Level II of the CFA® Exam

Mock Questions with Answers - Mock Exam 2025 #1- First Session

Offered by AnalystPrep

Last Updated: Feb 28, 2025

Case 1: Bane Investments Company

Bane Investments Company is a mid-sized investment firm that has adopted the CFA Institute's Code of Ethics and Standards of Professional Conduct but does not currently claim compliance with the Global Investment Performance Standards (GIPS). Several of Bane's employees are CFA charter holders or candidates registered to write CFA exams.

Jacqueline Hendrix, one of Bane's equity analysts and a Level III Candidate in the CFA Program, notes that she recently promised representatives of a prospective investment banking client that she would provide full research coverage of its stock if they agreed to have Bane underwrite their forthcoming initial public offering (IPO).

Hendrix later shares that she felt uncomfortable when she was recently asked by her supervisor, Bane's Director of Research, to issue an updated recommendation on shares of Shetland Oilfield Services (SOS), which she has covered for several years. SOS recently reported quarterly earnings that fell below most analysts' estimates, including Hendrix's. After analyzing the most current information over two days, Hendrix concluded that the market had overreacted to this negative news, and the company's shares were trading at a price below their intrinsic value. She issued a revised report on SOS stock that included a buy recommendation. Bane's dealers later sold clients some of the SOS shares the firm had been holding as inventory.

Bane's chief compliance officer Emily Chowda, CFA, calls a meeting with staff to outline the importance of proper communication with prospective clients. Chowda opens the discussion by asking participants to share their recent experiences. Leslie Barnhill, an analyst and Level I candidate in the CFA Program, makes the following statement:

“While I point out to clients that they will not lose money if they remain invested in equities for the long run, I never guarantee a specific return.;

Hendrix reveals that she receives part of her compensation in the form of a quarterly performance bonus based on the accuracy of her recommendations and that she has never disclosed the nature of this arrangement to current or prospective clients.

Barnhill mentions that she recently gave a presentation to prospective clients using materials that the company's public relations department had prepared. Among the materials, she

discussed in this presentation was a slide with a graph showing the returns of Bane's composites over the past four years. Before giving the presentation, Barnhill noticed that the slide in question used to return data for years 1 and 2 based on the ten accounts that were included in the composite at that time. At the end of Year 2, one of these accounts was terminated, and the return data presented for Years 3 and 4 were based on the performance of the nine accounts that remained in the composite for the entire period. The change in the composite was disclosed in a footnote at the bottom of the slide. Barnhill revealed that she reviewed the slide before giving her presentation and used it after deciding that no changes were necessary.

Barnhill also notes that she is preparing a separate presentation for prospective clients that includes a section that summarizes the performance that a model portfolio would have achieved on a gross-of-fees basis over the past five years if it had been managed following her proposed strategy. The fact that these gross-of-fee returns are simulated is disclosed in a footnote at the bottom of the slide.

Q.2 Is Barnhill's statement about investment returns *most likely* consistent with the Standards?

A. Yes, because she does not guarantee a specific return

B. No, this statement violates the Standards concerning misrepresentation

C. No, this statement violates the Standards with respect to additional compensation arrangements

The correct answer is **B.**

According to Standard I(C) - Misrepresentation, members and candidates are prohibited from guaranteeing a specific return on a risky asset or otherwise misleading investors about potential returns. Similarly, while historical data shows that equities have generally provided positive returns over the long-run, there is no basis for assuring investors that they" "will not lose money" on equity investments over any given period in the future. Therefore, Barnhill has violated this Standard by making this statement to clients.

Standard IV(B) - Additional Compensation Arrangements requires members and candidates to refrain from accepting any compensation for work that could reasonably be expected to conflict with their '" employer's interests without first receiving written approval from all parties. The standard is not relevant on this occasion.

CFA Level II, Learning Module 48: Guidance for Standards I-VII, LOS 48(a): demonstrate a thorough knowledge of the CFA Institute Code of Ethics and Standards of Professional Conduct by applying the Code and Standards to specific situations.

Q.1 By issuing a report recommending that investors purchase SOS stock, has Hendrix *most likely* violated the Standards'

A. No

B. Yes, with respect to independence and objectivity

C. Yes, with respect to diligence and reasonable basis

The correct answer is **A.**

Hendrix has adhered to the Standards in recommending SOS stock. Although Bane's dealers sold SOS shares to clients, there is no indication that Hendrix's research was influenced by, for example, pressure from within her firm or any source that could reasonably be expected to compromise her independence. Her research appears consistent with Standard I(B) - Independence and Objectivity. While it is not unusual for senior research personnel to ask subordinates to issue an updated recommendation in light of new information, such an update need not be negative.

Similarly, there is no evidence that Hendrix violated Standard V (A) - Diligence and Reasonable Basis, which requires members and candidates to exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions. Hendrix took two days to analyze the most recent information about a stock that she has covered for several years before issuing an updated recommendation.

CFA Level II, Learning Module 48: Guidance for Standards I-VII, LOS 48(a): demonstrate a thorough knowledge of the CFA Institute Code of Ethics and Standards of Professional Conduct by applying the Code and Standards to specific situations

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Q.4 If Barnhill presents the slide summarizing the five-year returns of the model portfolio as it currently appears, will she have most likely violated Standard III (D) - Performance Presentation?

A. No.

B. Yes, by presenting simulated returns.

C. Yes, by presenting gross of fees returns.

The correct answer is **A.**

Standard III (D) - Performance Presentation does not prohibit the presentation of returns that are simulated or stated on a gross-of-fees basis *provided that* this information has been appropriately disclosed.

CFA Level II, Learning Module 48: Guidance for Standards I-VII, LOS 48(a): demonstrate a thorough knowledge of the CFA Institute Code of Ethics and Standards of Professional Conduct by applying the Code and Standards to specific situations

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Q.3 By not disclosing the nature of her compensation arrangement to current and prospective clients, has Hendrix *most likely* violated the Standards'

A. No

B. Yes, with respect to the disclosure of conflicts

C. Yes, with respect to loyalty, prudence, and care

The correct answer is **A.**

Standard VI(A) - Disclosure of Conflicts requires members and candidates to make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity. The recommended procedures for compliance with this Standard advise members and candidates to “disclose special compensation arrangements with the employer that might conflict with client interests, such as bonuses based on short-term performance criteria, commissions, incentive fees, performance fees, and referral fees”. In this example, Hendrix is receiving a quarterly bonus, which could be considered as compensation for short-term performance. However, this bonus is based on the accuracy of her forecasts, so she is not being incentivized to act in a manner that conflicts with the interests of her clients. Failing to disclose this arrangement does not constitute a violation of this Standard.

*** For 2025 Exam**

Standard VI(A) - Avoid or Disclose Conflicts requires members and candidates to avoid or make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity. The recommended procedures for compliance with this Standard advise members and candidates to " disclose special compensation arrangements with the employer that might conflict with client interests, such as bonuses based on short-term performance criteria, commissions, incentive fees, performance fees, and referral fees". In this example, Hendrix is receiving a quarterly bonus, which could be considered as compensation for short-term performance. However, this bonus is based on the accuracy of her forecasts, so she is not being incentivized to act in a manner that conflicts with the interests of her clients. Failing to disclose this arrangement does not constitute a violation of this Standard.

Standard III(A) requires members and candidates to act for the benefit of their clients and place their client's interests before their employer's or their own interests. The recommended procedures for compliance state that candidates should make their clients aware of all forms of manager compensation. However, Hendrix is not being disloyal to her clients' interests by seeking to provide the most accurate forecasts. This type of bonus keeps her interests aligned with those of her clients.

While Hendrix would comply with both of the Standards discussed above if she disclosed the nature of her compensation arrangement, she has not obviously violated either of them by failing to do so.

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Case 2: Rajesh Singh

Rajesh Singh is the CFO of TBZ Ltd, a London-based retailer of fine jewelry and watches. Singh notices that the price of gold has begun to increase. If economic activity continues to pick up, the cost of gold is likely to accelerate its rate of increase as both the demand and inflation rates rise.

Implications for Rising Gold Prices

Singh is concerned about the cost implications for TBZ if gold prices continue to rise. He requests a meeting with Anita Sood, chief operations officer of TBZ. To prepare for the conference, Singh asked one of his staff, James Baker, to prepare a regression analysis comparing the price of gold to the average cost of TBZ purchases of finished gold jewelry. Baker provides the regression results as shown in Exhibit 1.

Exhibit 1: 1983-2013 Annual Data (31 Observations)

Variable	Coefficient	SE of Coefficient
Intercept	11.06	7.29
Cost of gold	2.897	0.615

* SEE = 117.8

While reviewing the regression results, Sood becomes even more concerned about the implications for the cost of finished jewelry to TBZ if the price of gold continues to rise. To remain profitable, the cost of finished jewelry should not exceed $1,500.

Testing for Heteroskedasticity

Sood remarks that the dramatic increase in price over the past 30 years leads her t0 suspect heteroskedasticity in the regression results. She suggests to Singh that they conduct a Breusch-Pagan test for heteroskedasticity.

Regression Concerns

Singh's principal concern about the regression is whether the period chosen is a good predictor of the current situation. He makes the following statement:

Statement 1: We may have a problem with parameter instability if the relationship between gold prices and jewelry costs has changed over 30 years.

Singh also focuses on the value of the slope coefficient. He expects it to be 4.0 based on his experience in the industry. Baker computes the appropriate test statistics and reports the following:

Statement 2: We fail to reject the null hypothesis that the slope coefficient equals 4.0 at the 5%

significance level.

Model Misspecification

Sood and Singh discuss the potential problem of model misspecification and the effects of any such misspecification.

- Sood worries that the regression model could be misspecified because it does not include a variable to measure the cost of the highly specialized labor used by manufacturing jewelers. She points out that omitting an essential variable in a regression analysis will make the regression coefficients biased and inconsistent.
- Singh adds that another common consequence of misspecifying a regression analysis is creating undesired stationarity.

Multiple Regression

Baker conducts regression analyses using all possible combinations of the suggested independent variables based on their average quarterly values. The regression results for the equation, which uses all suggested independent variables, are shown in Exhibit 2.

Exhibit 2: 2003-2013 Quarterly Data (44 Observations)

R-squared = 0.55

Durbin-Watson statistic = 3.89

Independent Variables	Coefficient	t-statistic
Intercept	-3.9	3.7
Gold price	4.7	14.5
Silver price	1.2	7.8
Platinum price	3.5	3.1
Labor costs	0.82	2.4
GDP (EU)	0.000274	5.7
Personal Income (EU)	0.000314	2.1

Baker is concerned about the equation described in Exhibit 2. He makes the following statement:

Statement 3: The Durbin-Watson statistic indicates the presence of positive autocorrelation at the 5% level.

Sood responds with the following statement:

Statement 4: An autocorrelation problem can be addressed using the Hansen method to adjust R^2.

Two-tailed t-distribution Table

df	α=0.05
25	2.060
26	2.056
27	2.052
28	2.048
29	2.045
30	2.042
31	2.040
32	2.037

Q.1 The per ounce price of gold that corresponds to the $1,500 cost of finished jewelry is *closest* to

A. $513.96.

B. $517.77.

C. $521.59.

The correct answer is **A.**

The regression model is of the form

$$y = \hat{b}_0 + \hat{b}_1 x$$

Where y is the cost of the finished jewelry, $\hat{b}_0$ is the intercept coefficient, $\hat{b}_1$ the slope coefficient, and x is the cost of gold.

Then, we can solve for x to find the cost of gold:

$$1500 = 11.06 + 2.897x$$

Hence, the cost of gold $= \frac{(1500 - 11.06)}{2.897} = 513.96$

B and C are incorrect. The correct calculation as per the regression model is 523.96.

CFA Level II, Learning Module 1: Basics of Multiple Regression and Underlying Assumptions, LOS 1(a): formulate a multiple linear regression model, describe the relation between the dependent variable and several independent variables, and interpret estimated regression coefficients.

Q.2 Sood suggests conducting a Breusch-Pagan test to check for the presence of heteroskedasticity. The *most appropriate* method to conduct the test would be to:

A. Regress the variance of error terms from the estimated regression equation on independent variables

B. Regress the square of error terms from the estimated regression equation on the dependent variables

C. Regress the square of error terms from the estimated regression equation on the independent variables

The correct answer is **C.**

The Breusch-Pagan test involves regressing the squared error terms from the estimated regression equation on the independent variables in the regression.

A and B are incorrect. The following steps are followed in conducting the Breusch-Pagan test;

- Fit the regression model.
- Calculate the squared residuals of the model.
- Fit a new regression model, using the squared residuals as the response values.
- Calculate the Chi-Square test statistic

CFA Level II, Learning Module 3: Model Misspecifications, LOS 3(b): explain the types of heteroskedasticity and how it affects statistical inference.

Q.3 Are Singh (Statement 1) and Baker (Statement 2) correct or incorrect regarding the usefulness of regression results described in Exhibit 1 and the value of the slope coefficient?

A. Singh: Correct; Baker: Correct.

B. Singh: Correct; Baker: Incorrect.

C. Singh: Incorrect; Baker: Correct.

The correct answer is **A.**

Both Singh and Baker's statements are correct. The data for regression analysis pertains to a period of more than 30 years, and during this period, the relationship between gold prices and jewelry costs could have changed. This would create parameter instability - a regression limitation.

$$\text{The test statistic is} = \frac{\hat{b}_1 - b_1}{s_{\hat{b}_1}} = \frac{2.897 - 4.0}{0.615} = -1.793$$

The critical value (t-value at 29 dfs and alpha = 0.025) is 2.045.
Our test statistic lies within the non-rejection region (±2.045). We therefore have insufficient evidence to reject the null hypothesis that the slope coefficient is equal to 4.

B and C are incorrect. Both Singh and Baker are correct based on the above explanation and calculations.

CFA Level II, Learning Module 2: Evaluating Regression Model Fit and Interpreting Model Results, LOS 2(b): formulate hypotheses on the significance of two or more coefficients in a multiple regression model and interpret the results of the joint hypothesis tests.

Q.4 Which of the following *best* describes Sood's suggestion to correct the autocorrelation problem?

A. Correct.

B. Incorrect.

C. Not enough information to make a judgment.

The correct answer is **B.**

Sood's statement for addressing the problem of autocorrelation of errors is incorrect. Hansen's method adjusts the standard error, not R^2, to solve the problem of autocorrelation.

A and C are incorrect. Sood's suggestion is incorrect concerning the autocorrelation problem.

CFA Level II, Learning Module 3: Model Misspecifications, LOS 3(c): explain serial correlation and how it affects statistical inference.

Case 3: John Cook

John Cook and Adrian Tuazon are CFA level II candidates. The two engage in a discussion over currency exchange rates in which they make several statements. Cook makes the following statements:

Statement 1:

“The offer price is always higher than the bid price.”

Statement 2:

“The party in the transaction which requests a two-sided price quote has the option (but not the obligation) to deal at either the bid or the offer quoted by the dealer. If the party chooses to trade at the quoted prices, the party is said to have either “hit the bid” or “paid the offer.” If the base currency is being sold, the party is said to have paid the offer. If the base currency is being bought, the party is said to have hit the bid.”

Statement 3:

“The bid-offer spread a dealer provides to most clients typically is slightly narrower than the bid-offer spread observed in the interbank market.”

As the discussion continues, Tuazon asks Cook to explain how an arbitrage opportunity would exist in the interbank market. Cook responds by making the following statement:

Statement 4:

“Suppose that the current spot USD/CAD price in the interbank market is 0.8214/0.8216. If a dealer showed a misaligned price quote of 0.8218/0.8219, then an arbitrage opportunity exists.”

Jessica Pearson, CFA, is a friend of Tuazon’s. Pearson works as a foreign exchange dealer in Sidney, Australia. She is contemplating trade opportunities in the EUR/GBP currency pair. The followings are the current spot rates and forward points being quoted for the EUR/GBP currency pair: