CFA LEVEL I STUDY SHEET · TOPIC 9

Alternative Investments

Chartered Financial Analyst (CFA®) Program Level I exam

6-9% of the exam · 7 learning modules · 2027 curriculum

Alternative Investments covers private equity and debt, real estate, infrastructure, natural resources and hedge funds: how they are structured and accessed, how managers are paid, and how their returns and risks are measured. The topic also opens with the one-period binomial model for valuing an option. Level I questions test features and structures, with short calculations on fees, waterfalls, cap rates, commodity returns and binomial values.

You should be able to: You should be able to value an option with a one-period binomial model, describe the structures and risks of each alternative asset class, and calculate net returns after fees, cap rates and commodity futures returns.

Every learning module: the key point and the trap

ALT.1 Alternative assets: types, access and fees

Alternatives include private capital, real estate, infrastructure, natural resources and hedge funds; they tend to be illiquid, less regulated and transparent, harder to value and more expensive than traditional assets.

Trap: Deal-by-deal waterfalls pay the general partner earlier; whole-of-fund waterfalls favour limited partners.

ALT.2 Measuring alternative returns after fees

Appraisal-based and infrequently priced returns are smoothed, understating volatility and correlation with listed markets and flattering Sharpe ratios.

Trap: Charging the incentive on the gross gain instead of the gain net of the management fee (or ignoring the hurdle) overstates fees.

ALT.3 Private equity and private credit funds

Private equity stages: venture capital (early-stage, high risk), growth equity (minority stakes in expanding firms) and buyouts (control, often leveraged).

Trap: Smoothed private equity returns look less correlated with listed equity than they really are.

ALT.4 Property and infrastructure investing

Real estate can be held as debt or equity, privately or publicly: direct property, mortgages, private funds, REITs and mortgage-backed securities.

Trap: Capitalize net operating income, not gross rent.

ALT.5 Land, timber, farmland and commodities

Raw land earns little or no income; its return comes from appreciation and the option to develop it.

Trap: Contango hurts a long futures investor; backwardation helps.

ALT.6 Hedge fund strategies and vehicles

Hedge funds are lightly regulated private funds that use leverage, short selling and derivatives, with high fees and restricted liquidity (lock-ups, notice periods, gates).

Trap: Market neutral means low correlation with the market, not low risk.

ALT.7 Ledger technology and crypto assets

A distributed ledger is a shared database kept in sync across many participants; a blockchain stores transactions in linked blocks secured by cryptography, and a consensus mechanism (such as proof of work or proof of stake) decides which records are valid.

Trap: Assuming that a low long-run average correlation guarantees diversification when correlations with equities have tended to rise in sell-offs.

Key terms

Risk-neutral probability: The probability that makes the underlying earn the risk-free rate in expectation; used to price options.

Limited partner: An investor in a fund whose liability is limited to its commitment and who takes no part in management.

Carried interest: The general partner's share of fund profits, usually after a preferred return.

Hurdle rate: The return a fund must exceed before an incentive fee is paid.

High-water mark: The previous peak value above which incentive fees are earned.

Clawback: A term requiring the general partner to repay carried interest later found excessive.

TVPI: Total value to paid-in capital: distributions plus remaining value, divided by paid-in capital.

Cap rate: Net operating income divided by property value.

Roll yield: The gain or loss from replacing an expiring futures contract with a longer one.

Brownfield: An existing infrastructure asset with an operating history.

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