EXAMINATION

6 September 2005 (am)

Subject SA6 — Investment Specialist Applications

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 both 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.

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

1 You are an investment consultant and have been asked to give advice on investment strategy to the trustees of a UK final salary pension scheme with total assets of £400m.

(i) Set out the considerations that need to be taken into account when formulating an investment strategy for a pension scheme. [12]

All the invested assets of the pension scheme are actively managed by one external fund management company that also provides custodial services through an associated company. The trustees have asked you to conduct a full review of this organisation. They have requested a proposal outlining, with reasons, the investigations you plan to carry out.

(ii) Write down the headings you would include in your proposal. [5]

(iii) Set out the points you would include under each heading. [22]

One of the trustees has read a newspaper article suggesting that, over time, all investment managers underperform market indices so everyone would be better off with an index-tracking manager instead. The article also said it doesn't really matter how the manager performs, if you get your asset allocation right.

(iv) Comment on the assertions of the article. [9]

Your firm has recently launched a manager-of-managers service for your clients in the belief that it represents the best way to maximise returns.

(v) Describe the arguments you would use to sell this concept to the trustees as an alternative to an index-tracking manager, identify the risks involved and comment on any negative aspects of such a service. [12]
[Total 60]

2 You are the chief investment officer of an investment management company managing over £10 billion of assets in a range of institutional and private client mandates and with global equity, bond and derivative capabilities.

One investment trust client with a UK equity remit has gross assets of £240m, 200 million shares in issue and an unsecured loan of £30m. The loan carries an interest rate of 7.5% and was issued with a margin of 100 basis points five years ago, with interest payable half yearly on 5 September and 5 March, and a maturity date of 5 September 2015. Investment management fees are 1.0% of net assets, other expenses are £375,000 and the annual dividend is 4.5 pence. The share price trades at a discount of 14.3% to the net asset value.

(i) Draw up the balance sheet and income account for the trust assuming that 75% of management fees and loan interest are charged to capital. [5]

Other investment trusts have been repaying their debt. The investment trust board wishes to consider what action it should take.

(ii) Outline the impact that repayment of the loan might have on this trust, stating any assumptions that you make. [8]

As an alternative, a stockbroker has suggested that he could place up to £75m zero coupon bonds, which would mature in ten years to replace the existing debt. The redemption amount would be £137.52m.

At the same time an insurance company that sells a product to its clients that tracks the value of the FTSE All Share Index has offered to lend the trust money. The insurance company will receive the dividend yield on the index as interest and a redemption value equal to the original loan plus the capital change in the index. The loan covenants include a condition that the size of the loan will not exceed 50% of the net assets of the trust at any time.

(iii) Evaluate these proposals and make a recommendation to the board on the appropriate action they should take. [13]

An investment bank has sent you some product ideas:

Product 1

A structured product offers a return of capital plus 80% of the upside of the FTSE 100 Index at the end of five years.

Product 2

A product with a term of six years offers either a monthly income of 0.6%, an annual income of 7.5% or a capital return of 140% provided the FTSE 100 Index does not close below 70% of its value at the date of the product's launch. If it does fall below 70%, the capital return will be reduced by 2% for each 1% that the index is below its start value at redemption, but will be 100% if the index is above its start value. If the index closes above 140% of its start value but has not fallen below 70% at any time prior to that being achieved, the capital returns become guaranteed.

(iv) Outline the investment structure required to back each product and explain how they work. [10]

(v) Explain why these products are useful and how they might be used for different clients. [4]

[Total 40]

END OF PAPER