



DIPLOMA WINTER 2008 EXAMINATION

FUND MANAGEMENT

DATE OF EXAM	Friday 5 December 2008
3 HOURS	2.00 pm – 5.00 pm
RUBRIC	SECTION A - <i>ALL</i> questions in this section are to be answered SECTION B – <i>ALL</i> parts of the question in this section are to be answered SECTION C – <i>THREE</i> questions in this section are to be answered

Candidates are reminded that no marks will be awarded for illegible work

NOTES TO CANDIDATES

1. Please insert your Candidate Number on the Answer Book cover. *Do not insert your name.*
2. Show *all* workings in your Answer Book.
3. Candidates may attempt the sections in any order. Please indicate clearly in your Answer Book which questions you are answering.
4. Please insert in the box provided on the cover of your Answer Book the numbers of the questions you have attempted in the order in which they appear in the Answer Book.
5. You may use the calculator provided or one approved by the Securities & Investment Institute.
6. You must hand your Answer Book to an invigilator before you leave the Examination Hall. *Failure to do so will result in disqualification.*
7. The decision of the Securities & Investment Institute is final and no correspondence will be entered into concerning the grade awarded.
8. Once submitted, the examination scripts become the property of the Securities & Investment Institute and will not be returned to candidates.

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PLEASE TURN OVER WHEN INSTRUCTED

Answer ALL questions in this section

- 1 What impact has the global financial crisis had on the price of commodities? If you are an investor suffering from a loss aversion bias, having a portfolio composed of 60% equity, 30% bonds and 10% commodities, would your asset allocation change as a result of the global market conditions? *(3 marks)*
- 2 Consider a 3 year bond with 9% coupon paid annually and yield to maturity of 10%. In year 2 interest rates go up to 11% and in year 3 they go down to 10.5%. If you sell this bond at the end of year 2, what would be your total income from that bond? *(3 marks)*
- 3 What are managed futures funds? Outline their investment advantages. *(3 marks)*
- 4 Explain and show using equations when the risk of a two asset portfolio is simply a weighted average of the risks of individual assets in that portfolio. *(3 marks)*
- 5 You are given the following data:

Data	Share A	Share B
Market Price	104p	190p
Current dividend	5p	9p
Dividend growth	4%	4%

Dividends are paid at the constant rate and the required rate of return is 9%. For which of these two shares would you give a sell recommendation? *(3 marks)*

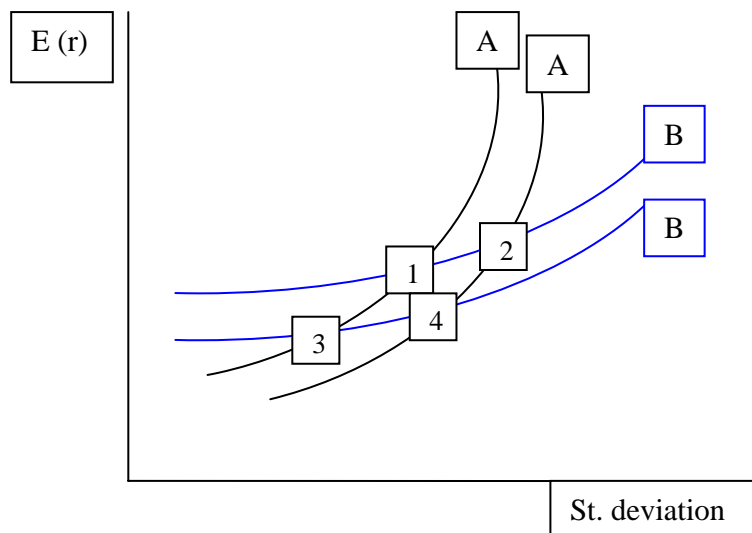
- 6 The beta coefficients and standard deviations for two portfolios are as follows:

Portfolio	Beta	Standard Deviation
1	0.95	15%
2	0.67	10%

The expected rate of return on the market portfolio of all risky assets is 13 percent, its standard deviation is 9.5 percent and the risk-free rate is 6 percent.

- a) What is the correlation coefficient between portfolio 1 and the market portfolio and portfolio 2 and the market portfolio? *(2 marks)*
- b) Is it possible to construct a zero beta portfolio from portfolio 1 and 2? *(1 mark)*
- c) Portfolio 1 has an actual return of 11.5%. According to the Security Market Line, is this portfolio fairly priced? *(1 mark)*

7 You are presented with the following graph:



Which investor, A or B:

- a) is more risk averse?
- b) prefers portfolio 1 to portfolio 3?
- c) prefers portfolio 4 to portfolio 3?

Explain all your answers.

(3 marks)

- 8 The efficient market hypothesis implies that abnormal returns are expected to be zero. Yet in order for markets to be efficient, arbitrageurs must trade when under/over valued securities are identified in order to force prices back into equilibrium. If they earn profits in doing so, is this fact inconsistent with market efficiency? *(3 marks)*
- 9 The current exchange rate is \$1.85:£1. Interest rates and bond yields in the UK and US are 7% and 5% respectively. Estimate the exchange rate in one year and calculate the expected return to a sterling investor from investing in a UK bond and a US bond. *(3 marks)*
- 10 What is a Venture Capital Trust (VCT) and which conditions does a fund have to meet to obtain a VCT status? *(3 marks)*

Answer ALL parts of this question

- 11 You are a sales person in an index tracking fund, tracking the FTSE All Share index. A potential client sends you a list of questions to clarify doubts she has related to passive investing in general:
- a) Explain how Exchange Traded Funds (ETFs) differ from index tracking funds. *(5 marks)*

 - b) Why is there a need for enhanced indexation? Describe one example of an enhanced indexation strategy. *(5 marks)*

 - c) Using the Capital Market Line (CML) from the CAPM model, explain the rationale behind the existence of index tracking portfolios that track main market indices. *(7 marks)*

 - d) Is it possible to apply an index tracking strategy to FTSE 350 Growth index? What are the characteristics of stocks in that index? *(3 marks)*

 - e) Differentiate between systematic and unsystematic risk both conceptually and using R-squared. What type of risk is one facing by investing in a portfolio tracking the FTSE All Share Index? How can such a risk be eliminated? *(5 marks)*

 - f) Explain quality and familiarity biases. Will they affect the decisions of managers of index tracking portfolios? Explain. *(5 marks)*

Answer ANY THREE questions

Each question carries 13 marks

- 12 What are the advantages and disadvantages of convertibles to the investor? Outline two common methods used in valuation of convertibles and give an example of a hedge fund strategy where these methods can be used. *(13 marks)*
- 13 Why has property become a popular asset in typical investors' portfolios? How would a small investor obtain access to the property market? What are the main risks associated with such an investment and does it perform well in periods of high inflation? *(13 marks)*
- 14 Would you use the Sharpe ratio and Tracking Error for measuring performance of passive funds? Would you use them for measuring performance of hedge funds? Explain your answer for both types of funds. *(13 marks)*
- 15 Is there any change in efficient frontier of risky assets if short selling of equity is introduced? Why are most investment companies restricted from short-selling equity? Explain. *(13 marks)*
- 16 The Investment Management Association Survey (2007) indicates that slightly over 51% of UK equity investment mandates are in the UK, the rest are allocated to foreign markets, both developed and emerging. Explain possible risks that a UK investor may be facing when investing internationally. *(13 marks)*