

EXAMINATIONS

7 April 2003 (am)

Subject 401 — UK Fellowship Investment

Paper One

You must answer this subject only, you may not attempt another subject in the 400 series.

Time allowed: Three hours

INSTRUCTIONS TO THE CANDIDATE

1. *Enter all the candidate and examination details as requested on the front of your answer booklet.*
2. *You have 15 minutes at the start of the examination in which to read the questions. You are strongly encouraged to use this time for reading only, but notes may be made. You then have three hours to complete the paper.*
3. *You must not start writing your answers in the booklet until instructed to do so by the supervisor.*
4. *Mark allocations are shown in brackets.*
5. *Attempt all 11 questions, beginning your answer to each question on a separate sheet.*

AT THE END OF THE EXAMINATION

Hand in BOTH your answer booklet, with any additional sheets firmly attached, and this question paper.

In addition to this paper you should have available Actuarial Tables and your own electronic calculator.

- 1
 - (i) List the possible uses for market indices and indicate the appropriateness of two UK equity indices against these uses. [6]
 - (ii) Discuss the factors affecting the choice of benchmark for a fund manager about to launch a UK Equity Socially Responsible Investment (SRI) fund suitable for pension funds. [3]

[Total 9]

- 2

A defined benefit pension scheme is winding up following the insolvency of the sponsoring employer. The scheme is believed to be only 95% funded and currently holds 80% of investments in a life office managed fund tracking the average performance of pension funds with the balance invested in a UK Gilt fund managed by the life office and a property that had been leased back to the employer.

You are an investment consultant and have been approached by the newly appointed independent trustee and asked to review the scheme's investment strategy. Draft a presentation for the forthcoming meeting setting out in bullet point format the issues for the trustees to consider. [8]

- 3

The yield on the UK equity market has risen to a level where it could soon be above the yield on long-term Government debt securities generating suggestions that the markets could reverse the negative yield gap that has persisted since the 1950s.

 - (i) Discuss possible reasons for the shift in relative yields. [3]
 - (ii) State other indicators that you would use to assess the relative attractiveness of the UK equity market. [3]
 - (iii) Explain briefly why emerging market investments may form a useful part of an actively managed portfolio of equities. [4]

[Total 10]

- 4

Your friend has received a letter from his financial adviser recommending he invest a regular monthly amount into a new series of tax-free unit trust funds covering the UK equity and bond markets.

For the last three years, your friend has been saving in his employer's stock option scheme. Each scheme year employees are allowed to save up to 15% of salary each month and use the proceeds at the end of the year to buy ordinary shares in the company at a discount of 15% to the prevailing market price. He has written to ask your opinion. Draft a letter outlining the areas that he ought to consider. [10]

- 5

Describe the properties of the stocks in which a value investor would invest and outline how such an investor would aim to outperform the median market return over long periods of time. [4]

6 A UK futures exchange is developing a UK property futures contract.

- (i) State the three main classes of investors who might make use of this contract, and briefly describe how they would use it. [3]
- (ii) List the properties of the contract that would need to be published in the pre-launch contract fact sheet. [2]
- (iii) A large UK life insurance company is interested in using this contract to manage its exposure to UK property based on the recommendations of the asset allocation committee, without altering its underlying investments in direct property holdings. Explain the difficulties it might face in using the contract in this way. [5]

[Total 10]

7 The government of a small island is concerned about the social impact of high house prices and is constructing a large number of new homes. Finance is to be raised by issuing 30-year bonds to a consortium of retail banks, priced in line with A-rated bonds. Occupants will pay the interest payments on the bonds to the bank, plus a premium of 150bps. The extra 150bps covers expenses of the scheme and goes some way towards covering the capital cost of the scheme. If the occupier maintains payments for 30 years, the government will repay the capital to the bank and the freehold will pass to the occupier. If payments are not maintained, the government will pay the capital to the bank and the government will retain the freehold.

At present A-rated bonds currently provide a spread of 100bps over government bonds of a similar term, and the bank is able to borrow funds from retail deposits at the government bond yield less 75bps (after expenses).

- (i) Describe briefly the income stream to the bank. [2]
- (ii) Describe the risks the bank is taking on. [4]

A new public sector accounting standard is being introduced which will require all government investments to be disclosed at market value in the notes to the accounts, including where they are part of a “partnership” agreement. Provided an independent actuarial opinion is obtained on the suitability of the assumptions, it is permitted for allowance to be taken of contingent events.

- (iii) Set out an approach including formulae to valuing the government’s assets and liabilities at issue date as a result of this scheme. Define all terms you use, listing any assumptions you make and mention sources of uncertainty in the assumptions. [9]

[Total 15]

- 8** You are the consultant to a construction company that wants to become involved in PFI (Private Finance Initiative). However, they are keen to avoid or reduce their exposure to the projects once the construction phases are completed. The board of directors has asked you to advise them on methods of financing capital investments that achieve this aim.
- Discuss briefly the main items that you would include in your response. [6]
- 9** (i) State the regulatory objectives of the Financial Services Authority (FSA). [2]
- (ii) List the areas over which the FSA now has supervisory control. [4]
[Total 6]
- 10** (i) List the four main methods of passive investment management and state briefly the advantages and disadvantages of each. [4]
- (ii) An investment researcher has compared both index tracker and active funds and concluded that “index trackers have a free ride upon the efficient markets that actively managed funds create”.
- Discuss the investment researcher’s statement. [6]
[Total 10]
- 11** You are the investment advisor to a large final salary pension fund that has experienced a prolonged period of poor investment performance. The chairman of the board of trustees has written to you in order to commence a tendering exercise to appoint new investment managers.
- (i) List the information that you need to collect on potential new fund managers. [4]
- (ii) Outline the stages to a tendering exercise and transfer of investment management to new fund managers giving likely timescales. [3]
- (iii) During the tendering process the chairman of the board of trustees has spoken with you saying that they favour New Investment Co as they have achieved excellent investment performance since they were formed and that the large number of new mandates they are winning shows they are an excellent choice. Outline your reply to the chairman of trustees. [5]
[Total 12]