INSTITUTE AND FACULTY OF ACTUARIES

EXAMINERS’ REPORT

Subject CA3 - Communications
(Written Paper)
March 2016

Scenario: Portfolio management

Introduction

The Examiners’ Report is written by the Principal Examiner with the aim of helping candidates, both those who are sitting the examination for the first time and using past papers as a revision aid and also those who have previously failed the subject.

The Examiners are charged by Council with examining the published syllabus.
For the CA3 communications examination the examination is designed to examine the communication of an “actuarial” concept to a non actuarial audience. Sufficient technical detail on the scenario is provided in the question so that candidates from all backgrounds are able to answer the question.

One approach to a solution is reproduced in this report; other valid approaches were given appropriate credit.

Fiona Layton
Chairman of the Board of Examiners

June 2016

A possible answer is given below. This is not intended to be a model solution. In practice, a wide number of solutions were acceptable and candidates would have achieved good pass standards without having the same level of detail as the answer below.

Candidates were asked to draft a short paper for a trustees' meeting explaining the rationale behind some recent investment decisions.

The main points that the Examiners were looking for and some common problems encountered were as follows:

1. Most candidates produced scripts that looked like a paper suitable for a trustees' meeting. Scripts gained marks for having a clear introduction clearly explaining what the paper would cover.

2. There was no evidence of candidates running out of time and therefore not completing their answer.

3. Poor scripts were unstructured with no clear headings, long sentences and poor explanations.

4. Most candidates included the points requested by their manager in their letter. Better scripts provided details of the three financial measures that candidates had been asked to include in a simple table or in a format that provided an easy comparison for the trustees.

5. Although the XY Pension Trustees included some newly elected member trustees candidates were expected to use the correct financial terms in their paper (with a brief explanation of what each of the terms meant). Poorer candidates chose to talk in general terms about the three financial measures. In these cases the language used could appear condescending.

6. Better scripts concluded with a summary of the main messages and a clear close.

7. There was not that much opportunity for candidates to use jargon in their letter. However, candidates lost marks for providing unnecessarily accurate financial details e.g. quoting the expected 3 year earnings growth for company X as 8.041% pa.

8. A few scripts suffered from poor spelling, grammar and punctuation.

9. The guideline length was around 650 words. Scripts which were very short (below 500 words) generally missed out some of the content that their manager had asked them to include. Scripts which were much longer (over 750 words) often lost marks for including unnecessary detail or being repetitive.

SOLUTION

BB Investments

XY Pension Trustees
Recent Changes to the UK Share Portfolio

1. Introduction

This paper is addressed to the trustees for discussion at their meeting on 11 May in response to a series of queries raised by the Chairman of the board of trustees.

BB Investments manages a portfolio of UK shares for the trustees. We have recently made a number of changes to the portfolio and have been asked by the Chairman about two in particular: the sale of our holding in Company Y plc ("Company Y") and the purchase of shares in Company X plc ("Company X").

In this short paper we outline the nature of our mandate and indicate why these changes are consistent with it. We also illustrate three of the factors that led us to select these investments.

2. Our Investment Mandate

We buy companies with strong long term prospects, whose shares we consider to be undervalued.

In the long term, the return from each investment comes from the company's profits, paid out as dividends. We therefore look for companies whose profits are expected to increase steadily in the future.

We also seek to take advantage of factors that may cause the share price to be temporarily depressed. Similarly, if market sentiment causes the share price to become temporarily inflated, we will take advantage of this and replace the investment with another offering better value.

It is important to follow these two principles because this is the basis on which we have been appointed to manage XY's funds.

3. How do we compare companies?

We use a number of measures to compare potential investments, three of which are explained below.

Measure	Relevance
1. Dividend Yield (% pa)	This tells us the amount of the cash dividend paid each year per £100 invested. We prefer a **high yield**.
2. Price Earnings Ratio (PER)	This tells us how expensive a company's shares are, in relation to its annual profits. We prefer a **low PER** (i.e. "cheap" shares).
3. Expected three-year earnings growth (% pa)	This is our estimate of how much the company's profits are expected to grow over each of the next three years. We prefer companies with **high earnings growth**.

4. Company X vs. Company Y

The table below outlines how Company X and Company Y compare with respect to the factors mentioned above.

	Company X	Company Y
1. Dividend Yield (% pa)	4.2	2.1
2. Price Earnings Ratio (PER)	9.5	17.9
3. Expected three-year earnings growth (% pa)	8.0	7.0

Company X has a higher dividend yield than Company Y. For every £100 invested, Company X pays a dividend of £4.20 per year, compared with £2.10 from Company Y.

Company X's PER is lower than for Company Y. So each £1 of Company X's annual profit costs £9.50, whereas £1 of Company Y's profit costs £17.90. These facts show Company X's shares are cheaper.

Company X's profits are expected to grow for the next three years at a slightly higher rate than Company Y's.

These factors all indicate that Company X is a more suitable investment, given our mandate.

5. Recent poor publicity

As the Chairman noted, Company X has received some negative publicity recently, causing its share price to fall. We believe this will be temporary, as its future growth prospects remain sound. We have taken advantage of this fall to acquire these shares at a lower cost. We have sold Company Y because we think it has become too expensive and now has lower prospects for good returns in the future.

6. Summary

Our basic investment philosophy is to purchase good quality shares at low prices. We have illustrated with three financial metrics how we assess companies against each other. Assessing Company X against Company Y against these criteria has led us to conclude that the former is a more suitable investment than the latter, hence why we switched.

We look forward to discussing this with you at the next trustees' meeting and addressing any questions you have.

Vanessa Turner
Analyst, BB Investments
March 2016

Word Count = 653 words (excluding title and sign-off)

END OF EXAMINERS' REPORT