EXAMINATIONS

September 2001

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
20 November 2001

Examiners' Comments

Paper 2

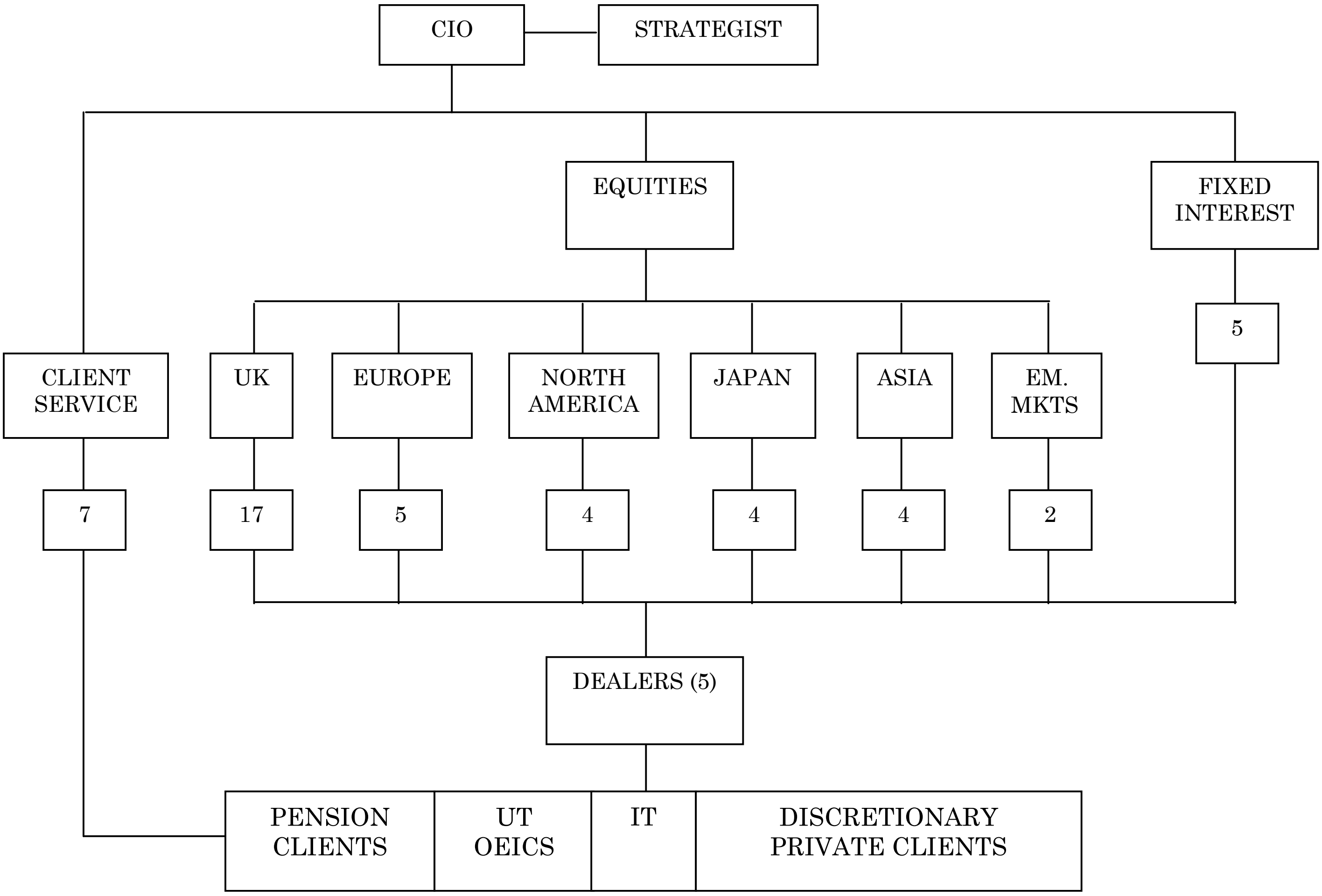
As in the first paper, candidates found application questions difficult. Overall, however, the average was better.

Q1. (i), (ii) & (iii) were done reasonably well. The answers to (iv) were disappointing with many candidates missing the obvious points. The apparent lack of knowledge displayed in answering (v) was worrying and recommendations were absent in a number of cases. Answers to (vi) were reasonable although many obvious points were not picked up on.

Q2. Despite being asked to compare, many candidates just listed the features and so did not pick up all the marks available despite lenient marking. Answers to (ii) and (iii) were reasonable.

Q3. Few candidates were able to do the required calculations correctly. Most failed to note that the management fees and interest costs were a capital charge. Report drafting was reasonable but the content lacked clarity perhaps because the answers to (i) and (ii) were poor. Alternative investment suggestions were also limited with few identifying with the income need.

1 (i)



(a) Schematic is worth 4 marks

(b) Dealers — 1 mark

(c) Team members — ± 1 okay but need minimum 2 in any team, at least 4 in fixed interest and at least 14 in UK given client mix and numbers —

(i) Advantages are

(a) each team is client focused in terms of servicing, investment style and investment development

(b) investment management is product defined and skills associated with closed fund and open fund management are enhanced

(c) private client business would expect an integrated and dedicated team of this nature

Disadvantages are

(a) research functions are likely to be duplicated and may cause brokers to give different service to different groups

(b) possibility on one team buying whilst another is selling — stock control system will therefore be required.

(c) more staff will be required to cover smaller asset groups as minimum of 2 required in any area or fewer asset groupings [Japan/Asia/Euro Markets amalgamated]

(d) new business opportunities will have to be staffed up separately or developed out of an existing area

Does not seem an appropriate structure

(iii) Advantages are

(a) allows stocks to be analysed relative to global competitors which may be appropriate given internationalisation of companies and markets

(b) team in central location allows consistency in decisions, reduces overheads and gives flexible cover

(c) allows greater degree of specialisation and knowledge to be applied

(d) broker research and servicing moving this way

(e) well suited to portfolio management based on stock selection methodology rather than asset allocation.

Disadvantages are

(a) local presence in regions will be impractical

(b) local market effects come to importance in total return and these may be lost

(c) some sectors are not global in nature or have regulatory controls that would offset views

(d) existing mandates may not fit comfortably into such a structure [may have been sold on asset allocation basis]

(e) currency movements have different effects for different clients [client base is multi-domicile]

(iv) Answer should be based on comparison with current UK pension fund median or average asset allocations for balanced, non-property, funds as for WM, CAPS etc.

Comment should be along the lines of

(a) u/w UK equities, fixed interest and cash

(b) o/w overseas equities, US and Asia particularly

Additional information required is

(a) What has trend been in these allocations — are they extreme or the norm compared with longer term record?

(b) What have clients been sold vis a vis median/average fund?

(c) What has performance record been in each asset class against benchmarks?

(d) What is the mix within the UK equity portfolio in terms of large v small sector biases etc?

(e) What is mix and structure of fixed interest portfolio (gilt v i-link v overseas, others)?

(f) What are hedges — future options, index, equity, gilt, currency?

(g) What are other equities — venture capital, funds, property units?

(v) The solution should be a commentary on equity and bond returns based on Core Reading Unit 9 Tables 2 and 4.

The factors that have influenced returns are

(a) low and stable inflation in UK and US but deflation in Japan

(b) greater efficiency through flexible labour and technology use helps all but reduces Asia's labour cost advantage

(c) economic debt crisis in Asia brought spectacular growth of early 90s to a halt

(d) better economic management has reduced UK and US gov't debt via budget surplus

(e) movement of sterling and other currencies generally reduced returns

In relation to bonds in particular

(a) conventional gilts better than index-linked over longer term

(b) MFR has pushed funds to long gilts

(c) overseas returns have not added value

(d) There has been a lack of liquidity in index linked and corporate debt market

(e) reduced supply of long dated gilts a concern.

(f) yield curve inverted at short end → shorter dated around 5 years may have attractions as yields fall

(g) more corporate issues coming to the market

(h) asset backed securities being developed

Recommendation

Diversification, subject to any MFR constraint, should be considered and should include corporate bonds, asset backed securities and shorter-dated gilts. Index-linked not so attractive unless required for matching purposes. Some overseas bond investments could be appropriate subject to currency considerations.

(vi) The paper needs to cover

(a) what the investment mandate will be

(b) what would be invested in

- futures, options or physical
- energy, precious metals, base metals, agricultural or meat

(c) what restrictions would apply to dealing in the units of the fund (if any)

- needs to address illiquidity of underlying assets
- timeframe of futures/options investments
- physical delivery

(d) new resources required to manage fund

- fund management
- administration
- custody/storage

(e) fees that could be charged

(f) to whom it could be sold, maximum fund size, minimum investment — UK institutions have not been interested

(g) volatility, professional arbitrage

(h) comparable fund returns in an appropriate context

2 (i) Table 1 below compares currency forward and currency futures contracts in terms of their usefulness for the manager.

Table 1
Comparison of Foreign Exchange Forwards & Futures Contracts

Comparison Heading	Forwards	Futures
Maturity Date Choice	Tailored to portfolio's needs	Standardised Considerable basis risk if closed out early to match transactions in underlying portfolio.
Contract Price	Quoted by foreign exchange dealers at a number of different banks	Arrived at by open outcry in the foreign exchange futures pits.
Dealing Expenses	Very low for large transactions	Very low for large transactions
Margins	Depending on the credit rating of the portfolio there may be initial margins and some marking to market.	Initial and variation margins required. Contracts are marked to market daily.
Availability	Major players in the foreign exchange markets will quote forward prices for a wide range of currencies over a wide range of terms.	Limited to a few currencies. Limited set of maturity dates which means contracts need to be rolled to provide a long-term hedge.
Marketplace	Telephone and screen based markets available	Central exchange; need to deal through a futures broker.
Accessibility	Limited to large customers	Contract size significantly smaller than in the forward market. Open to speculators, hedgers and arbitrageurs.
Clearing & Settlement	The quality of clearing and settlement is at the discretion of the bank counterparty.	All trades cleared and settled via the exchange clearing house.
Credit Risk	Depends on the bank you are dealing with	Guarantee of the clearing house available to general clearing members. Other participants bear credit exposure to their futures broker.
Closing Out a Position	Negotiate with the counterparty bank; very little competition on the unwind price for exotic currency forward contracts	Enter an offsetting contract

(ii) Futures contracts have both positive and negative cash flow implications as they require initial margin (negative cash flow for the portfolio) and variation margin (could be either negative or positive).

Forward contracts are usually settled at maturity but some counterparties could call for both initial and variation margin.

The cash flows on the underlying portfolio arise only when stocks are bought and sold.

For a long-term hedge, forward contracts for one term may have to be closed out and reopened for a further term.

The profit or loss on such transactions may be out of time step with the cash flows of the underlying portfolio.

These cash flows need to be funded and invested.

(iii) Despite their disadvantages in terms of closing out a position and credit risk,
forward contracts win hands down over futures for hedging purposes because of
the limited availability of foreign exchange futures contracts covering sterling and the inability to tailor maturity dates and amounts to the needs of the portfolio.

3 (i) Answer will depend on LIBOR in September 2001. Using current rate of 6%, the solution is:

Income = £50m × 8% + £50m × 1.5% = £4.75m
Expenses £(0.08m)
Net Income £4.67m
Dividend = £4.67m/60m = 7.78 pence.

(ii) Loan interest and management fees are being capitalised

Cost = £40m × 6.85% + £100m × 1.0% = £3.74m.

∴ Minimum return required on gross assets = 3.74%.

(iii) Four marks are available for drafting and will be given for producing the report in a suitable structure much as under the following headings

(a) Introduction
(b) Outline of trust structure
(c) Investment return factors (i) the trust (ii) the trust's assets.

(d) Risk assessment
(e) Dividend and taxation
(f) Other investment alternatives
(g) Recommendation

Points to be made under each heading are

(a) – highly geared investment trust debt/equity 40/60

– reason for investment would be to meet income requirements of clients.

(b) – balance sheet is

Assets		Liabilities	
Trust investment	50	Loan	40
Global Income	50	Shareholders	60
	100		100

∴ Shareholders only 50/60 = 83% expressed to equity.

(c) (i)

Assumed rate of Cap. Growth (%)	*Total return (%)*		
	Inv. Trusts	*Bonds*	*Proposed Trust*
0	1.5	8.0	4.0
5	6.5	8.0	6.5
7.5	9.0	8.0	7.8
10	11.5	8.0	9.0
15	16.5	8.0	11.4

(assumes bonds held to maturity i.e. no growth)

– trust proposed is never the best investment

(ii) global bonds — to achieve yield will need to be

– emerging markets
– corporates
– lower credit rated government

investment trusts — returns will be affected by

– underlying asset allocation
– discounts
– double management charges
– gearing of underlying assets

(d)
- life of trust is seven years but what is bond duration
- growth of 3.74% on total assets requires 7.48% on trust portion to return capital — is this realistic?
- currency risk in bonds — hedge?
- currency risk in dividends given source — hedge?
- loans convenants
- trust discount on own share price
- taxation changes in foreign location

(e)
- little dividend growth since ~80% income from bonds
- UK resident will pay tax at marginal rate with no credit (some double tax)
- security of dividend could be an issue given bad risk being assumed

(f)
- global fixed interest bond portfolio
- rebalance existing portfolio between bonds/equities
- raise yield on existing equity portfolio
- use corporate bonds
- use preference shares
- consider creating income using capital gains allowance

(g) Recommendation should be with regard to whether or not investment in the trust is suitable for clients.

There is no one answer but would expect something like:

"Provided risks are acceptable, it is a better investment than global bonds given equity growth should achieve the hurdle to return initial capital."

However an argument against with suitable reasoning should be equally acceptable.