EXAMINATION

6 October 2010 (pm)

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 before 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 three 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 from the approved list.

1 As the marketing director of a new asset management company, you have been asked to produce client brochures explaining the company's style of management and the key features of some new products that are being launched.

In your discussions with the Chief Investment Officer, she has argued that all investments generate returns from the risk free rate and a combination of one or more of:

- Asset class returns, or "beta"
- Returns from manager skill, or "alpha"
- An "illiquidity premium"

(i) Describe the drivers of return for each of these sources. [6]

(ii) Discuss, for the following investments, their return profiles in terms of the three sources listed in part (i). [16]

(a) Equity Exchange Traded Fund
(b) Active Long-Only Equity Fund
(c) Equity Market Neutral Hedge Fund
(d) Hedge Fund investing in "distressed opportunities"

The asset management company plans to offer fixed income management and the Investment Committee is unsure whether to use conventional or derivative approaches to managing the asset class.

(iii) Explain the uses, relative merits and the appropriateness of using the following instruments to manage exposure to fixed income markets.

(a) Credit Default Swaps
(b) Total Return Swaps

[18]
[Total 40]

2 You are the investment consultant to a Defined Benefit Pension Plan ("the Plan") and have recommended that the Trustees of the Plan follow a Liability Driven Investment approach. Following an asset and liability study, the Trustees of the Plan have adopted a strategic allocation of 55% to risk reducing assets, an increase of 5% from the previous strategic benchmark.

There is an election due in the country next year and whilst it is uncertain who will win, the new government will need to engage in significant public expenditure. Due to the recession the country has experienced, the government has attempted to increase liquidity by buying back its own bonds over the last 18 months.

One of the Plan Trustees, who is also the Corporate Treasurer for the sponsoring employer, has commented that while he agrees with the theory of decreasing investment risk, he does not think now is a good time to do it and it could make the Plan too expensive for the Company to support. He believes that the Trustees should delay implementation of the proposed strategic allocation and asks you to develop some triggers instead that would help the Trustees refine their timing.

(i) Describe the main considerations in implementing this Liability Driven Investment approach. [12]

In the interim, you have proposed that the Plan should maintain a portfolio of short and medium duration bonds and cash.

(ii) Describe the reasons for investing in bonds. [3]

(iii) Explain the practical problems with investing in bonds. [5]

(iv) Describe possible triggers that could be used to monitor the markets to help the Trustees improve the timing of the switch into risk reducing assets. [8]

An investment analyst has been comparing the yields offered by UK corporate bonds and UK gilts at various maturities. They have concluded that "if you buy UK corporate bonds and short-sell UK gilts at the same maturity you are guaranteed to make large profits".

(v) (a) Explain the investment analyst's rationale for this statement.

(b) Explain the difference in yields between UK corporate bonds and UK gilts at the same maturity. [4]

(vi) Comment on the validity of the investment analyst's statement. [4]

The investment analyst then goes on to say that "if you extend this process to hold short-dated corporate bonds and sell long-dated gilts the expected profits will increase for very little additional risk as long-dated gilt yields are very low by historical standards".

(vii) Describe the assumptions implicit in the analyst's thinking, and how a loss might arise if the assumptions are invalid. [6]

[Total 42]

3 You are the Head of Alternative Investments for a very large institution and have been approached to be the seed investor in a new fund that will be investing in renewable energy, predominantly wind and solar, projects in Central and Eastern Europe.

The proposition has been brought to you by a former banker who specialised in originating and financing transactions in this area. He has identified a pipeline of potential transactions and the management team he would like to recruit.

You need to prepare a report for the Chief Investment Officer setting out the strengths, weaknesses, opportunities and threats ("SWOT") associated with the proposal.

(i) Outline the investigations you would need to carry out. [9]

(ii) Set out the SWOT summary. [9]
[Total 18]

END OF PAPER