

EXAMINATIONS

September 1999

Subject 401 — UK Fellowship Investment

Paper Two

**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. *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.*
2. *You must not start writing your answers in the booklet until instructed to do so by the supervisor.*
3. *Write your surname in full, the initials of your other names and your Candidate's Number on the front of the answer booklet.*
4. *Mark allocations are shown in brackets.*
5. *Attempt both questions, beginning your answer to each question on a separate sheet.*

AT THE END OF THE EXAMINATION

Hand in BOTH your answer booklet and this question paper.

*In addition to this paper you should have available
Actuarial Tables and an electronic calculator.*

- 1 You are the investment manager of a UK pension scheme. Following the results of an asset liability study of the scheme, the trustees have adopted a fixed benchmark. The investment objective is to outperform the benchmark by 0.75% p.a. The fixed benchmark is as follows:

	Portfolio Weight %	Benchmark Weight %	Benchmark
UK Equities	50	50	FTSE All Share
Overseas Equities	22	25	
US	4	7.5	FT/S&P US
Europe ex UK	8.5	7.5	FT/S&P Europe ex UK
Japan	5.5	5	FT/S&P Japan
Far East ex Japan	4	5	FT/S&P Pacific ex Japan
Total Equities	72	75	
UK Fixed Interest	7	5	FTSE Govt Securities Over 15 Year Gilts
UK Index Linked	8	15	FTSE Index Linked Over 5 Year Gilts
US TIPS (see below)	6	—	
Property	4	4	IPD Property Index
Cash	3	1	7 Day Call Deposit
Total Non Equities	28	25	

There are tolerances around the benchmark weights which allow the manager to take active positions in order to deliver the required outperformance. As a consequence of a number of asset allocation decisions you have taken (all of which are satisfactorily within acceptable tolerances), a number of stock and asset class positions have arisen. One of the trustees has asked you to provide a written response to the following three questions about these positions. Draft your responses.

- (a) BP Amoco is the largest stock in the FTSE All Share Index with a benchmark weight of 7.0% in that index. Your current holding in BP Amoco is 9% of the UK equity weighting which is 4.5% of the total fund. At the same time, you are underweight in US equities relative to the benchmark, so that your total exposure to US equities is only 4% of the total fund.

How do you justify holding more in one UK stock than you hold in all of the US which is the world's largest stockmarket? [16]

- (b) As part of your Index Linked exposure, you have chosen to hold 6% of the total fund in US Treasury Inflation Protected Securities (TIPS). TIPS are US Treasury Bonds which provide US inflation proofed returns, both at the income and capital level. They currently yield 3.9%, whereas the corresponding UK Index Linked securities are yielding 1.8%. You have hedged the US dollar currency exposure of the TIPS back to sterling.

Why have you hedged the currency of the US Index-Linked position, when you have never hedged the currency exposure of any of your overseas equity holdings? [16]

(c) The Japanese economy has been suffering from a series of structural problems such as

- abandonment of the former economic growth model,
- major financial restructuring,
- a continued decline in traditional industries,
- an ageing population,
- the strength of the Yen,
- the problems of dealing with global pressures of competition, and
- the country's balance of trade.

In order to prevent these problems from plunging the economy into deep recession, the government has been obliged to provide large scale public spending plans. This would appear to be a poor environment for the market.

Can you explain why you currently hold an overweight position in Japanese equities relative to benchmark? [18]
[Total 50]
[including 9 marks for drafting]

2 You are an investment consultant recently appointed to advise the trustees of a pension scheme. For its UK equity content, the scheme employs a passive manager and two active managers, with each manager responsible for approximately one third of the UK equity assets.

The first active manager uses a sector neutral approach, i.e. it holds index weight in each industry sector and seeks to achieve outperformance by stock selection alone. The second active manager uses the following process for portfolio construction. It restricts equity selection to FTSE 350 stocks. It uses a factor-based screening program based on several accounting ratios to identify 70 stocks for deeper analysis. It then researches these 70 stocks intensively, using investment research techniques, in order to determine the 30 “best” stocks. Its UK equity portfolio holds an equal weight in each of these 30 stocks, irrespective of the index weight of the stock. The research process is continuous and the holdings change to reflect the manager's research opinions.

The combined portfolio of the three managers has underperformed the FTSE All Share Index by 1.5% p.a. over the last three years, after allowing for investment management fees. The trustees of the pension scheme have asked you to conduct an evaluation of the managers individually and in combination.

Explain in detail how you would conduct your investigation, identifying the additional information you will require. You may assume that you will have the opportunity to interview the managers and will have access to complete performance data on the pension scheme. [50]