

STUDY HINTS FOR THE LEVEL II CFA EXAM

The Level II CFA exam will be 50% multiple choice and 50% essay. Ethics, Economics, Quantitative Methods, and Financial Statement Analysis will be multiple choice in the form of item sets (a "story" or data set, followed by several multiple choice questions pertaining to the information given in the "story" or data set). Asset Valuation and Portfolio Management (including Real Estate and Derivatives) will be essay questions and problems.

Read the exam rules on page 14 of the CFA Level II Study Guide provided by AIMR. Specifically, note that only two brands of calculators are permitted for the exam: the HP 12C and the TI BAII Plus. Answers to multiple choice questions will be recorded by darkening ovals on answer sheets provided for the exam. **No. 2 or HB pencils with attached erasers must be used to record multiple choice answers.** Erasers that are not attached to pencils are not permitted on the exam. Essay answers are to be written using blue or black ink pens. Answer space will be provided in booklets for each essay. You must write your answers in the space provided to answer each question. It is suggested that you bring several approved pencils and pens to the exam, since none will be provided at the exam site.

The Level II exam is expected to cover a *sampling* of the topics that are included in the reading assignments. The LOS's should be used as a guide to determine what topics are likely to be sampled for inclusion on the exam. New topics, assigned for the first time this year, and topics that have not been previously tested have an above-average probability of appearing on the exam. As a guide to final preparation for the exam, we suggest that you review the following materials in the *Stalla Review for the CFA Exam*:

Ethics (10% of the exam):

The Ethics questions will be in the form of item set multiple-choice questions similar to those found in the three Practice Exams book as well as in some of the Homework problems found in the Ethics section of *Stalla Review for the CFA Exam*.

At Level II, the exam tends to concentrate on Standards IV and V (ET18-46 and ET59-63). Also, pay special attention to some of the articles that are unique to the Level II readings (ET67-81 and ET87-89). If you do the Homework questions found in the Ethics section of the *Stalla Review CFA Exam* and in the *Practice Exams*, you should be sufficiently prepared for the item set multiple-choice questions in Ethics. Reviewing the pages indicated here and doing the Ethics problems provided in the Stalla Seminars texts should lead to a highly successful result in the Ethics portion of the exam.

Quantitative Methods (10% of the exam):

Traditionally, multiple regression and correlation analysis has appeared on the Level II exam. Review Hypothesis Testing, paying special attention to concepts not tested at Level I, such as hypothesis test concerning variances (Q1: 25-37). Also, review simple

regression and correlation (Q1: 38-68). Pay particular attention to pages Q1:55-59 and Q1: 63-68, especially ANOVA tables and how to use them. The material covered on pages Q2: 1-26 has traditionally appeared on the Level II exam, especially Q2:3-14. The probability of having something in this area is high. Q2: 31-56 (Time Series Analysis) is newly added this year and, if tested at all at Level II, the questions are likely to be fairly simple.

Economics (5% of the exam):

The Economics portion of the exam should be relatively easy if you read the assigned material.

- Economic policy issues (EC1-10) is very easy and, if it is on the exam, you should score 100%. If the rest of the exam is hard, AIMR might want to make Economics easy to bolster scores.
- Currency issues on pages EC11-33 is a review of Level I material and, therefore, have a lower probability of being on the exam. Watch out for interest rate parity and covered interest arbitrage, however (EC25-33).
- The parity relationships of EC34-55 is the most important material covered in the Economic readings and, therefore, could be the source of an essay.
- Methods of forecasting currency exchange rates are also a possible source of material for the exam. Review pages EC44-53.
- The article covered on EC56-61 is somewhat outdated, it has been tested in the past and, therefore, has a low probability of being on this year's exam.

Financial Statement Analysis (25% of the exam):

Financial Statement Analysis traditionally has been the hardest part of the Level I exam. If you have done your studying, this topic may be less difficult at Level II because the breadth of topics in this area is relatively small. Nevertheless, some in-depth knowledge of a few subjects is required. Major topics that are likely to be covered in this area are:

- Financial Ratios: Pay attention to pages FS1:3-27. The ratios themselves may be less important because they were tested at Level I. At Level II, interpretation of ratios is likely to be more important than calculating them. Thus, concentrate on what the ratios are supposed to measure and how they should be interpreted.
- Accounting for Intercorporate Investments could be on the test. Pay attention to the examples of the cost and equity methods on FS1:30-36.
- Consolidation: You may be called upon to do a consolidation or a proportionate consolidation. Review the examples on FS1: 38-41.
- Segmented Data: Just be able to answer the LOS on FS1:42.
- Business Combinations: Be prepared to do a purchase/pooling problem. Review the examples on FS1:45-54, especially Purchase Accounting.
- Accounting for Foreign Operations: This is likely to be on the exam. Know the material on FS2:1-23 well.

- Pension Benefits: Stick with the LOS's and you will find that this section may be easier than you may suspect from the readings. The readings are quite detailed, but the LOS's in this area are not. Most of them concentrate on how changes in such factors as the discount rate, wage rate, expected return on assets, and so forth will impact the pension obligation and pension expense.
- Quality of Earnings Analysis: Be prepared to make a few adjustments to a balance sheet, income statement, and cash flow statement. Adjustments that are most likely will be to convert a LIFO balance sheet to FIFO and to adjust for operating leases or take-or-pay contracts. Understand that the adjustment requires that the present value of the lease or contract obligations be added to the balance sheet both as an asset (the right to use the equipment or product) and as a liability (the obligation to pay). Be prepared to adjust an income statement for nonrecurring items, make the associated income tax adjustments, and define normalized earnings and earnings power. Finally, be prepared to make the adjustments to the cash flow statement.
- Know the answers to the LOS's on page FS3:30.

Equity Analysis (15% of exam):

For most candidates, the Equity Analysis portion of the exam should be relatively easy (especially when compared with Fixed Income). Some key points to review include:

- The dividend discount model (EQ1: 3-11).
- The internal growth rate equation (EQ1: 4).
- The DuPont model (EQ1: 13-14).
- Growth models: Know the inverse relationship between payout ratios and growth rates (EQ1: 14-24). Understand the basic growth pattern, usefulness, and limitations of the two-stage, H, and three-stage models.
- The free cash flow to the firm models (constant growth, two-stage, and E-model versions, especially their usefulness, advantages and limitations).
- The free cash flow to common equity models (constant growth and growth versions (two-stage and three-stage).
- You might have to write an essay comparing DDM with FCFCE (see EQ1: 31-36 and EQ1: 43-45).
- Understand basic EVA and MVA, especially pages EQ1: 59-77.
- Understand the LOS's regarding P/E, P/S, and P/B ratios (EQ1: 78-105). Concentrate only on equations in boxes, which primarily relate to the constant growth models.
- The article on EQ1: 106-109 may be the subject of an essay, since it is a topical issue.
- Traditionally, the industry life cycle analysis has been on the Level II exam (EQ2:6-9).
- Financial forecasting is often on the Level II exam (EQ2: 28-35).
- The Porter article (EQ2: 44-54) has often been on the Level II exam in detail, requiring candidates to know the 5 basic competitive forces, the 3 generic

strategies, the "Achilles heel" of each strategy. Memorize some of the lists in this article.

- Understand the factors that determine the size of the marketability discount for closely held companies (EQ2: 77-80) and the control premium (EQ2: 84-87). AIMR emphasized this in its April Bulletin to candidates.
- The impact of leverage (EQ2: 88-96) could be the source of an essay question.
- Review the LOS's on pages EQ2: 97-124.
- Review the article on EQ287-290.

Fixed Income Analysis (13% of the exam):

Fixed income analysis may be one of the harder sections of the exam because the material is detailed and complicated. Furthermore, only a minority of candidates have a working knowledge of this material. Topics that are likely to be covered on the exam include:

- Expect to have a question on how to determine the quality of some kind of bond (F1:1-36). They usually pick one type of bond; but, you never know which one.
- Review Duration and Convexity (F1: 41-58). AIMR emphasized them in its April Bulletin to candidates.
- Spot and Forward Rates (F2: 1-37). Be prepared to do some calculations. However, also be prepared to write an essay explaining the pure expectations theory (and its various interpretations), the biased expectations theory, and the market segmentation theory of the term structure of interest rates. Also be prepared to write an essay covering a topic discussed in the material on (F2:20-37). The question could be on the concept of rolling down the yield curve, the concept of breakeven rates, the effect of liquidity premiums and convexity bias, or how to use these concepts to determine what maturity of bonds to buy or sell.
- You might have to calculate or describe the use of key rate durations (F2:38-39).
- Binomial interest rate trees are very likely to be covered on the exam, since they were not on the exam last year. Most likely, you will be given a binomial interest rate tree with the forward rates and coupons already given for each node of the tree and you will have to calculate the value of the bond at one or more nodes using the backward induction process. Therefore, review the technique on pages F2: 52-68. You may also have to determine when to replace a calculated nodal value with the call or put price. In addition, be able to describe, define, and interpret a static (Z-) spread and an OAS.
- It is likely that you will have to calculate and use effective duration and convexity. Review pages F2: 69.
- Convertible bonds are tested from time to time, but not very often.
- Mortgage passthroughs and CMOs are traditionally on the exam, but not in great detail. Know the basics, especially prepayment risk. Review the LOS's on F3:2-5, F3: 14-16, F3:18-19, F3: 25-29. Note: know the terminology, such as the meaning of a *lockout* period in a credit card-backed security.
- Spread analysis is important (F3: 32-33, F3: 37-39, and F3: 43-45).\
- Structured bonds could be on the exam (F3:57-62).

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Derivative Instruments (12% of the exam):

Traditionally, the derivative instruments portion of the Level II exam has been somewhat difficult. The emphasis has been on valuing various kinds of futures contracts, options, and swaps.

- Be prepared to value a futures contract using the cost-of-carry relationship.
- Be prepared to calculate a cash-and-carry (or reverse cash-and-carry) arbitrage profit.
- Understand why arbitrage valuation models might produce a range of values.
- Normal backwardation and contango (the Hicks-Keynesian analysis) was new material added last year and, therefore, has an above-average probability of being on the exam (DF17-20).
- Expect a simple hedging problem (DF50-65).
- Be prepared to value a call option and/or a put option using a single stage or two-stage binomial model (DO16-20)
- Be able to answer the LOS's on pages DO28-53.
- Understand the inputs to the Black-Scholes model and implied volatility (DO20).
- Know how to value a bond option using the binomial interest rate tree (DO64-67). This is new material added last year and, therefore, has an above-average probability of being on the exam.
- Review the article on pages DO55-56.
- Be prepared to analyze and draw the payoff diagram for one of the strategies discussed on pages DO28-41.
- Review the mimicking examples on pages DO41-47.
- Understand how to employ delta neutral hedges (DO47-50).
- Be able to discuss a simple equity, interest rate, or currency swap. In addition, be able to price and value an interest rate swap (D/A1-18). This is newly added material and has an above-average probability of being on the Level II exam.
- Be prepared for an essay on one of the subjects covered in the LOS's on pages D/A19-31.

Alternative Investments (5% of the exam):

Traditionally, both real estate and venture capital is on the Level II exam.

The real estate portion of the exam has concentrated on:

- Methods of determining the required return on real estate investments (D/A 33-43).
- Methods of valuing real estate properties. Review the example problems on pages D/A45-49.
- Review the LOS's on A/P 1-15.

Portfolio Management (5% of the exam):

There is not much new material in the Portfolio Management section of the Level II exam compared with what you had at Level I. Therefore, this portion of the exam should be relatively easy compared with Fixed Income and Derivative Instruments. Just make sure you can answer the LOS's on pages A/P17-53. Pay particular attention to subjects not covered at Level I, especially A/P36-53.

Good Luck!!