EXAMINATIONS

14 April 2000 (pm)

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.*

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 A large well funded pension scheme was set up many years ago to meet the needs of a defined benefit pension plan for the employees of a large manufacturing company. The defined benefit section of the scheme is now closed to new entrants. All new employees join a recently introduced section offering defined contribution benefits, which is backed by assets in a separate fund. Transfer values are permitted by request from the defined benefit plan to the defined contribution scheme.

The current split of the assets of the defined benefit plan is as follows:

UK Equities	65%
Overseas Equities	10%
UK Fixed Interest	10%
UK Index Linked Securities	5%
UK Property	5%
Cash	5%

You have been appointed by the Trustees to review the investment strategy of both funds within the scheme. The Financial Director and Chairman have written to you with their suggestions.

The Financial Director wishes to move all of the assets of the defined benefit plan into UK Equity stocks and UK Bonds.

(i) Explain how the concept of matching applies to a defined benefit UK pension fund and why this may lead to the Financial Director's suggested strategy. [10]

The Chairman of the Board of Trustees wants to consider further asset diversification. He asks you consider the merits or otherwise of Private Equity and Hedge Funds. He also feels that the plan should consider employing a new strategy towards its overseas exposure. He wishes to make use of a new index which consists solely of large global companies, all of which have a substantial part of their sales outside their domestic market. He does not have a view as to whether these assets should be managed on an active or passive basis but would welcome your opinion. Finally he feels that the UK Index Linked Market is overvalued and proposes a switch into US Treasury Inflation Protection Securities (which are US Government securities with an inflation guarantee on income and capital repayment).

(ii) Draft a reply to the Chairman's letter. Your reply should describe the key characteristics of the alternative asset classes suggested by him and discuss in detail the idea that any or all of them form part of the defined benefit section of the fund. [28]

One of the member trustees points out that the defined contribution scheme includes an ethical fund in its range of alternatives for members and that many members utilise this option. He suggests that the defined benefit section should also invest in an ethical manner.

(iii) Draft a reply to the member trustee. Your reply should explain how the investment considerations of the defined benefit and defined contribution sections differ, and how these differences may influence any Socially Responsible Investment (SRI) policy for the defined benefit section.

Your reply should also explain how the government requirements for SRI impact pension schemes and the options which are open to trustees and their managers in meeting these requirements.

[14]

[60 including 8 marks for drafting]

2 You act as an investment consultant and have been asked to advise a major financial institution. To date, the institution's use of derivatives has been confined to stock-index futures contracts and forward foreign exchange contracts, in conjunction with the management of investments. They wish to investigate making wider use of derivatives, e.g. in support of new product development. You have been asked to prepare a report comparing over-the-counter (OTC) and exchange-traded derivatives.

(i) List 10–12 headings you would use in your report. This list should cover practical issues which the client might encounter in using the two types of derivatives, and the different risks applying to each type.

(ii) Detail the similarities and differences between exchange-traded and OTC derivatives under each of the above headings, explaining (where possible) ways in which providers have overcome the relative disadvantages of either type of derivative. [40]