



**SECURITIES & INVESTMENT INSTITUTE DIPLOMA**  
**SUMMER 2009**  
**CHIEF EXAMINER'S REPORT-**  
**PRIVATE CLIENT INVESTMENT ADVICE AND MANAGEMENT**

**INTRODUCTION**

The overall standard was good; at least on a par with the last four sittings. Most candidates showed clear evidence of having thoroughly prepared for the examination. This was most apparent in Section A, which tested the range of subject knowledge and understanding. Many candidates scored high marks in this section. Section B was generally reasonably answered. However answers in Section C were, on the whole, disappointing. Consequently, there were many good scripts, but few outstanding ones.

In Section A the average mark was good, and by far the best of the three sections. For four questions many candidates achieved close to full marks: Q1 (Children's Trust Funds and Bonus Bonds), Q2 (VCTs and EIS), Q3 (Income tax liability) and Q9 (Discretionary trusts). In contrast, only in Q7 (Income priority percentages) did many candidates do poorly.

In Section B by far the most popular question was that relating to the performance of gilts and corporate bonds. However, the distribution of marks was similar for the three questions.

In Section C too few candidates addressed the questions asked. Often candidates were dismissive of the proposed strategy, without adequately justifying their conclusions. In many cases, they wrote at length on alternative strategies, such as maximum portfolio diversification across asset classes and different countries. Answers on market timing were also particularly poor; many candidates wrote instead on the converse strategy of pound-cost averaging.

## Section A

**Q1** This question was very well answered, and many candidates earned full marks with four of the following differences:

	<b>Child Trust Fund</b>	<b>Children's Bonus Bonds</b>
<b>Issuer</b>	Wide range of financial institutions	National Savings & Investments
<b>Product</b>	Three types of account-stakeholder and non-stakeholder stock market; and deposit account	Fixed interest (Issue 33 2.30%, compound fixed rate for five years (1.65% if repaid before fifth year) ; and final bonus at 21 )
<b>Maximum age</b>	18 ( cannot be accessed before then)	21
<b>Subsidy</b>	Initial £250 (double for low income families +additional payment at age seven)	None
<b>Contribution limits</b>	£0-£1200 per year	£25-£3,000 per issue

**Q2** Similarly, the majority of candidates could list two advantages and disadvantages, including the following:

<b>Advantages of VCTS</b>		
	<b>VCT</b>	<b>EIS</b>
Rate of tax relief on contributions	30% if held 5years	20% if held 3 years
Dividends	Tax-free (no HRT)	Taxable
Capital gains tax	NO (exempted assets)	YES if disposed of within 3 years
Diversification of portfolio	YES	NO

<b>Advantages of EIS</b>		
	<b>VCT</b>	<b>EIS</b>
Max amount qualifying for tax relief	£200,000	£500,000
Capital gains deferral relief	NO	YES (within one year before or three years after disposal)
Capital loss relief	NO	YES
Inheritance tax exempted	NO	YES

**Q3** Most candidates were able to accurately perform an income tax calculation along the following lines; many candidates scored full marks.

	£
Pension	14,000
Interest            £4,000 x 100/80	5,000
Dividend Income £4,500 x 100/90	<u>5,000</u>
	24,000
PA	<u>(8,080)*</u>
Taxable Income	15,920

Non-savings income

£2,320 x 20%	464
£3,600 x 20%	720

Interest £5,000 x 20%	1,000
Dividend income	
£5,000 x 10%	<u>500</u>
Total tax liability	<b>2,684</b>

*\*Age allowance has been partially clawed back.*

Gross income	£24,000.
Less income limit	<u>(21,800)</u>
Excess	2,200.
 Clawback	 = 1/2 x £2,200 = £1,100

*The age allowance has been partially clawed back, i.e. £9,180- £1,100 =£8,080.*

**Q4** The majority of candidates successfully calculated the conversion price and premium, as set out below. Most candidates realised that immediate conversion would result in a loss of capital and income, but fewer commented on the failure to convert at expiry. This could result in a substantial loss, as the convertible, currently valued as equity, reverted to a straight loan stock.

- (a) (i) Conversion price        = Convertible price/ conversion ratio  
    = £477/100  
    = £4.77
- (ii) Conversion premium = Conversion price – share price  
    = £4.77– £4.44p  
    = 33p (7.4% premium to share price)

- (b) Because of the conversion premium, the conversion rights should be exercised at the last opportunity before expiry. In the meantime it would be more profitable to sell in the market; and the convertible has a higher income (£5) than the grossed-up dividends on the equivalent shares (£1.67). But the convertible must be exercised before the rights expire because the bond support price is very low compared with the conversion value.

**Q5** Answers were of variable standard, reflecting different levels of understanding of the features of these two derivatives. Good answers included some of the following points:

**Similarities:**

- Both are geared investments; provide greater percentage gains and losses on initial investment than percentage change in underlying asset
- In both cases can go long or short; buy or sell a CFD; buy a call/write a put; buy a put/write a call

**Differences:**

- CFDs are contingent liabilities; you can lose more than initial investment if the price moves against you; but this does not apply to buying traded options (only writing them)
- CFDs can only be taken on individual equities; traded options can also be taken on indices
- CFDs have no fixed expiry date; traded options are for 1,2,3, 6 and 9 months
- CFDs have no fixed contract size; traded options are in contracts of 1,000 shares
- CFDs have an initial margin and daily financing charges; traded option have an initial option premium and an exercise price.

**Q6** Part (a) was very badly answered, with very few candidates having an awareness of the meaning of the term. A common misconception was that it referred to the choice of investments within the pension plan. Part (c) also revealed a lack of awareness, although less than in (a). In contrast, part (b) was well answered.

(a) An investor in a personal pension does not have to purchase the annuity from the fund provider; they can transfer the fund to any annuity provider in the open market.

(b) Relevant points include the following:

Income Drawdown ('unsecured pension') is available from the age of 50 (55 from 2010), and can be use in entirety or for only part of the personal pensions; provides an income and capital without immediate purchase of an annuity.

Any cash (up to 25%) must be taken at the outset.

The income taken in any year can range from zero to 120% of the equivalent single life annuity (GAD calculation uses the 15 year gilt yield as benchmark, reviewed every five years).

A 35% tax charge applies to any lump sum death benefits payable under an income drawdown plan.

On the death of the member the remaining vested pension fund can be returned to the individual's beneficiaries and remain in pension drawdown, free from Inheritance Tax and the additional 35% tax charge.

Charges are higher for income drawdown than for a conventional annuity due to the requirement for regular reviews.

By age 75 an annuity must be bought, or else the fund will be moved into an Alternatively Secured Pension (ASP).

- (c) An impaired life annuity pays a higher rate because of reduced life expectancy due to some diagnosed serious or terminal illness.

**Q7** Most candidates were aware of the meaning of income priority percentages and cover, and attempted to set out answers in the following format; but only a minority managed to earn the majority of the marks.

$$\text{Profit available for distribution} = £7.5\text{m} \times 0.72 = \mathbf{£5.4\text{m}}$$

SECURITY	Net Cost	Income Priority %	Income Cover
£25m 8% ULS	£25m x 8% x 0.72 = £1.44m	£1.44 / £5.4m = <b>0 – 26.7%</b>	<b>3.75</b>
£50m 10% sub ULS	£50m x 10% x 0.72 =£3.6m	£5.04/ £5.4 = <b>26.7% - 93.3%</b>	<b>1.07</b>
£10m 9% PREF	£10m x 9% = £0.9m	£5.94 /£5.4m = <b>93.3 –110%</b>	<b>0.91</b>
£100m £1 ORD	£100m x 0.05 = £5.0m	£10.94m/ £5.4m = <b>110 – 202.6%</b>	<b>0.49</b>

**Q8** This question was generally well answered, although some candidates made no mention of the importance of the revenue reserves in part (c), instead focussing solely on the latest earnings.

- (a) (i) Share premium account is a non-distributable shareholder's reserve. It represents the excess of the price the shares were issued at over their nominal value.
- (ii) Revenue reserves are cumulative retained profit. They are a distributable shareholders' reserve.
- (b) The dividend was cut because the previous level of dividends was uncovered by current profits and revenue reserves were insufficient to meet the shortfall (even though there was adequate cash in the bank).
- (c) As part of the ordinary business at the AGM ordinary shareholders have to approve the final dividend. They can vote to decrease it but not to increase it.

**Q9** Discretionary trusts were well understood, with many candidates earning full marks. The main reasons for establishing a discretionary trust include:

- complex succession plans, particularly where there is a second marriage or step – children; the surviving spouse or civil partner can be included as one of the beneficiaries of the trust
- to create flexibility to react to changes in circumstances; the trustees usually have a power to select which beneficiaries payments will be made to from within the ‘class’ that is stated, e.g grandchildren and great grandchildren; and the trustees can select the amount of trust income or capital that the beneficiary receives. The settlor can guide the trustees. This is usually achieved by leaving a ‘letter of wishes’ with the will; it may suggest what, if any, conditions to impose on the recipients and their behaviour
- to protect young or improvident beneficiaries against creditors; as the beneficiary has no claim to any specific part of the trust fund, none of the trust fund is vulnerable in the bankruptcy of any beneficiary
- in certain jurisdictions, a discretionary trust can be used to protect family assets from forming part of any divorce settlement
- although any unused nil-rate band can be transferred to the surviving spouse or civil partner, there are circumstances where it is beneficial to include a discretionary trust in a will to utilise the nil-rate band on the first death, particularly where assets are expected to increase in value faster than the anticipated future increases in the nil-rate band allowance
- estates containing assets eligible for business property relief or agricultural property relief.

**Q10** With the exception of definitions of ‘free float’, this question was generally well answered. Good answers included some of the following points:

- (a) (i) ‘Free float’ represents the proportion of securities of a company available to ‘outside’ investors. (FTSE indices remove government holdings in companies, such as banks, and restrictions on non-resident holdings in overseas securities. It also applies to inter-company holdings). It is the ‘free float’ which is used in the weights of FTSE indices.
- (ii) FTSE4Good are ethical indices; screening companies in each of the FTSE indices for specified positive and negative criteria. FTSE4Good Index series selects from the FTSE All-Share Index and the FTSE All-World Developed Index (Global). (Around three-quarters of the FTSE 100 shares qualify for the UK FTSE4Good Index).
- (b) The APCIMS Private Investors’ Indices are designed to provide a benchmark for private client portfolios. There are three types of fund – Growth, Balanced and Income

The returns on each benchmark fund are derived by varying the weightings of UK equities, international equities, gilts and cash. There are different weightings for Growth, Balanced and Income portfolios. The weightings are set by a committee of stockbrokers based on regular surveys. For example,

	<b>INCOME</b>	<b>BALANCED</b>	<b>GROWTH</b>
	<b>%</b>	<b>%</b>	<b>%</b>
UK Equities	45	42.5	47.5
International Equities	10	22.5	30
Bonds	35	17.5	5
Cash	5	5	5
Commercial Property	5	5	5
Hedge funds	0	7.5	7.5

The indices use the FTSE All-Share index as a benchmark for UK equities; the FTSE World ex UK is the benchmark for international equities; the FTSE UK the Gilts (All Stocks) as a benchmark for gilts; the 7 day LIBOR-1% as a benchmark for cash; the FTSE UK Commercial Property index; and the FTSE Hedge index.

## **Section B**

**Q11** This was a very popular question, and generally well answered. Most candidates were aware of the divergent performance of gilts and corporate bonds. There was also a divergence in the performance of short and longer-term gilts, as was apparent from shift in the yield curve, illustrated on the gilts price list provided. Good answers made reference to these yield curves, and the details of specific gilts.

Short gilt yields fell while those of longer gilts and corporate bonds rose.

Gilt yields fell particularly sharply at the short end (1 year gilts 4.20% March 2008 to 0.93% March 2009) less so at the long end (30year from 4.39% to 4.34%).

The shape of the yield curve changed from inverted to normal up ward sloping.

Most candidates mentioned that there was a 'flight to quality' ; gilts have no credit (default) risk.

Yields fell to their lowest levels for fifty years.

Gilts were seen as one of the few safe havens, particularly with credit risk of bank deposits.

In contrast corporate bonds were seen as having increased credit risk.

The increase in the credit risk premium was greater than the reduction in gilt yields.

Particularly in the financial sector; no protection for bonds unlike deposits.

Whereas previously risk premiums were narrow they now widened to record levels

This was reflected in credit default swap rates.

Some bonds downgraded by credit rating agencies; 'fallen angels' go from investment grade to non-investment grade.

The credit risk premia were discounting record default levels ( far higher than 1930s).

The credit risk premia also reflected much higher risk aversion.

In terms of outlook, had gilt prices peaked and corporate bond prices bottomed?

It depends on the depth of the recession.

The direction of lower quality corporate bond prices may be correlated more with equities than gilts.

Falling inflation and actual deflation is favourable to conventional gilts.

'Quantitative easing' may have favourable short-term but unfavourable long-term effects on gilt prices.

In the short-term £75bn ( 5% GDP) was being used to purchase 5-25 year gilts.

That represented 30% of the outstanding stock.

But longer-term fears of inflation may adversely affect longer-term conventional gilts, particularly if inflation is used as a means of eroding real debt levels.

This was generally seen as favourable in the longer term for index-linked gilts, although most answers made little mention of them.

**Q12** Despite its topicality, few candidates attempted this question. There was a wide range of material that good answers could have drawn upon.

Most answers commenced by stating 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; apply disciplinary measures)
- iv. Contributing to reduce financial crime  
(money laundering; fraud and dishonesty; insider dealing)

Regulation in the UK has generally been principles based rather than rules based. Prior to 2000 the system was accused of excessive bureaucracy and duplication. But there is an inevitable conflict between promoting competition and innovation and providing protection. (For example, AIM was said to attract international business because of its lax regulation). Generally the FSA has preferred warnings and assessing the appropriateness of the client rather than outright bans. Many are factors outside of the control of the FSA -macro-economic, offshore, contagion. Recent preliminary reviews have concluded that the 'light touch' had been 'mistaken'.

- (i) The first objective is done in conjunction with the Treasury and the Bank of England. It is the one most criticised since banking failures. 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 will also fall under the FSA if they are involved in investment business. Banks observed Basle 2 solvency but little intervention in lending or incentive practices. Although the failure of the banking system had received the most publicity there was surprisingly little discussion of it in most answers.
- (ii) The FSA uses its website to provide information and advice. But understanding even among professionals of financial engineering was weak. From June 2005 there was a new requirement for advisers to give a 'menu' to customers about the firm's charging structure. This can run to several pages. Principally it requires a company to show its maximum charge for each deal against an industry average. Clients will have to be offered the choice of paying fees rather than commission. This accords with the FSA's second objective of making consumers better informed

- (iii) FSA implemented changes under MIFID to protect investor - including authorisation, regulation and passporting; client categorisation to assess their suitability for each type of investment product; post-trade transparency; and best execution

The 1986 Act established an *Investors' Compensation Scheme*, with a maximum limit of £48,000 per person.

A key change is 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 £31,700 (i.e. 100% of the first £2,000, then 90% of the next £33,000). More recently, following the collapse of Northern Rock, the upper figure was considered too low and increased to £50,000. Joint accounts are entitled to twice this figure. The compensation limits for general insurance are 100% for compulsory insurance, and for non-compulsory insurance 100% of the first £2,000, and 90% of the balance.

Consumers are expected to carry some risk in order to reduce 'moral hazard'.

- (iv) Combating financial crime has produced inconvenience at the retail end but has not produced spectacular results where large sums are involved. There are heavy penalties for money laundering:

Knowingly assisting a money launderer in concealing, retaining, or investing funds if that person knows or suspects that the proceeds came from serious criminal misconduct:

Maximum penalty 14 years imprisonment, a fine, or both;

Failing to report knowledge or suspicion of money laundering:

Maximum penalty 5 years imprisonment, a fine or both;

Tipping off money launderers that suspicions have been disclosed to the relevant authorities:

Maximum penalty 5 years imprisonment, a fine or both;

Failure to observe the regulations, irrespective of whether or not any money laundering has taken place:

Maximum penalty 2 years imprisonment, or a fine or both.

Insider dealing has been a criminal offence in the UK since 1980. Under the Criminal Justice Act (1993) insider dealing remains a criminal offence; maximum penalty 7 years imprisonment. But there have been few prosecutions, particularly in relation to take-overs.

Market abuse is an offence introduced in the Financial Services and Markets Act 2000. It was designed to extend the range of offences and to make prosecution easier. 'Market abuse' covers much the same area as insider dealing and market manipulation, but is a civil rather than criminal offence. It therefore requires lower standards of proof to convict. The maximum penalty is an unlimited fine. This change has restricted the activities of PR consultants, and made companies more wary of leaking information to privileged brokers, newspapers, or important investors.

Market abuse includes insider dealing, improper disclosure; misuse of information; manipulating transactions and devices; distortion and misleading behaviour.

In July 2005 The FSA adopted the EU Market Abuse Directive (MAD!) and incorporated it into its Code of Market Conduct.

**Q13.** This question was also only attempted by a small minority of candidates, but those that did so generally produced reasonable answers that incorporated many of the following points:

Absolute return funds aim to achieve positive returns for investors regardless of market conditions, but this is not guaranteed.

One definition is that it's a fund which aims to grow every year. So even if the market as a whole falls, an absolute return fund would aim to deliver a positive performance. That may mean that an absolute return fund lags the market in good years (delivering a poor *relative* return), but beats the market in bad years.

In technical terms, they aim to achieve *alpha* ( a return in excess of the cash rate) whilst removing *beta* (susceptibility to market movements).

The performance of absolute return bond funds can be designed to have a low correlation with the overall direction of bond markets, and they may have a lower risk profile than equity funds.

Consequently, they are generally measured against cash, thereby having an 'absolute' benchmark.

There are two main forms – those based on bonds, a combination of money market securities, bonds and bond market derivatives; these are the majority of absolute return funds. Others use a wider range of asset classes, including shares and a wider range of derivatives.

The first absolute return funds were hedge funds, but several investment trusts are now following the trend.

UCITS III regulations permit unit trusts and OEICs 'going short' and the use of derivatives.

Unlike bank and building society accounts investors may not get back the original amount invested and that some funds are not designed as alternatives to cash accounts.

They operate in a more regulated environment than a hedge fund – onshore rather than offshore, but normally cannot borrow.

Absolute return funds are a form of hedge fund in that they can go short and use extensive derivatives. But hedge funds differ in that they have

- High gearing
- High Charges and Performance fees
- Aim to achieve absolute rather than relative returns
- Lock-in periods - illiquid
- Lightly regulated through offshore centres
- Lack of transparency ('black box')
- High minimum sums.

Unlike stock market guaranteed (or 'protected' funds), absolute return funds do not guarantee the return of capital after a specified number of years. They should produce better relative returns when equities are falling or static, but less in arising market. They should appeal to those who accept that their capital is not guaranteed but who want to reduce the risk of losing value and get a return in all market circumstances.

Another similar type of investment is a 'with-profit' bond. This aims to produce returns irrespective of market conditions through a balanced portfolio. However the 'smoothed' returns are achieved through reversionary bonuses. The fund may suffer losses but these are smoothed through holding reserves. Capital is protected but may be subject to 'market value adjusters'.

## Section C

**Q14.** Most answers to the case study were disappointing, notably parts (a) and (b). Candidates generally failed to grasp the essential issues involved in part (a), particularly the concept of the equity risk premium, providing a reward for bearing risk. Too many answers simply dismissed the strategy, and then proceeded to discuss alternative more widely diversified strategies! There was little discussion of the underlying concepts of the equity risk premium; gearing of returns; and time diversification.

- (a) The strategy was based on the belief that over the long run the return on equities will exceed borrowing costs. Because of higher risk /return, over the long run returns on equities have generally exceeded those of treasury bills and gilts; this is the 'equity risk premium' of 4-6%. As a result of the credit crisis this premium may have increased because of increased risk aversion and low interest rates. It was suggested that the client diversified across the FTSE 100 companies by buying a tracker fund (ETF). This diversifies unsystematic risk but leaves market risk. Weightings and constituents are constantly changing, particularly banks, oils, and mining in recent times. Although many candidates recommended global diversification, some recognised that these are largely multinational companies, providing high overseas content. They thus provide some hedge against currency depreciation. The cheapest means of investing in a tracker fund is generally by means of an exchange traded fund. The FTSE 100 ETF has a lower total expense ratio than unit and investment trusts and is free of stamp duty. Many candidates mentioned continuous trading, although that would be less relevant for a long-term buy-and-hold investor! (ETFs can have counterparty risk but iShares have zero counterparty risk because its ETFs are cash-based, unlike 'notes'; the funds hold underlying 'securities' in ring-fenced separate accounts). If the client could borrow at a low rate of interest the equity risk premium suggests he should be able to generate returns on equities in excess of borrowing costs. Studies show that the longer the period of investment the greater the probability that equity returns will exceed cash, gilts, and inflation. This is known as 'time diversification'; that is, it is more risky to invest for one year than twenty years. There is a wide probability distribution of positive and negative annual returns, but over twenty years the average of the distribution is much narrower. This can be reinforced by 'mean reversion'; if bull and bear markets tend to overshoot there is a tendency for returns to converge towards the mean in the long run. Twenty years was also consistent with the client's age and the age he might wish to gift assets to children. The borrowing takes advantage of the collateral available on the property.

Given the existing predominance of property, the strategy provided greater asset diversification to the wealth portfolio.

The dividend yields on equities could cover all or most of interest costs; although many candidates erroneously seemed to believe that ETFs cannot distribute income.

But there would be no tax shelter for most of the equities; 32.5% tax on dividends and 18% on capital gains. Only a small proportion could be sheltered in ISAs or personal pensions.

Although if borrowings were set against property income it could be possible to offset interest charges against taxable rental income.

However, it was important to emphasise that the strategy involved risk.

Given the possibility of a severe economic depression equities might take many years to recover.

Some candidates were concerned that 20 years might coincide with a future downturn; could the exit be more flexible?

The Dow-Jones in USA took until 1954 to reach the 1929 peak; the Japanese Nikkei was recently at a 26 year low.

A recent academic study by Arnott showed that, contrary to expectation, in the USA shares had under-performed Treasury bonds over the forty years to 2009.

Are long run historical returns a good guide to the future if circumstances have changed?

- (b) This section was generally badly answered. Some candidates scored zero because their comments did not relate to the question. Often candidates commented that market timing was difficult, and then proceeded to write an answer about the converse merits of pound-cost averaging!

‘Market timing’ means attempting to predict turning points in overall stock markets as a whole.

There are fundamental and technical measures that could be used to assess the absolute and relative cheapness of equities.

Absolute measures are the market price earnings ratio (based on past averaged, current or prospective earnings); the current or prospective market dividend yield, and the market multiple to net asset ratio.

These gave good signals at end of bear market in 1974-75 and more recently, at the end of the bull market in 1999-2000.

The last of these measures (otherwise known as the price: replacement book ratio) is generally known as Tobin’s ‘q’.

The lower the PE ratio, the lower Tobin’s ‘q’, and the higher the dividend yield the cheaper the absolute valuation of equities.

But in recent times it has been difficult to assess prospective earnings, dividends and the fair value of assets.

Market timing assumes that there is eventually reversion to long-term norms.

But in the short-medium term there may be wider divergence.

As Keynes remarked ‘The market can remain irrational longer than many investors can remain solvent!’

There is apparently no consistency in bull/bear markets in terms of length or amplitude. Many fundamental analysts were predicting end of bull

market at much lower levels (Alan Greenspan referred to 'irrational exuberance' when the Dow was at 6,000).

The turning point may be more psychological than fundamental.

Relative valuation compares the cheapness/deariness of equities relative to gilts. This is the 'reverse yield gap' and the 'yield ratio'.

The 'reverse yield gap' is the excess of the gross redemption yield of long-dated gilts minus the grossed-up dividend yield of equities (FTSE All-Share index); it was the norm from 1959-2008 in the UK because of inflationary growth.

Generally the smaller the RYG, or the greater the normal yield gap, the cheaper equities relative to conventional gilts.

Recently the RYG has disappeared for the first time in 50 years because of falling gilt yields and rising historic dividend yields.

The normal yield gap should equal the expected equity risk premium minus the expected growth in dividends.

It can also be expressed as a yield ratio (gross redemption yield / grossed-up dividend yield).

The RYG and yield ratio can also be used to compare equities and index-linked gilts, as they are both expected to provide real yields.

Sometimes earnings are substituted for dividends as the former represent potential dividends.

By these historic norms, equities appeared cheap relative to gilts.

Technical measures that could be employed include chart patterns, such as support and resistance levels, filters and moving averages to identify significant upside movement.

Few candidates mentioned sector rotation nor changes in macro-economic data, particularly leading indicators.

- (c) Other factors candidates could have considered include :
- Inheritance tax; potentially very large at 40% on an estate of more than £100m.
  - What is the extent of Business Property Relief and Agricultural Relief?
  - It might be more IHT efficient to borrow against the shares rather than the estate.
  - Was the client married, divorced, separated or living with unmarried partner?
  - Had he made a will; gifts to spouse would avoid immediate liability?
  - Health?
  - Was there adequate liquidity; bank and building society accounts – what % of financial assets; deposit protection?
  - Were there likely to be further cash demands?
  - Were there other assets or liabilities?
  - School fees planning?
  - Were there trust funds? Had the client considered charitable and discretionary trusts?

Ethical considerations?  
Who would manage or monitor the portfolio?  
Gift Aid?  
Tax efficient investments; pension planning, ISAs.  
Were there capital losses from previous sales of shares?  
Global diversification would provide a reduction in systematic risk and greater protection against a weakening of the sterling currency.  
Smaller companies would be riskier but more tax efficient (AIM companies had fallen in value more than FTSE100 companies; but usually not liable to IHT and VCTs receive tax relief on contributions and dividends are tax-free).

### **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, most candidates demonstrated a good breadth of knowledge. As usual, candidates tended to score better with the more descriptive questions.
3. Candidates demonstrated a good understanding of 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 used in Q11.
4. Many candidates display evidence of essay plans and `mind maps` in Section B. Candidates are expected to be able to marshal information in a sophisticated manner to support or refute any particular assertion in an essay question.
5. The case study was generally not 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. In this exam, too many candidates seemed to prefer to answer questions different from those set by the Examiner!

**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.**