



SECURITIES & INVESTMENT INSTITUTE

SECURITIES & INVESTMENT INSTITUTE DIPLOMA

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CHIEF EXAMINER'S REPORT- PRIVATE CLIENT INVESTMENT ADVICE AND MANAGEMENT

INTRODUCTION

The overall standard was good; on a par with recent exams. There were many good scripts, and a few excellent ones. At the lower end candidates generally failed because of an inability to manipulate numerical data and to correctly structure answers.

In Section A the average mark was good, and the best of the three sections. For three questions many candidates achieved full marks: Q5 (Exchange Traded Funds), Q6 (Share Analysis) and Q7 (Trustee Act 2000). No question was particularly badly answered.

In Section B Q11 (funds) was by far the most popular question and generally competently answered. Q13 (convertibles) was by far the least popular and generally the weakest answered. Q12 (regulation and protection) scored marginally the highest average mark.

In Section C most candidates had a reasonable understanding of the contrasting investment strategies and could draw sensible conclusions, even when they were not familiar with the intricacies of the financial models and their academic underpinning.

Section A

Q1 Most candidates could identify at least one criterion by which an individual can establish their domicile, and they were generally aware of the IHT implications. Domicile is determined by:

- *Origin*, acquired at birth (usually that of the father in the UK; of mother if unwed
- *Choice* (this requires positive choice, eg. changing residence, making a will under the laws of the new country, obtaining citizenship of the new country; a high standard of proof is required. To change domicile by choice it is necessary to prove to the satisfaction of the Inland Revenue that an individual has permanently abandoned the UK
- *Dependency* (applies to women who married before 1974, who acquired the domicile of their husband automatically; this is no longer automatically the case).

All individuals who are domiciled in the UK are liable to IHT on all their assets worldwide.

This also applies to persons with deemed domicile ,i.e if they have been resident for 17 of the last 20 years. Similarly, a person will continue to treated as having UK domicile for 3 years after ceasing to have domicile for other purposes.

Other individuals not domiciled in the UK are liable to IHT on their UK assets (but unit trusts and OEICS are exempted for these individuals).

Q2 There were many different investment strategies utilised by hedge funds to which candidates made reference. These include:

Global Macro: this aims to profit from changes in global economies, typically brought about by shifts in government policy which impact on interest rates; in turn affecting currency, share, bond and commodity markets. This strategy generally uses gearing and derivatives to accentuate the impact of market moves. Geared directional investments tend to have the largest impact on performance.

Emerging Markets: this invests in equity or debt of emerging markets which tend to have higher inflation and volatile growth. Short selling is not permitted in many emerging markets; therefore effective hedging is often not available.

Short Selling: this involves selling securities short in anticipation of being able to repurchase them at a future date at a lower price due to the manager's assessment of the overvaluation of the securities, or the market, or in anticipation of earnings disappointments often due to accounting irregularities, new competition, change of management, etc. Often used as a hedge to offset long-only portfolios and by those who feel the market is approaching a bearish cycle.

Market Timing: this allocates assets among different asset classes depending on the manager's view of the economic or market outlook. Portfolio emphasis may swing widely between asset classes. Unpredictability of market movements and the difficulty of timing entry and exit from markets adds to the volatility of this strategy.

Aggressive Growth: this invests in equities expected to experience acceleration in growth of earnings per share. These generally have high P/E ratios, low or no dividends; they are often smaller and micro cap stocks which are expected to

experience rapid growth. These include sector specialist funds such as technology, banking, or biotechnology. They tend to be long-biased, but sometimes include hedges by shorting equities where earnings disappointment is expected.

Special Situations: this invests in event-driven situations such as mergers, hostile takeovers, reorganizations, or leveraged buy outs. It may involve simultaneous purchase of shares in companies being acquired, and the sale of stock in its acquirer, hoping to profit from the spread between the current market price and the ultimate purchase price of the company. It may also utilize derivatives to gear returns and to hedge out interest rate and/or market risk. Results are generally not dependent on the direction of the market.

Distressed Securities: this involves the purchase at deep discount of equity or debt of companies in or facing liquidation or reorganization. It is designed to profit from the market's perceived lack of understanding of the true value of the deeply discounted securities and because the majority of institutional investors cannot own securities below investment grade (This selling pressure creates the deep discount). Results are generally not dependent on the direction of the markets.

Value: this invests in securities perceived to be selling at deep discounts to their intrinsic worth. Such securities may be out of favour or neglected by analysts.

Income: this invests with the primary focus on yield. However, it may utilize gearing to buy bonds and sometimes fixed income derivatives in order to profit from principal appreciation and interest income.

Market Neutral - Arbitrage: this attempts to hedge out most market risk by taking offsetting positions, often in different securities of the same issuer. For example, it can be long of convertible bonds and short of the underlying equity. It may also use futures to hedge out interest rate risk. It focuses on obtaining returns with low or no correlation to both the equity and bond markets.

Market Neutral - Securities Hedging: this generally matches long and short equity portfolios in the same sectors of the market. Market risk is greatly reduced; index futures are sometimes utilised to hedge out systematic risk. The emphasis is on individual share selection. Gearing may be used to enhance returns.

Opportunistic: the investment theme here changes from strategy to strategy as opportunities arise to profit from events such as IPOs, sudden price changes often caused by an interim earnings disappointment, hostile bids, and other event-driven opportunities. May utilize several of these investing styles at a given time and is not restricted to any particular investment approach or asset class.

Multi Strategy: this investment approach is diversified by employing various strategies simultaneously to realize short- and long-term gains. Other strategies may include systems trading such as trend following and various diversified technical strategies. This style of investing allows the manager to overweight or underweight different strategies to best capitalize on current investment opportunities.

Fund of Funds: this mixes and matches hedge funds and other pooled investment vehicles. This blending of different strategies and asset classes aims to provide a more stable long-term investment return than any of the individual funds. Capital preservation is generally an important consideration.

Some candidates lost marks by simply listing the titles of strategies, rather than briefly outlining them. Others simply made reference to characteristics, such as gearing and derivatives.

- Q3** This income tax calculation was reasonably well answered, along the lines set out below. The most common failing was the incorrect calculation of the partially clawed back age allowance.

Pension	14,000.00
Dividend Income $\text{£}8,000 \times \frac{100}{90}$	<u>8,888.89</u>
	22,888.89
PA	<u>(6,695.55)*</u>
Taxable Income	16,193.34
<u>Non-savings income</u>	
$\text{£}2,230 \times 10\%$	223.00
$\text{£}5,074.45 \times 22\%$	1,116.38
Dividend income	
$\text{£}8,888.89 \times 10\%$	<u>888.89</u>
Total tax liability	2,228.27

Note

**Age allowance has been partially clawed back.*

Gross income	<u>£22,888.89</u>
Less income limit	<u>(20,900.00)</u>
Excess	1,988.89
Clawback	$= \frac{1}{2} \times \text{£}1,988.89$
	$= \text{£}994.45$

The age allowance has been partially clawed back, i.e. $\text{£}7,690 - \text{£}994.45 = \text{£}6,695.55$.

- Q4** Most candidates were able to correctly calculate the proceeds from the sale of the gilt, but many fewer were able to derive the income tax liability. A common error was to assume only one interest payment was received in the fiscal year, rather than two.

(a)	Consideration on sale	$= \text{£}10,000 \times 1.3354$
		$= \text{£}13,354$
	Accrued interest	$= \text{£}10,000 \times 8.75\% \times 0.5 \times \frac{21}{182}$
		$= \text{£}50.48$
	Proceeds	$= \text{£}13,354 + \text{£}50.48$
		$= \text{£}13,404.48$
(b)	Yearly interest received	$= \text{£}10,000 \times 8.75\%$
		$= \text{£}875.00$
	Accrued interest	$= \text{£}50.48$
	Taxable interest	$= \text{£}925.48$

Income tax	= £925.48 x 20%
	= £185.10

Q5 Most candidates were aware of some of the following advantages Exchange Traded Funds have compared with tracker funds. Many candidates earned maximum marks. The advantages are:

- Free of stamp duty
- Continuous trading
- Lower total expense ratio (As far as private investors are concerned, they're closed-ended, like investment trusts. This means that there is continuous trading and they can avoid most of the administration costs involved with creating and cashing-in units)
- Low tracking error (The ETFs currently available in the UK achieve it by fully replicating the shares in a particular index, giving a very small tracking error)
- Wider range of indices than usually available as unit trusts or OEICs, particularly emerging markets such as iShares FTSE Xinhua China 25, and style indices (growth, value, smallcap), and commodities
- A means that can be used for shorting indices.

Q6 Most candidates were able to identify four factors that indicated the riskiness of the share. These included:

- High dividend yield; dividend per share greater than share price;
- net dividend yield 135%! (although some candidates assumed that this must be 1.35%, indicating a growth share!)
- Earnings yield nearly 600%!
- Low liquidity, in terms of daily volume of shares traded; and less than £33,000 in value
- Very low market capitalization
- Large % price fall over the last twelve months; more than 97%; price at bottom end of trading range
- Beta coefficient marginally above 1.

Good candidates commented that the yields were not sustainable. These figures were historic, including the good dividend cover of 4.4. The drastic fall in the share price and the low market capitalisation should have served as a warning that trading conditions had probably deteriorated, undermining the historic figures, and indicating above average risk, including risk of financial distress.

Q7 The main elements of the Trustee Act 2000 were generally well understood. These include:

Investment powers: there are much wider investment powers than previously available under the 1961 Act. Trustees may make any investment of the kind that they could if the funds were their own, except for land outside the UK.

A duty of care: as a counter to the much wider investment powers, there is an explicit general duty for trustees to exercise reasonable care in investment, employing an agent, insuring trust property, holding funds, paying debts or acquiring land. Higher standards are expected of investment professionals acting as trustees.

Investment duties: the Act imposes three special duties on trustees:

- to review investments regularly
- to obtain and consider `proper advice`
- to be aware of the need for *diversification* of funds, and the suitability of the investments

Delegation of trust functions: a trustee can now delegate day today duties to an agent, including the powers of investment, although the Act requires a Policy Statement from the trustees if this occurs. This is a written statement giving guidance on how the investment management functions should be managed in the best interest of the trust.

Paying fees to trustees: the Act regulates the arrangement for paying a trustee who is appointed in their professional capacity, for example a solicitor or accountant. The Act allows for payment of out-of-pocket expenses without the need for an authorising clause in the deed.

Insuring a trust: the Act created a power for trustees to insure 100% a trust's property. The purchase of investments with capital guarantees would normally fall within these powers.

Q8 The characteristics of rights issues were generally well understood, although there were frequent errors in calculating either the ex-rights price, nil-paid price, or both.

(a) A deep discounted rights issue would not normally require underwriting because the nil paid would normally be virtually guaranteed to have a positive intrinsic value (however, good candidates sometimes made reference to prevailing adverse market conditions that challenged this assertion). In favourable markets, it could also be utilised to reduce the trading price to a more desirable level (a quasi-share split or bonus issue; following the British tradition of not having heavily priced shares).

(b) Pre-emptive rights means that existing shareholders usually have to be offered new shares rather than the public in general. This prevents dilution. If they do not want to take up the shares they can sell the rights.

(c) (i) Ex-rights price = $\frac{2 \times \pounds 11.50 + 1 \times \pounds 1.00}{3}$
= **£8.00**

(ii) Nil-paid = £8.00 - £1.00
= **£7.00**

Q9 The differences between ISAs and personal pension plans were generally reasonably well understood. But candidates sometimes lost marks by being insufficiently precise (e.g. frequent references to ‘retirement age’); or only making reference to ISAs without the counterpart disadvantages of personal pensions. Many candidates wrongly assumed it was not possible to personally control the investments in a personal pension, despite the fact that SIPPs are now available for quite modest sums.

The advantages of ISAs include:

- No minimum age requirement for encashment; usually 50 years of age (rising to 55) for a PPP
- There is no requirement for eligible earnings to invest £7,000 (£7,200 2008-09) into an ISA; for a PPP if no eligible earnings the annual contribution is limited to £3,600 per year
- The whole of the proceeds of an ISA can be taken as cash; only 25% of a PPP can be taken as capital; the balance must be used to purchase an annuity by the age of 75.
- Charges are generally cheaper for Unit and Investment trusts in an ISA than for a PPP
- Income can be withdrawn from an ISA if required; it cannot be withdrawn from a PPP before encashment or drawdown.

Q10 The specific features of the bonds were generally known, but many candidates lost marks by not indicating how it impacted on their level of risk. Where this was done, it was often imprecise.

- (a) A sinking fund makes provision for repayment of the capital, either by gradually establishing a counterpart fund, or by using the annual provision to buy in through the market or by ballot.
This will reduce the market risk (i.e reduce the duration) and the default risk of the bond. Some candidates mentioned reduced liquidity in the bond and possible loss of premium if selling over-par when drawn by ballot as counterpart increased risk.
- (b) A floating rate bond has a coupon which is linked to some predetermined market rate, such as LIBOR.
This means that has income risk but very little market (price) risk
- (c) A fallen angel is a bond that has migrated from investment to non-investment grade.
It has increased credit (default) risk.
- (d) A perpetual subordinated unsecured loan stock(e.g. PIBS) ranks after all other creditors and is irredeemable.
Hence it has the highest credit risk of the liabilities of the issuing institution and it also has a high market risk because of its high duration.

Section B

Q11 This was a very popular question, and most answers showed that candidates had a reasonable understanding of the similarities and differences between unit trusts, OEICs, and single premium bonds (SPLABs). Generally, the first two were better understood than the last. A minority of candidates thought that SPLABs were confined to guaranteed income and growth bonds, sometimes with the addition of with-profit bonds.

The examiner expected good answers to include many of the following points:

Similarities

- In both cases prices of units reflect the value of the fund divided by the number units
- They both open-ended
- There is generally no or low long term borrowing
- Both have a bid-offer spread, which includes initial charge (OEICs have single price and levy initial management charge separately), and both levy annual charges
- Both are normally bought and sold through the managers
- Both can hold a wide range of assets including equities, preference shares, gilts and other fixed interest, property and cash
- Both provide diversification for a relatively small outlay
- Both subject to similar marketing arrangements under the Financial Services and Markets Act.

Differences

- A unit trust is a trust fund, governed by trust law, and has a separate trustee
- A single premium investment bond contains a minimal element of life assurance, which has to be paid for separately
- Life assurance funds have greater discretion and wider range of eligible investments; also more flexible limits on holdings
- In the case of a unit trust the fund is exempt from CGT; the personal investor is liable to CGT on any gains made on units. In contrast, a life assurance fund pays CGT; the individual has no liability to CGT, but may be liable to higher-rate income tax less basic-rate (i.e. 40%-20%)
- The new rules regarding CGT favour unit trusts; a flat rate 18% whereas bondholders could pay an extra 18% , in addition to the fund discharging the basic-rate liability
- It is usually cheaper to switch between funds within a single premium bond (and no CGT liability) than is the case when switching between funds of a unit trust management company
- But generally charges are higher and less transparent for bonds than for unit trusts and OEICs
- The 5% withdrawal facility enables higher-rate taxpayers defer their higher-rate liability
- With-profit bonds provide 'smoothing' in terms of reversionary bonuses
- But bonus rates have recently been poor
- Market value adjusters often applied at various times to with-profit bonds, effectively reclaiming bonuses granted
- Single premium bonds also include Guaranteed Income and Growth Bonds
- Life policies can be written in trust, so that the proceeds on death fall outside the estate

- A protection scheme (100% of the first £2,000 and 90% of the value of the policy in excess) is provided by the Policyholders' Protection Act 1975, now part of the Financial Services Compensation Scheme (FSCS). This is uncapped, unlike the £48,000 limit applied to most other investments, including unit trusts and OEICs.

Q12 This was a wide ranging reflective question, which gave candidates the opportunity to opine on regulation and protection in general terms, and the efficacy of provision in the UK. Generally, there was very little reflection on the case for and against regulation. Most answers were confined to the details of the FSMA 2000 and recent examples of failure; most answers made reference to Northern Rock. Occasionally, the British system was compared unfavourably with the USA, where more robust methods, including handcuffs, were thought to be more effective.

In general terms, consumer protection is particularly important in financial services because of:

- The nature of the product. Unlike tangible products, many consumers are unsure as what they are buying, and rarely read the 'small print'
- Financial services can have a major influence on a household's current and future standard of living (yet many people will spend longer checking out a new car than a pension!)
- It may be some years into the future before the features and performance of a product become apparent
- It may be very difficult and expensive to reverse an investment decision
- Charges and other expenses are not always readily apparent
- Past performance cannot be relied upon as an accurate guide to future performance; future returns in many cases are only estimates, not guaranteed
- But any attempt at regulation and protection can never be absolute.
- It is impossible to provide perfect investment protection. For one thing, portfolio planning is a matter of risk and return. How far should investors be protected against themselves? As with smoking, the Government prefers to rely on 'wealth warnings' rather than outright prohibition. This is most prominent where the product is inherently risky (e.g. derivatives) and where the investor is unsophisticated
- The trade-off between protection and cost. The costs of regulation and compliance are ultimately borne by the consumer
- It is impossible to measure 'best advice', except with hindsight
- How far should the advisor be expected to allow for the changing circumstances of a client?
- Fees v. commissions (can some-one rewarded by differing rates of commission ever give objective advice?)
- Protection schemes may encourage a disregard for risk ('moral hazard')
- Is it possible any longer to have a purely domestic policy, particularly with the impact of the internet; firms may simply move offshore?

In terms of the regulation and protection in the UK, the first comprehensive Act was the Financial Services Act 1986. It established a system of investor protection in the UK of self-regulation within a statutory framework. Significant powers were delegated to self-regulating organisations (SROs). However, this was largely deemed to be a failure. This regime was replaced by a single authority – the Financial Services Authority – following the Financial Services and Markets Act 2000.

Under the 1986 Act, for the first time in the UK there were precise definitions of 'investors' and 'investments'. Under the 2000 Act these were retained and extended. 'Investors' need to be authorised or exempted when giving investment advice or managing investments. There are penalties for breach of authorisation requirements (up to 2 year imprisonment, or a fine, or both), and for making false, deceptive, or reckless statement or promises, or engaging in misleading practices (up to seven years' imprisonment, or a fine, or both).

The 1986 Act established an *Investors' Compensation Scheme* with 100% on first £30,000; 90% cover on next £20,000; maximum £48,000.

The SROs were criticised for unnecessary duplication in their areas of work and their rulebooks and, at times, differing interpretations of rules. However, the greatest criticism was that they favoured practitioners at the expense of the public, and were not sufficiently diligent in preventing mis-selling. Customers expected to be given best (or at least suitable) advice. In reality, there was a lot of dissatisfaction as a result of widespread evidence of misselling of life assurance and personal pensions in particular.

Many features of the 1986 Act were retained in the 2000 Act. There were 10 general principles, which were codified into separate rule books. Some rules remain, or have been harmonised. The 1986 Act introduced the principle of polarisation; advisors either had to be tied or totally independent. The intention was to make clear to investors the nature of the advice they were receiving. The reality was that it resulted in a considerable diminution of investor choice because most institutions eventually opted for tied status. Polarisation has been partially abandoned.

The Financial Services and Markets Act 2000 received the Royal Assent in June 2000 but did not become fully implemented until the second stage, N2- New Regulator 2- on 1st December 2001. The FSA was given massive powers as a 'super-regulator'. Only Sweden and Ireland have similar institutions; in other countries, including the USA, no single authority has such over-arching powers.

Most candidates stated that the Financial Services Authority has four main aims:

- (i) Maintaining confidence in the UK financial system (supervising exchanges, settlement houses, market surveillance and transaction monitoring).
- (ii) Promoting public understanding of the financial system (make consumers better informed so that they manage their financial affairs more effectively).
- (iii) Securing the right degree of protection for consumers (vetting for honesty, competence, and financial soundness; applying disciplinary measures).
- (iv) Contributing to reduce financial crime (money laundering; fraud and dishonesty; insider dealing).

Before the 2000 Act investor protection in the UK was very fragmented. In addition to the Financial Services Act 1986, there have been the following:

- the Policyholders Protection Act 1975 (amended 1997)
- the Credit Unions Act 1979
- the Insurance Companies Act 1982

- the Building Societies Act 1986
- the Banking Act 1987
- the Friendly Societies Act 1992
- the Pensions Act 1995
- the Pensions Act 2004

These, among other things, all established separate ombudsmen and protection schemes.

From December 2000 the FSA absorbed ten separate financial regulators including the three SROs (SFA, IMRO, PIA), the Bank of England surveillance division, the Insurance Directorate from the Treasury, the UK Listing Authority from the London Stock Exchange, Lloyd's of London, the Building Societies Commission, the Friendly Societies Commission and the Registrar of Friendly Societies. Accountants, solicitors and actuaries also fall under the FSA if they are involved in investment business. Following Northern Rock debacle however, there was feeling that the tripartite division between the FSA, Treasury, and the Bank of England resulted in none taking direct responsibility.

A key change was to the compensation available. Instead of five separate bodies covering investment generally, banks, building societies, insurance and friendly societies, there is now only one - The Financial Services Compensation Scheme. The bank and building societies cover for deposits was increased from a maximum of £18,000 to initially £31,700 (i.e. 100% of the first £2,000, then 90% of the next £33,000), and most recently to a full 100% of the first £35,000. Joint accounts are entitled to twice this figure.

The compensation limits for general insurance were also raised - to 100% for compulsory insurance, and for non-compulsory insurance 100% of the first £2,000 and 90% of the balance.

The Pensions Act 2004 applies to occupational pension schemes. It established the Pension Protection Fund (providing compensation if employer becomes insolvent and pension scheme is under-funded). A new Pensions Regulator extended the previous powers of OPRA. The Pension Protection Fund (PPF), introduced in April 2006, provides limited protection for employees in occupational schemes- for people still working the scheme pays out 90% of their retirement income entitlement, up to a cap of £25,000 For those already drawing occupational pensions there is no cap on benefits and they can receive 100% of their entitlement.

In similar fashion the separate ombudsmen, who arbitrate between investors and the product providers, have been amalgamated.

Other forms of statutory protection for investors are:

- the Companies Act 1985
- the Criminal Justice Act 1993 (insider dealing).

Take-overs and mergers are subject to a non-statutory City Code, first published in 1968. It has been revised several times. It does not prescribe the exact manner in which take-overs bids should be made. Rather, it states certain general principles and elaborates these in certain specific rules it is a cardinal rule that the spirit of the Code, and not merely its letter, be observed. The Listing Agreement

of the London Stock Exchange, and the law on insider dealing also play prominent roles.

‘Market abuse’ covers much the same area as insider dealing and market manipulation, but is a civil rather criminal offence. It therefore requires lower standards of proof to convict. Market abuse is an offence introduced in the Financial Services and Markets Act 2000. In July 2005 The FSA adopted the EU Market Abuse Directive (MAD!) and incorporated it into its Code of Market Conduct. FSA states that seven types of behaviour can amount to market abuse. The maximum penalty is an unlimited fine. However, there has been a poor prosecution record for ‘insider’ dealing in general.

In November 2007 the *Markets in Financial Instruments Directive* (MiFID) was implemented. It is a European Union law which provides a harmonised regulatory regime for investment services across the 30 member states of the European Economic Area (the 27 Member States of the European Union plus Iceland, Norway and Liechtenstein). The main objectives of the Directive are to increase competition and consumer protection in investment services. As of the effective date, 1 November 2007, it replaced the Investment Services Directive (Directive 93/22/EEC).

MiFID is the cornerstone of the European Commission's Financial Services Action Plan whose 42 measures will significantly change how EU financial service markets operate. MiFID retains the principles of the EU 'passport' introduced by the Investment Services Directive (ISD) but introduces the concept of 'maximum harmonization' which places more emphasis on home state supervision.

The main features of MiFID are:

Authorisation, regulation and passporting: firms covered by MiFID are authorised and regulated in their "home state" (broadly, the country in which they have their registered office). Once a firm has been authorised, it is able to use the MiFID passport to provide services to customers in other EU member states. These services are regulated by the member state in their ‘home’ state.

Client categorisation: MiFID requires firms to categorise clients as "eligible counterparties", professional clients or retail clients (these have increasing levels of protection). Clear procedures must be in place to categorise clients and assess their suitability for each type of investment product. That said, the appropriateness of any investment advice or suggested financial transaction must still be verified before being given. The degree of protection is in inverse relation to the expertise and knowledge of the investor. This was frequently commented upon by candidates.

Under MiFID, brokers have to make a distinction between complex and simple instruments - and, in the case of complex instruments, ensure clients have the necessary experience to trade them. These include CFDs, futures, options, covered warrants, commodities and certain ordinary shares not frequently traded. Execution-only brokers have to make an assessment of whether an investor has the knowledge and experience to understand the risk associated. Most private investors are classified as ‘retail’ rather than ‘professional’ investors under the new rules, which affords extra regulatory protection.

Best execution: MiFID requires that firms take all reasonable steps to obtain the best possible result in the execution of an order for a client. The best possible result is not limited to execution price but also includes cost, speed, likelihood of execution and likelihood of settlement and any other factors deemed relevant.

Candidates were not expected to regurgitate all of this voluminous material, but rather to utilise elements of it to support their assessment of its range and effectiveness.

Q13. This was the least popular question, probably because it was the most specialist and technical. A few answers demonstrated depth of understanding, but the majority were superficial.

In order to earn a good mark, candidates had to demonstrate they understood the features of a convertible including bond support price, conversion ratio and conversion price; and why they might be regarded as attractive by investors at times of uncertainty, when there is likely to be high market volatility.

Convertibles are a hybrid of debt or preference shares and usually equity.

They are a combination of a pure bond or preference share with a call option which can be exercised by exchanging the bond or preference share for a specified number of other securities, usually equities.

They offer the advantage of upside participation of the equity with downside protection provided by the bond (or preference) support price.

If the share price rises the bond will be eventually exercised.

If the share price falls and remains 'under water' (below the conversion price) the call option is allowed to lapse by not exercising the conversion rights.

In this respect they are ideal in volatile markets.

But it comes at a price.

The option cost is the cost of the call option; the excess over the cost of a pure bond.

The greater the option cost, the lower the yield of the bond.

The conversion premium is the excess of the of the conversion price over the cost of the market price of the equity.

Generally there is a trade-off between the option cost and the conversion premium.

When the conversion premium is small and the expiry date long-term the option cost is generally expensive.

Options are also more expensive the more volatile the underlying asset.

So convertibles will be more expensive relative the 'straight' bond when equity markets are volatile.

When interest rates are low the reduction in yield from holding the convertible instead of the vanilla bond is less marked.

It is difficult for private clients to understand the different elements comprising the value of a convertible.

Convertibles are usually issued by companies where there is a lack of security for the debt.

The conversion rights enable such companies to issue unsecured debt without prohibitive coupon and servicing costs.

This means that the underlying bond may weaken and cause the bond support price to reduce.

Many may be non-investment grade. Consequently the equity 'sweetener' may be regarded as a compensation for the high default risk.

It is important to establish the risk of the underlying bond, including income and capital priority percentages.

The investor needs to ask whether they would purchase the debt if it was 'vanilla debt'.

Diversification is required in contrast to holding gilts directly.

But there is a concentration of convertibles in certain sectors, reducing the scope for diversification.

A disadvantage is that convertibles are subject to capital gains tax, unlike most UK corporate debt.

Section C

Q14

Most answers to the case study were competent; but few were outstanding. Most candidates could identify some of the key elements and were familiar with the terminology, but often answers were over-descriptive, including repeating information from the case rather than analysing its implications. Some candidates spent too much time commenting on the specifics and trading prospects of the individual equities rather than considering the portfolio as a whole.

- (a) The total market value of assets given in the case was £4,342,790. Almost all candidates noted that the overall asset allocation appeared heavily biased toward equities. The equity holdings accounted for 92% of the total financial assets (i.e £4m/£4.342790m). This was contrary to life-style and APCIMs benchmarks. Given the client's age, at most around 2/3 might have been more appropriate weighting for equities..

There were only 10 holdings, with an average of £400,000.

Most candidates were aware that modern investment theory recommends 15-20 holdings to diversify unsystematic risk (some candidates confused it with systematic).

No-one mentioned that Buffett recommends focus rather than diversification; but that only applies if you think you know more than the Market!

Warren Buffett sees risk in terms of investing in shares he does not understand, i.e it increases rather than diminishes with diversification.

The 'buy and hold' policy accorded with Buffett. 'Complacency' presumably referred to the lack of activity by the previous, now retired, stockbroker.

The portfolio was rebalanced five years previously, but, as many candidates indicated, the holdings may have become significantly different in value over the subsequent five years.

The policy was also not utilising the annual CGT allowance.

All shareholdings were leading FTSE 100 companies (with equity market capitalisations ranging from Marks & Spencer's £6.5bn to BP £103bn in early 2008) with good marketability.

Although UK based, all were global companies with high overseas earnings; indirectly providing overseas diversification.

Many had significant earnings in US dollars, exposing them to a decline in the value of that currency.

Generally, they had relatively low specific and liquidation risk.

But HSBC might be exposed to the sub-prime crisis?

Dividend Cover is Earnings/Dividends. It shows the security of the dividends.

All had dividend covers greater than 1, indicating that dividends were covered by earnings, albeit on an historic basis.

All had strong brand names, not usually reflected in intangibles in the balance sheet. This accords with Buffett's desire for companies with 'economic moats' to safeguard profits.

Generally they would provide long-term growth, but ‘elephants don’t gallop!’, meaning that, given their already large size, growth would unlikely to be dramatic.

But as at least one candidate remarked, ‘For this type of client, dullness is exactly what was required!’

The average net dividend yield was 3.7% (slightly below the FTSE 100 average at the time). The grossed up dividend yield was 4.1%.

This would have generated grossed-up dividends of around £160,000, more than satisfying the client’s needs.

The client was obviously a higher-rate taxpayer. Candidates often noted this tax inefficiency, and the absence of tax-efficient investments.

The three gilt holdings had a total market value of £332,790 at the prices in the case study. A few candidates further noted, from the Gilts Daily Price List, that they had subsequently declined to £319,030, a fall of 4.1%. Each was selling over-par; therefore tax-inefficient for a higher-rate taxpayer.

They generated a gross income of £13,375.

It was frequently noted that they all had a high modified duration; and therefore high market risk. Durations were also often cited from the Gilts Daily Price List.

Given the income needs were more than adequately covered, many candidates sensibly suggested that it might be preferable to switch into medium-dated index-linked gilts.

Most candidates noted that cash was a very modest proportion of the overall portfolio (0.2%), although, given the size of the portfolio, the frequently quoted norm of 10% was generally recognised to be excessive in the longer term.

There was no indication of the interest rate being received. This would be more critical if larger sums were involved.

There were frequent comments regarding the potentially large IHT liability.

On the valuations in the case, the IHT liability would be £1.617,116.

However, there was no evidence of the utilisation of PETs and other IHT exemptions.

- (b) The essence of the strategy advocated by the new stockbroker was the need to create a ‘good’ portfolio. According to modern portfolio theory this implies a portfolio lying on the ‘efficient frontier’. Because of their correlations, a combination of ‘good’ companies might not be a good portfolio. Conversely, a combination of ‘bad’ companies might create a ‘good’ portfolio in terms of overall portfolio risk and return. This viewpoint was not articulated and criticised in even the best answers. But as the better candidates recognised, this was a ‘top down’ approach. Furthermore, the ratings of the good companies might be a reflection more of their past growth rather than their future performance. It might be difficult to rationalise such a strategy to an elderly financially unsophisticated client, and its validity would crucially depend on accurate estimates of risk and return. The new, younger stockbroker advocated small and overseas companies with low price: book values.

The price:book ratio is similar to the PE ratio (some candidates confused them) but uses net asset value in the denominator rather than earnings. NAV/share is essentially shareholders' funds divided by the number of issued ordinary shares.

Some candidates were aware that with many 'new economy' companies the major assets are intangibles, often not adequately reflected in the balance sheet, and usually ignored when calculating net assets.

It is a criterion for selecting shares underpinned by assets, and was advocated by Warren Buffett's mentor, Benjamin Graham. It is generally regarded as a 'value' strategy.

In contrast, small companies are generally regarded as growth rather than value investments. They would likely produce a much lower level of dividend income than existing holdings. The 'small company effect' suggests that, on the whole, they produce more growth than large companies over the long run.

However, few candidates were able to analyse the risk implications correctly. Small companies tend to have low systematic (beta) risk, but high unsystematic (specific) risk. Many candidates incorrectly thought that small companies would increase the beta of the portfolio. Nevertheless, despite diversification, the high specific risk would mean that they would probably not be appropriate to the client.

Virtually, no candidate was aware that combining the two factors of small size with low price:book is a well-known strategy associated in the academic literature with Fama and French, as the two key elements of their widely publicised 'Three Factor Model'

They demonstrated that it produced above average performance in most periods in most countries over long periods of time.

But they argued that it did not invalidate the efficient market hypothesis. Rather, the explanation for the excess returns ('alpha') was that the usual financial models did not capture all aspects of risk, notably increased risk of liquidation.

Furthermore, small companies in the UK have significant tax advantages.

If not listed on the main market or any other recognised exchange, and held for two years, they are exempted from IHT; important in this case.

AIM shares are therefore generally exempted from IHT.

Dividends and capital gains from VCTs are tax-free; significant in this case (but not exempt from IHT).

But in recent years small companies have been poor stock market performers, both in the UK and in many overseas markets, and are vulnerable in a recession.

The young stockbroker also recommended overseas companies rather than UK listed companies with high overseas earnings.

Some candidates noted that, particularly in this case, this would most likely mean collective vehicles rather than direct ownership.

Overseas shares provided opportunities for above-average growth, together with portfolio risk reduction because of divergences between markets (low correlation of returns with those in home country). Unfortunately, the correlations tend to increase and converge at times of maximum economic problems –all the eggs fall out of the basket!).

Overseas investment provides access to specialist companies and industries (e.g. Russia and oil).

In theory, overseas diversification provides a better trade-off between risk and return. Global diversification should reduce the systematic risk (beta) relative to the UK market.

But there are many other disadvantages:

- Political risks (change of leadership; political reform);
- Economic risks (particularly in transition from command to free market economies; exchange controls);
- Portfolio risk (correlation coefficients can increase in times of crisis
- Concentration in a few sectors (e.g. oil and gas in Russia-around 70% of the market);
- `Information Gap` (time differences; language barriers);
- Lack of Regulatory controls (accountancy standards, insider dealing);
- Settlement problems;
- Counterpart risk;
- Currency conversion costs for payments and receipts;
- Custodial problems;
- Brokerage expensive;
- Double taxation;
- Speculative bubble in Chinese market; mainland index increased by 5x in two years (but down 50%+ from peak in 2008);
- The largest overseas market is USA, with weak dollar and subprime crisis!

According to the Capital Asset Pricing Model (CAPM) there is an explicit trade-off between returns and beta; the higher the beta, the higher the expected return.

The theory says that there is no additional return for unsystematic risk, as this can be diversified away.

Alpha is the excess return achieved, i.e. the return achieved in excess of that justified by the level of beta. Many candidates were familiar with the CAPM, and referred to 'alpha' shares lying above the Security Market Line.

The CAPM, based on the concept of Efficient Markets, postulates that alpha should be zero.

Small companies and emerging markets are more likely to have pricing 'inefficiencies', but these could be negative as well as positive.

However, the performance of Berkshire Hathaway (Buffett's fund) has shown a consistent alpha far in excess of what could be explained by chance.

Momentum is a recognition of trends.

It can be measured by relative strength, including moving averages.

If stop-losses were adopted, how would they be set? Would they be subject to frequent revision?

If, like filters, they were set relative to recent peaks, it might result in frequent trading when the market was volatile; leading to increased brokerage.

A 'value' investor may see price weakness as an opportunity to buy more cheaply rather than sell.

However, stop-losses might be useful with small and overseas companies where there is high volatility and imperfect knowledge.

In conclusion, the new strategy recommended was consistent with much modern thinking on investment strategy but would be probably inappropriate to this particular client.

CONCLUSIONS & GENERAL OBSERVATIONS

1. Scripts were generally well presented, with most candidates using double-spacing, numbering, underlining, and sensible use of paragraphs, and occasional highlighting.

The best scripts demonstrate a succinctness and clarity in summarizing the essentials of the answer, usually without the need of additional pages. However, there was a small minority of scripts which had appalling handwriting; at worst when it was small and cramped.

- 2 In Section A, candidates demonstrated a good breadth of knowledge. As usual, candidates tended to score better with the more descriptive questions, but marks for the four numerical questions were not significantly inferior. Some candidates lost marks by wrongly interpreting the imperative ‘briefly outline’ as simply ‘list’.
- 3 Candidates demonstrated a good understanding of all the material contained in tax tables and in the Gilts Daily Price List. The tax tables were necessary to answer Q3. The Gilts Daily Price List was often utilised in Q14(a).
- 4 Many candidates display evidence of essay plans and ‘mind maps’. Candidates are expected to be able to marshal information in a sophisticated manner to support or refute any particular assertion in an essay question. In this exam the average mark in this section was marginally the weakest of the three sections. Poor answers lacked analysis, simply writing around the topic. Some candidates left this section to last, and only had time to write brief notes.
5. The case study was generally reasonably well answered. A frequent failing in previous exams was writing in an unstructured manner, not attributing answers to the correct parts of the question; and giving inadequate justifications for recommendations. The former was less apparent in this case as there were only two parts. Most candidates made reasonable use of the range of information provided. Marks on average were marginally higher for part (a), a conventional portfolio, than for part (b), which required a greater synthesis of academic theory and practice.

These same points are repeatedly made in the Examiner’s Reports and are the major reasons why candidates succeed or fail. Moreover, the indicative answers sometimes contain material relevant to future questions.