Level III of the CFA® Exam

Item-Set Questions - Asset Allocation

Offered by AnalystPrep

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Table of Contents

1	-	Boyle Thomas	3
2	-	Chris McCeary	7
3	-	Dianne Fernandez	11
4	-	Earl Webber	15
5	-	Larry Winer	18
6	-	Monica Garza	21
3	-	Claire Dell	24
4	-	Richard Dennehy	28
5	-	Jonathan Rockford	32
6	-	Margaret Jones	35
7	-	Mary Whitman	38
8	-	Sanjay Khalsa	41
7	-	Gareth Jeffries	44
8	-	Haley Seabrook	47
9	-	Mark Bernardis	50
10	-	Martin Feuerstein	53
11	-	Simrita Singh	56
12	-	Ursula Drew and David Garnett	59
13	-	Julius Foster	62

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Case 1: Boyle Thomas

Boyle Thomas, CFA, is meeting with his client, Susan Winger, to plan her asset allocation and investment plan. Winger will turn 55 next month and is planning to retire at 60. Winger is meeting Thomas to understand if her financial assets of $25 million are sufficient to fund her lifetime, charity, and bequest goals. Her current spending is $500,000 per year, and her income as an executive of an investment firm covers her spending. Her goals are as follows:

Goal 1: "Maintain her current lifestyle until her death. Her family has a history of living longer, and her life expectancy is ~85 years. She wants to meet this with 99% success for the next 15 years from when she reties. And 95% for the subsequent 10 years."

Goal 2: "She wants to bequeath at least $5 million to her son when he turns 35 in 10 years after retirement. She wants to be able to do this with 95% success."

Goal 3: "She also wants to donate to charity 15 years after retirement, but that is a wish list, and she assigns a success rate of 75%. Thomas recommends keeping aside 1/3rd of the portfolio for emergency needs, longevity risk, and to cover for any adverse portfolio decline."

Thomas's firm offers the following sub-portfolio modules for goal-based planning for clients. All returns are after-tax and nominal. Inflation of 2% is assumed for the next 30 years.

Portfolio	**A**	**B**	**C**	**D**
Return	4.3%	5.5%	6.4%	8.0%
Risk	2.7%	4.5%	6.0%	10.0%

Annual minimum expectation returns with varied probabilistic success and time horizons for the above portfolios are as below:

Time horizon - 15 years	**A**	**B**	**C**	**D**
99% success	1.5%	0.9%	0.2%	-2.4%
95% success	2.3%	2.2%	2.0%	0.7%
80% success	2.7%	3.0%	3.0%	2.3%
75% success	3.5%	4.2%	4.6%	5.0%

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Time horizon - 20 years	A	B	C	D
99% success	2.3%	2.2%	2.0%	0.7%
95% success	3.2%	3.7%	4.0%	4.0%
85% success	3.7%	4.6%	5.1%	5.9%
75% success	4.1%	5.2%	5.9%	7.2%

Time horizon - 25 years	A	B	C	D
99% success	2.8%	2.7%	2.5%	3.5%
95% success	3.3%	4.0%	4.3%	4.5%
85% success	3.9%	4.8%	5.3%	6.0%
75% success	4.2%	5.3%	6.1%	7.6%

Time horizon - 30 years	A	B	C	D
99% success	3.3%	3.9%	4.0%	4.5%
95% success	3.5%	4.3%	4.8%	5.2%
85% success	4.0%	5.0%	5.7%	6.3%
75% success	4.5%	5.5%	6.5%	8.0%

Winger then asks Thomas about the risk budgeting and risk parity approach to asset allocation.

Thomas comments on Risk budgeting and risk parity:

Comment 1: "Risk budgeting not only considers the volatility of each asset but also the asset's correlation with other portfolio assets."

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Comment 2: "A risk budget is optimal when the ratio of excess return to absolute contribution to total risk is equal for all assets."

Comment 3: "Risk parity is an approach to achieve asset allocation such that each asset's Marginal Contribution to Risk is equal."

Comment 4: "Criticism of the risk parity approach is that it makes the opposite mistake to the MVO approach."

Q.1 For Winger's lifestyle goals for the first 15 years of retirement and the subsequent 10 years, the proportionate amount and in what sub-portfolio that Thomas is to allocate is *closest* to:

A. $5,765,874 in Portfolio A and $1,249,191 in Portfolio D

B. $7,240,868 in Portfolio A and $2,354,500 in Portfolio D

C. $7,957,354 in Portfolio B and $3,499,591 in Portfolio C

Q.2 The amount of money that would be put into the bequest to Winger's son and in the *most likely* portfolio is:

A. $1,971,721 in Portfolio C

B. $2,239,665 in Portfolio B

C. $3,554,966 in Portfolio A

Q.3 The total amount that Winger will donate to charity 15 years after her retirement is *closest* to:

A. $8,229,202

B. $12,458,548

C. $20,169,041

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Q.4 If Winger adjusts her donation goal to $5 million and increases the amount to his son's bequest, the amount she will be able to bequeath is *closest* to:

A. $7,611,518

B. $11,830,967

C. $13,940,692

Q.5 Which of Thomas's comments on risk budgeting is (are) *most accurate*?

A. Comment 1

B. Comment 2

C. Both Comments 1 and 2

Q.6 Which of Thomas's comments on the risk parity approach is (are) *most accurate*?

A. Comment 3

B. Comment 4

C. Both Comments 3 and 4

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Case 2: Chris McCeary

Chris McCeary is the chief economist at Indigo Investment Management (IIM), asset management and financial advisory firm in the USA. McCeary works with research analysts in the firm's research department, including statisticians, portfolio managers, financial analysts, and economists. McCeary is currently performing a country analysis of Russia and Brazil, both emerging market economies considered by IIM as attractive inclusions to their emerging markets fund. After his comprehensive analysis of the countries, McCeary made the following recommendations for each country:

Russia: During the past year and a half, businesses in Russia have been increasing production and have seen a significant rise in sales and profits. They have been building inventories to meet sales, so that, until recently, the inventories reached a significant high level relative to Russia's historical inventory levels. Given such a positive outlook, I believe we should invest in cyclical stocks in Russia, as they would gain the most from such changes.

Brazil: Brazil's inventory to sales ratio has moved significantly after following a falling trend for the past fourteen months. In addition, interest rates are low, and unemployment is high in the country. I believe this is a point of economic weakness, so investing in stocks would be a bad choice.

McCeary has been assigned the task of analyzing the economic scenario of Japan, one of the major developed economies in the world. During his analysis, McCeary discovered that asset prices in the country had fallen considerably, as measured using consumer price indices. Also, the interest rates in the Japanese economy lie in the range of 0.88%-1.0%. McCeary is not sure how this scenario can affect the Japanese economy.

After completing his country analysis of Japan, McCeary met with Liz Radley, a research analyst at IIM. During a conversation with McCeary, Radley mentioned using the Taylor rule to predict a country's central bank's behavior. She stated that since the rule could provide a reasonably accurate description of the central bank's stance, she is using it to predict the optimal short-term interest rate for the U.S. over her forecast period. Exhibit 1 presents some information she gathered over her forecast horizon.

Exhibit 1 U.S. Economic Information

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The short-term interest rate when GDP growth is on trend and inflation on target	4.5%
The current short-term interest rate	5.0%
The inflation target	3.0%
The GDP trend rate	3.75%
Inflation forecast	4.5%
Historical inflation	4.75%
GDP forecast	2.5%

As their conversation continued, McCeary made the following comments to Radley:

Statement 1: “ Two years ago, the U.S. economy went through a slowdown as unemployment increased and the economy saw a large decline in business investment. However, during the same period, the U.S. budget deficit rose because tax revenues fell and government spending on unemployment benefits increased. This served as a stimulus to the economy, which caused it to revive in a year.”

Statement 2: “ The fiscal and monetary policies of a government can affect the yield curve. If both policies are expansive, the yield curve is steep. If both are tight, the yield curve is inverted. However, if one is tight and the other is loose, the yield curve tends to be flat.”

McCeary has invested his portfolio in diversified Mexican stocks. However, he is unsure how his investment will perform in the coming years. As part of his assessment of the Mexican economy, McCeary gathered the following information::

1. The Mexican government has been running a budget deficit for the past few years, and the deficit has increased over the last two years.
2. The Mexican labor market is subject to rules and regulations governing the hiring and firing of employees.
3. The Mexican government has reduced trade tariffs and barriers, which has increased competition and reduced stock market valuations in the country.

In addition, as part of the country risk analysis of Mexico, McCeary gathered the following information:

1. The ratio of the fiscal and current account deficit to GDP has persistently been above 4%.
2. The ratio of debt to current account receipts is above 200% and the ratio of reserves to short-term debt is below 100%.

McCeary will use this information to assess the risks of investing in the country's capital

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markets.

Q.1 With regards to Brazil and Russia, McCeary's recommendations are *most accurate* in the following areas:

A. Russia only.

B. Both Brazil and Russia.

C. Neither Brazil nor Russia.

Q.2 The economic scenario in Japan is *most likely* a threat to the economy because it:

A. Tends to undermine debt-financed investments.

B. Negatively affects commodity-producing businesses.

C. Threatens a recession

Q.3 Using Exhibit 1, the optimal short-term interest rate in the U.S. is *closest* to:

A. 4.750%

B. 6.25%.

C. 9.125%

Q.4 McCeary is *most accurate* concerning:

A. Statement 1 only.

B. Statement 2 only.

C. Neither Statement 1 nor Statement 2.

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Q.5 Which of the above points regarding the Mexican economy *most likely* boosts trend growth in the country?

A. Point 3 only.

B. Points 1 and 2 only.

C. Points 2 and 3 only.

Q.6 Which of the above points regarding the country risk analysis of the Mexican economy *most likely* indicates high risk?

A. Point 1 only.

B. Point 2 only.

C. Both points 1 and 2.

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