

Chartered Financial Analyst (CFA) Practice Exam Level 2 (Sample)

Study Guide



Everything you need from our exam experts!

Copyright © 2025 by Examzify - A Kaluba Technologies Inc. product.

ALL RIGHTS RESERVED.

No part of this book may be reproduced or transferred in any form or by any means, graphic, electronic, or mechanical, including photocopying, recording, web distribution, taping, or by any information storage retrieval system, without the written permission of the author.

Notice: Examzify makes every reasonable effort to obtain from reliable sources accurate, complete, and timely information about this product.

SAMPLE

Questions

SAMPLE

- 1. Which of the following has a higher duration?**
 - A. A bond with a longer maturity**
 - B. A bond with a higher coupon**
 - C. A bond with a higher market yield**
 - D. A bond with an embedded option**
- 2. Which of the following is a disadvantage of direct real estate investment?**
 - A. High liquidity**
 - B. Geographical diversification opportunity**
 - C. Low transaction costs**
 - D. Higher cost of acquiring information**
- 3. What occurs in a callable bond's price behavior during rising interest rates?**
 - A. The bond price consistently increases**
 - B. The bond demonstrates negative convexity**
 - C. The bond becomes less attractive to investors**
 - D. The bond price remains stable regardless of rate changes**
- 4. In financial terms, what does "trailing PE" refer to?**
 - A. Price to Earnings based on future growth**
 - B. Price to Earnings based on historical earnings**
 - C. Forward-looking price to earnings ratio**
 - D. Price to Earnings adjusted for inflation**
- 5. What does the H-Model compute?**
 - A. Market value of equity**
 - B. Required rate of return**
 - C. Discounted cash flows**
 - D. Portfolio diversification**

- 6. How is the Durbin-Watson statistic interpreted in terms of correlation?**
- A. A value exactly equal to 2 indicates no correlation**
 - B. A value below 2 indicates negative correlation**
 - C. A value above 2 indicates positive correlation**
 - D. Values near 2 indicate reduced predictive accuracy**
- 7. In which model do residuals that show long-term trends indicate serial correlation?**
- A. Linear Trend Model**
 - B. Log Linear Model**
 - C. Exponential Trend Model**
 - D. Quadratic Trend Model**
- 8. What is the implication of heteroskedasticity in regression analysis?**
- A. Constant variance around the regression line**
 - B. Variance of the error term varies with explanatory variables**
 - C. Independence of errors across observations**
 - D. Normal distribution of residuals**
- 9. According to financial theory, what impact do dividend payments have on a company's stock price?**
- A. Dividends increase stock price**
 - B. Dividends decrease stock price**
 - C. Dividends have no impact on stock price**
 - D. Dividends fluctuate based on market conditions**
- 10. What does the variable "b" represent in the P/E ratio formulas?**
- A. The expected growth rate**
 - B. The payout ratio**
 - C. The plowback ratio**
 - D. The return on equity**

Answers

SAMPLE

- 1. A**
- 2. D**
- 3. B**
- 4. B**
- 5. A**
- 6. A**
- 7. B**
- 8. B**
- 9. C**
- 10. C**

SAMPLE

Explanations

SAMPLE

1. Which of the following has a higher duration?

- A. A bond with a longer maturity**
- B. A bond with a higher coupon**
- C. A bond with a higher market yield**
- D. A bond with an embedded option**

Duration measures the sensitivity of a bond's price to changes in interest rates, and it reflects the weighted average time until cash flows are received. A bond with a longer maturity typically has a higher duration because for longer maturities, cash flows extend over a longer period of time. As a result, the present value of these cash flows is more sensitive to changes in interest rates. The rationale is that the longer the duration, the greater the potential change in price relative to interest rate movement. Thus, among the choices given, a bond that has a longer maturity tends to have a higher duration compared to counterparts with shorter maturities, regardless of coupon or yield. While a bond with a higher coupon might provide more cash flows upfront, which reduces duration, and a higher market yield generally results in lower duration due to increased discounting effects, the fundamental principle here is that maturity is the dominant factor in determining duration. Likewise, bonds with embedded options may have modified durations that vary depending on the likelihood of the option being exercised. Thus, the focus on maturity clearly indicates that a bond with a longer maturity will have a higher duration compared to the others listed.

2. Which of the following is a disadvantage of direct real estate investment?

- A. High liquidity**
- B. Geographical diversification opportunity**
- C. Low transaction costs**
- D. Higher cost of acquiring information**

Direct real estate investment involves purchasing physical properties, and one of the inherent challenges of this approach is the significant cost associated with acquiring necessary information. This includes market research, property appraisals, zoning regulations, and various legal considerations. Investors must conduct thorough due diligence to understand the specific property and its market dynamics. The resources required for this process can lead to higher costs, making it a disadvantage compared to other investment vehicles, such as publicly traded securities, which often have readily available information and analysis from various sources. The other options highlight advantages or characteristics of direct real estate investment. High liquidity is generally not associated with real estate, as properties can take time to sell. Geographical diversification can be achieved through various investments, but it becomes challenging when dealing with localized real estate markets, as there are limits to how diversified one can be in property investments without incurring additional costs. Lastly, low transaction costs are not typical of real estate investments, as they often involve significant expenses related to legal fees, commissions, and maintenance. Thus, the correct choice emphasizes the financial burden related to information acquisition in direct real estate investments.

3. What occurs in a callable bond's price behavior during rising interest rates?

- A. The bond price consistently increases**
- B. The bond demonstrates negative convexity**
- C. The bond becomes less attractive to investors**
- D. The bond price remains stable regardless of rate changes**

In the context of callable bonds and their price behavior during periods of rising interest rates, it is important to understand the concept of negative convexity. Callable bonds are those that can be redeemed by the issuer before the maturity date, typically when interest rates fall. When interest rates rise, the likelihood of a callable bond being redeemed early diminishes, as it would be less advantageous for the issuer to call the bonds and refinance at higher rates. This causes the price of callable bonds to react differently than non-callable bonds. As interest rates rise, the price of a callable bond is constrained by the call option embedded in it, leading to a situation where the bond's price does not rise as quickly as a non-callable bond's price and can even decline. This phenomenon creates what is known as negative convexity. While non-callable bonds exhibit positive convexity (where price increases more dramatically as interest rates decrease), callable bonds have a flatter price response to interest rate movements when rates rise, which results in negative convexity. Therefore, the correct answer highlights that the bond demonstrates this unique characteristic in its pricing behavior during periods of rising interest rates. In contrast, other options suggest behaviors inconsistent with the nature of callable bonds. For example, the

4. In financial terms, what does "trailing PE" refer to?

- A. Price to Earnings based on future growth**
- B. Price to Earnings based on historical earnings**
- C. Forward-looking price to earnings ratio**
- D. Price to Earnings adjusted for inflation**

Trailing PE, or trailing price-to-earnings ratio, is calculated using a company's earnings from the most recent four quarters. This metric takes the current stock price and divides it by the earnings per share (EPS) from the past year, reflecting historical earnings performance. It is a widely used measure to assess how much investors are willing to pay for each dollar of earnings, based on past results. This concept helps investors gauge the relative value of a company's shares compared to its earnings, allowing for comparisons across different companies and industries. It's particularly useful because it reflects actual earnings as opposed to forecasts, providing a clearer picture of a company's recent financial performance.

5. What does the H-Model compute?

- A. Market value of equity**
- B. Required rate of return**
- C. Discounted cash flows**
- D. Portfolio diversification**

The H-Model is a valuation model used to compute the intrinsic value of a stock by estimating future cash flows, particularly focusing on the growth rates of dividends. It is particularly useful for companies that are expected to grow at a high rate initially, followed by a sustainable growth rate in the long term. In particular, the H-Model differentiates between two phases of growth: the initial higher growth period and the stable growth period that follows. It incorporates the idea that dividends will grow at a high rate for a certain period before transitioning to a more stable rate. This approach allows investors to compute the present value of expected future cash flows, thus arriving at the market value of equity. The other choices do not accurately represent what the H-Model computes. The required rate of return pertains to the expected return necessary to compensate for the risk of an investment, whereas discounted cash flows relate to the broader area of valuing projected cash flows rather than specifically focusing on equity markets. Portfolio diversification pertains to the risk management strategy of spreading investments across various assets, and it doesn't specifically relate to the intrinsic valuation approach of the H-Model.

6. How is the Durbin-Watson statistic interpreted in terms of correlation?

- A. A value exactly equal to 2 indicates no correlation**
- B. A value below 2 indicates negative correlation**
- C. A value above 2 indicates positive correlation**
- D. Values near 2 indicate reduced predictive accuracy**

The Durbin-Watson statistic is a test used to detect the presence of autocorrelation in the residuals from a regression analysis. Its values range from 0 to 4, where a value around 2 suggests that there is no autocorrelation. Specifically, a value exactly equal to 2 indicates that the residuals are uncorrelated, which implies that the errors from one time period to the next are not correlated with each other. This is a crucial indicator in regression analysis as it confirms the validity of the model's assumptions. When interpreting the Durbin-Watson statistic, values less than 2 indicate positive autocorrelation, while values greater than 2 suggest negative autocorrelation. Therefore, the assertion that a value exactly equal to 2 indicates no correlation is accurate and reflects the core purpose of the statistic in regression analysis. Understanding this helps analysts ensure that their regression model meets the assumption of independence of errors, which is vital for reliable inference and forecasting based on the model.

7. In which model do residuals that show long-term trends indicate serial correlation?

A. Linear Trend Model

B. Log Linear Model

C. Exponential Trend Model

D. Quadratic Trend Model

In a Log Linear Model, the analysis involves transforming the data using the logarithm of the dependent variable, which allows for multiplicative relationships to be linearized. This model is often used when the data is expected to grow at a constant relative rate, making it particularly useful for economic data that increases over time. When residuals from a Log Linear Model display long-term trends, it suggests that there is a systematic pattern rather than a random distribution of errors. Such patterns in the residuals imply the presence of serial correlation, meaning that current residuals are correlated with past residuals. This indicates that the model may not adequately capture all relevant information and dynamics in the data, leading to biased estimates and invalid inferences. In contrast, other models such as the Linear Trend Model, Exponential Trend Model, and Quadratic Trend Model can also exhibit serial correlation under certain conditions, but the context provided here specifically addresses how long-term trends in residuals signal serial correlation particularly in a Log Linear Framework where the transformations of dependent variables help in illuminating such trends. Therefore, the presence of long-term trends in residuals is primarily indicative of serial correlation, making the Log Linear Model particularly relevant in this context.

8. What is the implication of heteroskedasticity in regression analysis?

A. Constant variance around the regression line

B. Variance of the error term varies with explanatory variables

C. Independence of errors across observations

D. Normal distribution of residuals

Heteroskedasticity refers to the condition in which the variance of the error terms in a regression model varies across different levels of an independent variable. This characteristic can lead to inefficient estimates and statistics that are not valid for hypothesis testing because standard errors might be biased. In regression analysis, the assumption of homoskedasticity (constant variance of error terms) is crucial for the reliability of statistical tests. When heteroskedasticity is present, it implies that, as the value of an explanatory variable changes, the spread of the residuals (the differences between observed and predicted values) also changes. This violation of the constant variance assumption means that some predictions may be more variable than others, thus affecting the accuracy and reliability of the model's predictive power. Understanding heteroskedasticity is essential because it impacts the interpretation of regression results, particularly the coefficients and the validity of statistical tests, which assume that residuals are equally dispersed regardless of the value of independent variables. Addressing heteroskedasticity often involves using weighted least squares or transforming the data to achieve homoskedasticity.

9. According to financial theory, what impact do dividend payments have on a company's stock price?

- A. Dividends increase stock price**
- B. Dividends decrease stock price**
- C. Dividends have no impact on stock price**
- D. Dividends fluctuate based on market conditions**

The impact of dividend payments on a company's stock price is grounded in financial theory, particularly the Dividend Discount Model (DDM) and the Modigliani-Miller theorem. According to these theories, dividend payments do not intrinsically affect a company's stock price; rather, they are viewed as a distribution of the company's earnings to shareholders. The DDM suggests that the value of a stock is equal to the present value of its future dividends. If a company is expected to grow and retain earnings for reinvestment rather than paying them out as dividends, the stock price can still rise based on anticipated future cash flows. Thus, dividends, while providing immediate income to shareholders, do not change the underlying fundamentals of the company or its growth potential. Moreover, the Modigliani-Miller theorem postulates that, in a perfect market with no transaction costs or taxes, the value of a firm remains constant regardless of its dividend policy. This indicates that whether a company pays dividends or reinvests its earnings, the total value to shareholders will remain the same. Any change in stock price due to dividends is often offset by changes in investor expectations about future growth or risk. Therefore, while dividends certainly play a role in investor perception and can influence market behavior,

10. What does the variable "b" represent in the P/E ratio formulas?

- A. The expected growth rate**
- B. The payout ratio**
- C. The plowback ratio**
- D. The return on equity**

In the context of the P/E ratio, the variable "b" refers to the plowback ratio, which is a critical component in determining how much of a company's earnings are retained for reinvestment in the business versus how much is paid out as dividends to shareholders. The plowback ratio, also known as the retention ratio, indicates the portion of earnings that is not distributed as dividends. This retained portion is often used for reinvestment in the company, such as funding expansion projects or paying off debt. In financial models, an understanding of the plowback ratio helps analysts assess the potential future growth of a company. When considering the P/E ratio and its relation to growth, the underlying assumption is that the growth in earnings (and thus potentially in stock price) can be partially attributed to how much earnings are reinvested in the business. The more a company retains to plow back into growth initiatives, the higher the potential future earnings, which can lead to a higher P/E ratio. While the other options like the expected growth rate, payout ratio, and return on equity are related concepts, they do not represent the meaning of "b" in the P/E ratio formulas directly. The expected growth rate is influenced by