EXAMINATIONS

September 2003

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.

J Curtis
Chairman of the Board of Examiners

25 November 2003

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There were no general issues with the papers and candidates do not appear to have had any time constraints. We would also re-emphasise that candidates should use the information given in a question and frame their answer around that.

Answers in this paper were often too general and failed to focus on the specific problem.

1 (i) There are three methods by which the firm could add an international product.

- direct — setting up a full investment management team similar to the current UK set-up

- joint venture — find a partner with similar style and methods and arrange to cross market each others product

  — market "guest funds" for a commission to generate goodwill with client base

- acquisition or merger — as with joint venture but take it a step further and fully integrate the businesses

(ii) Direct

Advantages

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

Disadvantages

- takes time to build track record
- 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
- UK product could suffer from dilution of management time
- poor overseas performance could damage UK reputation

Joint-Venture

Advantages

- good brand will allow sales sooner (track record)
- infrastructure and management expertise in place
- low development costs

Disadvantages

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

Acquisition/Merger

Advantages

- good brand will allow sales sooner (track record)
- infrastructure and management expertise in place (but see disadvantages also)
- greater control of business
- better control of processes and knowledge
- direct/immediate access to market share
- potential economies of scale

Disadvantages

- cost of acquisition
- agreeing merger terms and modus operandi
- integration of businesses may be difficult
- brand dilution/confusion

difficulties of finding an appropriate target

(iii) There are many points to be made here and the solution is not necessarily fully comprehensive but all the main points are covered.

Marketing

Is this the International Equity Product (IEP) going to be marketed in the UK only, or overseas as well?
If so, where?
Need to consider local market conditions.
Marketing authorisation by regulators in each country needed.
And how will the marketing be done, from the UK or with local offices?

Will the IEP be retail only, institutional only or both?
Retail market driven by mainly performance and star name managers.
Institutional market less so, and may take longer to achieve sales even with good performance; would need to give consultants access to portfolio managers for detailed, in-depth meetings; investment process would need to be very clearly articulated.

Will the IEP be available as a pooled fund or as a segregated product, or both?

Clearly retail market requires funds.
Institutional requires both.

What is the market demand for this product?
Who are the principle competitors?
Need to perform SWOT analysis on competitive products and compare with own proposal.

Who will do the marketing?
Often in small houses, the portfolio managers do much of the marketing and client servicing themselves, at least in the early days of the company; will this be so for the IEP? Or will specialist marketing staff be needed?

People

What investment skills and experience will be needed
How many portfolio managers and research analysts will be needed?
How easy will they be to hire?
How much will they cost?
How will they be organised? Career analysts in separate team? Or analysts as junior portfolio managers?

Investment Objectives & Process

What will the benchmark be?
Could be market cap, or regionally fixed-weight
What is the outperformance target?
Over what period?
How will the product be managed? Style bias? Large cap/small cap bias?
Bottom-up, top down or combination?
Regional allocations, or sector allocations, or stock picking only?
Risk controls? E.g. tracking error (ex-post or ex-ante), limits on divergence from benchmark country/regional, sector or stock weights.
Will there be a single version? Or variants by: differing performance targets, risk, etc.
What will expected turnover of stocks be?
Is current UK process likely to be successful internationally?

Location

Will the portfolio managers be based in UK?
Or overseas?
How will overseas markets be covered for analysis of companies?
Local analysts for US, Far East? Hard to establish credibility without international coverage.

Financial Projections

A full cost/revenue analysis needs to be carried out.
What are the required financial targets of launching the new IEP?
Funds under management? Fee income? Profit directly attributable to the IEP would be ideal, but may be hard to quantify precisely if there is sharing of costs between it and the UK product in some functions.

Dealing

This will now need to be international, no longer just UK stocks.
Experience of current staff?
Extra staff needed?

Other

Can the current business infrastructure cope with this expansion?
E.g. such mundane areas such as internal mail delivery, office space, desks, IT support, number of support staff in each function (marketing support, RFP team, Finance department, admin etc. etc.)

Can client requested Corporate Governance policies be implemented for the IEP?
It is much easier to do this for UK Equity mandates only.

Administration

Will admin systems cope with the IEP?
Differing currencies involved?
Staff skills able to deal with overseas stock portfolios?
Custodian issues — need international excellence
Client agreements will need looked at and possibly amended
Tax implications for both clients and fund manager need to be investigated

Client reporting/servicing

More staff needed?
Will the systems need changing to deliver non-UK reports in appropriate formats?

There were no major issues with candidates' answers and candidates appear to have had no interpretation issues.

2 (i) RE: Reporting on New Asset Management

In order to provide an assessment of New Asset Management (NAM) I will look at the following:

1. Past performance

As NAM has only been in existence for three years and eight months, the performance time periods will be short and it will therefore be necessary to carry out extensive research on the individual managers and their track records at previous investment management houses.

I would look at:

- Past performance relative to the appropriate benchmark. We tend to favour looking at comparative rolling 3 year returns as a good indicator of fund management ability, and would compare this with other large investment managers. It is likely that NAM would have few funds that would have been run for the full three years therefore shorter periods would need to be looked at. In addition the individual managers previous track records would need to be studied.

- In addition we would look at the volatility of performance relative to the benchmark as this is a good indicator of the risk profile of NAM. Again we would show how NAM compares with other large investment managers. We should also compare performance against stated objectives

- In-house volatility — we would look at the dispersion of returns achieved by NAM for portfolio with similar mandates. Ideally one would wish for a small dispersion thus implying NAM manages its portfolios consistently. Again this investigation might be hampered by the short life of NAM, it is likely that NAM will have started with only one or two funds to manage.

- Attribution analysis — we would analyse where NAM's performance or underperformance relative to its benchmark comes from i.e. asset allocation, sector allocation, stock selection etc., and how this compares with NAM's stated investment philosophy.

- Portfolio style analysis — The stated style of NAM should be compared against the actual portfolios composition. I.e., NAM are running the portfolios as they say they are.

2. Client Relationship Considerations

The quality and speed of delivery of the quarterly investment reports is a good indication of the efficiency of the NAM's mid and back office. Again the fact that NAM has only been in existence for a short period might make this difficult, it is also possible that some or all of the back office functions have been contracted out to a third party and the stability of this operation should also be investigated.

Need to compare the products and fee structures offered and whether suitable for clients

How would transition from existing manager be handled

3. People

The importance of the senior people who work for NAM is self-evident. The research will examine:

- The quality of senior people — their experience, track record and commitment to the business.
- Depth of resources — the number of investment staff involved for each major sector, systems at their disposal, the dependence on any "star" fund managers.
- Continuity of staff — this is a critical determinant of success. It is important to examine whether the investment fund managers who have achieved the returns for the funds are still in NAM, and if not, what changes have been made. We will also examine how NAM plans to retain key staff. While still a relatively new fund management operation the history of personnel changes will be worthy of investigation.

4. Investment process

The firm should have a clear process of how it expects to outperform the competition/benchmark. This process should be analysed in detail, looking at how research is carried out, buy and sell disciplines and how asset allocation is determined. It is important to try to evaluate the consistency of the process so that the exploitation of market inefficiencies is repeatable. The process should also be looked at in relation to the performance attribution analysis carried out. The decision structure will also be analysed in terms of its ability to enable making fast effective decisions.

5. Business management

It is likely that NAM has grown over the last three years and attracted new clients. This growth should be examined in detail and also how they have planned for and coped with this growth, specifically looking at:

- Investment in new capacity — hiring new staff ahead of the new business or improving the technology and systems to allow fund managers to cover more clients.
- Maintaining the quality of staff/not impairing the investment process by having more people involved.
- Solving the liquidity problem of growth — this could affect the firm's ability to buy/sell stocks and may require adjusting the investment process.

This full analysis will obviously generate a lot of information about NAM. The key points about our review are that:

- Performance statistics should be used to gain a better understanding of the investment style of NAM.
- The quality of NAM as an investment organisation reflects a combination of factors the most important of which are the quality of the investment process and the quality of the people.

6. Attitudes to Corporate Governance and Socially responsible investment

- What principles do they employ with regard to corporate governance and from whom do they take advice (NAPF, ABI, PIRC)
- NAM's attitude to failing management.
- Attitude to Myners report and likely response.

(ii) The information ratio is a method by which the return a manager adds can be evaluated given the risk they assume. The information ratio takes a fund's excess return over benchmark and divides it by the tracking error. The higher the information ratio the more successful the fund manager has been at adding value without taking excessive risk.

The figure of 0.91 is a high level for the information ratio and implies that the fund manager has added value over the time period which the information ratio was calculated.

A tracking error gives an estimate of the risk relative to the benchmark the fund manager takes. It measures the deviation from the benchmark of the portfolio(s) in question.

The figure of 2.8% would be consistent with many UK equity portfolios targeting modest outperformance of a benchmark and is not overly aggressive.

The price to book of a portfolio gives an indication of the style of the fund manager, a high price to book ratio would indicate that the manager was not a value manager as in general value managers would tend to prefer stocks that had asset backing.

The price to book ratio of 0.75 relative to the benchmark obviously shows the portfolio has a bias towards asset backed companies and it therefore indicates that the manager has a bias towards value.

The probability that the manager has a value bias is increased by looking at the figure for the yield. Dividend yield is last 12 months dividend as a percentage of current market price. The portfolio(s) yield 25% more than the benchmark, this is another characteristic of a value fund manager.

The sales to market capitalisation ratio, defined as annual turnover divided by the product of shares in issue and current market price, is also greater than one which is another trait of a value fund manager indicating that the fund manager may be more interested in current sales than potential future growth in sales.

Historic earnings growth is defined as the annualised change in earnings per share over a period of time, normally three or five years.

Viewed in isolation the historic earning growth figure of 1.2 is less conclusive in terms of style. Depending on how growth or value stocks earnings had performed relative to each other in the past different conclusions can be reached. Over the recent past value stocks have produced higher earnings growth, or smaller earnings declines, than many growth stocks.

It is therefore not incompatible for a value fund manager to have a portfolio with a historic earnings growth of 1.2 relative to the benchmark.

The market capitalisation ratio indicates that the fund(s) have a bias to smaller companies within the index.

Beta measures a stock's volatility relative to movements in the whole market.

The beta of 0.95 shows that, overall the portfolio has a defensive stance indicating that it should outperform a falling market and underperform a rising market.

(iii) Looking at the style information above it is probable that the manager is a value investor and that the funds have probably performed well over the period in question as equity markets have fallen sharply with growth stocks giving back much of the gains they had made prior to 2000.

Value fund managers have benefited in this climate.

The information ratio also indicates that the fund(s) have outperformed in the period over which the ratio was calculated.

(i) A number of candidates focused their report on a specific audience. This tended to restrict their commentaries. The short track record was not commented upon sufficiently and many business management issues were skirted over.

(ii) and (iii) Candidates were able to define the items but conclusions tended to be weak. This was particularly evident in (iii) amongst weaker candidates many of whom were unable to demonstrate understanding of what the numbers actually meant.