EXAMINATIONS

April 2004

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 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.

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Chairman of the Board of Examiners

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1 (i) Incumbent Review — assessing quality of incumbent investment manager and recommending action.

Manager Structure — creating combinations of investment managers to manage mandates identified by asset liability modelling and other analysis.

Manager Selection — finding suitable candidates to populate structure.

Qualitative Monitoring — more information available to allow detailed qualitative analysis as to whether manager and structures in place optimal.

Detailed Quantitative Monitoring — with own "universe" of managers closely monitored, able to compare manager against peer group.

Selling Research — database of managers and median data could if desired be sold to clients/selected third parties.

Becoming a Manager of Managers — knowledge of managers and ability to combine them could be used to enter manager of managers market.

Manager Advice — with knowledge base of how successful managers operate, option to consult to investment managers on how to improve their overall offering. (This would have to be done at a strictly arms length basis to avoid creating conflicts with client advice.)

(ii)

- Option A will mean your firm is more in control.
- Finding staff for A may be difficult and expensive.
- Staff cost within A could be high (people likely to be close to highly paid fund management community).
- Time to build A could be a problem if wanting to enter the market immediately.
- Option A would be a significant departure from your key business strengths.
- Ability to "sell" A to your client base may be constrained at first. You need to build up credibility over time. Option B should come with ready made (acceptable) track record.
- Both options could damage relationships with existing clients if it went wrong.
- Option B might be more appealing than A if things did go wrong. (Providing arrangement with supplier included appropriate termination clauses.)
- Finding a supplier under B might be difficult.
- There would likely be significant costs involved in surveying the market to find a supplier under B and choosing between the different options available.

- There would be significant legal costs on negotiating a deal with a supplier under B although regulation costs associated with option A would also be likely to be high.
- Managing option A once established could prove to be time consuming and expensive (with staff always liable to be tempted back to more lucrative fund management industry).
- If option B taken, significant in-house investment may well still be required since manager selection activities are only part of the work that you would wish to be doing.
- As well as credibility with your clients, you would need credibility with the fund management community whom you would be researching. Would the managers make time for you as a new player were you to take option A?

The suitability of each option depends on whether your firm is expecting revenue growth in this market for the long run. Any lack of conviction in your ability to add value or your desire to commit to this part of your market promotes option B ahead of A. A long term commitment would be best served by A but it would involve serious initial investment and long term running costs.

(iii) A manager of managers uses investment manager research data to identify skilled managers who are usually operating in specialist areas of the markets.

The manager of managers then combines the managers into packaged "solutions", negotiates acceptable fees and makes them available to groups of investors.

This route benefits the investors as they gain access to carefully chosen and combined specialist managers that otherwise would be prohibitively expensive to find and appoint.

Responsibility for the manager line up shifts to the manager of managers with the investor not (usually) involved in monitoring the underlying structure at all.

In your circumstances, this route is likely to be attractive to mid and small cap clients and prospects who might not otherwise be able to create multi specialist investment manager structures.

(iv) By entering the manager of managers market, you will be establishing your firm (in some way) as an investment manager leading to an extra regulatory burden.

Aside from this, the cost of marketing the products to ensure the assets under management and hence the revenue gained momentum would be significant and beyond your "normal" activities.

Charging on the manager of manager funds would be asset based with a likely shortfall to be absorbed whilst assets under management remained small. Your revenue stream on this line of business would always be market dependent compared with the likely time cost based or retainer fees associated with your current business.

Whilst not necessarily a problem, your "performance" as an investment consultant would be very much in the public domain — i.e. if your manager line up proves successful then no problem, if they underperformed then you would have questions to answer.

If the manager of manager funds were only part of your investment consulting offering, you would have to answer questions over your "independence" if you were seen to promote your own funds over the competition.

(v) The fund range design would be largely based on both your past strategic work (through your asset liability modelling etc.) and market research.

Your strategy work would, over the last few years, have led you to recommend certain combinations of asset classes to your clients. Coverage of these classes would be required to ensure suitability for your existing client base. However, some control would be required — i.e. covering the entire range of assets used by your target market might prove too wide and hence prohibitively expensive.

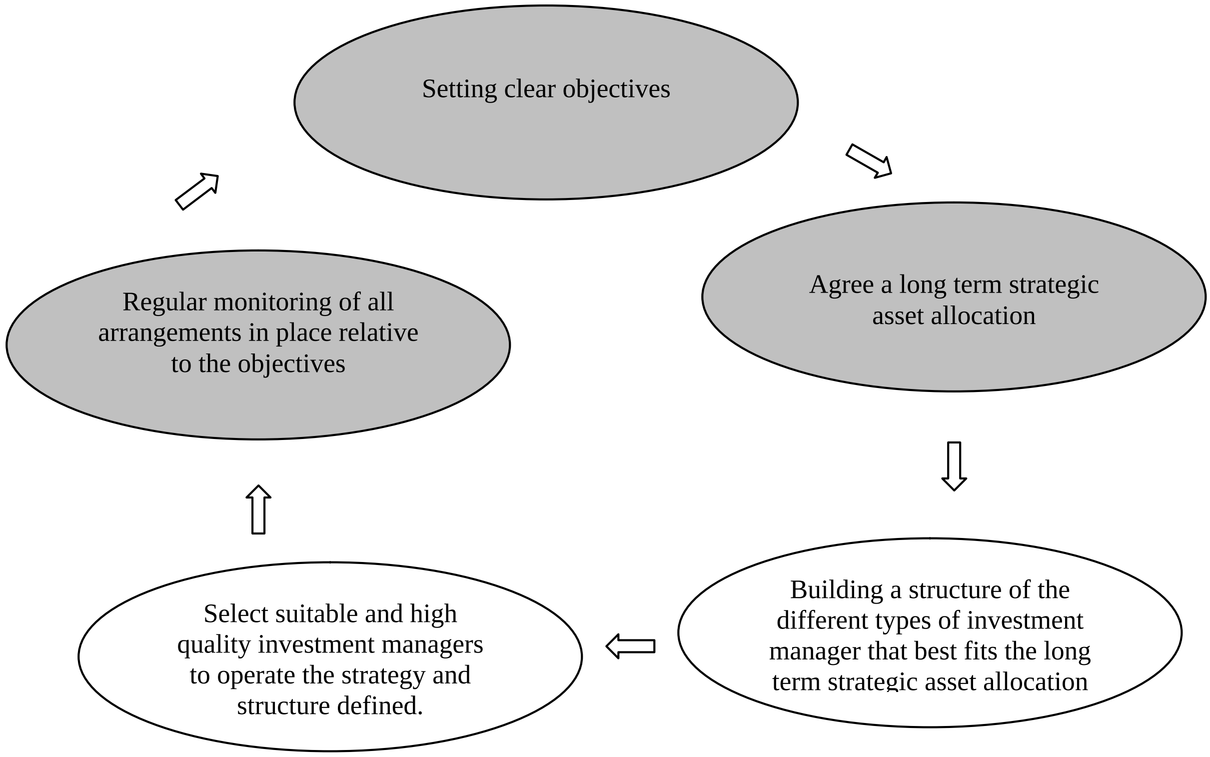
Your range would also have to be controlled by the capability of your new investment consulting practice. It would be important to restrict your fund range to market areas where you had expertise and, hence, the ability to add value.

Market research would help to confirm that your client base was representative of the market (or not). It would also help identify whether there were other asset classes for which there was likely to be a demand.

A reasonable fund line up for the current market might be as follows:

Domestic Equities
Overseas Equities (sub-divided by geography)
Global Equities (sub-divided by sector)
Index Linked Gilts
Fixed Interest Gilts
Discretionary Bond Fund
Fund of Hedge Funds

(vi) With each fund's investment strategy or asset allocation defined, your team would follow the actuarial control cycle as applied to investment arrangements (relevant areas non-shaded):



The structure of the investment managers would likely be defined first. This would include the following:

- The number of managers required.
- The overall balance of value/growth/core managers.
- The balance of large/mid/small cap managers.
- The out-performance targets.
- The role of a passive manager (to perhaps, by careful combination with the central active option, allow alternative performance targets in certain cases).
- Transition arrangements for new/departing clients and manager rebalancing should be set at this stage.

The manager selection activity would be focused on populating the structure already defined:

- With already established opinions on the investment managers available, the senior investment professionals in your firm should agree "best in class" managers according to the normal qualitative and quantitative process.

- Formal "beauty parades" would be unlikely to be required although candidates might be called upon to discuss any queries coming out of the existing research.

- Fee negotiations will be a vital part of the manager selection exercise. You will want to agree discounts with the managers to reflect your increased workload and their decreased workload in client servicing. Crucially, however, it would be dangerous to not select a manager based on your inability to negotiate a discount.

- Expected asset sizes will also need to be factored into the fee negotiation to ensure you and the clients got value for money.

2 (i)

Comparison Heading	Writer of a Put Option	Holder of a Corporate Bond
Premium	In a written put option the writer receives a limited amount of money (a premium) in return for taking on the risk that the price of the underlying asset will fall.	The holder of a corporate bond pays an upfront payment to purchase the bond and expects to receive a limited payment stream in return. The purchaser expects to get his/her money back plus a return for assuming credit default risk.
Limited upside	The upside for the writer of the put option is limited to the amount of the premium.	The nominal return to the holder of the corporate bond is limited to the gross redemption on the bond at the time of purchase assuming that coupons can be reinvested at that rate.
Very significant downside	The downside potential is significant if the share price falls to zero.	The downside potential is significant if the company decides to default on its debt.
Credit risk	The writer of the put option receives the premium at the outset of the contract and faces no credit risk.	The holder of the bond pays the purchase price of the bond and is exposed to credit risk throughout the life of the bond. The credit exposure is exceptionally high in this case as the coupon rate is very low.

(ii) If the company's earnings were to fall significantly or even become negative over the remaining life of the corporate bond, then the probability that the company would default on its debt would increase.

This would cause the price of the bond to fall below that of other bonds of similar maturity and coupon or, in the case of outright default with no possibility of recovery, to become worthless.

A substantial fall in earnings or negative earnings would cause the share price to fall also.

In such circumstances, the investor may feel that the loss on the bond would be made up by the fact that the investor could buy the shares of the company back at a much lower price that he received when he first borrowed the shares from the pension scheme and sold them.

(iii) A rise in interest rates accompanied by a rise in share prices would significantly worsen the protection afforded to the investor. (Strange as this may seem, it actually happened in the US market 1999.)

In order to achieve a practical hedge, investor would need to continuously adjust the hedge by borrowing more or returning stock to the pension scheme as the price of the bond relative to that of the shares changed.

If the pension scheme were to recall the shares it lent or stop lending further shares, the hedging strategy would fail or be severely curtailed.

If the dividend payouts of the company rose, the investor would have to manufacture an increased amount of dividends for the pension scheme over the life of the hedge. This could be caused by fiscal changes (such as the change in the tax treatment of dividends in the US earlier this year) quite independently of any action by the company.

It is possible that the share price could rise precisely because the company settles its outstanding corporate debt at a substantial discount or defaults on its corporate bond debt relieving it of a debt burden. This would prove a double blow for the investor as he loses on his bond holding and loses on this borrowed shares position at the same time.

A rise in the credit spread of corporate bonds over government bonds of the same coupon and term without a significant deterioration in the price of the stock would cause the hedge to perform poorly.

The credit default hedging strategy may decrease the return on the bond especially in circumstances where the company performs well and the share price rises and there is a low risk of credit default.

(iv) The investor could purchase a put option on the shares of the company.

Again, if we assume that a bond default would be accompanied by a fall in the share price, then the put option provides some protection.

The risk for the investor in (iii) of being unable to borrow more shares or having the borrowed shares recalled would be removed.

The investor has an exposure to the credit risk of the option writer.

The dividend risk would be eliminated for the investor unless the strike price of the put option is adjusted for dividends.

The hedging strategy reduces return in the event that the share price rises and the bond does not default.

The other market risks identified for the strategy in (iii) remain.

Credit derivatives may be available, which could be used as insurance. However these are likely to be market related rather than stock specifically. Nevertheless they should be considered.

END OF EXAMINERS' REPORT