Common Exam Traps

17 Mistakes to Avoid · Modules 3.1 & 3.2

Module 3.1 — Money-Weighted and Time-Weighted Returns

Each trap is a wrong answer the exam is built to tempt you with. Know why it is wrong.

1 Not netting cash flows that happen on the same date

WHY IT'S WRONG
A purchase and a dividend at t = 1 are one net cash flow. Entering them separately at different times gives the wrong IRR.

DO THIS INSTEAD
Net each date: +120 purchase - 2 dividend = **+118** at t = 1.

2 Entering all cash flows with the same sign

WHY IT'S WRONG
IRR needs money in and money out on opposite sides; with one sign there is no rate that makes NPV = 0.

DO THIS INSTEAD
Account view: deposits +, withdrawals and ending value -. Investor view: the reverse. Same IRR.

3 Forgetting dividends in the cash flows or HPRs

WHY IT'S WRONG
Dividends are part of what the investor receives. Leaving them out understates both MWR and TWR.

DO THIS INSTEAD
Include every dividend: in MWR as a cash flow, in TWR inside each HPR.

4 Starting the next subperiod at the old value

WHY IT'S WRONG
After a deposit the portfolio is bigger. Using the pre-deposit value mixes the new money into the return.

DO THIS INSTEAD
Start the new subperiod at the value **right after** the deposit (e.g. 2 × $120 = $240).

5 Annualizing TWR with the number of subperiods

WHY IT'S WRONG
Four quarterly HPRs in one year are one year, not four. Taking a 4th root would understate the return.

DO THIS INSTEAD
Exponent = 1 ÷ number of **years**. One year of subperiods → no root at all.

6 Averaging HPRs to get TWR

WHY IT'S WRONG
(22% + 10%)/2 = 16% ignores compounding.

DO THIS INSTEAD
Multiply: (1.22)(1.10) = 1.342, then take the root for years → **15.84%**.

7 Assuming MWR is always lower than TWR

WHY IT'S WRONG
It depends on timing. Money added before a strong period makes MWR **higher**.

DO THIS INSTEAD
Ask: when was more money invested, in the good period or the bad one?

8 Judging a fund manager with MWR

WHY IT'S WRONG
Clients decide when to invest and redeem. MWR would blame or credit the manager for client timing.

DO THIS INSTEAD
Use TWR for managers. Use MWR only when the manager controls cash flows (GIPS exceptions).

Module 3.2 — Security Market Indexes

9 Comparing a fund with a price index

WHY IT'S WRONG
The fund receives dividends; a price index ignores them, so the fund looks better than it is.

DO THIS INSTEAD
Benchmark against a **total return** index (SEBI requires TRI benchmarks).

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10 Thinking a price-weighted index reflects company size

WHY IT'S WRONG
Weights depend only on share price. A tiny company with a high price dominates.

DO THIS INSTEAD
Price-weighted → highest **price** dominates. Market-cap → largest **company** dominates.

11 Forgetting to adjust a price-weighted divisor after a split

WHY IT'S WRONG
The sum of prices falls with no change in value; without adjustment the index shows a fake fall.

DO THIS INSTEAD
Solve Σ post-split prices / D_{new} = old index value (e.g. D falls 1.2 → 0.75).

12 Adjusting a market-cap index divisor for a split

WHY IT'S WRONG
Price halves but shares double, so market cap is unchanged.

DO THIS INSTEAD
Market-cap divisor changes only when **components** change.

13 Doing the full equal-weighted calculation under exam time pressure

WHY IT'S WRONG
Shares, divisor and values take minutes and invite arithmetic errors.

DO THIS INSTEAD
Equal-weighted return = **average of the price changes** (e.g. (5% - 4% + 8.33%)/3 = 3.11%).

14 Saying rebalancing an equal-weighted index buys the winners

WHY IT'S WRONG
Winners now exceed their target weight, so they must be trimmed.

DO THIS INSTEAD
Rebalancing = **sell winners, buy losers** — contrary to trend-following.

15 Confusing rebalancing with reconstitution

WHY IT'S WRONG
Swapping bonds that matured or defaulted is not a weight adjustment.

DO THIS INSTEAD
Weights → **rebalancing**. Members added or removed → **reconstitution**.

16 Mixing up market float and free float

WHY IT'S WRONG
Free float is narrower: it also excludes shares foreigners cannot buy.

DO THIS INSTEAD
Market float excludes controlling holders; free float also excludes foreign-restricted shares.

17 Calling fundamental weighting a growth strategy

WHY IT'S WRONG
Weights ignore price, so cheap stocks get more weight than in a cap-weighted index.

DO THIS INSTEAD
Fundamental weighting has a **value tilt**.

Two questions that beat most traps: (1) Whose return is it — the investor's (MWR) or the manager's (TWR)? (2) Which weighting method is the index using — and therefore which stocks dominate?

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