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PRACTICE QUESTIONS

CAIA Exams

L1

CAIA Level I Exam

EDITION	QUESTIONS	FORMAT
Demo	9	Limited Edition PDF

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Before you begin

What this is

9 practice questions for CAIA Exams `L1`, each with its answer key and an explanation. Answer a question before you read its key — the explanation is worth more once you have committed.

If something looks wrong

Send us three things and we will check it:

- the exam code, `L1`
- the question number
- the email address on your order

Write to **support@mometrix.net**. We reply within one business day.

QUESTION 1 SINGLE CHOICE

Which characteristic most clearly distinguishes a fixed-income security from an equity security?

- A Fixed-income securities represent ownership claims on the issuing firm.
- **B Fixed-income securities obligate the issuer to pay a stated schedule of cash flows.**
- C Fixed-income securities always have voting rights attached to each unit.
- D Fixed-income securities are traded exclusively on organized exchanges.

ANSWER **B**

WHY Fixed-income securities are debt instruments with contractual payment obligations (coupons and principal), whereas equities are residual ownership claims. Options A and C describe equity features, and D is false because most fixed-income trading occurs in over-the-counter markets.

QUESTION 2 SINGLE CHOICE

In the context of private equity fund structures, which role is typically held by a limited partner (LP)?

- A The general partner that manages the fund's investments
- **B The investor that commits capital but does not participate in day-to-day management**
- C The investment banker that arranges the fund's leveraged buyouts
- D The portfolio company in which the fund invests

ANSWER **B**

WHY Limited partners are passive investors who commit capital to a private equity fund and do not manage the fund's investments. The general partner (A) manages the fund, while C and D describe other participants in the broader private equity ecosystem.

QUESTION 3 MULTIPLE CHOICE

A portfolio manager assumes investment returns are normally distributed. Which of the following statements about this assumption are accurate? (Choose two.)

- A It implies that extreme returns occur more frequently than they typically do in real financial markets.
- **B Kurtosis of the distribution is exactly 3.**
- C It accurately captures the fat-tailed nature of observed return distributions.
- **D The probability of a return within one standard deviation of the mean is approximately 68 percent.**

ANSWER **B · D**

WHY A normal distribution has kurtosis of exactly 3 (B) and approximately 68 percent of observations fall within one standard deviation of the mean (D). Real return distributions exhibit excess kurtosis (fat tails), so option A is incorrect, and option C contradicts the documented limitation of the normal model.

QUESTION 4 SINGLE CHOICE

Two otherwise identical bonds trade at different prices in two separate markets. Which principle predicts that arbitrageurs will trade until the prices converge?

- A Efficient market hypothesis
- **B Law of one price**
- C Capital asset pricing model
- D Modern portfolio theory

ANSWER **B**

WHY The law of one price states that identical assets must sell for the same price in efficient markets; arbitrageurs exploit price differences and their trading drives prices back together. The EMH (A) is a related but broader hypothesis, while CAPM (C) and MPT (D) address expected returns and portfolio construction, not arbitrage convergence.

QUESTION 5 SINGLE CHOICE

Which of the following is a primary function of a fund of funds (FoF) in alternative investments?

- A To eliminate all investment risk through diversification
- **B To provide investors with access to a diversified set of underlying fund managers**
- C To guarantee a minimum rate of return to limited partners
- D To replace the due diligence responsibilities of the investor entirely

ANSWER **B**

WHY A fund of funds aggregates capital and allocates it across multiple underlying managers, providing diversification across managers and strategies. It does not eliminate risk (A), guarantee returns (C), or replace all investor due diligence (D); the FoF charges an additional layer of fees on top of the underlying funds.

QUESTION 6 MULTIPLE CHOICE

Which of the following hedge fund strategies typically aim to profit from corporate transactions such as mergers, acquisitions, and bankruptcies? (Choose two.)

- **A Merger arbitrage**
- **B Distressed securities investing**
- C Fixed-income arbitrage
- D Long/short equity

ANSWER **A · B**

WHY Merger arbitrage (A) profits from the spread between announced deal price and market price, and distressed securities investing (B) focuses on companies in or near bankruptcy. Fixed-income arbitrage (C) exploits mispricings across related debt instruments, and long/short equity (D) involves equity positions; neither is primarily event-driven.

QUESTION 7 SINGLE CHOICE

An analyst reports that a portfolio has a one-day 99 percent value at risk (VaR) of $2 million. Which interpretation is correct?

- A There is a 99 percent probability that the portfolio will not lose more than $2 million in one day.
- **B There is a 1 percent probability that the portfolio will lose more than $2 million in one day.**
- C The portfolio will lose exactly $2 million tomorrow.
- D The expected daily loss on the portfolio is $2 million.

ANSWER **B**

WHY VaR at the 99 percent confidence level states that losses will exceed the VaR amount only 1 percent of the time. Option A reverses the confidence level, C describes a certainty that VaR does not provide, and D confuses VaR with expected loss.

QUESTION 8 SINGLE CHOICE

Which party in the investment management value chain is primarily responsible for safekeeping an institutional investor's securities?

- A Investment consultant
- **B Custodian**
- C Plan trustee
- D Performance analyst

ANSWER **B**

WHY Custodians are responsible for safekeeping securities, settling trades, and administering corporate actions. Investment consultants (A) advise on manager selection, plan trustees (C) oversee the fund, and performance analysts (D) measure returns and risk.

QUESTION 9 SINGLE CHOICE

According to modern portfolio theory, which combination of assets produces the highest Sharpe ratio on the capital market line?

- A The portfolio consisting entirely of the risk-free asset
- B The minimum-variance portfolio of risky assets
- C **The tangency portfolio of risky assets combined with the risk-free asset**
- D A portfolio of assets with the highest individual standard deviations

ANSWER C

WHY The tangency portfolio is the unique risky portfolio on the efficient frontier that, when combined with the risk-free asset, generates the capital market line with the highest possible Sharpe ratio. The other options do not maximize the risk-adjusted return per unit of risk.