EXAMINATIONS

13 September 2002 (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) Define the term "bulldog bond". [1]

(ii) Compare and contrast a bulldog bond with a UK gilt. [3]

(iii) Describe two circumstances where a borrower would have reason to issue such a bond. [2]
[Total 6]

2 Describe the characteristics of high yield non-investment grade bonds. [11]

3 You are an investment consultant. One of your duties is to research fund management organisations and to assess whether you would recommend them for use by your clients.

Explain the key points, other than investment performance, you consider when judging fund managers. [5]

4 A small private company has a defined benefit pension scheme. Due to a downturn in sales, the company can no longer afford the accruing benefits and wants to close the scheme. The scheme has a deficit of 5% that the company would be required to fund. As a way of recouping the shortfall, the scheme's investment managers have suggested diverting half of the scheme's equity exposure into a new fund they are launching that aims to outperform the market by 3% p.a. Two of the trustees, who happen to be the managing director and the principal shareholder respectively, are agreeable to the proposal in principle but have asked you to prepare a report for the full trustee board to consider.

(i) Describe the further information you would request from the investment managers and the company to complete your report. [6]

(ii) Discuss the principal considerations and risks involved for the trustees and company in implementing the suggested policy. [10]
[Total 16]

5 Your friend has received a letter from a financial adviser. The letter promotes the launch of a new venture capital trust with a fixed term of three years and highlights the tax advantages. Although you are qualified to give advice, he knows that you are not a tax specialist but recalls you have been discussing venture capital with your pension fund clients in response to a government initiative to increase investment in this area. Your friend thinks that with all large pension funds investing, the price of venture capital trusts are bound to rise and asks you whether he should invest.

Outline the points to be considered by your friend before investing. [6]

6 (i) You advise the trustees of large final salary pension scheme. Several years ago, the trustees changed their investment policy to adopt a liability-led strategy that was implemented by one of the leading index-tracking investment managers. The scheme is well funded and the pensioner membership accounts for two-thirds of the liabilities.

Describe the key features of an index suitable for index-tracking management. [4]

(ii) The chairman of the trustees has recently been appointed as a non-executive director of a venture capital firm and is convinced the scheme should allocate 10% of their equity investments to private equity funds. The existing fund manager does not offer a suitable private equity index-tracking fund. The chairman has asked you to investigate why and recommend an appropriate strategy.

(a) Discuss the problems in designing an index for private equity investments. [4]

(b) Explain, with reasons, whether you would support the 10% proposed allocation. [6]

[Total 14]

7 A new global accounting standard for valuing defined benefit pension funds within sponsoring company accounts has been introduced. In order to achieve consistency between companies, the assets of the scheme are taken at their market value at the close of business on the last day of the accounting year. The dividend yield on the domestic equity market is taken as the discount rate for valuing the liabilities. Discuss the implications of the new standard for investment strategy. [10]

8 (i) A recently established defined benefit pension scheme is expecting a large transfer payment in cash that will constitute 95% of the scheme's assets once received. The payment is in respect of the past service entitlements of current employees following the management buyout of the company.

Discuss the principal considerations and responsibilities of the trustees in setting an asset allocation. [6]

(ii) The company's finance director, who is also a very vocal trustee and shareholder in the new business, is concerned that the market is at a high level and wishes to protect the assets from a fall in the next 12 months. He suggests that they put the transfer payment in an interest bearing deposit account and asks you to prepare a report for the trustees on the proposed strategy.

(a) Comment on the potential risks involved in adopting the finance director's suggestion. [5]

(b) Describe briefly an alternative strategy that could satisfy the finance director's concerns. [3]

[Total 14]

9 Two companies intend to merge. One company is UK tax resident. The other company is not. They intend to merge by offering their current shareholders one share in a new holding company for each share held in the current companies.

The foreign company currently pays corporation tax on profits and may pay dividends from taxed profits only. Dividends received by shareholders, who are tax resident in the foreign country, are treated as taxable income.

Managements of the two companies are considering whether to make the new holding company tax resident in the UK or the foreign country.

(i) Describe briefly the UK corporation tax system. [1]

(ii) Explain the tax factors that the management should consider before deciding the tax residency of the holding company. [5]

[Total 6]

10 Outline three ways that technical analysis can be used to make trading decisions. [6]

11 Compare the use of a capitalisation weighted world market index with the alternative of fixed equal weights for allocating overseas equity exposures between the major regions. [6]