EXAMINATIONS

April 2004

Subject 401 — UK Fellowship Investment

Paper One

EXAMINERS' REPORTS

Introduction

The attached subject report has been written by the Principal Examiner with the aim of helping candidates. The questions and comments are based around Core Reading as the interpretation of the syllabus to which the examiners are working. They have however given credit for any alternative approach or interpretation which they consider to be reasonable.

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Chairman of the Board of Examiners

5 July 2004

1 (i) The answer should include

Definition of a commodity — Any product that can be used in commerce i.e. any goods that are traded. For most people the term refers to internationally traded agricultural goods such as coffee, fuels and raw materials such as copper.

Institutions do not invest directly in commodities as this would involve shipping and storage of large amounts of material and institutions do not have the necessary skills or facilities.

While it can be argued that commodity futures are suitable investments for institutional investors they are not widely held in the UK. It is argued that there is no strong historical evidence for a real return from commodities and that the markets are volatile being driven by a number of factors unrelated to the underlying economic factors that affect institutional liabilities.

No income from commodity investment is a negative for pension fund.

There is a negative perception about investing/trading in commodities

It may not be permitted as an investment by the pension fund

(ii) Should an institution wish to gain exposure to commodity price movements it can do so in 3 ways.

The most obvious is via commodity derivatives, which are widely traded on major exchanges such as LIFFE and the Chicago Mercantile Exchange.

Options and futures are also available.

The futures which are available to trade fall into five main catergories

Energy, Precious Metals, Base Metals, Agricultural, Meat & Live Stock

The specification of a commodity futures contract is considerably more complex than that of a contract for a future based on an investment index as it is necessary to specify contract size, delivery dates, quality of product, method of packaging etc.

There are a number of commodity price indices produced by investment banks, contracts based on these indices allow some diversification and avoid the danger of having to take delivery of the product.

Alternatively institutional investors do invest in companies whose share price is influenced by commodity prices.

Typical examples of this are the oil & mining companies.

Investing in these companies also overcomes the problems of investing directly in the commodity itself and prices are generally less volatile than the commodity futures.

There are, however, a number of disadvantages if these companies are used as a proxy for commodity investment, these are:

It is unlikely that there will be exposure to just one commodity.

The company's management may alter the exposure via acquisitions or disposals or by hedging its position.

The company may be geared or hold cash thus altering the overall return.

The company's share price may be influenced by other factors.

The company will incur various operating expenses which will dilute the overall return.

2 (i) There are three charges an institution will incur when dealing in the UK market:

(a) Bid/Offer Spread
(b) Commission
(c) Stamp duty on purchases

The bid offer spread is the difference between the buying and selling prices, it varies from stock to stock and is generally bigger for stocks with small market capitalisations or are infrequently traded. Typically the bid-offer spread would be 1% for a FTSE 100 stock.

Commission is the sum paid to the broker who sells or buys the stock on your behalf, this varies between institutions with larger institutions generally paying less than small institutions. Typically commission will vary between 0.3% and 0.1%.

Stamp duty is payable on all purchases of UK equities, it is paid to the Inland Revenue and is fixed at 0.5%.

If dealing in the US market stamp duty is not payable, however commission and the bid offer spread are payable and would be set at similar levels to that paid on UK stocks.

(ii) A programme trade is a trade involving a number of stocks that the institution wants to buy or sell. There are rules relating to the minimum size and the minimum number of stocks that constitute the programme.

A programme trade is normally dealt at the mid price, i.e. half way between the bid and the offer price and therefore the bid-offer spread does not exist as a charge.

Depending on whether the programme is dealt on an agency or principal basis the commission charge will be either very low (under 10bp) or close to the commission the institution normally pays.

Stamp duty is still payable on any purchases within the programme trade.

(iii) (a) The difference between EBITDA and pretax profit is that pretax profit is calculated after deducting, interest, depreciation and amortisation.

Each of these items may have been distorted owing to the accounting policies adopted by a company,the amount and timing of capital expenditure, the capital structure of a company or the acquisition history of the company.

Therefore by looking at EBITDA these distortions are removed thus making a fairer comparison possible.

(b) Dividend yield is the declared dividend per share divided by the price per share, it is a reflection of the company's ability and willingness to pay a dividend.

It can therefore be distorted by management's views on how the cash generated by the company should be allocated.

Cash-flow yield measures the cash generated by the company per share and divides it by the share price.

This removes any distortions introduced by management and therefore allows better comparisons between companies.

(c) Interest cover is operating profits divided by interest and measures the company's ability to pay the interest on its debt.

The debt equity ratio is defined as the debt the company has on its balance sheet divided the amount of equity on the balance sheet.

It is therefore a much more pertinent figure than the debt equity ratio when determining whether or not a company can continue servicing its obligations.

3 The three elements of institutional development finance are:

(i) The funding of the development with interest being rolled up at a predetermined rate.

(ii) The purchase of the completed let development by the institution.

(iii) The payment of any profit the developer has earned.

The developer's profit is a percentage of the value of the completed development less building costs and the rolled up interest on the funding provided by the institution.

The profit will relate to the rent and the years purchase capitalization rate that is applied, the latter is fixed at the outset.

The rent used in determining the developer's profit is a function of the value of the let building at completion.

4 (i) ISA investors are entitled to exemption from income and capital gains tax on their investments.

Withdrawals may be made at any time without loss of tax relief.

Annual limit is £7,000 for full ISA or £3,000 for cash ISA.

The account can include:

Cash;
Stocks and shares listed on any recognised exchange;
Life assurance;
National savings.

(ii) The stocks and shares that are eligible for an ISA are:

Ordinary shares
Fixed interest pref shares and convertible pref shares.
Fixed interest corporate and convertible bonds with at least 5 years to maturity.
Shares and loan stock issued by UK industrial and provident societies.
Units in UK authorized unit trusts.
Shares in equivalent UK OEICs.
Shares and securities issued by UK approved investment trusts.
Units and shares in overseas collective investment schemes certified under UCITS.
UK gilts and gilt strips.
Securities issued by other countries within EEC.

5 The first thing that needs to be decided is what is meant by ethical.

Ethics mean different things to different people.

Are drug companies ethical?

What views are taken on environmental issues, some companies can't avoid being polluters however is it sufficient that they minimise their environmental impact or should such companies be avoided altogether?

Is it enough to avoid prohibited activities or does the company have to promote good causes as well?

Assuming pornography is not regarded as ethical does that mean newsagents who sell pornography or video shops are not ethical?

Does a company have to totally avoid prohibited areas or can they have limited exposure, if so what is the limit?

It should also be established whether the ethical considerations should be extended to bonds in particular corporate bonds though some Government bonds may be prohibited if the Government regime is offensive

Does the fund manager have the expertise/resources to be able to run an ethical fund?

If not should the resources be bought in or developed?

If not should the mandate be declined or alternative offered?

Is there a market for this type of product which would give the FM further opportunities in the future?
Assuming that the fund manager believes that they should take on the mandate the following issues need to be addressed:

Against which benchmark is the fund to be measured?

If there is no change in the benchmark then the ethical status of the fund may put the FM at a disadvantage when their performance is compared with the benchmark. Additionally any risk limits that had been previously applied e.g. tracking error would be inappropriate.
If there is to a specialised benchmark e.g. FTSE for good, does the client's views on ethics match those that are used to compile the benchmark? If it doesn't then there might be performance issues going forward.

What is penalty for purchasing a stock that is deemed unethical?

What is the position if a previously ethical company expands it operations into something that is deemed unethical or vice versa for a company that is deemed unethical.

Do companies have to have the correct corporate structure e.g. have the Chairman and Chief Executive roles split.

Is the fund manager expected to vote their stock in a proscribed way?

If so does the fund manager have the necessary systems to ensure voting occurs?

6 (i) Core Reading 401 Unit 5 Sections 2.1, 2.2 and 2.3

(ii) To achieve the required asset allocation, the manager has to sell £100 million of equity futures and buy £150 million of gilt futures. He has to sell 2273 contracts of UK FTSE100 future and buy 1415 UK long gilt futures.

(iii) Price of future may be trading cheap/dear to underlying for both or either contract
UK equity future not a good match for underlying portfolio
Portfolio different to benchmark index
Dealing costs will impact performance
Other costs will impact performance
Dividend income of fund different to notional

7 Core Reading 401 Unit 10 Section 3

8 (i) Assume that new investment occurs at end of period.

	Fund Rtn	*Weight*	*B'mark rtn*	*B'mark weight*	*Perf from Asset Alloc*	*Perf from Stock Sel.*	*Total*
Equities	8.33	60.0	9.0	50	0.07	(0.40)	(0.33)
Gilts	10.00	30.4	8.0	45	0.04	0.61	0.65
Cash	4.00	9.6	3.5	5	(0.22)	0.05	(0.17)
Total	8.42	100.0	8.28	100.0	(0.11)	0.26	0.15

(ii) There is minor rounding error
The fund actual return was 8.4% compared with 8.42% using weighted performance
Asset allocation was poor, over weight cash
Stock selection positive, gilts good, equities poor
Manager appears good fixed interest manager but suspect in other areas

END OF EXAMINERS' REPORT