

EXAMINATIONS

21 September 2004 (am)

Subject 301 — Investment and Asset Management

Time allowed: Three hours

INSTRUCTIONS TO THE CANDIDATE

1. *Enter all the candidate and examination details as requested on the front of your answer booklet.*
2. *You have 15 minutes at the start of the examination in which to read the questions. You are strongly encouraged to use this time for reading only, but notes may be made. You then have three hours to complete the paper.*
3. *You must not start writing your answers in the booklet until instructed to do so by the supervisor.*
4. *Mark allocations are shown in brackets.*
5. *Attempt all 12 questions, beginning your answer to each question on a separate sheet.*

AT THE END OF THE EXAMINATION

Hand in BOTH your answer booklet, with any additional sheets firmly attached, and this question paper.

In addition to this paper you should have available Actuarial Tables and your own electronic calculator.

1 You have been given the following information.

	<i>Year 1</i>	<i>Year 2</i>
Benchmark asset allocation:		
Equities Index	60%	30%
Bonds Index	40%	70%
Actual asset allocation of fund:		
Equities	50%	50%
Bonds	50%	50%
Investment returns:		
Average return for similar funds	7.0%	8.0%
Equity index return	10.0%	12.0%
Bond index return	5.0%	4.0%
Equity return in fund	9.0%	14.0%
Bond return in fund	6.0%	5.0%

- (i) List three methods used to assess portfolio performance, and compare the merits of each method. [6]
 - (ii) Evaluate the past performance for the fund as a whole over the two year period, using the three different methods. [5]
- [Total 11]

- 2**
- (i) You are a UK equity analyst and have been asked to prepare a fundamental analysis of one of the companies you cover. List the quantitative factors that you would investigate. [3]
 - (ii) You are analysing a company which has just completed a major refinancing. List which factors you would spend the most time investigating, explaining why they have been selected. [3]
- [Total 6]

- 3**
- (i) Explain why margin is levied on exchange-traded futures contracts. Include in your explanation a description of initial margin and variation margin, and the process by which these are determined. [5]
 - (ii) Your local currency is the Euro and you wish to actively hedge the currency exposure in an actively traded £50m US equity holding. Explaining your reasoning, state whether you would hedge the currency exposure using an exchange-traded future or an over the counter forward contract, assuming that the hedge is adjusted weekly. [3]
- [Total 8]

- 4**
- (i) Outline the factors to be considered before a tactical switch can be made by an institutional investor from their benchmark position. [4]
 - (ii) Explain what an anomaly switch is, commenting on the risks and the scope for profits in larger bond markets. [2]
 - (iii) Describe three techniques to identify opportunities for anomaly switches. [3]
 - (iv) Describe two methods by which an investor could take advantage of an anomaly whilst maintaining no overall market exposure (a market neutral position) to the bond markets. [2]
- [Total 11]

- 5**
- A developed country is reviewing its market regulations following a number of high profile company bankruptcies. The country currently has a mixed regime backed by rigid codes of practice that it believes have contributed to events.
- (i) Describe what is meant by a mixed regime. [2]
 - (ii) There has been a proposal to weaken the rigid codes of practice and to replace these with codes of principles to be adhered to. Discuss the advantages and disadvantages of this proposal. [4]
- [Total 6]

- 6**
- (i) List the advantages of investing through an investment trust rather than a unit trust. [2]
 - (ii) Define the investment trust term “discount to net asset value per share”. [1]
 - (iii) Discuss three circumstances under which this discount may become a premium. [3]
- [Total 6]

- 7**
- You are the consultant to a large defined benefit pension fund that has historically invested significantly in equities. The new finance director is concerned about the volatility of company contributions resulting from the strategy.
- (i) Set out the reasons for and against continuing a high equity strategy for the pension fund. [3]
 - (ii) Discuss the advantages of investing in government bonds as an alternative. [2]
 - (iii) State the other factors that the trustees should consider in setting investment strategy. [4]
- [Total 9]

- 8**
- Explain the advantages of overseas investment for an institutional investor. [3]

- 9** An airline which has an average credit rating for its sector needs to issue debt to pay for some new aircraft that it expects to be in service for the next 20 years.

An investment bank has suggested the following three types of debt:

Bond A — a 20 year bond with a coupon of 7.0% p.a.

Bond B — a 20 year bond with a coupon of 6.5% p.a. for the first 10 years with an option for the airline to redeem at par at that point. If the bond is not redeemed then the coupon increases to 8.0% for the final 10 years.

Bond C — a 20 year bond with an initial coupon of 6.5% p.a.. If the company's credit rating improves relative to its initial rating the coupon reduces to 6.0% p.a. and if the credit rating deteriorates from the initial rating the coupon rate increases to 7.5% p.a. Alterations apply immediately for the period of the change in rating.

Compare the three bonds from the risk management perspective of the airline company. [12]

- 10** (i) Describe four financial risks faced by an institutional investor. [4]
(ii) Describe methods for controlling each of these financial risks. [6]
[Total 10]

- 11** The electricity distribution network of a country enjoys a natural monopoly. The Electricity Market Authority is responsible for ensuring that the price that the network operator charges for distribution is reasonable.

- (i) List the key factors, treating the electricity distribution network as a capital project, that affect the long-term cashflow and rates of return of the electricity distribution network. [6]

The government believes that the electricity distribution network is making too much profit.

- (ii) Discuss the measures that may be introduced to limit the profits being made. [6]
[Total 12]

- 12** (i) Give a generalised formula for a total return index suitable for property performance measurement purposes, defining all terms used. [3]
(ii) Outline the problems in constructing such an index for quarterly publication. [3]
[Total 6]

END OF PAPER