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REVISION NOTES

CFA Level III: Recall & Confusion Pairs

Memory hooks and the look-alikes that cost marks

12 memory hooks **15** confusion pairs

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HOW TO USE THIS

Level III is half constructed response, and that changes what a memory hook is FOR. You are not selecting an option from four — you are producing a justification a human grader will read. A hook that only gets you to the right answer is not enough; it has to get you to the right SENTENCE.

So the hooks here are written as things you could actually write in the box. And the pairs are mostly recommendation pairs: two strategies that both look defensible, where the exam is testing whether you know which one this client needs.

The pairs cover the shared core (asset allocation, performance, derivatives, behavioural) plus the highest-traffic pathway confusions. All three pathways sit the core, and the core is where candidates fail.

Rehearse aloud. Then rehearse in WRITING, in bullets, under time. The morning session punishes people who can think but cannot write quickly.

PART 1 — MEMORY HOOKS · 12 hooks

Each is written so it could be lifted almost verbatim into an answer box.

“Allocation is about weights. Selection is about picks.”

Unlocks: The Brinson attribution decomposition.

▸ *Allocation = (weight difference) × benchmark return. Selection = benchmark weight × (return difference). Each effect uses the BENCHMARK for the thing it is not testing. Getting these backwards is the most common attribution error there is.*

“Immunise the surplus, not the assets.”

Unlocks: Liability-driven investing.

▸ *D_A × A = D_L × L. A fully funded plan holding short-duration assets is NOT safe — when rates fall, liabilities rise faster than assets and the surplus evaporates. This is the single most important idea in LDI, and it is worth writing in exactly these words.*

“You only profit if you disagree with the forwards.”

Unlocks: Every yield-curve strategy.

▸ *"Rates will rise" is not a view. "Rates will rise MORE than the forwards imply" is. Being right about a move the market already priced earns you nothing. State this explicitly — it is a marked point.*

“Bond-like human capital ⇒ more equity.”

Unlocks: Private wealth asset allocation.

▸ *A tenured professor's earnings are bond-like, so the financial portfolio can carry more equity. A commission trader's are equity-like, so it should carry less. It is a HEDGING argument, not a risk-appetite one — say that, and the mark is yours.*

“Core capital first, gifting second.”

Unlocks: Any estate or philanthropy recommendation.

▸ *Establish what the client must keep to fund their own life. Only the surplus above core capital can be given away. Recommending a transfer strategy before doing this is the one unforgivable error in private wealth.*

“Commitments are exposure.”

Unlocks: Private markets liquidity planning.

▸ *Effective PE exposure = (NAV + unfunded commitments) / (portfolio + unfunded). Capital calls arrive precisely when markets fall and your spending distribution is still due. That double squeeze is what broke endowments in 2009.*

“DPI is money. TVPI is money plus an opinion.”

Unlocks: Private markets performance metrics.

▸ *The GP marks NAV themselves, so RVPI — and therefore TVPI — is an appraisal. DPI is cash in the LP's account. Ask what share of TVPI is DPI; that ratio reveals whether the GP can actually exit.*

“Capital, hurdle, catch-up, carry.”

Unlocks: The distribution waterfall, in strict order.

▸ *Return of capital ⇒ preferred return ⇒ GP catch-up ⇒ carry split. Write the four tiers down BEFORE computing anything. Skipping a tier corrupts every number after it, and visible working protects the marks.*

“Urgency costs impact. Patience costs opportunity.”

Unlocks: Trade execution and algorithm selection.

▸ *Information-driven, urgent trade ⇒ take liquidity, accept market impact. Liquidity-driven, patient trade ⇒ provide liquidity, accept the risk of not filling. Implementation shortfall captures BOTH — which is why it beats VWAP as a benchmark.*

“Skill matters more than breadth.”

Unlocks: The fundamental law: $IR = IC \times \sqrt{BR} \times TC$.

▸ *Breadth is under a square root. And the bets must be INDEPENDENT — five hundred correlated positions are one bet. TC is how much of your view survives long-only constraints and position limits.*

“Volatility drag: $G \approx A - 0.5\sigma^2$.”

Unlocks: Why risk control creates return.

▸ *Two portfolios with the same arithmetic mean but different volatility do not compound the same. The volatile one ends up poorer. This is the quiet mathematical reason for managing risk, and it is tested indirectly.*

“Cognitive ⇒ educate. Emotional ⇒ accommodate.”

Unlocks: Behavioural finance recommendations.

▸ *Cognitive errors are information-processing failures and can be MODERATED with data and education. Emotional biases come from feeling and are usually ADAPTED to instead. Naming which type it is, then acting accordingly, is exactly what the grader wants.*

REMEMBER

- For each hook, practise writing it as a one-line answer in the box. Level III rewards the candidate who can produce the sentence, not just recognise it.
- The grader is looking for keywords, not prose. "Immunise the surplus: $D_A \times A = D_L \times L$" scores. A beautiful paragraph that never says it does not.

PART 2 — CONFUSION PAIRS · 15 pairs

Most of these are recommendation pairs. Both options look defensible — the exam is testing whether you know which one this client needs.

Brinson allocation vs selection

Allocation effect	Selection effect
• $(w_p - w_b) \times (R_{b,i} - R_b)$	• $w_b \times (R_{p,i} - R_{b,i})$
• WEIGHT difference × BENCHMARK return	• BENCHMARK weight × RETURN difference
• Did you overweight a winning sector?	• Did your picks beat the sector?

THE SEPARATOR **Allocation is about weights. Selection is about picks. Each uses the benchmark for the thing it is not testing.**

▸ *You can be a brilliant stock-picker inside a sector you should never have owned. That is positive selection and negative allocation — and it is exactly the scenario the exam constructs.*

Sharpe vs information ratio

Sharpe ratio	Information ratio
• $(R_p - R_f) / \sigma_p$	• $(R_p - R_B)$ / tracking error
• Excess return over TOTAL risk	• ACTIVE return over ACTIVE risk
• Changes if you add leverage or cash	• Unaffected by leverage (unconstrained)

THE SEPARATOR **Sharpe judges the whole portfolio. IR judges only the active bets inside it.**

▸ *The elegant identity: $SR^2_{combined} = SR^2_{benchmark} + IR^2$. Adding an active overlay improves the combined Sharpe by exactly the manager's IR, squared.*

Active share vs tracking error

Active share	Tracking error
• $\frac{1}{2}\Sigma\lvert w\_p - w\_b\rvert$ • How DIFFERENT the holdings are • A diversified stock-picker scores high	• $\sigma(R_p - R\_B)$ • How differently the portfolio BEHAVES • A sector bet scores high

THE SEPARATOR **Active share measures the holdings. Tracking error measures the behaviour. They are not the same thing.**

▸ *High fee + low active share + low tracking error = a closet indexer. If a vignette gives you all three, it is asking you to say so plainly.*

Cognitive vs emotional bias

Cognitive error	Emotional bias
• A processing / reasoning failure • Conservatism, anchoring, availability, framing • MODERATE it — educate, provide data	• Arises from feeling and impulse • Loss aversion, overconfidence, regret, status quo • ADAPT to it — accommodate the client

THE SEPARATOR **Cognitive ⇒ educate. Emotional ⇒ accommodate. Naming the type dictates the recommendation.**

▸ *The full answer has three parts every time: name the bias, quote the EVIDENCE from the vignette, state the consequence. Then recommend moderate or adapt. All three, or you lose marks.*

European vs American waterfall

European (whole-fund)	American (deal-by-deal)
• LPs get all capital + hurdle FIRST • GP carry comes last • No clawback risk for the LP	• GP takes carry as each deal exits • GP is paid much earlier • CLAWBACK risk if later deals fail

THE SEPARATOR **European makes the LP whole first. The LP always prefers it — say so, and say why.**

▸ *American waterfalls create a real conflict: the GP is incentivised to exit winners early and hold losers, because carry is booked per deal.*

Cash flow matching vs immunisation

Cash flow matching	Immunisation
• Bonds mature exactly when liabilities fall due • Eliminates interest-rate risk entirely • Expensive and inflexible	• Match duration to the liability horizon • Protects against SMALL PARALLEL shifts only • Cheaper, but requires rebalancing

THE SEPARATOR **Matching eliminates the risk. Immunisation manages it — and only for small parallel shifts.**

▸ *The three immunisation conditions: PV of assets ≥ PV of liability, Macaulay duration = horizon, and MINIMISE cash-flow dispersion around it. All three, or it is not immunised.*

Barbell vs bullet

Barbell (short + long)	Bullet (concentrated)
• HIGHER convexity at the same duration • Wins in high volatility • Wins on non-parallel moves	• LOWER convexity • Wins in a stable, upward-sloping curve • You are paid for carry, not convexity

THE SEPARATOR **Volatile curve ⇒ barbell. Stable curve ⇒ bullet. Convexity is only worth paying for if the curve actually moves.**

▸ *Convexity is not free — the barbell gives up yield for it. If the curve stays put, you paid for insurance you did not need.*

Implementation shortfall vs VWAP

Implementation shortfall	VWAP
• Explicit + delay + impact + opportunity	• Execution price vs volume-weighted average
• Captures UNFILLED shares	• Ignores what you never filled
• The honest total cost	• Easy to game — just trade with the volume

THE SEPARATOR **IS captures the cost of NOT trading. VWAP does not. When a question compares the two, that is the answer.**

▸ *VWAP is meaningless for an order that is itself a large share of the day's volume — because you ARE the VWAP.*

Endowment vs foundation

Endowment	Private foundation (US)
• Spending rate is a POLICY choice	• 5% minimum distribution is a LEGAL floor
• Perpetual, intergenerational equity	• Must pay out whether it wants to or not
• $R = s + c + \pi$	• $R \geq 0.05 + c + \pi$

THE SEPARATOR **The endowment chooses its spending. The foundation is compelled to spend 5%. That is the structural difference.**

▸ *The forced 5% payout means a foundation has less flexibility to cut spending in a drawdown — which raises its liquidity requirement relative to an endowment.*

Tax-deferred vs tax-exempt account

Tax-deferred (traditional)	Tax-exempt (Roth)
• $FV = (1 + r)^n(1 - T_n)$	• $FV = (1 + r)^n$
• Pre-tax in, taxed on withdrawal	• After-tax in, tax-free out
• Favourable if FUTURE rate is LOWER	• Favourable if FUTURE rate is HIGHER

THE SEPARATOR **One comparison settles it: today's marginal rate versus the expected rate at withdrawal. Everything else is detail.**

▸ *A high earner today who will retire into a lower bracket wants deferral. A young professional in a low bracket wants the Roth. State the client's bracket trajectory in your justification.*

Collar vs exchange fund (concentrated stock)

Collar / prepaid variable forward	Exchange fund
• Long put + short call around the position	• Swap into a diversified pool
• Defers tax, keeps the shares	• Defers tax, achieves diversification
• CAPS the upside	• Long LOCK-UP (typically 7 years)

THE SEPARATOR **A collar hedges but does not diversify. An exchange fund diversifies but locks you up. Match the tool to what the client actually needs.**

▸ *Outright sale is always an option — it just triggers the tax immediately. Name the tax consequence of every alternative you present; that is where the marks are.*

Strategic vs tactical asset allocation

Strategic (SAA)	Tactical (TAA)
• The IPS policy portfolio	• Short-term deviations within IPS BANDS
• Long-horizon, capital market expectations	• Exploits perceived mispricing
• Changes rarely	• Must net down for costs and tax

THE SEPARATOR **Tactical deviations must live inside the IPS bands. A recommendation that breaches them is wrong no matter how good the market view is.**

▸ *$\alpha\_net = \alpha\_gross$ − transaction costs − tax. Tactical calls are gross-alpha ideas that die on net-alpha arithmetic — a standard, marked essay point.*

Effective vs modified duration

Modified duration	Effective duration
• D_Mac / (1 + y)	• $(P_- - P_+) / (2 \times P_0 \times \Delta y)$
• Assumes FIXED cash flows	• Cash flows CHANGE with yields
• Fine for a bullet bond	• Required for options, MBS, callables

THE SEPARATOR **Embedded option ⇒ effective duration. Always. Modified duration is meaningless there.**

▸ *And for a NON-parallel shift, even effective duration is not enough — you need key rate durations. Level III escalates the same idea twice.*

Hedged vs unhedged foreign bonds

Hedged	Unhedged
• R_hedged ≈ R_local − (r_local − r_base)	• R_DC = (1 + R_FC)(1 + R_FX) − 1
• Strips out the rate differential	• Keeps the currency exposure
• The yield pickup often DISAPPEARS	• Adds FX volatility

THE SEPARATOR **Hedging hands the interest-rate differential straight back to the market. A hedged yield pickup is usually an illusion.**

▸ *The roll yield tells you the cost of hedging; the correlation tells you the benefit. A currency that already hedges the underlying asset may be best left unhedged.*

IRR vs MOIC (private equity)

IRR	MOIC / TVPI
• Time-sensitive	• Ignores time entirely
• Flattered by an EARLY exit	• The honest headline multiple
• Gameable via subscription lines	• Says nothing about how long it took

THE SEPARATOR **Shortening the hold raises IRR without raising MOIC. Always look at both — neither is sufficient alone.**

▸ *A 2.0× over four years and a 2.0× over ten years are the same multiple and wildly different investments. That gap is exactly what IRR is for — and exactly what a GP can manipulate.*

REMEMBER

- Recommendation pairs need a recommendation. "Both have merits" scores zero. Pick one, name the client fact that drove it, and move on.
- Cite the vignette. "Because the client is in the top marginal bracket and has a 20-year horizon" scores. "Because of tax" does not.

THE CONSTRUCTED-RESPONSE SESSION

Answer the command word

- Calculate ⇒ number plus working. Justify ⇒ a reason drawn from the vignette. Determine ⇒ the decision FIRST, then the support. Recommend ⇒ pick one and defend it.
- Answer in the box provided. Anything written outside it may not be marked at all.
- Bullets, not prose. Graders are hunting for specific keywords, and paragraphs bury them.

Protect your marks

- Show the formula, then the substitution, then the answer. If the arithmetic slips, a visible method still earns most of the marks.
- Allocate time by the MINUTES PRINTED on the question, not by how interesting it is. Overrunning one question steals marks from an easier one you then never reach.
- An unfinished, visible method beats a bare wrong number every single time. Never leave a box blank.

Where candidates actually fail

- Not on their pathway. On the CORE — asset allocation, performance evaluation, behavioural finance, and ethics.
- All three pathways sit the same core, and the core is roughly two-thirds of the exam. Budget your revision accordingly.
- Ethics is high-weight and unforgiving of vagueness. Learn the Standards well enough to name them, not just recognise them.