

EXAMINATIONS

September 1999

Subject 201 — Communications

Paper Two

EXAMINERS' REPORT

Today's Date

Dear Aunt,

Thank you very much for entertaining me to lunch last week. The salmon was delicious, and I thoroughly enjoyed the game of Scrabble.

You mentioned that you were intending to invest a lump sum, and were comparing the charges on the AA fund and the BB fund. I have had a brief look and I noticed that there are some differences in the charges that you will want to take into account.

Both funds have two types of charge: an initial or upfront charge and an annual charge. The initial charge is higher, but because it is only deducted once, it has the greatest impact on short term investments. The annual charge is smaller but, as it is taken every year, is more significant over longer periods.

The AA fund has an initial charge of 2.5% and an annual charge of 1.0%. Thus over 5 years the average annual charge is 1.6%. This is approximately $2.5\% \div 5 + 1.0\% = 1.5\%$. This approximation understates the effect of charges slightly, because once a charge is deducted, you also lose any future investment growth on the amount of that charge.

The BB fund has an initial charge of 4.75% and an annual charge of 0.5%. Thus over 5 years the average charge is also 1.6% p.a. (approximately $4.75\% \div 5 + 0.5\%$).

So, for investments of 5 years, both funds have the same charge.

For investments of under 5 years, the AA fund has lower charges, because of its low initial charge.

For investments of over 5 years, the BB fund becomes better value, because it only charges 0.5% annually compared to the 1.0% on the AA fund, and the higher initial charge has already been covered.

So, firstly you need to consider how long you think you will keep the money invested. This depends in part on your financial plans. You also need to take consider whether your plans are totally fixed or are open to change: e.g. the unexpected cost of going to Australia for Julia's wedding this year.

Looking again at the BB fund, I noticed that they offer a reduced initial charge for people investing £20,000 or more. The initial charge reduces from 4.75% to 3.75%. This makes fund BB more attractive, for such large investments, even if held for only 3 years.

You also questioned why the monthly investment option is so much more expensive for the BB fund.

For people who pay monthly over 5 years, their first payment is invested for 5 years, the second is for 4 years and 11 months and so on. The final payment only remains invested for 1 month. The effective annual charge for the first payment is 1.6%, as before. The effective annual charge for the very last payment is far higher: because

the whole 4.75% is charged, even though it is only for a one-month period. Averaging out all of these charges gives the 2.5% you have seen quoted.

To summarise, the charges do affect the choice of fund — you will want to consider how much you are investing and for how long:

- If you invest less than £20k for less than 5 years, fund AA has lower charges.
- If you invest less than £20k for over 5 years, fund BB has lower charges
- If you invest £20k or more for 3 years or more, fund BB has lower charges

I trust this information will help you in your decision. If you have any further questions, I'd be happy to help.

All the best,

Signature

[592 words]

INSTITUTE / FACULTY OF ACTUARIES EXAMINATIONS – SEPTEMBER 1999

EXAMINERS' REPORT: SUBJECT 201 – COMMUNICATIONS

Candidates were asked to draft a letter to an aunt explaining how the charges of two investment funds should influence her choice of fund and why the impact of the charges seemed greater under the monthly option. This report summarises the main points that the examiners were looking for and some common problems encountered.

1. The question involved a letter to an aunt about some queries that she has about charges. Some scripts jumped straight into the explanation on charges without any general introductory words or description of the query.
2. A number of replies contained words that were more appropriate to a technically minded audience. Phrases such as “duration”, “weighted charges” were not appropriate or necessary.
3. Most candidates seemed to understand how the impact of the two sets of charges differed. However, the explanations needed to be appropriate. In particular:
 - Scripts that had numbers or formulae in a high proportion of sentences were unlikely to be understandable to the aunt.
 - Scripts that had no numbers, or hardly any, did not explain the charges adequately.
4. A number of questions contained tables showing the impact of total charges for different periods of investment. In general these were helpful. However some scripts had not given enough consideration to making the headings meaningful to the reader. Some scripts used a table, but failed to draw out the main messages in the text of the letter, or show how the table should be used.
5. A significant number of scripts had inadequate explanations of the greater impact of charges on the monthly option. Some scripts incorrectly put this down to greater administrative expense. A number of candidates appeared to have a correct understanding, but did not go through the steps of the explanation.
6. Some scripts stated that the rate of investment growth was important. This was incorrect when determining the relative impact of charges on these funds.
7. Some candidates referred to “interest” on the funds, which was inappropriate for equity funds.
8. The guideline length was 500-600 words. Scripts which were much longer than this generally contained much irrelevant detail and thus lost the main points of the message. Scripts that were shorter generally left a general impression of the impact of charges, but failed to get across the required key messages.
9. Some candidates wrote over 150 words on the reasons for charges – giving details on administration expenses and profits. This distracted from the main purpose of the letter.

10. Some scripts contained a long description on the monthly option, and only a short discussion on the impact of charges and the choice between the two funds. This did not meet the aims of the letter.
11. A number of scripts lost marks because they appeared to be disorganised and/or did not make appropriate use of paragraphs. Poor spelling, grammar and punctuation were also penalised.
12. Marks for technical content accounted for approximately 30% of the total. It was not necessary to make all technical points to gain all these marks. However, candidates who missed a significant number of points also lost marks for failing to answer the aunt's query.
13. At the end of reading the letter, the aunt should have known which fund to choose in respect of charges. Some scripts showed the impact of charges correctly, but then failed to draw out the consequences. This left the aunt with the vague impression that "charges are important" which missed the aim of the letter.

A possible letter appears at the beginning of this report. It does not cover all the possible points, and is not intended to be a model solution. In practice a wide range of solutions was acceptable.