

# Chartered Alternative Investment Analyst (CAIA) Level II Practice Test (Sample)

## Study Guide



**Everything you need from our exam experts!**

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# Introduction

Preparing for a certification exam can feel overwhelming, but with the right tools, it becomes an opportunity to build confidence, sharpen your skills, and move one step closer to your goals. At Examzify, we believe that effective exam preparation isn't just about memorization, it's about understanding the material, identifying knowledge gaps, and building the test-taking strategies that lead to success.

This guide was designed to help you do exactly that.

Whether you're preparing for a licensing exam, professional certification, or entry-level qualification, this book offers structured practice to reinforce key concepts. You'll find a wide range of multiple-choice questions, each followed by clear explanations to help you understand not just the right answer, but why it's correct.

The content in this guide is based on real-world exam objectives and aligned with the types of questions and topics commonly found on official tests. It's ideal for learners who want to:

- Practice answering questions under realistic conditions,
- Improve accuracy and speed,
- Review explanations to strengthen weak areas, and
- Approach the exam with greater confidence.

We recommend using this book not as a stand-alone study tool, but alongside other resources like flashcards, textbooks, or hands-on training. For best results, we recommend working through each question, reflecting on the explanation provided, and revisiting the topics that challenge you most.

**Remember:** successful test preparation isn't about getting every question right the first time, it's about learning from your mistakes and improving over time. Stay focused, trust the process, and know that every page you turn brings you closer to success.

Let's begin.

# How to Use This Guide

**This guide is designed to help you study more effectively and approach your exam with confidence. Whether you're reviewing for the first time or doing a final refresh, here's how to get the most out of your Examzify study guide:**

## **1. Start with a Diagnostic Review**

**Skim through the questions to get a sense of what you know and what you need to focus on. Your goal is to identify knowledge gaps early.**

## **2. Study in Short, Focused Sessions**

**Break your study time into manageable blocks (e.g. 30 - 45 minutes). Review a handful of questions, reflect on the explanations.**

## **3. Learn from the Explanations**

**After answering a question, always read the explanation, even if you got it right. It reinforces key points, corrects misunderstandings, and teaches subtle distinctions between similar answers.**

## **4. Track Your Progress**

**Use bookmarks or notes (if reading digitally) to mark difficult questions. Revisit these regularly and track improvements over time.**

## **5. Simulate the Real Exam**

**Once you're comfortable, try taking a full set of questions without pausing. Set a timer and simulate test-day conditions to build confidence and time management skills.**

## **6. Repeat and Review**

**Don't just study once, repetition builds retention. Re-attempt questions after a few days and revisit explanations to reinforce learning. Pair this guide with other Examzify tools like flashcards, and digital practice tests to strengthen your preparation across formats.**

**There's no single right way to study, but consistent, thoughtful effort always wins. Use this guide flexibly, adapt the tips above to fit your pace and learning style. You've got this!**

## Questions

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- 1. What does an excess return index provide?**
  - A. Returns below market average**
  - B. Returns over cash, linked to commodity futures prices**
  - C. Returns that are exclusively interest-based**
  - D. Returns with minimal risk exposure**
  
- 2. What characteristic distinguishes operating foundations from traditional endowments?**
  - A. They have lower spending requirements**
  - B. The income supports operational funding**
  - C. They are perpetual in nature**
  - D. They require ongoing donations**
  
- 3. Which anomaly relates to the observation that low-beta stock portfolios have outperformed in the past?**
  - A. Risk parity anomaly**
  - B. Volatility anomaly**
  - C. Betting against beta anomaly**
  - D. Market timing theory**
  
- 4. How many hedge funds do concentrated funds of hedge funds typically allocate assets to?**
  - A. 15 to 20**
  - B. 30 to 50**
  - C. 5 to 10**
  - D. 1 to 5**
  
- 5. What are the three phases of the GP-LP lifecycle in private equity?**
  - A. Entry, competition, transition**
  - B. Establish, growth, decline**
  - C. Entry and establish, build and harvest, decline**
  - D. Formulate, operate, dissolve**

- 6. What advantage do principal-guaranteed commodity notes typically offer?**
- A. The ability to invest in commodities without any risk**
  - B. A commitment to return the entire principal amount regardless of market conditions**
  - C. Opportunity to profit from rising commodity prices while guaranteeing some principal return**
  - D. A fixed redemption value at maturity**
- 7. Which of the following describes the purpose of factor loadings in finance?**
- A. To summarize individual asset returns**
  - B. To assess the potential risk of an investment**
  - C. To indicate the degree of risk of a collective group of assets**
  - D. To provide a measure of market trends**
- 8. What element does the distance to default (DD) incorporate in its calculation?**
- A. The firm's long-term obligations**
  - B. Volatility of the firm's assets**
  - C. The market conditions**
  - D. The immediate cash flow requirements**
- 9. What is the primary feature of program-related investments (PRI)?**
- A. Exclusively focusing on financial returns**
  - B. Addressing social issues through investments**
  - C. Investments limited to government sectors**
  - D. Utilization of market trends for profit**
- 10. Who first proposed the Adaptive Markets Hypothesis (AMH)?**
- A. Fama**
  - B. Lo**
  - C. Shiller**
  - D. Berk**

## **Answers**

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1. B
2. B
3. C
4. C
5. C
6. C
7. C
8. B
9. B
10. B

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## **Explanations**

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## 1. What does an excess return index provide?

- A. Returns below market average
- B. Returns over cash, linked to commodity futures prices**
- C. Returns that are exclusively interest-based
- D. Returns with minimal risk exposure

An excess return index measures the returns generated from an investment after accounting for a benchmark, often related to risk-free rates or other relevant indices. In the context of commodity futures prices, an excess return index provides a measure of the returns above the cash yield of the underlying commodity. This means that it captures not only price changes in the commodity futures but also any income generated from holding the commodities, which is particularly relevant when the return is linked to the performance of futures contracts. In the case of this index, it reflects the risk premium associated with investing in commodities, as it includes returns that are derived from both capital appreciation and the roll yield of futures positions. This makes it relevant for investors looking to assess performance in the commodity markets compared to simply holding cash or other safer investments. The other options do not accurately capture the essence of the excess return index related to commodity futures. While some may imply certain types of returns, they do not encompass the broader concept of an excess return index whose focus is on capturing the performance relative to cash and risk factors in the commodities market.

## 2. What characteristic distinguishes operating foundations from traditional endowments?

- A. They have lower spending requirements
- B. The income supports operational funding**
- C. They are perpetual in nature
- D. They require ongoing donations

Operating foundations are distinct from traditional endowments primarily because their funds are specifically allocated towards the foundation's operational activities rather than being invested indefinitely. The income generated from an operating foundation is used directly to support its day-to-day expenses and programs. This means that the foundation is actively involved in executing its mission and initiatives, as opposed to simply preserving capital or generating returns for future use, which is typically the case with traditional endowments. In contrast, traditional endowments generally focus on permanence and long-term capital appreciation, where the generated income is often reinvested to grow the principal, or allocated to support specific projects or distributions based on a spending policy. This difference emphasizes the operational focus of an operating foundation in utilizing its resources to achieve immediate goals, making it crucial to understand this characteristic to differentiate between the two types of entities effectively.

**3. Which anomaly relates to the observation that low-beta stock portfolios have outperformed in the past?**

- A. Risk parity anomaly
- B. Volatility anomaly
- C. Betting against beta anomaly**
- D. Market timing theory

The observation that low-beta stock portfolios have outperformed in the past is known as the betting against beta anomaly. This phenomenon indicates that investors have historically been able to achieve higher returns from portfolios with low market risk (low beta) compared to those with high market risk (high beta). The rationale behind this anomaly is that investors tend to prefer high-beta stocks for their potential to provide higher returns, despite these stocks being riskier. As a result, high-beta stocks can become overvalued, while low-beta stocks may be undervalued. Consequently, low-beta portfolios have often produced excess returns relative to what would be predicted based on their risk profiles. This contradicts traditional financial theories that suggest higher risk should correspond to higher expected returns. In contrast, the other options do not specifically pertain to the historical outperformance of low-beta stock portfolios. For example, risk parity focuses on balancing risk contributions across different asset classes; volatility anomaly relates to how asset prices respond to volatility; and market timing theory pertains to the ability of investors to predict future movements of the market, rather than the characteristics of low-beta stocks. Thus, the most fitting identification for the anomaly observed is indeed the betting against beta anomaly.

**4. How many hedge funds do concentrated funds of hedge funds typically allocate assets to?**

- A. 15 to 20
- B. 30 to 50
- C. 5 to 10**
- D. 1 to 5

Concentrated funds of hedge funds typically allocate assets to a smaller number of hedge funds, generally in the range of 5 to 10. This approach allows for a more focused investment strategy where the fund manager can conduct in-depth research and maintain close relationships with the few selected hedge fund managers. By limiting the number of investments, concentrated funds look to maximize their return on investment by targeting specific strategies or funds believed to have the most significant potential for outperformance. This concentrated strategy contrasts with more diversified funds of hedge funds, which tend to spread investments across a larger number of hedge funds (usually 30 to 50 or more) to mitigate risk. Concentrated allocation can be more suitable for investors who are comfortable with the higher risk associated with fewer investments and have strong conviction in the selected hedge funds' ability to generate alpha.

**5. What are the three phases of the GP-LP lifecycle in private equity?**

- A. Entry, competition, transition**
- B. Establish, growth, decline**
- C. Entry and establish, build and harvest, decline**
- D. Formulate, operate, dissolve**

The three phases of the GP-LP (General Partner - Limited Partner) lifecycle in private equity consist of "Entry and establish," "build and harvest," and "decline." In the first phase, "Entry and establish," the General Partner raises capital from Limited Partners and begins deploying that capital into private equity investments. This phase is crucial for setting the foundation of the fund, which includes establishing relationships with Limited Partners, defining the investment strategy, and making initial investments. The second phase, "build and harvest," involves actively managing the portfolio investments to increase their value. During this time, the General Partner focuses on operational improvements, strategic direction, and scaling the portfolio companies. This phase typically lasts several years, after which the General Partner looks to exit the investments either through sales, secondary offerings, or initial public offerings (IPOs), thus realizing returns for the Limited Partners. The final phase, "decline," reflects the winding down of the fund's activities. The General Partner completes the exit process for remaining investments and distributes the proceeds to the Limited Partners. This phase may also involve the closure of the fund, as the General Partner may begin preparing for future fundraising efforts for a subsequent fund. These three phases together capture the lifecycle of a private

**6. What advantage do principal-guaranteed commodity notes typically offer?**

- A. The ability to invest in commodities without any risk**
- B. A commitment to return the entire principal amount regardless of market conditions**
- C. Opportunity to profit from rising commodity prices while guaranteeing some principal return**
- D. A fixed redemption value at maturity**

Principal-guaranteed commodity notes provide a unique investment opportunity that combines exposure to commodity price movements with a level of principal protection. The correct answer highlights that these notes allow investors to capitalize on the potential appreciation of commodity prices, which can enhance returns. At the same time, they ensure that some portion of the principal investment is protected, typically guaranteeing that investors will receive back a predetermined amount of their initial investment, even if the value of the underlying commodities falls. This structure appeals to risk-averse investors who wish to gain from commodity price increases while mitigating the risk of losing their principal. They essentially offer a safety net that reassures investors during periods of market volatility while still providing the possibility of upside in favorable market conditions. In contrast, while other options might seem related, they do not accurately capture the combined exposure and protection feature that principal-guaranteed commodity notes provide. The allure of these investments lies in their hybrid nature—offering both potential returns from commodity investments and principal protection, distinguishing them from more traditional commodity investments that do not guarantee principal.

7. Which of the following describes the purpose of factor loadings in finance?
- A. To summarize individual asset returns
  - B. To assess the potential risk of an investment
  - C. To indicate the degree of risk of a collective group of assets**
  - D. To provide a measure of market trends

Factor loadings serve as important tools for understanding the sensitivities or exposures that a particular asset or portfolio has to various risk factors. In finance, factor loadings reflect how strongly an asset's returns are correlated with a particular factor, which can be systematic (like market returns) or specific to certain characteristics (like size or value). When a collective group of assets—such as a portfolio or an index—is analyzed, factor loadings help in quantifying how much of the returns from that group can be attributed to the underlying factors. This is crucial for portfolio management and risk assessment, as it allows investors and analysts to gauge the collective exposure of the group to those factors, helping them to understand potential risks and diversify accordingly. Understanding the exposure to various risks is vital, as this informs decision-making regarding asset allocation and risk management strategies, making factor loadings essential for both individual assets and the collective behavior of groups of assets.

8. What element does the distance to default (DD) incorporate in its calculation?
- A. The firm's long-term obligations
  - B. Volatility of the firm's assets**
  - C. The market conditions
  - D. The immediate cash flow requirements

Distance to default (DD) is a measure used in credit risk analysis to assess the likelihood that a firm will default on its obligations. It essentially indicates how far a company's asset value is from the default point, which is usually considered to be the level of liabilities. The correct answer highlights the volatility of the firm's assets as a critical component in the computation of DD. This volatility reflects the uncertainty or risk associated with the firm's asset values over time. A higher volatility indicates greater uncertainty, which can increase the likelihood of the firm's assets falling below the threshold of liability levels, suggesting a higher distance to default. By incorporating asset volatility, investors and risk managers can better estimate the credit risk associated with a firm. Other elements may influence a company's financial stability, but the specific focus on asset volatility directly affects how distance to default is computed and interpreted. In contrast, other choices might mention various financial components, but they do not directly address the key role of asset volatility in determining the default risk within the context of the distance to default framework. As such, understanding the effect of asset volatility is paramount in grasping how distance to default is structured and its implications for risk assessment in the investment landscape.

**9. What is the primary feature of program-related investments (PRI)?**

- A. Exclusively focusing on financial returns
- B. Addressing social issues through investments**
- C. Investments limited to government sectors
- D. Utilization of market trends for profit

The primary feature of program-related investments (PRI) is their purpose of addressing social issues through investments. PRIs are designed to fulfill the charitable purposes of foundations and other organizations that aim to achieve social objectives besides generating financial returns. By using the capital to support projects that offer solutions to social, economic, or environmental challenges, PRIs uniquely blend philanthropic goals with investment strategies. These investments may take various forms, such as loans, equity investments, or grant equivalents, providing flexibility in how organizations can support initiatives that align with their missions. This approach not only creates positive social change but also enables the potential for some level of financial return, although it is secondary to the primary objective of social benefit.

**10. Who first proposed the Adaptive Markets Hypothesis (AMH)?**

- A. Fama
- B. Lo**
- C. Shiller
- D. Berk

The Adaptive Markets Hypothesis (AMH) was first proposed by Andrew Lo in 2004. Lo's hypothesis seeks to reconcile traditional financial theories with behavioral economics, suggesting that market behavior evolves over time due to the adaptive nature of human investors. According to AMH, financial markets are influenced by the adaptive behavior of investors who use past experiences to inform their future decisions. This perspective places importance on the idea that market efficiency is not static, but rather can change and adapt based on prevailing market conditions and investor behaviors. Lo's work emphasizes the role of psychology and environmental factors in financial decision-making, which contrasts with the classical efficient market hypothesis that implies markets are always perfectly efficient. By acknowledging the adaptive nature of both markets and investors, the AMH provides a framework for understanding phenomena such as market anomalies and bubbles, making it a significant contribution to the field of finance.

## Next Steps

**Congratulations on reaching the final section of this guide. You've taken a meaningful step toward passing your certification exam and advancing your career.**

**As you continue preparing, remember that consistent practice, review, and self-reflection are key to success. Make time to revisit difficult topics, simulate exam conditions, and track your progress along the way.**

**If you need help, have suggestions, or want to share feedback, we'd love to hear from you. Reach out to our team at [hello@examzify.com](mailto:hello@examzify.com).**

**Or visit your dedicated course page for more study tools and resources:**

**<https://caialevel2.examzify.com>**

**We wish you the very best on your exam journey. You've got this!**

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