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PRACTICE QUESTIONS

CFA® Program Level I

Alternative Investments: 23 Free Practice Questions

2027 curriculum · 7 readings · answers and full explanations

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Version v2027.3 · October 2026

ABOUT THIS EDITION

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How to use these questions

The 23 free questions on credguild.com for Alternative Investments, 2027 CFA® Program Level I curriculum, each with its answer and full explanation.

- The questions are grouped by topic and reading, in curriculum order. Answers and explanations follow each topic, on a new page, so you can work a topic before you check it.
- Each explanation says why the right answer is right and why each other option is wrong, and names the reading, with a link to its notes.
- At exam pace, 90 seconds a question, a topic of 40 questions takes about an hour.

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If these questions help you, pass the file on to someone else who is studying.

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CFA® PROGRAM LEVEL I · FREE PRACTICE QUESTIONS

Alternative Investments

Questions 1–23 · 7 readings

80 Alternative Investment Features, Methods, and Structures

Question 1

A trustee new to the investment committee of a family foundation asks what sets alternative investments apart as a group. Which statement is *most accurate*?

A They trade in markets that tend to be more efficient than those for listed stocks and bonds.

B They cover investments other than long-only holdings of cash and publicly traded stocks and bonds.

C Their returns tend to be highly correlated with the returns on traditional investments.

Question 2

A large insurer is weighing whether to buy stakes in private companies itself instead of committing money to a private equity fund. Compared with fund investing, direct investing *most likely* offers:

A lower fees.

B broader diversification.

C smaller minimum investment amounts.

Question 3

A foundation holds stakes in both a hedge fund and a private equity fund. The management fee charged by the *hedge fund* is *most likely* calculated as a percentage of:

A assets under management.

B committed capital.

C invested capital.

Question 4

The partnership agreement of Halvorsen Growth Partners provides that, each time a portfolio company is sold, the profit on that sale is split between the general partner and the limited partners immediately, without waiting for the rest of the portfolio to be exited. This arrangement is *best* described as a:

A whole-of-fund waterfall.

B deal-by-deal waterfall.

C clawback provision.

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81 Hurdle Rate

Question 5

Two private equity funds each invested all of their investors' capital at inception and each made a single distribution. Fund Aldgate took in $60 million; at the end of Year 4 it distributed $84 million, and its remaining holdings were then valued at $24 million. Fund Brixton took in $50 million; at the end of Year 8 it distributed $70 million, and its remaining holdings were then valued at $20 million. Which statement is *most* accurate?

A Each fund's MOIC is 1.40, because only distributed capital counts as returned.

B Each fund's MOIC is 1.80, so the two funds earned the same annualized return.

C Each fund's MOIC is 1.80, but Aldgate earned the higher annualized return.

Question 6

Brackwater Credit Partners, a hedge fund whose lockup period has expired for all investors, has a 10-day redemption notice period. It holds a few thinly traded corporate bonds, and each position is a large part of that bond's outstanding issue. In one month two issuers default, the fund's net asset value falls by 12%, its prime broker makes margin calls, and investors ask to redeem 40% of the partnership interests. The *most likely* result is that:

A the 10-day notice period gives the fund enough time to sell 40% of its holdings in an orderly way.

B forced sales are likely to push prices lower, deepen losses and prompt further redemption requests.

C prices received will be largely unaffected, since redemptions are paid only after the notice period.

Question 7

A private equity fund invests $60 million in Ashby Robotics and $40 million in Corran Freight. In the same year, Ashby is sold for $81 million and Corran is liquidated for $34 million. The general partner's carried interest is 20%, profits are distributed under a deal-by-deal (American-style) waterfall, and there is no clawback provision. The limited partners' return on the $100 million, after carried interest, is *closest* to:

A 15.0%.

B 12.0%.

C 10.8%.

82 Mezzanine Financing

Question 8

A private equity firm acquires Ashcombe Textiles in a leveraged buyout. As part of the deal, the firm removes Ashcombe's current executives and installs a leadership team it has recruited from outside the company. This transaction is *best* described as a:

A management buyout.

B management buy-in.

C private investment in public equity.

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Question 9

A private equity fund exits its stake in Norquay Logistics by selling the company to Tidewell Freight, a larger rival in the same industry that expects cost synergies from the deal. This exit is *best* described as a(n):

A secondary sale.

B trade sale.

C initial public offering.

Question 10

To make fair comparisons, a consultant groups private equity funds by vintage year, so that each group holds funds that began putting capital to work under similar market conditions. A fund's vintage year is the year in which it:

A receives its first capital commitment.

B makes its first investment.

C exits its first investment.

83 Real Estate and Infrastructure

Question 11

A pension fund buys a portfolio of commercial mortgage-backed securities. Within the basic four-quadrant classification of real estate investments, this holding is *best* classified as:

A public equity.

B private debt.

C public debt.

Question 12

Which of the following is *least likely* to be classified as social infrastructure?

A Schools.

B Waste treatment facilities.

C Health care facilities.

Question 13

Which type of infrastructure investment typically offers the highest risk and the highest potential return?

A Greenfield.

B Secondary stage.

C Brownfield.

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84 Natural Resources

Question 14

An investor in land-based natural resources wants the most regular annual cash flow. Which of the following is *most likely* to provide it?

A Timberland.

B Farmland.

C Raw land.

Question 15

For a particular commodity, the convenience yield outweighs the storage and financing costs of holding the physical good. In this situation:

A the spot price is below the futures price.

B long-only futures investors see lower returns.

C the forward curve exhibits backwardation.

Question 16

Which of the following is *least likely* to be a benefit of adding commodities to a portfolio of stocks and bonds?

A Current income.

B Diversification.

C Inflation hedge.

85 High Water Mark

Question 17

An adviser makes three claims to a client about hedge funds as a vehicle. Which claim is *least* accurate?

A They are generally offered only to investors who meet accredited, qualified or institutional-investor thresholds.

B Their use of leverage and derivatives can give them a risk and return profile quite unlike that of the assets they hold.

C They are regulated about as heavily as mutual funds, which confines them to a narrow set of permitted strategies.

Question 18

A hedge fund that follows a macro strategy is *most likely* to make which of the following trades?

A Buying the shares of a company that has agreed to be acquired and selling short the acquirer's shares.

B Buying a company's convertible bonds and selling short the same company's common shares.

C Selling a country's currency and its government bond futures ahead of an expected rise in its inflation.

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Question 19

The Northgate Teachers' Pension Plan is choosing between investing in a hedge fund's commingled vehicle and hiring the same manager through a separately managed account (SMA). Which of the following is a drawback of the SMA route?

A Fees that are often negotiated lower than the pooled vehicle charges.

B An investor-specific investment mandate tailored to the plan.

C Weaker alignment of interests, because the manager has no stake in the account.

Question 20

An analyst reviewing a hedge fund index database notes three practices. Each one illustrates a different hedge fund index bias: survivorship bias, backfill bias or selection bias. Which practice is the example of selection bias?

A Two funds running almost identical convertible arbitrage books are placed in different strategy categories by the index provider.

B A fund that suffered heavy losses and closed is removed from the index, and its record no longer appears in the index history.

C A fund joins the index after three strong years, and its returns for those earlier years are added to the index history.

86 Introduction to Digital Assets

Question 21

Two blockchains differ in how new blocks are accepted. On the first, miners compete to solve a cryptographic problem before a block is locked in. On the second, validators pledge some of their own holdings as collateral to vouch for a block, and further validators then confirm it. The two blockchains differ in their:

A network of participants.

B digital ledger.

C consensus protocol.

Question 22

Kestrel Robotics is weighing two ways of raising new capital: a regulated initial public offering (IPO) or an initial coin offering (ICO). Compared with the IPO, the ICO would *most likely* involve:

A a longer capital-raising period.

B more voting rights for investors.

C lower issuance costs.

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Question 23

An investment committee is debating whether to add digital assets to a multi-asset portfolio. Regarding their role as an investment class, which statement is *most accurate*?

A Their returns have historically moved closely with stocks and bonds.

B Their low historical correlations with traditional assets may aid diversification.

C They have behaved as a relatively stable, low-volatility asset class.

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ALTERNATIVE INVESTMENTS

Answers and explanations

Answer key: 1. B · 2. A · 3. A · 4. B · 5. C · 6. B · 7. C · 8. B · 9. B · 10. B · 11. C · 12. B · 13. A · 14. B · 15. C · 16. A · 17. C · 18. C · 19. C · 20. A · 21. C · 22. C · 23. B

Question 1 **Answer: B**

Alternative investments are defined by exclusion: traditional investments are long-only positions in cash and publicly traded stocks and bonds, and everything else is an alternative. The group includes private capital, real assets such as real estate, infrastructure and natural resources, and hedge funds, which may use short positions, leverage and derivatives.

Why the other options are wrong

- **A.** The reverse holds. Markets for some alternatives are thought to be less efficient than public stock and bond markets, which is one reason investors hope to earn higher returns from them.
- **C.** Alternatives are valued for their relatively low correlation with stocks and bonds, which is the source of their diversification benefit. Correlations can rise in periods of stress, but they are not typically high.

Key takeaway Traditional means long-only cash, listed stocks and listed bonds. Anything outside that definition is an alternative investment. Alternatives tend to have relatively low correlation with traditional assets, and some trade in markets that may be less efficient.

Reading 80: Alternative Investment Features, Methods, and Structures. Notes: credguild.com/cfa/level-1/notes/alternative-investments/alternative-investment-features-methods-and-structures/

Question 2 **Answer: A**

Direct investing avoids paying management and performance fees to an outside manager, so its fees are lower. Its drawbacks are less diversification, larger minimum investments and the need for in-house expertise to evaluate deals.

Why the other options are wrong

- **B.** Fund investing gives access to a broader, more diversified pool of assets. A direct investor typically holds fewer, larger positions.
- **C.** Direct deals require larger amounts. In a fund, the cost of each investment is shared with other investors.

Key takeaway Direct investing: lower fees and more control, but less diversification, larger amounts and more expertise needed.

Reading 80: Alternative Investment Features, Methods, and Structures. Notes: credguild.com/cfa/level-1/notes/alternative-investments/alternative-investment-features-methods-and-structures/

Question 3 **Answer: A**

Hedge fund management fees are a percentage of assets under management, typically the fund's net asset value. The private equity fund, by contrast, would charge its management fee on committed capital.

Why the other options are wrong

- **B.** Committed capital is the basis for private equity fund management fees. Hedge funds charge on assets under management.

- **C.** Neither structure normally uses invested capital. Private equity funds use committed capital so the manager is not rewarded for deploying money quickly.

Key takeaway Hedge fund management fee: % of AUM (NAV). Private equity fund management fee: % of committed capital.

Reading 80: Alternative Investment Features, Methods, and Structures. Notes: credguild.com/cfa/level-1/notes/alternative-investments/alternative-investment-features-methods-and-structures/

Question 4 Answer: B

In a deal-by-deal waterfall (American waterfall), profits are distributed as each investment is sold and shared under the partnership agreement. This favors the GP, because performance fees can be paid before LPs have received all of their capital plus the hurdle rate.

Why the other options are wrong

- **A.** In a whole-of-fund (European) waterfall, LPs receive all distributions until they have recovered 100% of their capital plus the hurdle rate, usually after all investments are sold.
- **C.** A clawback provision lets LPs recover incentive fees already paid if later losses reverse earlier gains. It does not describe how each sale is distributed.

Key takeaway American = deal-by-deal (GP-friendly). European = whole-of-fund (LP-friendly).

Reading 80: Alternative Investment Features, Methods, and Structures. Notes: credguild.com/cfa/level-1/notes/alternative-investments/alternative-investment-features-methods-and-structures/

Question 5 Answer: C

The multiple of invested capital (MOIC) divides the total capital returned plus the value of the remaining assets by the total capital paid in. Both funds have a MOIC of 1.80. MOIC ignores the timing of cash flows, however. Aldgate reached 1.80 times its capital in four years and Brixton needed eight, so Aldgate's annualized return (its IRR) is much higher.

$$\text{MOIC} = \frac{\text{capital returned} + \text{value of remaining assets}}{\text{capital paid in}}$$

Aldgate: $(84 + 24)/60 = 1.80$. Brixton: $(70 + 20)/50 = 1.80$.

With one outflow at inception and all value measured at the end of year n, the annualized return (IRR) is $\text{MOIC}^{1/n} - 1$:

Aldgate: $1.80^{1/4} - 1 = 15.8\%$ a year. Brixton: $1.80^{1/8} - 1 = 7.6\%$ a year.

Why the other options are wrong

- **A.** 1.40 counts only the distributions ($84/60$ and $70/50$). MOIC also includes the value of the holdings that have not yet been realized.
- **B.** The MOICs are equal, but MOIC says nothing about how long the capital was tied up. The same multiple earned over four years and over eight years implies annualized returns of 15.8% and 7.6%.

Key takeaway MOIC is simple to compute and interpret but ignores timing; the IRR accounts for when cash flows occur and is the preferred measure when the manager controls that timing.

Reading 81: Alternative Investment Performance and Returns. Notes: credguild.com/cfa/level-1/notes/alternative-investments/hurdle-rate/

Question 6 **Answer: B**

Poor returns trigger redemption requests, and, like margin calls, redemptions can force a fund to sell at unfavorable prices and at bad times. Brackwater must raise cash quickly for both the margin calls and a 40% redemption, while its bonds are thinly traded and its positions are large relative to each issue. Selling them fast will depress their prices further, which lowers the value of the remaining interests and gives other investors a reason to redeem as well.

Why the other options are wrong

- **A.** Notice periods exist so that managers can reduce positions in an orderly way, but 10 days is short for selling 40% of a portfolio of large, thinly traded bond positions, and the margin calls add pressure to sell immediately.
- **C.** The notice period delays the payout, not the selling. The fund still has to sell large, illiquid positions within a short window, and its own sales will push the prices it receives down.

Key takeaway Redemptions after poor performance, like margin calls, can force sales at bad prices. Large, illiquid positions and short notice periods make the damage worse, which is why funds use lockups, notice periods, gates and redemption fees.

Reading 81: Alternative Investment Performance and Returns. Notes: credguild.com/cfa/level-1/notes/alternative-investments/hurdle-rate/

Question 7 **Answer: C**

Under a deal-by-deal waterfall, carried interest is paid on each profitable exit on its own. The GP earns 20% of Ashby's $21 million gain, and Corran's $6 million loss does not reduce that fee. Without a clawback, the limited partners cannot recover the part of the fee that exceeds 20% of the fund's net gain.

Carried interest on Ashby: $0.20 \times (81 - 60) = \$4.2$ million. Corran lost $40 - 34 = \$6$ million, so no fee is paid on it.

Proceeds to LPs: $81 + 34 - 4.2 = \$110.8$ million.

$$\text{LP return} = \frac{110.8}{100} - 1 = 10.8\%$$

Whole-of-fund comparison: net gain $= 115 - 100 = \$15$ million, fee $= \$3.0$ million, LP return $= 112/100 - 1 = 12.0\%$. A clawback would return the $4.2 - 3.0 = \$1.2$ million difference.

Why the other options are wrong

- **A.** 15.0% is the return before any carried interest, $115/100 - 1$. The GP's 20% share of the profit on the Ashby exit must be deducted.
- **B.** 12.0% is the result under a whole-of-fund (European-style) waterfall, or under a deal-by-deal waterfall with a clawback, where the fee is 20% of the $15 million net gain. The fund's terms use a deal-by-deal waterfall with no clawback.

Key takeaway Deal-by-deal: fee on each winning deal, losses ignored. Whole-of-fund: fee on the net gain across all deals. A clawback brings the deal-by-deal result back to the whole-of-fund result.

Reading 81: Alternative Investment Performance and Returns. Notes: credguild.com/cfa/level-1/notes/alternative-investments/hurdle-rate/

Question 8 **Answer: B**

In a management buy-in (MBI), the private equity manager replaces the company's existing management with a new team. In a management buyout, the existing team takes part in the purchase.

Why the other options are wrong

- **A.** In a management buyout, the *existing* management team participates in the purchase and stays on.
- **C.** A PIPE is a minority investment in a company that stays public. It is not a buyout of the whole company.

Key takeaway MBO = existing managers take part in the purchase; MBI = outside managers are brought in.

Reading 82: Investments in Private Capital: Equity and Debt. Notes: credguild.com/cfa/level-1/notes/alternative-investments/mezzanine-financing/

Question 9 **Answer: B**

A trade sale is the sale of a portfolio company to a strategic buyer, such as a competitor, by direct sale or auction. Strategic buyers often pay a premium because of the synergies they expect.

Why the other options are wrong

- **A.** A secondary sale is a sale to another private equity firm or group of financial investors. Tidewell is an operating competitor.
- **C.** An IPO sells some or all of the company's shares to the public.

Key takeaway Sale to a competitor or strategic buyer: trade sale. Sale to another PE firm: secondary sale. Sale to the public: IPO.

Reading 82: Investments in Private Capital: Equity and Debt. Notes: credguild.com/cfa/level-1/notes/alternative-investments/mezzanine-financing/

Question 10 **Answer: B**

The vintage year is the year a private equity or venture capital fund makes its first investment. Commitments may come earlier, because capital that has been committed is not necessarily deployed straight away.

Why the other options are wrong

- **A.** The first commitment can come well before the first investment, because there may be a lag before committed capital is called and invested. Some industry databases date funds by fundraising or first close, but the vintage year that captures the conditions in which capital was deployed is the year of the first investment.
- **C.** Exits happen years later, near the end of the holding period. They do not define the vintage year.

Key takeaway Vintage year = first investment. Compare funds of the same vintage.

Reading 82: Investments in Private Capital: Equity and Debt. Notes: credguild.com/cfa/level-1/notes/alternative-investments/mezzanine-financing/

Question 11 **Answer: C**

Real estate investments are classified as public or private, and as debt or equity. CMBS are traded securities that give a claim on pools of commercial mortgages, so they are public debt.

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Why the other options are wrong

- **A.** Public equity would be shares of an equity REIT or a real estate company, which are ownership claims rather than claims on mortgages.
- **B.** Private debt would be a mortgage or loan held directly. CMBS are traded securities.

Key takeaway Debt vs. equity = lender vs. owner; public vs. private = traded securities vs. privately held interests.

Reading 83: Real Estate and Infrastructure. Notes: credguild.com/cfa/level-1/notes/alternative-investments/real-estate-and-infrastructure/

Question 12 **Answer: B**

Waste treatment facilities are utility assets, which are part of economic infrastructure. Schools and health care facilities are social infrastructure.

Why the other options are wrong

- **A.** Schools are social infrastructure.
- **C.** Health care facilities are social infrastructure.

Key takeaway Utilities (power, gas, water and waste treatment) are economic infrastructure.

Reading 83: Real Estate and Infrastructure. Notes: credguild.com/cfa/level-1/notes/alternative-investments/real-estate-and-infrastructure/

Question 13 **Answer: A**

Because a greenfield asset does not exist yet, its investors face construction risk and uncertainty about future demand, and they are paid for it with the most upside. At the other end, a fully operating secondary-stage facility with an established record of cash flows sits lowest on the risk-return scale. Brownfield assets lie between the two.

Why the other options are wrong

- **B.** Secondary-stage investments are fully operational and generate steady cash flows, so they have the lowest risk-return profile.
- **C.** Brownfield investments involve existing assets. They are riskier than secondary-stage investments but less risky than greenfield.

Key takeaway Risk/return: greenfield > brownfield > secondary stage.

Reading 83: Real Estate and Infrastructure. Notes: credguild.com/cfa/level-1/notes/alternative-investments/real-estate-and-infrastructure/

Question 14 **Answer: B**

Farmland produces income every year from leasing the land or from selling crops, which must be harvested within a short window. It therefore has the steadiest cash flows of the three.

Why the other options are wrong

- **A.** Timberland produces cash flow, but the owner decides when to harvest: it can let the trees keep growing when prices are low. Its cash flows are therefore less regular.

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- **C.** Raw land produces no output to sell. It may earn some lease income, but its return comes mainly from price appreciation, so it offers the least regular cash flow.

Key takeaway Cash-flow steadiness: farmland > timberland > raw land.

Reading 84: Natural Resources. Notes: credguild.com/cfa/level-1/notes/alternative-investments/natural-resources/

Question 15 Answer: C

If the convenience yield is large enough to more than offset storage and financing costs, the net cost of carry is negative and futures prices are below spot prices. This is backwardation. Backwardation raises the returns of long-only investors. The opposite case, where carrying costs dominate, is contango.

Why the other options are wrong

- **A.** A spot price below the futures price is contango, which occurs when carrying costs exceed the benefit of holding the good.
- **B.** Lower returns for long-only investors are a feature of contango. In backwardation, long-only returns are increased.

Key takeaway When the benefit of holding exceeds the carry cost, the market is in backwardation (futures < spot), which helps long-only investors.

Reading 84: Natural Resources. Notes: credguild.com/cfa/level-1/notes/alternative-investments/natural-resources/

Question 16 Answer: A

Holding a commodity produces no current income. Any return comes from price changes realized when it is sold. Commodities do offer diversification (low correlation with stocks and bonds) and an inflation hedge (their prices tend to rise with inflation).

Why the other options are wrong

- **B.** Diversification is a benefit: commodity returns have historically had low correlations with global equities and bonds.
- **C.** An inflation hedge is a benefit: commodity prices generally rise and fall with inflation, so their correlation with it is positive.

Key takeaway Commodities: diversification and inflation hedge, but no income from simply holding them.

Reading 84: Natural Resources. Notes: credguild.com/cfa/level-1/notes/alternative-investments/natural-resources/

Question 17 Answer: C

Hedge funds are private pooled vehicles that face light regulation and give managers wide latitude over strategy, leverage and instruments, so the claim that they are tightly regulated and strategy-constrained is false. The other statements are accurate: access is limited to investors meeting high suitability standards, and although most holdings are liquid stocks and bonds, leverage and derivatives change the fund's risk profile, which is why managing the fund's risk exposure matters.

Why the other options are wrong

- **A.** Accurate. Hedge funds are sold privately to investors who satisfy wealth or sophistication requirements.

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- **B.** Accurate. Leverage and derivatives can make the fund's risk and return behave very differently from the underlying debt and equity positions. For the same reason, owning mostly liquid assets does not make a hedge fund lower risk than, say, a private equity fund.

Key takeaway Hedge funds = private, lightly regulated, flexible. Liquid holdings do not equal low risk once leverage and derivatives are involved.

Reading 85: Hedge Funds. Notes: credguild.com/cfa/level-1/notes/alternative-investments/high-water-mark/

Question 18 Answer: C

Macro strategies belong to the opportunistic group of hedge fund strategies. They take long or short positions in equities, fixed income, currencies or commodities based on global economic trends and events. The view is top-down: a forecast of a country's inflation drives positions in its currency and bond market, not the analysis of a particular company.

Why the other options are wrong

- **A.** Buying a takeover target and shorting the acquirer is merger arbitrage, an event-driven strategy built around a specific corporate transaction.
- **B.** Exploiting price discrepancies between a convertible bond and the issuer's shares is convertible arbitrage, a relative value strategy.

Key takeaway Macro and managed futures are opportunistic strategies driven by economy-wide views; merger arbitrage is event-driven; convertible arbitrage is relative value.

Reading 85: Hedge Funds. Notes: credguild.com/cfa/level-1/notes/alternative-investments/high-water-mark/

Question 19 Answer: C

In an SMA the manager has no stake of its own in the account, so the manager's interests are less closely aligned with the investor's than in a commingled fund, where the manager often invests alongside the investors. Other SMA drawbacks are the heavier operational oversight it requires and the risk of receiving allocations of only the manager's most liquid trades.

Why the other options are wrong

- **A.** Lower negotiated fees are a benefit of an SMA, although the benefit can be offset if the account receives allocations of only the manager's most liquid trades.
- **B.** A more customizable portfolio with an investor-specific investment mandate is one of the main reasons large institutions choose an SMA.

Key takeaway SMA advantages: a portfolio tailored to the investor and often lower negotiated fees. SMA drawbacks: heavier operational oversight, weaker alignment because the manager has no capital at stake, and possibly receiving only the manager's most liquid trades.

Reading 85: Hedge Funds. Notes: credguild.com/cfa/level-1/notes/alternative-investments/high-water-mark/

Question 20 Answer: A

Selection bias arises when index providers assign funds to strategy categories inconsistently, or apply differing rules about which funds are included. Placing two funds with practically the same strategy in different categories is that kind of inconsistent assignment, so the category indexes no longer represent comparable peer groups.

Why the other options are wrong

- **B.** Dropping a failed or non-reporting fund so that its poor results disappear from the index is survivorship bias.
- **C.** Adding a newly included fund's earlier (and usually favorable) track record to the index history is backfill bias.

Key takeaway Survivorship = losers drop out; backfill = winners' history is added; selection = inconsistent classification or inclusion.

Reading 85: Hedge Funds. Notes: credguild.com/cfa/level-1/notes/alternative-investments/high-water-mark/

Question 21 **Answer: C**

A DLT network has three components: the digital ledger, the consensus mechanism and the network of participants. Consensus protocols determine how blocks are validated and chained together. The first chain uses proof of work (miners solve cryptographic problems and earn cryptocurrency), and the second uses proof of stake (validators stake collateral and earn a return on it).

Why the other options are wrong

- **A.** The network of participants determines who may perform network functions. Those functions are open to all users in a permissionless network and restricted in a permissioned one. The network of participants does not set the rule used to validate and add blocks.
- **B.** The digital ledger is the shared, identical record of transactions itself. Proof of work and proof of stake are ways of agreeing on how to update that ledger. They are not ledgers in their own right.

Key takeaway Proof of work and proof of stake are the two main consensus protocols. Miners belong to PoW; validators and staking belong to PoS.

Reading 86: Introduction to Digital Assets. Notes: credguild.com/cfa/level-1/notes/alternative-investments/introduction-to-digital-assets/

Question 22 **Answer: C**

An ICO may be less expensive to issue and may raise capital in less time than a regulated IPO. These are possible advantages, not guaranteed outcomes.

Why the other options are wrong

- **A.** An ICO may raise capital in less time than an IPO, so a longer capital-raising period is the opposite of the expected difference.
- **B.** Most ICOs attach no voting rights to the tokens sold, whereas common shares sold in an IPO normally carry votes. ICO buyers therefore typically get fewer voting rights.

Key takeaway An ICO may be less costly and faster than an IPO; it typically offers fewer investor protections and often no voting rights.

Reading 86: Introduction to Digital Assets. Notes: credguild.com/cfa/level-1/notes/alternative-investments/introduction-to-digital-assets/

Question 23 **Answer: B**

Cryptocurrency returns have historically shown low correlations with traditional asset class returns, so they may provide diversification benefits. The evidence is not conclusive, and correlations can rise in periods of extreme market stress, so the benefit is potential rather than assured.

Why the other options are wrong

- **A.** Returns have not closely tracked traditional asset classes; the low correlations are what make diversification possible. Digital assets have also produced much higher (and more volatile) returns than traditional assets.
- **C.** Digital assets are a new, highly speculative asset class with no clear legal protections, marked by high returns and very high volatility, so they are not a stable asset class.

Key takeaway Crypto offers potential diversification (low historical correlation) but with high volatility, and correlations may rise under stress.

Reading 86: Introduction to Digital Assets. Notes: credguild.com/cfa/level-1/notes/alternative-investments/introduction-to-digital-assets/

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