an investor's net return given this fee structure? A) 28.50%. B) 23.40%. C) 21.4%.
Answer	**B)** 23.40%.
Explanation	B is correct. Step 1: Calculate the management fee. Value of investment at the end of first year (after return) = 100 million * 1.30 = 130 million. Management fee = 130 million * 0.02 = 2.6 million. Step 2: Calculate the incentive fee. Given a 10% hurdle rate, the amount to consider for the incentive fee = 30 – 10 = 20 million. Incentive fee = 20 million * 0.20 = $4.0 million. Total fees earned = 2.6 million + 4.0 million = 6.6 million. Investor's net return = (130.00 - 6.60) / 100 = (123.40/100) - 1 = 23.4%.

Question	Q-Code: L1-AI-INAI-052
50	A hedge fund had invested capital of 200 million on which it earned a return of 35% in its first year. It follows a 2 and 20 fee structure and calculates the incentive net of management fees. The total fee for the hedge fund in the first year is *closest* to: A) 44.00 million. B) 19.40 million. C) 18.32 million.
Answer	**C)** 18.32 million.
Explanation	C is correct. Invested capital = 200,000,000 Value of fund after a year = 200,000,000 * 1.35 = 270,000,000. Management fee = 270,000,000 * 0.02 = 5,400,000. Incentive fees = (270,000,000 – 200,000,000 – 5,400,000) * 0.2 = 12,920,000. Total fee = 5,400,000 + 12,920,000 = 18,320,000.

Question	Q-Code: L1-AI-INAI-053
51	BMB Capital is a hedge fund with a portfolio valued at \$500,000,000 at the beginning of the year. One year later, the value of assets under management is \$555,500,000. The hedge fund charges a 2% management fee based on the end-of-year portfolio value as well as a 15% incentive fee. If the incentive fee and management fee are calculated independently, the effective return for a hedge fund investor is *closest* to: A) 7.21%. B) 7.55%. C) 11.1%.
Answer	**A)** 7.21%.
Explanation	A is correct. Management fee = \$555,500,000 * 0.02 = \$11,110,000. Incentive fee = (\$555,500,000 – \$500,000,000) * 0.15 = \$8,325,000. Total fees = \$19,435,000. Return = (\$555,500,00 - \$500,000,000 - \$19,435,00) / \$500,000,000 = 7.21%.

Question	Q-Code: L1-AI-INAI-054
52	A hedge fund begins the year with $200 million and earns a 20% return for the year. The fund charges a 1% management fee on end-of-year fund value and a 10% incentive fee on the return, net of the management fees, that is in excess of a 10% fixed hurdle rate. The fund's investors' return for the year, net of fees, is *closest* to: A) 16.80%.

B) 16.92%.
C) 17.92%.

Answer **C)** 17.92%.

Explanation C is correct.

Value of fund after a year = \$200,000,000 * 0.2 = \$240 million.

Management fee = \$240,000,000 * 0.01 = \$2.4 million.

Incentive fee net of management fees and in excess of 10% fixed hurdle rate:

(240,000,000 - 200,000,000 - 2,400,000 – 20,000,000) *0.1 = $1.76 million.

Investor's return, net of fees = (240 - 200 - 2.4 - 1.76) / 200 = 17.92%.

Question Q-Code: L1-AI-INAI-055

53 The following information is available about a hedge fund:

Initial investment capital	£200 million
Return at the end of one year	15%
Management fee based on assets under management	2%
Incentive fee based on the return net of the management fee	10

Assume management fees are calculated using end-of-period valuation. The investor's net return given this fee structure is *closest* to:

A) 11.20%.
B) 11.43%.
C) 13.00%.

Answer **B)** 11.43%.

Explanation B is correct.

Management fee = 200 * 1.15 * 0.02 = £4.6 million

Incentive fee = (230 -200 – 4.6 million) * 0.1 = £2.54 million

Fund value after fees = £230 million – £4.6 million – £2.54 million = £222.86 million

Investor return = (222.86 million / 200 million) - 1 = 11.43%.

Question Q-Code: L1-AI-INAI-056

54 The following information is available about a hedge fund:

Initial fund assets	\$200 million
Fund assets at the end of the period (before fees)	\$225 million
Management fee based on assets under management	1%
Incentive fee based on the return	15%
Soft hurdle rate	12%

No deposits to the fund or withdrawals from the fund occurred during the year. Management fees are calculated using end-of-period valuation. Management fees and incentive fees are calculated independently. The net-of-fees return of the investor is *closest* to:

A) 9.5%.
B) 9.67%.
C) 11.5%.

Answer **A)** 9.5%.

Explanation A is correct.

The soft hurdle rate is surpassed, because the return of the fund is 12.50%. For that reason, the full fee, based on the full performance, is due.

Management fee = 225 million * 0.01 = \$2.25 million.

Incentive fee = \$25 million * 0.15 = \$3.75 million.

Total fees = \$6 million.

Fund assets at the end of the period after fees = 225 – 6 = \$219 million.

Return for the investor = 219/200 = 9.5%.

Question Q-Code: L1-AI-INAI-057

55 A hedge fund with an initial value of \$200 million has a management fee of 2% and an incentive fee of 20%. Management and incentive fees are calculated independently using end-of-period valuation. The value must reach the previous high water mark before incentive fees are paid. The table below provides end-of-period fund values over the next three years.

	Fund Value ($ millions)	
Year	**Before Fees**	**After Fees**
1	240	227.2
2	220	215.6
3	250	?

The total amount of fees earned by the hedge fund in Year 3 is *closest* to:

A) \$8.56 million.
B) \$9.56 million.
C) \$11.00 million.

Answer **B)** \$9.56 million.

Explanation B is correct.

Incentive fee is based on the performance relative to the previous high-water mark after fees. Management fee = \$250 million * 0.02 = \$5 million.

Incentive fee = (\$250 million – \$227.2 million) * 0.2 = \$4.56 million.

Total fees = \$5 million + \$4.56 million = \$9.56 million.

Question Q-Code: L1-AI-INAI-058

56 The management fee of a hedge fund that has not yet invested all of its committed capital is *most likely* based on:

A) invested capital.
B) remaining capital.
C) committed capital.

Answer **A)** invested capital.

Explanation A is correct. The management fee of hedge funds is based on invested capital until the committed capital is fully drawn down and invested. This approach is in contrast to private equity funds, for which the management fee is based on committed capital.

Question Q-Code: L1-AI-INAI-059

57 SHM Capital is a hedge fund with \$200 million of initial investment capital. They charge a 3 percent management fee based on assets under management at year-end and a 15 percent incentive fee. In its first year, SHM Capital has a 28 percent return. Assume management fees are calculated using end-of-period valuation.

If the incentive and management fees are calculated independently, the fees earned by SHM is *closest* to:

A) \$7.680 million.
B) \$14.928 million.
C) \$16.080 million.

Answer	**C)** \$16.080 million.
Explanation	C is correct. Value of the fund at the end of year = 200*1.28 = 256 Management fee = \$256 million * 0.03 = \$7.68 million. Incentive fee = (\$256 – \$200) million * 0.15 = \$8.4 million. Total fees to SHM Capital = \$16.08 million.

Question	Q-Code: L1-AI-INAI-060
58	SHM Capital is a hedge fund with $200 million of initial investment capital. They charge a 3 percent management fee based on assets under management at year-end and a 15 percent incentive fee. In its first year, SHM Capital has a 28 percent return. Assume management fees are calculated using end-of-period valuation. What is an investor's effective return if the incentive and management fees are calculated independently? A) 18.46%. B) 19.96%. C) 20.54%.
Answer	**B)** 19.96%.
Explanation	B is correct. Investor return = (\$256 - \$200 - \$16.08) / \$200 = 19.96%.

Question	Q-Code: L1-AI-INAI-061
59	SHM Capital is a hedge fund with $200 million of initial investment capital. They charge a 3 percent management fee based on assets under management at year-end and a 15 percent incentive fee. In its first year, SHM Capital has a 28 percent return. Assume management fees are calculated using end-of-period valuation. If the incentive fee is calculated based on return net of the management fee, the fees earned by SHM is *closest* to: A) $7.68 million. B) $14.93 million. C) $16.08 million.
Answer	**B)** $14.93 million.
Explanation	B is correct. Management fee = \$256 million * 0.03 = \$7.68 million. Incentive fee = (\$256 – \$200 – \$7.68) million * 0.15 = \$7.24 million. Total fees to SHM Capital = $14.928 million.

Question	Q-Code: L1-AI-INAI-062
60	SHM Capital is a hedge fund with $200 million of initial investment capital. They charge a 3 percent management fee based on assets under management at year-end and a 15 percent incentive fee. In its first year, SHM Capital has a 28 percent return. Assume management fees are calculated using end-of-period valuation. What is an investor's effective return if the incentive fee is calculated based on return net of the management fee? A) 18.46%. B) 19.96%. C) 20.54%.
Answer	**C)** 20.54%.
Explanation	C is correct.

Investor's return = (\256 − \$200 − \$14.928)/200 = 20.54%

Question	Q-Code: L1-AI-INAI-063
61	SHM Capital is a hedge fund with \$200 million of initial investment capital. They charge a 3 percent management fee based on assets under management at year-end and a 15 percent incentive fee. In its first year, SHM Capital has a 28 percent return. Assume management fees are calculated using end-of-period valuation. If the fee structure specifies a hurdle rate of 8% percent and the incentive fee is based on returns in excess of the hurdle rate, what are the fees earned by SHM assuming the performance fee is calculated net of the management fee? A) \$12.528 million. B) \$13.680 million. C) \$14.928 million.
Answer	**A)** \$12.528 million.
Explanation	A is correct. Management fee = \$256 million * 0.03 = \$7.68 million. Incentive fee = (\$256 – \$200 – \$16 – \$7.68) million * 0.15 = \$4.848 million. Total fees to SHM Capital = \$12.528 million.

Question	Q-Code: L1-AI-INAI-064
62	SHM Capital is a hedge fund with \$200 million of initial investment capital. They charge a 3 percent management fee based on assets under management at year-end and a 15 percent incentive fee. In its first year, SHM Capital has a 28 percent return. Assume management fees are calculated using end-of-period valuation. If the fee structure specifies a hurdle rate of 8% percent and the incentive fee is based on returns in excess of the hurdle rate, what is an investor's net return? A) 20.54%. B) 21.16%. C) 21.74%.
Answer	**C)** 21.74%.
Explanation	C is correct. Investor's return = (\$256 - \$200 - \$12.528) / \$200 = 21.74%.

Question	Q-Code: L1-AI-INAI-065
63	SHM Capital is a hedge fund with \$200 million of initial investment capital. They charge a 3 percent management fee based on assets under management at year-end and a 15 percent incentive fee. In its first year, SHM Capital has a 28 percent return. Assume management fees are calculated using end-of-period valuation. If the fee structure specifies a hurdle rate of 8% percent and the incentive fee is based on returns in excess of the hurdle rate, what are the fees earned by SHM assuming the incentive and management fees are calculated independently? A) \$12.52 million B) \$13.68 million. C) \$14.92 million.
Answer	**B)** \$13.68 million.
Explanation	Management fee = \$256 million * 0.03 = \$7.68 million. Incentive fee = (\$256 – \$200 – \$16) million * 0.15 = \$6.00 million. Total fees to SHM Capital = \$13.68 million.

Question	Q-Code: L1-AI-INAI-066
64	SHM Capital is a hedge fund with \$200 million of initial investment capital. They charge a 3 percent management fee based on assets under management at year-end and a 15 percent incentive fee. In its first year, SHM Capital has a 28 percent return. Assume management fees are calculated using end-of-period valuation. If the fee structure specifies a hurdle rate of 8% percent and the incentive fee is based on returns in excess of the hurdle rate, what is an investor's net return assuming the incentive and management fees are calculated independently?

A) 20.54%.
B) 21.16%.
C) 22.74%.

Answer	**B)** 21.16%.
Explanation	B is correct. Investor's return = (\$256 - \$200 - \$13.68) / \$200 = 21.16%.

Question	Q-Code: L1-AI-INAI-067
65	SHM Capital is a hedge fund with \$200 million of initial investment capital. They charge a 3 percent management fee based on assets under management at year-end and a 15 percent incentive fee. In its first year, SHM Capital has a 28 percent return. Assume management fees are calculated using end-of-period valuation. In the second year, the fund value declines to \$225 million. In the third year, the fund value increases to \$250 million. If the incentive and management fees are calculated independently, the fees earned by SHM in the second year is *closest* to: A) \$2.10 million. B) \$4.65 million. C) \$6.75 million.
Answer	**C)** \$6.75 million.
Explanation	Management fee = \$225 million * 0.03 = \$6.75 million. No incentive fee because the fund has declined in value. Total fees to SHM Capital = \$6.75 million.