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PRACTICE QUESTIONS

CFA® Program Level I

Portfolio Construction: 27 Free Practice Questions

2027 curriculum · 6 readings · answers and full explanations

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Version v2027.3 · October 2026

ABOUT THIS EDITION

CredGuild · CFA® Program Level I · Portfolio Construction: 27 Free Practice Questions
2027 curriculum · Version v2027.3 · Generated October 6, 2026

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How to use these questions

The 27 free questions on credguild.com for Portfolio Construction, 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.

On credguild.com the same questions are scored as you answer and your wrong answers are kept for review. A free account answers any of the 3,369 questions in the bank, up to 50 new questions a day: credguild.com/cfa/level-1/practice/

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

Portfolio Construction

Questions 1–27 · 6 readings

87 Modern Portfolio Theory

Question 1

A pension trustee reviews close to a century of capital market history for the United States and other developed markets, comparing equity asset classes with fixed-income asset classes. Relative to fixed-income securities, equities have *most likely* shown:

A higher average annual returns and higher standard deviation of returns.

B lower average annual returns and higher standard deviation of returns.

C higher average annual returns and lower standard deviation of returns.

Question 2

Priya Nair and Tomas Ekberg share the same capital market expectations. Ekberg's risk–return indifference curves are flatter than Nair's. Compared with Nair, Ekberg is *most likely*:

A less risk averse and will choose an optimal portfolio with a higher expected return.

B more risk averse and will choose an optimal portfolio with a higher expected return.

C less risk averse and will choose an optimal portfolio with a lower expected return.

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Question 3

An analyst collects four years of returns for two stocks:

Annual returns on two stocks (%)

Year	Stock P	Stock Q
1	9	14
2	3	6
3	12	10
4	8	10

Using the sample formula, the covariance between the returns of Stock P and Stock Q (in percent squared) is *closest* to:

A

B

C

Question 4

Fund Lark has a standard deviation of returns of 7.4%, and Fund Wren has a standard deviation of returns of 5.2%. The two funds' returns are perfectly positively correlated. If short sales are not allowed, which allocation minimizes the standard deviation of a portfolio of the two funds?

A Lark 0%, Wren 100%.

B Lark 100%, Wren 0%.

C Lark 41%, Wren 59%.

Question 5

Investors can borrow and lend at the risk-free rate, which is below the expected return of every portfolio on the efficient frontier of risky assets, and all investors hold the same expectations about risky assets. A rational, risk-averse investor is *least likely* to choose which of the following as her entire portfolio?

A 100% in the risk-free asset.

B The global minimum-variance portfolio.

C 140% in the optimal risky portfolio, financed by borrowing at the risk-free rate.

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88 Systematic vs Unsystematic Risk

Question 6

An investor combines a risk-free asset with a portfolio of risky assets. Which statement about the new portfolio is *least accurate*?

A Its variance equals the weighted average of the variances of the risk-free asset and the risky portfolio.

B Its expected return is a weighted average of the risk-free rate and the risky portfolio's expected return.

C Its standard deviation equals the risky portfolio's weight multiplied by the risky portfolio's standard deviation.

Question 7

A fixed-income manager holds bonds from many different issuers. After this diversification, the risk from which of the following events is *most likely* to remain in the portfolio?

A A downgrade of one issuer after an accounting scandal.

B A recession that lowers revenues at most companies.

C A fire that shuts the main plant of one issuer.

Question 8

An analyst's CAPM-based expected return for Harwell Mining shares is 2.2 times the 10% return expected on the market portfolio. With a risk-free rate of 4%, the beta of Harwell Mining shares is *closest* to:

A 3.0.

B 2.2.

C 1.8.

Question 9

Denholm Freight shares have a beta of 1.15. The risk-free rate is 2.5% and the expected return on the market is 8.5%. According to the capital asset pricing model, the required return on Denholm shares is *closest* to:

A 12.3%.

B 9.8%.

C 9.4%.

Question 10

About 60% of Mariela Cortez's wealth is in shares of the software company she founded; the rest is in a broad mix of bonds and equity index funds. Which of the following risk-adjusted performance measures is *least appropriate* for evaluating her overall portfolio?

A Sharpe ratio.

B Jensen's alpha.

C M-squared.

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89 Defined Benefit vs Defined Contribution

Question 11

An investor who applies modern portfolio theory in the tradition of Markowitz is deciding whether to add a utility stock to her holdings. She should *most appropriately* judge the stock by:

A its expected return viewed on its own.

B how it would change her portfolio's overall risk and return.

C whether its intrinsic value exceeds its market price.

Question 12

An analyst using a top-down approach is evaluating the outlook for chemical company stocks. Which of the following factors should the analyst examine *first*?

A Return on equity for the chemicals industry.

B The outlook for fiscal policy.

C Competitive risks within the chemicals industry.

Question 13

Shares of the Norcastle Frontier Fund trade on a stock exchange and have been priced at a discount of about 14% to the fund's net asset value per share for several months. Norcastle is *most likely* a(n):

A closed-end fund.

B open-end fund.

C exchange-traded fund.

Question 14

A pooled investment fund buys all of the outstanding shares of a listed industrial manufacturer, removing it from the stock exchange. The fund installs a new executive team and restructures the company's operations, and four years later it sells the company back to the public through an initial public offering. The fund is *most likely* a(n):

A venture capital fund.

B event-driven fund.

C private equity fund.

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90 Basics of Portfolio Planning and Construction

Question 15

An adviser explains to a new client why they should agree on a written investment policy statement (IPS) before any money is invested. Which of the following is *least likely* to be one of the reasons she gives? A written IPS:

A names the individual securities the portfolio will buy first.

B makes the client spell out objectives, circumstances and constraints.

C helps keep return goals realistic given the client's risk tolerance.

Question 16

A client's IPS lists several investment objectives. Which one is a relative return objective?

A Achieve a nominal return of at least 7% per year.

B Keep to 5% the probability of losing more than 7% in any 12-month period.

C Outperform a global equity index by 1.5% per year.

Question 17

Holding everything else constant, which of the following changes would *most likely* reduce a client's ability to take investment risk?

A A sharp rise in near-term spending needs.

B A rise in the client's net worth.

C The purchase of additional insurance coverage.

Question 18

Which of the following is a characteristic of a well-specified set of asset classes for strategic asset allocation?

A Each class groups assets with widely differing risk and expected return.

B Taken together, the classes cover roughly the whole universe the IPS permits.

C Returns of each class are highly correlated with those of the other classes.

Question 19

Which of the following statements about integrating environmental, social and governance (ESG) considerations into portfolio construction is *most* accurate?

A Adding ESG constraints to the investment process will most likely reduce portfolio returns.

B Clients pursuing active ownership must vote their shares themselves instead of through the manager.

C A broad market index is unlikely to be an appropriate benchmark for a negatively screened portfolio.

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91 The Behavioral Biases of Individuals

Question 20

An adviser notes several tendencies in a client's behavior. Which one is *most likely* a cognitive error rather than an emotional bias? The client:

A takes on more risk rather than selling a stock at a loss.

B avoids buying stocks for fear of the regret she would feel if they fell.

C assumes a new company will behave like others it seems to resemble.

Question 21

Which of the following is classified as an information-processing bias?

A Regret aversion.

B Anchoring and adjustment.

C Status quo.

Question 22

Which of the following groups consists *only* of cognitive errors?

A Representativeness, framing, and overconfidence biases.

B Confirmation, anchoring and adjustment, and availability biases.

C Endowment, regret-aversion, and self-control biases.

Question 23

Studies find that many investors hold far fewer securities than traditional portfolio theory would recommend. Which behavioral bias *best* explains this under-diversification?

A Overconfidence.

B Anchoring.

C Fear of regret.

92 Value At Risk

Question 24

Which of the following is *most likely* one of the goals of an organization's risk management process?

A Identifying the risks the organization faces.

B Minimizing the risks the organization faces.

C Eliminating the risks the organization faces.

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Question 25

Which statement about how an organization sets its risk tolerance is *most accurate*?

A The organization's financial strength is one of the factors it should weigh.

B An organization with low risk tolerance should cut every risk it identifies.

C Only risks that come from outside the organization need to be considered.

Question 26

To protect its equity portfolio, the Ashcombe Teachers' Pension Fund buys over-the-counter put options from a single dealer. Over the next quarter, equity prices fall 25% and the puts move deep in the money. Which risk has *most likely* increased the most for the fund as a result of this move?

A Market risk on the equity portfolio.

B Credit risk on the put options.

C Operational risk in the fund's trading.

Question 27

Westbury College buys a flood insurance policy for its campus buildings. For each flood claim, the college pays the first $400,000 of damage itself, and the insurer pays the rest. Which description of this arrangement is *most accurate*?

A Losses of any size are transferred to the insurer, so the college bears no flood risk.

B The policy is a form of risk shifting, because it changes the distribution of the college's outcomes.

C The first $400,000 of each loss is self-insured, and the part above it is transferred.

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PORTFOLIO CONSTRUCTION

Answers and explanations

Answer key: 1. A · 2. A · 3. A · 4. A · 5. B · 6. A · 7. B · 8. A · 9. C · 10. B · 11. B · 12. B · 13. A · 14. C · 15. A · 16. C · 17. A · 18. B · 19. C · 20. C · 21. B · 22. B · 23. A · 24. A · 25. A · 26. B · 27. C

Question 1 **Answer: A**

Long-run data show a positive risk–return tradeoff across asset classes. Both small-cap and large-cap stocks have earned higher average annual returns than long-term corporate and government bonds, and they have done so with a larger standard deviation of returns. Results in other developed markets are similar.

Why the other options are wrong

- **B.** Equities have earned higher average returns than bonds over long periods. The extra return is the reward for their extra volatility.
- **C.** Equities have been more volatile than bonds; higher return with lower risk would contradict the risk–return tradeoff.

Key takeaway Over long periods: more average return has come with more standard deviation (small caps > large caps > bonds > T-bills).

Reading 87: Portfolio Risk and Return: Part I. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/modern-portfolio-theory/

Question 2 **Answer: A**

Flatter indifference curves mean Ekberg requires less extra expected return for each additional unit of risk, so he is less risk averse than Nair. Facing the same set of portfolios, his flatter curve is tangent further out along the frontier (or CAL), so his optimal portfolio has more risk and a higher expected return.

Why the other options are wrong

- **B.** Flatter curves indicate lower risk aversion; a more risk-averse investor has steeper curves.
- **C.** The degree of risk aversion is right, but a less risk-averse investor's tangency point lies further out, at a higher expected return.

Key takeaway Flatter curves mean less risk aversion and an optimal portfolio with more risk and higher expected return.

Reading 87: Portfolio Risk and Return: Part I. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/modern-portfolio-theory/

Question 3 **Answer: A**

Sample covariance is the sum of the products of the two stocks' deviations from their own means, divided by $T - 1$. The products sum to 24 over four observations, so the covariance is $24/3 = 8$.

Means: $\bar{R}_P = (9 + 3 + 12 + 8)/4 = 8\%$; $\bar{R}_Q = (14 + 6 + 10 + 10)/4 = 10\%$

Year	$R_P - \bar{R}_P$	$R_Q - \bar{R}_Q$	Product
1	1	4	4
2	−5	−4	20

Year	$R_P - \bar{R}_P$	$R_Q - \bar{R}_Q$	Product
3	4	0	0
4	0	0	0

$$\text{Cov}_{P,Q} = \frac{4 + 20 + 0 + 0}{4 - 1} = \frac{24}{3} = 8$$

Why the other options are wrong

- **B.** 14 is the sample variance of Stock P $(1 + 25 + 16 + 0)/3$. The question asks for the covariance between P and Q.
- **C.** 24 is the sum of the cross-products before dividing by $T - 1 = 3$.

Key takeaway Covariance: multiply paired deviations, sum, divide by $T - 1$. Don't confuse it with one stock's variance.

Reading 87: Portfolio Risk and Return: Part I. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/modern-portfolio-theory/

Question 4 **Answer: A**

With a correlation of +1 there is no diversification benefit: portfolio standard deviation is just the weighted average of the two funds' standard deviations. The weighted average is lowest when everything is in the fund with the lower standard deviation, Wren (5.2%).

With $\rho = +1$: $\sigma_p = w_L(7.4\%) + w_W(5.2\%)$, a weighted average that is minimized at $w_W = 100\%$, giving $\sigma_p = 5.2\%$.

Why the other options are wrong

- **B.** Putting everything in Lark gives the highest possible portfolio risk (7.4%), because Lark is the more volatile fund.
- **C.** These weights $(w_{Lark} = 5.2/12.6 = 41\%)$ would create a zero-risk portfolio only if the correlation were −1. With $\rho = +1$, this mix has $\sigma_p = 0.41(7.4\%) + 0.59(5.2\%) = 6.1\%$, more than Wren alone.

Key takeaway With perfect positive correlation, hold only the lower-σ asset to minimize risk.

Reading 87: Portfolio Risk and Return: Part I. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/modern-portfolio-theory/

Question 5 **Answer: B**

By the two-fund separation theorem, every investor's optimal portfolio is a combination of the risk-free asset and the optimal risky portfolio, so it lies on the capital allocation line (CAL). Because the risk-free rate is below the frontier's returns, the CAL touches the concave efficient frontier only at the optimal risky portfolio, which lies above the global minimum-variance portfolio; every other risky portfolio, including the global minimum-variance portfolio, plots below the CAL. A mix of the risk-free asset and the optimal risky portfolio with the same standard deviation offers a higher expected return, so the global minimum-variance portfolio is not an optimal choice.

Why the other options are wrong

- **A.** A very risk-averse investor may rationally hold only the risk-free asset, the starting point of the capital allocation line.

- **C.** A less risk-averse investor may rationally borrow to hold more than 100% of her equity in the optimal risky portfolio, a point on the line beyond the risky portfolio.

Key takeaway With a risk-free asset, optimal portfolios lie on the CAL through the optimal risky portfolio; the global minimum-variance portfolio lies below the CAL and is dominated.

Reading 87: Portfolio Risk and Return: Part I. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/modern-portfolio-theory/

Question 6 **Answer: A**

The variance of the new portfolio is $w^2\sigma_P^2$, not $w\sigma_P^2 + (1-w)(0)$. The standard deviation, rather than the variance, is the weighted average of the two assets' standard deviations (zero for the risk-free asset and σ_P for the risky portfolio).

Example with $w = 0.5$, $\sigma_P = 20\%$: variance $= 0.5^2 \times 0.04 = 0.01$ (standard deviation 10%), whereas a weighted average of variances would give $0.5 \times 0.04 = 0.02$ (standard deviation 14.1%).

Why the other options are wrong

- **B.** Accurate: $E(R_C) = wE(R_P) + (1-w)R_f$.
- **C.** Accurate: because the risk-free asset has zero standard deviation and zero covariance with the risky portfolio, $\sigma_C = w\,\sigma_P$.

Key takeaway Standard deviation is linear in the risky weight; variance is not.

Reading 88: Portfolio Risk and Return: Part II. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/systematic-vs-unsystematic-risk/

Question 7 **Answer: B**

A recession is an economy-wide event that affects nearly all issuers at once, so its risk is systematic (market) risk and cannot be diversified away. Holding bonds of many issuers removes only unsystematic risk, which comes from events specific to one issuer.

Why the other options are wrong

- **A.** A downgrade after one issuer's accounting scandal is specific to that issuer. It is unsystematic risk, and its effect on a portfolio of many issuers' bonds is diversified away.
- **C.** A fire at one issuer's plant is a firm-specific event. Holding bonds of many issuers diversifies this unsystematic risk away.

Key takeaway Ask: does the risk come from one issuer or from the whole economy? Issuer-specific = unsystematic, diversified away; economy-wide = systematic, remains.

Reading 88: Portfolio Risk and Return: Part II. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/systematic-vs-unsystematic-risk/

Question 8 **Answer: A**

The CAPM links a stock's expected excess return to the market's expected excess return through beta, so beta can be backed out once both excess returns are known. Harwell's expected return is $2.2 \times 10\% = 22\%$.

$$E(R_i) = R_f + \beta_i[E(R_m) - R_f]$$

$$22\% = 4\% + \beta(10\% - 4\%) \;\Rightarrow\; 18\% = 6\%\,\beta \;\Rightarrow\; \beta = 3.0$$

Why the other options are wrong

- **B.** 2.2 is the multiple of the market's return. That multiple relates total returns, whereas beta relates excess returns over the risk-free rate.
- **C.** 1.8 divides the stock's excess return (18%) by the market's total return (10%) instead of by the market risk premium (6%).

Key takeaway To back out beta: $\beta = [E(R_i) - R_f]/[E(R_m) - R_f]$. Subtract R_f from both returns.

Reading 88: Portfolio Risk and Return: Part II. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/systematic-vs-unsystematic-risk/

Question 9 **Answer: C**

The CAPM adds a beta-adjusted market risk premium to the risk-free rate. The market risk premium is the expected market return minus the risk-free rate, 6.0%.

$$E(R_i) = R_f + \beta_i[E(R_m) - R_f] = 2.5\% + 1.15(8.5\% - 2.5\%) = 2.5\% + 6.9\% = 9.4\%$$

Why the other options are wrong

- **A.** 12.3% multiplies beta by the full market return instead of the market risk premium: $2.5\% + 1.15 \times 8.5\% = 12.3\%$.
- **B.** 9.8% is simply beta times the market return ($1.15 \times 8.5\%$), ignoring the risk-free rate and the premium structure of the CAPM.

Key takeaway CAPM: $E(R_i) = R_f + \beta_i[E(R_m) - R_f]$. Subtract R_f from the market return before multiplying by beta.

Reading 88: Portfolio Risk and Return: Part II. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/systematic-vs-unsystematic-risk/

Question 10 **Answer: B**

Jensen's alpha adjusts for systematic (beta) risk only, which suits a well-diversified portfolio. Cortez's portfolio is dominated by one stock and carries a large amount of unsystematic risk, so a measure based on total risk is needed.

Why the other options are wrong

- **A.** The Sharpe ratio uses standard deviation (total risk), so it captures her large firm-specific risk and is appropriate for a concentrated portfolio.
- **C.** M-squared is derived from the Sharpe ratio and also uses total risk, so it remains suitable when the portfolio is concentrated in one holding.

Key takeaway Use total-risk measures (Sharpe, M²) for a concentrated portfolio and beta-based measures (Treynor, Jensen's alpha) for a well-diversified one.

Reading 88: Portfolio Risk and Return: Part II. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/systematic-vs-unsystematic-risk/

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Question 11 **Answer: B**

Markowitz's framework, the basis of modern portfolio theory, evaluates an investment by its effect on the risk and expected return of the portfolio as a whole. Because risk that can be diversified away is not rewarded, how the asset interacts with existing holdings matters more than its standalone characteristics.

Why the other options are wrong

- **A.** Looking only at expected return ignores risk and ignores how the stock combines with the rest of the portfolio.
- **C.** Comparing intrinsic value with market price is standalone security valuation (bottom-up analysis). The Markowitz framework calls for a portfolio-level evaluation.

Key takeaway Modern portfolio theory: no asset is judged in isolation.

Reading 89: Portfolio Management: An Overview. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/defined-benefit-vs-defined-contribution/

Question 12 **Answer: B**

A top-down approach moves from the broad economy to industries and only then to individual companies. Fiscal policy (government spending and taxation) is a macroeconomic influence, so it is assessed before any industry-level factor.

Why the other options are wrong

- **A.** Industry return on equity is an industry-level factor. In a top-down sequence it is analyzed after the macroeconomic environment.
- **C.** Industry risks are also assessed at the industry stage, after the macroeconomic analysis.

Key takeaway Top-down order: the economy first (e.g., GDP growth, inflation, interest rates, fiscal and monetary policy), then the industry, then the company.

Reading 89: Portfolio Management: An Overview. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/defined-benefit-vs-defined-contribution/

Question 13 **Answer: A**

Closed-end fund shares trade in the market at prices set by supply and demand for the shares, so they can sit at a large and persistent premium or discount to NAV.

Why the other options are wrong

- **B.** Open-end fund shares are bought from and redeemed by the fund at NAV, so they cannot trade at a discount to NAV (and they do not trade on an exchange).
- **C.** An ETF's special redemption provisions let arbitrageurs profit from any gap between price and NAV, which keeps ETF prices very close to NAV; a 14% gap lasting months is inconsistent with an ETF.

Key takeaway A large, lasting premium or discount to NAV points to a closed-end fund.

Reading 89: Portfolio Management: An Overview. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/defined-benefit-vs-defined-contribution/

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Question 14 **Answer: C**

A private equity (buyout) fund acquires entire companies, often public ones that it takes private, restructures them to increase their value and cash flow, and exits after a few years, for example through an IPO.

Why the other options are wrong

- **A.** Venture capital funds invest in start-up companies. An established listed manufacturer is not a venture capital target.
- **B.** An event-driven fund is a hedge fund strategy that trades around corporate events such as mergers and acquisitions; it does not buy and run whole companies.

Key takeaway Take private + restructure + exit via IPO = private equity (buyout) fund.

Reading 89: Portfolio Management: An Overview. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/defined-benefit-vs-defined-contribution/

Question 15 **Answer: A**

An IPS works at the level of objectives, constraints, strategy and benchmark. It does not go down to the choice of particular securities, which is a later, implementation decision within the policy the IPS sets.

Why the other options are wrong

- **B.** Forcing the client to articulate needs, circumstances and constraints is a central purpose of a written IPS; it imposes discipline on both parties.
- **C.** The IPS makes the client reconcile return expectations with risk tolerance, so it does help keep goals realistic and makes the risks of investing explicit.

Key takeaway The IPS is the starting point of the portfolio management process. It sets policy; security selection comes later.

Reading 90: Basics of Portfolio Planning and Construction. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/basics-of-portfolio-planning-and-construction/

Question 16 **Answer: C**

A return objective is relative when it is expressed against a benchmark, such as an index or a portfolio. Beating a global equity index by a stated margin is therefore a relative return objective.

Why the other options are wrong

- **A.** A specific numerical outcome (7% nominal) is an absolute return objective.
- **B.** A probability statement about losses is a risk objective. Because it refers to a loss threshold rather than a benchmark it is an absolute risk objective. Stating something in probability terms does not make it relative.

Key takeaway Relative = measured against a benchmark. Numerical targets are absolute; probability-of-loss statements are risk objectives (absolute unless tied to a benchmark).

Reading 90: Basics of Portfolio Planning and Construction. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/basics-of-portfolio-planning-and-construction/

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Question 17 **Answer: A**

Ability (capacity) to bear risk depends on financial circumstances. Large near-term spending needs are a fixed obligation the portfolio must reliably fund, so the client can afford less uncertainty and the ability to take risk falls.

Why the other options are wrong

- **B.** Greater wealth relative to needs and liabilities increases the ability to take risk.
- **C.** More insurance protects against unexpected events and so increases the ability to take investment risk.

Key takeaway Wealth, insurance, a long horizon and a secure job raise the ability to bear risk; large spending needs and dependents lower it.

Reading 90: Basics of Portfolio Planning and Construction. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/basics-of-portfolio-planning-and-construction/

Question 18 **Answer: B**

Properly specified asset classes, taken as a group, should approximate the universe of permissible investments set out in the IPS.

Why the other options are wrong

- **A.** Assets within a class should have similar risk and return characteristics, with high correlation within the class.
- **C.** Correlations between asset classes should be low, so that allocating across classes provides diversification.

Key takeaway Good asset classes: homogeneous inside, low correlation across, and together they span the permitted universe.

Reading 90: Basics of Portfolio Planning and Construction. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/basics-of-portfolio-planning-and-construction/

Question 19 **Answer: C**

When negative screening removes companies or industries from the investment universe, a broad market index no longer reflects what the manager could hold. A more appropriate benchmark is an index that also excludes the companies or industries such investors commonly avoid.

Why the other options are wrong

- **A.** The effect of ESG constraints on returns is uncertain: a narrower universe and research costs may reduce returns, but good governance and avoiding ESG-related risks may increase them.
- **B.** Investors using engagement/active ownership may vote their shares themselves or direct the manager to vote according to specified ESG factors; either is possible, and the point is to clarify which.

Key takeaway A negatively screened portfolio is better judged against a benchmark that excludes the same companies; ESG effect on returns is uncertain; active ownership voting can be done by the client or delegated.

Reading 90: Basics of Portfolio Planning and Construction. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/basics-of-portfolio-planning-and-construction/

credguild.com

Question 20 **Answer: C**

Classifying something by a few features and assuming it will share the characteristics of that category is representativeness bias, a belief perseverance bias and therefore a cognitive error.

Why the other options are wrong

- **A.** Taking extra risk to avoid realizing a loss is loss-aversion bias, an emotional bias.
- **B.** Inaction driven by fear of regretting a wrong decision is regret-aversion bias, an emotional bias.

Key takeaway Representativeness (categorizing) is cognitive; loss aversion and regret aversion are emotional.

Reading 91: The Behavioral Biases of Individuals. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/the-behavioral-biases-of-individuals/

Question 21 **Answer: B**

Anchoring and adjustment is a cognitive error in the information-processing group: an initial number is used as an anchor and adjusted too little as new information arrives.

Why the other options are wrong

- **A.** Regret aversion is an emotional bias.
- **C.** Status quo bias is an emotional bias.

Key takeaway Information-processing biases: anchoring and adjustment, mental accounting, framing, availability. By contrast, loss aversion, status quo and regret aversion are emotional biases.

Reading 91: The Behavioral Biases of Individuals. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/the-behavioral-biases-of-individuals/

Question 22 **Answer: B**

Confirmation bias is a belief perseverance bias, and anchoring and adjustment and availability are information-processing biases. All three are therefore cognitive errors.

Why the other options are wrong

- **A.** Representativeness and framing are cognitive errors, but overconfidence is classified as an emotional bias.
- **C.** Endowment, regret-aversion and self-control biases are all emotional biases.

Key takeaway Cognitive = belief perseverance (conservatism, confirmation, representativeness, illusion of control, hindsight) + information processing (anchoring and adjustment, mental accounting, framing, availability). The six emotional biases are loss aversion, overconfidence, self-control, status quo, endowment and regret aversion.

Reading 91: The Behavioral Biases of Individuals. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/the-behavioral-biases-of-individuals/

Question 23 **Answer: A**

Overconfidence leads investors to overestimate their knowledge and underestimate risk, which results in overtrading and insufficient diversification.

Why the other options are wrong

- **B.** Anchoring may cause investors to treat recent highs as rational prices even as prices fall; it is not the usual explanation for under-diversification.
- **C.** Fear of regret (of missing gains) may keep skeptical investors in an overvalued market; it does not explain holding too few securities.

Key takeaway Under-diversification, overtrading and underestimating risk are hallmarks of overconfidence.

Reading 91: The Behavioral Biases of Individuals. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/the-behavioral-biases-of-individuals/

Question 24 **Answer: A**

The risk management process identifies the organization's risk tolerance, identifies and measures the risks it faces, and then modifies and monitors those risks. Its aim is the optimal bundle of risks rather than the smallest possible amount of risk.

Why the other options are wrong

- **B.** Minimizing risk is not the goal. Returns above the risk-free rate require bearing risk, and an organization may deliberately increase risks it manages well.
- **C.** Eliminating all risk would also eliminate the returns that come from bearing it; risk management keeps the risks that fit the organization's tolerance and goals.

Key takeaway Risk management chooses which risks to bear; it does not try to avoid all risk.

Reading 92: Introduction to Risk Management. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/value-at-risk/

Question 25 **Answer: A**

Financial strength matters since it indicates how large a loss the organization can absorb. Other factors are its expertise in its lines of business, its skill at responding to negative outside events and its regulatory environment.

Why the other options are wrong

- **B.** Even with low risk tolerance, an organization may choose to keep some risks that fit its objectives; risk management does not aim to reduce every risk.
- **C.** Risk tolerance must reflect risks arising inside the organization as well as those arising outside it.

Key takeaway Risk tolerance depends on expertise, response skill, regulation and financial strength, and covers internal and external risks.

Reading 92: Introduction to Risk Management. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/value-at-risk/

Question 26 **Answer: B**

Risks interact. The puts reduced the fund's market risk, but after the fall the dealer owes the fund a large payment on them. If the dealer fails to pay, the fund loses the protection it bought just when it needs it, so its credit (counterparty) risk has grown with the value of the puts.

Why the other options are wrong

- **A.** The puts were bought to offset losses on the equities, and their gains now cushion the fall. The decline has moved exposure from the market to the dealer.

- **C.** Operational risk comes from human error, faulty processes, poor security or business interruptions. Nothing in the market move changes the fund's internal processes.

Key takeaway Hedging market risk with OTC derivatives creates counterparty credit risk, and that credit risk grows as the hedge gains value.

Reading 92: Introduction to Risk Management. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/value-at-risk/

Question 27 **Answer: C**

Insurance is a form of risk transfer: the insurer takes on the losses it covers in return for premiums. Because the college pays the first $400,000 of every claim, it bears that layer of each loss itself, which is self-insurance. The arrangement therefore combines risk transfer with self-insurance.

Why the other options are wrong

- **A.** The deductible means the college still bears every loss up to $400,000, so it keeps part of its flood risk.
- **B.** Risk shifting changes the distribution of outcomes mainly through derivative contracts, such as forwards, swaps or options. Buying insurance is classified as risk transfer.

Key takeaway Insurance transfers risk; a deductible is a layer of self-insurance; derivatives used to alter outcomes are risk shifting.

Reading 92: Introduction to Risk Management. Notes: credguild.com/cfa/level-1/notes/portfolio-construction/value-at-risk/

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