

EXAMINATION

27 March 2006 (am)

Subject CA1 — Core Applications Concepts

Paper 1 (Assets)

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 9 questions, beginning your answer to each question on a separate sheet.*
6. *Candidates should show calculations where this is appropriate.*

AT THE END OF THE EXAMINATION

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

<p><i>In addition to this paper you should have available the 2002 edition of the Formulae and Tables and your own electronic calculator.</i></p>

- 1** A retired homeowner has no current debts but needs to release capital tied up within his main residence.
- State two ways in which this could be achieved and describe the cashflows involved. [4]
- 2** (i) State both the general formula and the simplified formula for the dividend discount model defining all the terms used. [4]
- (ii) List the assumptions underlying the simplified version of the model. [2]
- [Total 6]
- 3** A country with a developing economy wishes to encourage investment in its domestic equity market. It intends to introduce domestic equity market indices that can be used by index tracking funds.
- Describe the features to be taken into account when designing indices for this purpose. [6]
- 4** An investment management company operates a wide range of funds investing in different types of securities. In the last twelve months new investments into its corporate bond fund have increased rapidly compared with new investments into its other funds.
- Discuss possible reasons why this may have occurred. [7]
- 5** Outline reasons why the ordinary shares of two companies might trade at different price earnings ratios. [8]
- 6** A fund that only invests in overseas equities is expanding the range of countries in its portfolio. It is considering including developing countries.
- (i) Discuss possible reasons for including developing countries in its portfolio. [3]
- (ii) List the points it should consider before investing in a particular developing country. [5]
- (iii) State, with an example, one additional factor that it needs to take into account when investing in small economies. [2]
- [Total 10]

- 7** (i) Define the following terms:
- (a) Arbitrage
 - (b) Spot interest rate [2]
- (ii) Outline the following theories used to explain the shape of the yield curve:
- (a) Expectations theory
 - (b) Liquidity preference theory
 - (c) Market segmentation theory [5]

A provider offers a ten year single premium investment product where the investment return (before charges) credited at the end of each year is the higher of a fixed rate and the one-year zero-coupon bond yield at that time. The yield curve at the time the guarantee is priced is upward sloping.

- (iii) Discuss the implications of using this yield curve to predict the anticipated cost of the guaranteed investment return, using the theories in part (ii). [11]
[Total 18]

- 8** (i) Outline the main factors to consider in developing a long term investment strategy. [5]
- (ii) Comment on the specific issues likely to affect the investment strategy for the following investors:
- (a) An individual who has recently received an inheritance of ten times his annual salary.
 - (b) A contributor to a personal pension policy.
 - (c) A life insurance company closed to new business, which has never written with profits business.
 - (d) A general insurance company.
 - (e) A charity. [15]
- [Total 20]

- 9** A food retailer is considering introducing an organic food range. It is carrying out an initial appraisal of the proposed project.
- (i) Discuss the appraisal methods the food retailer should use to determine whether to pursue this project. [7]
- (ii) Identify the major risks involved with the project and suggest how they might be mitigated. [6]
- (iii) Describe how the discount rate to be used in evaluating this project should be chosen. [8]
- [Total 21]

END OF PAPER