EXAMINATIONS

September 2002

Subject 401 — UK Fellowship Investment

Paper Two

EXAMINERS' REPORT

Introduction

The attached subject report has been written by the Principal Examiner with the aim of helping candidates. The examiners are mindful that a number of interpretations may be drawn from the syllabus and Core Reading. 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.

The report does not attempt to offer a specimen solution for each question — that is, a solution that a well prepared candidate might have produced in the time allowed. For most questions substantially more detail is given than would normally be necessary to obtain a clear pass. There can also be valid alternatives which would gain equal marks.

K Forman
Chairman of the Board of Examiners

26 November 2002

© Faculty of Actuaries
© Institute of Actuaries

In the main candidates scored better on Question 1 than Question 2. A number of candidates seem to have been unsettled by hedge funds being introduced, suggesting that it was not part of the syllabus. The examiners have taken this into consideration but believe that only limited detailed knowledge of hedge funds was required to answer part (ii) of the second question and that the rest of the question was well covered in the syllabus. Additionally, hedge funds were adequately covered in much of the recommended reading and were a regular feature of day-to-day commentary in the financial press. Consequently the examiners do not believe that the question was unfair.

Specific comments on each question follow at the end of the individual solution.

1 (i) In order for the trustees to better understand unquoted investment they need to understand what they are, their advantages and disadvantages and what venture capital is.

Unquoted shares are not listed on a stock exchange
Their advantages are higher expected returns, opportunity to profit from pricing anomalies due to poorer information, opportunity to invest early in emerging businesses (or companies) which may grow strongly in their formative years. Less correlation with other assets so helping portfolio diversification. (although the low correlation may be more illusory than real due to the effect that a lack of liquidity has on the price history statistics.
The disadvantages are poor marketability (especially in the case of private equity funds or partnerships where there may be little or no chance to exit early), higher dealing costs, higher portfolio management costs (either directly through the need for additional specialised staff or indirectly through the higher fees charged by specialised funds), lack of information, uncertain valuation and greater investment risk. (Lower liquidity may not be an issue in a less mature growing fund which has few pensions in payment or at least is still cash flow positive.)
Venture capital (development capital, private equity) is a specific form of unquoted investment
Common venture capital investments are
small companies at an early growth stage
larger companies for secondary growth stage
management buy-ins or buy-outs
taking a public company private
The methods by which one can invest in unquoteds are through establishing ones own fund and hiring appropriate staff, investing in an established fund or partnership or investing in a venture capital company (e.g. III). Often the investment in a fund (or fund of funds) takes the form of a commitment to invest a certain amount. The funds are drawn down over a period of time as suitable opportunities arise and eventually distributions are made as investments mature or as fund wind-up.
Bonus mark for most suitable method (own fund)

(ii) The report should be set out as follows:

<u>Outline of Project</u>

operating life
cashflows (in real money terms)

<u>Evaluation of Project</u>

Net Present Value (NPV) and appropriate/required discount rate
Internal Rate of Return (IRR)
Payback Period

<u>Determine Viability of Project</u>

satisfies established criteria — return, risk, synergy, political constraints, effective use of capital

<u>Risk</u>

identify and investigate
outline best course of risk mitigation
list other risks not allowed for
consider upside risk as well as downside

<u>Submission</u>

specify expected return
risks (allowed for in return and otherwise)
proposed method of finance
overall expected return and recommendation

(iii) Size of issue
Credit rating
Relative cost of debt, equity
Cash flow
Leverage
Investor tax position
Current financing arrangements
Market conditions

The answer to this capital raising part of the question required reference to the company's relative cost of debt and equity, the company's desired leverage and the effect of the new capital raising on both of these after the knock on effects of potential changes in credit rating, share market reaction to the announcement etc...

Hence the answer required the student to appreciate both the cost of the financing and the need to put it to good use.

(iv) Loan servicing
Premium yield for structure
Premium yield for lower marketability, lower security
Underwritten, pre-placed, syndicated
Convertible loan stock, value depends on likelihood of conversion, higher income than shares until conversion. Better security. Floor is the share price subject to conversion conditions.
Co. is writing a put

There was evidence that candidates assumed the question related to a large U.K. self-managed pension fund throughout although the information was contained only in (i) and not as a paragraph at the start of the question. As a consequence answers to (iii) and (iv) missed many of the points. The examiners believe that the question was correctly worded and lack of examination technique caused poorer candidates to misinterpret the questions, but have taken this into account when marking.

Answers to (iv) were particularly disappointing with many candidates showing little understanding of debt and convertible loan stock issues.

2 (i) The following points should be mentioned:

Myners' Review — Effective allocation of capital, more use of alternative strategies, transaction costs, soft commission, unbundling of research, passive increasing market share, increased focus and scrutiny putting downward pressure on fees.

Increased competition from international houses
Increased competition from new products impacting traditional funds
Smaller firms will be impacted more than large ones

Problems in finding, training and retaining key staff
Problems in delivering expected returns to shareholders

Poor absolute returns in recent years
Poor relative returns from balanced funds and MFR/FRS17 impact
Lower forecast future returns impact profitability of managers
Move to passive, fund of funds, specialists, increased bond exposure
Increased interest in alternatives
Alternative investments are less developed asset class = opportunity
Higher fees available
Performance fees often the norm

(ii) The key characteristics are

More emphasis on absolute returns
Returns not solely a function of underlying assets

Limited downside often a feature
Extensive use of all investment instruments
Diversification due to low correlation with bond/equity returns
Make use of short selling, stock lending, gearing, arbitrage

The main types are

Long and short equity/bond funds (specific asset classes)
Long and short strategies based on futures/options worldwide
Global opportunities — speculative investments
Relative value funds — exploitation of perceived anomalies
Event driven — takeover, merger, political

(iii) Run underlying hedge funds directly

Advantages

- full fee income captured
- direct control of investment process and performance

Disadvantages

- takes time to build track record (longer time than fund of funds)
- no brand image
- seed capital required
- specialist staff require to be hired
- infrastructure required to manage new "product"
- timeframe for building successful business may be short

Run fund of funds that constructs portfolios of hedge funds run by other houses

Advantages

- less costly to set up
- quicker to set up
- less infrastructure needed
- more immediate choice to customers (product tailored)
- performance risks spread over different organisations and strategies

Disadvantages

- lower fees
- less control of customers (could go direct)
- needs manager research process to be set up
- less investment control

Set up a Joint Venture with hedge fund manager

Advantages

- good hedge fund brand will allow sales sooner (track record)
- infrastructure and management expertise in place

Disadvantages

- less control
- share of fees
- exit/development strategy needed
- knowledge transfer
- brand dilution/confusion

(iv) This last part requires the candidate to look at who the clients might be both from the existing clients and new clients perspective. For each possible client we need to look at it from their view and so consider

- their overall objective and strategy
- whether the structure of the vehicle is right for them
- their performance targets
- their risk management requirements
- product constraints — dealing, redemption, investment minimum
- administration (what is required by clients)
- reporting

There are no marks for drafting.

(i) Candidates have interpreted "market-place" as stock market and so have commented on returns and ignored Myners, active to passive switch and increased investment in bonds. As a result, few candidates scored well on this part.

(ii) Well-prepared candidates scored good marks on this section.

(iii) This was done well by many candidates since it was more bookwork orientated

(iv) It was disappointing that this part was not well answered, as it is application of a well-covered bookwork section.