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REVISION NOTES

CFA Level I: Recall & Confusion Pairs

Memory hooks and the look-alikes that cost marks

14 memory hooks **16** confusion pairs

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HOW TO USE THIS

You do not fail Level I because a concept was too hard. You fail because under time pressure you reached for the formula next to the right one.

This is not a formula sheet — it is the layer above one. Part 1 is memory hooks: short phrases that regenerate a rule instead of storing it. Part 2 is confusion pairs: the look-alikes that swallow marks, set side by side with the single line that separates them.

Use it in the last three weeks, and use it OUT LOUD. A hook you can say is a hook you can recall in an exam hall; a hook you have only read is a hook you will lose.

A note on how these are built: the good hooks encode the REASON, not just the answer. "Own the post" beats any acronym, because if you forget it you can rebuild it from first principles. That is deliberate — under stress, understanding survives and rote memory does not.

PART 1 — MEMORY HOOKS · 14 hooks

Say each one aloud. If you can say it, you can recall it under pressure.

“Income over Balance $\Rightarrow$ average the Balance.”

Unlocks: Every turnover and return ratio: ROA, ROE, inventory turnover, receivables turnover.

► An income statement item is a FLOW over a period; a balance sheet item is a STOCK at a moment. Divide a flow by a stock and you must average the stock. This one hook fixes half of FSA.

“Sample subtracts.”

Unlocks: Sample variance divides by $(n - 1)$. Population variance divides by N .

► Bessel's correction removes downward bias. If the question hands you a whole population, the exam is hoping you reach for the sample formula.

“D₁ over the gap.”

Unlocks: Gordon growth: $V_0 = D_1 / (r - g)$.

► NEXT year's dividend, over the gap between required return and growth. If the question gives you D_0 , you must grow it one period first — that single step is the most common Level I valuation error.

“Own the post.”

Unlocks: VC ownership % = Investment / POST-money valuation.

► Post-money = pre-money + new investment. Dividing by pre-money overstates the stake, and that wrong answer is always one of the options.

“Income out, cost in.”

Unlocks: Cost of carry: dividends and coupons LOWER the forward price; storage costs RAISE it.

► $F_0 = S_0(1 + r)^T$, minus the PV of income, plus the PV of carrying costs. Get the two signs and the whole forwards topic collapses into one formula.

“Whole portfolio $\Rightarrow$ total risk. A slice of one $\Rightarrow$ beta.”

Unlocks: Sharpe (and M²) vs Treynor (and Jensen).

► If it is the investor's ENTIRE wealth, undiversified risk still hurts them, so use total risk: Sharpe. If it is one sleeve of a diversified whole, only systematic risk matters: Treynor. This settles the question forever.

“Longer, lower, lower.”

Unlocks: Higher duration: longer maturity, lower coupon, lower yield.

► Every “which bond has the highest duration” question resolves the same way. A zero-coupon bond has Macaulay duration exactly equal to its maturity — that is the anchor.

“The issuer owns the call.”

Unlocks: Callable $\Rightarrow$ OAS < Z-spread. Puttable $\Rightarrow$ OAS > Z-spread.

► *OAS = Z-spread – option value. The call belongs to the ISSUER, so you subtract its value from your spread. You own the put, so it adds. Rebuild it from ownership and you never memorise a direction again.*

“Pay rent to own convexity.”

Unlocks: Long options: positive gamma, positive vega, negative theta.

► *Theta is the rent you pay for the right to be convex. Short options collect the rent and are short the convexity — which is exactly how option sellers blow up.*

“Payoff is not profit.”

Unlocks: The difference is always the premium.

► *Long call payoff = $\max(S_T - X, 0)$. Profit = payoff – premium paid. The exam alternates between the two words deliberately, sentence to sentence.*

“MWR judges the investor. TWR judges the manager.”

Unlocks: Money-weighted vs time-weighted return.

► *MWR is an IRR and is sensitive to when the client added or withdrew cash. TWR strips that out, which is why GIPS requires it — a manager cannot control the timing of inflows.*

“FCFF meets WACC. FCFE meets cost of equity.”

Unlocks: The cash flow / discount rate pairing.

► *FCFF belongs to everyone, so discount it at everyone's cost: WACC → firm value. FCFE belongs to shareholders, so discount at the cost of equity → equity value directly. Crossing the streams is an instant wrong answer.*

“Divide the rate, multiply the periods.”

Unlocks: Any TVM problem with non-annual compounding.

► *12% compounded quarterly $\Rightarrow r = 3\%$, $n = 4$ per year. This one slip causes more wrong answers at Level I than any conceptual gap.*

“Below AVC, walk away.”

Unlocks: Shutdown vs breakeven.

► *Breakeven: $P = ATC$. Shutdown: $P < AVC$. If $AVC < P < ATC$, keep going — you are losing money, but the contribution still covers part of the fixed cost, and shutting down loses more.*

REMEMBER

- Rehearse these out loud once a day in the final fortnight. Thirty seconds. It is the highest-return revision you will do.
- When a hook fails you in practice, do not just re-read it — find out WHY the underlying logic did not fire. A hook is a handle on understanding, not a substitute for it.

PART 2 — CONFUSION PAIRS · 16 pairs

The look-alikes. In each case the exam is betting you grab the wrong one.

Leading vs trailing justified P/E

Leading (P_0/E_1)	Trailing (P_0/E_0)
• $(1 - b) / (r - g)$ • Uses NEXT year's forecast earnings • Preferred for valuation — forward-looking	• $(1 - b)(1 + g) / (r - g)$ • Uses LAST year's realised earnings • Preferred for screening — observable

THE SEPARATOR Trailing carries the extra $(1 + g)$. That factor is what converts E_0 into E_1 .

► *Do not memorise both. Derive the trailing version from the leading one by growing earnings a period — you will never mix them up again.*

D₀ vs D₁

D₀ — the dividend just paid - Already happened, already in the past - Must be grown before use: $D_1 = D_0(1 + g)$	D₁ — the dividend about to be paid - What the Gordon model actually needs - Goes straight into $V_0 = D_1/(r - g)$
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THE SEPARATOR The Gordon model always needs D₁. If the stem says "just paid" or "last dividend", you must grow it.

► Read the stem twice. "Recently paid a dividend of \$2" and "will pay a dividend of \$2" produce different answers, and both appear in the options.

Modified vs effective duration

Modified duration $D_{\text{Mac}} / (1 + y)$ - Assumes cash flows are FIXED - Meaningless for a callable bond	Effective duration $(P_- - P_+) / (2 \times P_0 \times \Delta y)$ - Allows cash flows to CHANGE with yields - Required for callables, putables, MBS
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THE SEPARATOR If the bond has an embedded option, the cash flows are not fixed — so modified duration does not apply. Use effective.

► The word "callable" anywhere in the stem is the signal. It is not a subtlety; it is the whole question.

Sharpe vs Treynor

Sharpe $(R_p - R_f) / \sigma_p$ - Denominator = TOTAL risk - For a standalone / whole portfolio	Treynor $(R_p - R_f) / \beta_p$ - Denominator = SYSTEMATIC risk - For one sleeve of a diversified whole
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THE SEPARATOR Total risk when it is everything they own. Beta when it is one component of a bigger portfolio.

► If the stem stresses that the portfolio is NOT well diversified, it wants Sharpe. If it says "one of several managers", it wants Treynor.

CML vs SML

Capital Market Line - x-axis is σ (total risk) - Only EFFICIENT portfolios lie on it - Slope = the market's Sharpe ratio	Security Market Line - x-axis is β (systematic risk) - ANY asset lies on it, efficient or not - Slope = the market risk premium
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THE SEPARATOR CML plots against sigma. SML plots against beta. Only efficient portfolios make the CML.

► A single stock sits ON the SML (if fairly priced) but BELOW the CML, because it carries diversifiable risk nobody pays for.

Sample vs population variance

Sample - Divides by $(n - 1)$ - Bessel's correction — removes bias - Used when you have a subset	Population - Divides by N - No correction needed - Used when you have everything
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THE SEPARATOR Sample subtracts one. Population does not.

► The exam gives you a complete population — "all twelve funds in the family" — and offers the sample answer as a distractor.

Money-weighted vs time-weighted return

Money-weighted (MWR) • An IRR on the client's cash flows • Sensitive to the SIZE and TIMING of flows • Describes the investor's experience	Time-weighted (TWR) • Geometric link of sub-period returns • Immune to cash-flow timing • GIPS-required; judges the manager
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THE SEPARATOR MWR judges the investor. TWR judges the manager.

► A manager can have a great TWR and their clients a terrible MWR — because the clients all bought in at the top. Both numbers are true.

Inventory vs receivables turnover

Inventory turnover • COGS / Average inventory • COST in the numerator • Inventory is carried at cost	Receivables turnover • Revenue / Average receivables • SALES in the numerator • Receivables arise from sales
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THE SEPARATOR Cost over inventory. Revenue over receivables. Match the numerator to how the asset arose.

► Using sales in the inventory ratio is the standard distractor, and it produces a plausible-looking number.

FCFF vs FCFE

FCFF • Belongs to debt AND equity holders • Pre-financing — interest added back after tax • Discount at WACC $\Rightarrow$ FIRM value	FCFE • Belongs to equity holders only • Post-financing — interest already deducted • Discount at $r_e \Rightarrow$ EQUITY value directly
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THE SEPARATOR FCFF meets WACC. FCFE meets cost of equity. Never cross them.

► $FCFE = FCFF - \text{Int}(1 - t) + \Delta \text{Debt}$. Subtract what lenders take, add what they lend.

Systematic vs unsystematic risk

Systematic (market) risk • Cannot be diversified away • Measured by beta • COMPENSATED — you earn a premium	Unsystematic (specific) risk • Diversified away for free • Company-specific noise • NOT compensated — no premium
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THE SEPARATOR The market only pays you for risk you cannot avoid. Diversification is free, so nobody pays you to skip it.

► This is the entire logic of CAPM in one sentence. If you understand why unsystematic risk earns nothing, you understand why beta is the only term in the equation.

Forward vs futures

Forward • OTC, customised • Settles once, at maturity • Counterparty credit risk	Futures • Exchange-traded, standardised • Marked to market DAILY • Clearing house takes the credit risk
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THE SEPARATOR Daily settlement is the only real difference. At Level I both are priced identically.

► The daily settlement means futures gains earn interest — which is why they diverge from forwards in theory, and why Level I explicitly assumes the difference away.

Price vs value of a forward

Price (F_0)	Value (V_t)
- The delivery price locked in - Set at initiation, then FIXED - Non-zero	- What the contract is currently worth - Changes every day - Exactly ZERO at initiation

THE SEPARATOR The price is what you agreed. The value is what that agreement is worth today. At $t = 0$ the value is zero — the price is not.

► This distinction is tested almost every sitting, and candidates reliably fumble it because in everyday English the two words mean the same thing.

DOL vs DFL

Degree of operating leverage	Degree of financial leverage
- Driven by FIXED COSTS - Contribution margin / EBIT - Sensitivity of EBIT to sales	- Driven by DEBT - EBIT / (EBIT – I) - Sensitivity of EPS to EBIT

THE SEPARATOR Operating leverage comes from the cost structure. Financial leverage comes from the balance sheet.

► $DTL = DOL \times DFL$. They MULTIPLY, they do not add — which is why a high-fixed-cost, highly levered firm is so fragile in a downturn.

Effective annual rate vs stated annual rate

Stated (nominal) annual rate	Effective annual rate
- The headline number - Ignores compounding within the year - Not comparable across conventions	$(1 + r/m)^m - 1$ - Includes intra-year compounding - The only honest comparison

THE SEPARATOR Always convert to EAR before comparing two rates quoted on different compounding frequencies.

► A "12% rate compounded monthly" is really 12.68% a year. The exam quotes the 12% and offers 12% as an answer.

Cap rate vs discount rate (real estate)

Cap rate	Discount rate (required return)
- NOI / Value - A single-year yield - Observable from comparable sales	- The full IRR you demand - Covers all future cash flows - Cap rate = $r - g$

THE SEPARATOR Cap rate = discount rate – growth. A LOW cap rate can mean high expected growth, not a cheap building.

► The relationship is exactly the Gordon growth model wearing a hard hat. Same equation, different asset class.

Accuracy vs precision (and R^2 vs adjusted R^2)

R^2	Adjusted R^2
- RSS / SST - NEVER falls when you add a variable - Even a useless variable raises it	- Penalises extra regressors - CAN fall when you add a variable - Falls whenever the new $t < 1$

THE SEPARATOR R^2 always rises. Adjusted R^2 only rises if the variable earned its place.

► This is why adjusted R^2 exists at all. If adding a variable lowers it, that variable is noise — a clean, examinable conclusion.

REMEMBER

- Work through these as a self-test: cover the right-hand column and reconstruct it. Reading them is worth very little; reproducing them is worth a lot.
- When you get a practice question wrong, ask which PAIR you fell into. Most Level I errors are one of these sixteen, and naming yours turns a mistake into a fix.

THE FINAL FORTNIGHT

Say the hooks out loud, daily

- Thirty seconds a day, spoken. A hook you have only read will not surface under exam pressure.
- If a hook fails in practice, do not just re-read it — rebuild the logic underneath it. Understanding survives stress; rote memory does not.

Audit your errors by pair, not by topic

- "I got equity valuation wrong" is not actionable. "I used D_0 where D_1 belonged" is.
- Keep a running tally of which pairs catch you. The list will be short and it will be stable — those are your real weak points.

On exam day

- Ninety seconds per question. If a question is not resolving in ninety seconds, flag it and move — a skipped question costs one mark, a time overrun costs several.
- Clear TVM between questions (2ND → CLR TVM). A leftover value from the previous problem is a silent, confident wrong answer.
- Read the stem twice on anything involving a dividend, a duration, or a turnover ratio. Those are the three places the exam hides its traps.

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