



SII MASTERS DECEMBER 2008 EXAMINATION

FINANCIAL MARKETS

DATE OF EXAM	Wednesday 3 December 2008
3 HOURS	2.00 pm – 5.00 pm
RUBRIC	SECTION A – answer FOUR questions in this section SECTION B – answer BOTH questions in this section SECTION C – answer ALL parts of the question in this section

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 ANY FOUR questions in this section. Each question carries 5 marks

- 1 Briefly discuss how interest rates are affected by inflation. *(5 marks)*

- 2 Discuss five of the areas where European Integration has furthest to go. *(5 marks)*

- 3 Explain what is meant by “Revenue Expenditure”. *(5 marks)*

- 4 Discuss the difference between systematic and non-systematic risk. *(5 marks)*

- 5 Explain the potential risks faced by investors who invest in cash deposits. *(5 marks)*

- 6 Although most bonds are redeemable, there are a number of variations where redemption is not “normal”. Discuss these variations. *(5 marks)*

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PROCEED TO SECTION B OVERLEAF

Answer BOTH questions in this section

- 7 Nawaz Pension Management Ltd is investigating whether or not it should buy some shares in Blades Plc. You have to advise the Board about the price which should be paid for the shares based upon the following information.

Blades Plc. Profit & Loss Account for the year ending 30th April 2008

	£m
Turnover	30
Profit before Interest & tax	18.3
Interest	2
Profit before tax	16.3
Net profit after tax	13.45
Preference Dividend	2
Dividend	8
Retained profit	3.45

Balance Sheet as at 30th April 2008

	<u>Cost (£m)</u>	<u>Depreciation (£m)</u>	<u>Net Value (£m)</u>
Fixed Assets	18	12	6
Land	20	4	16
Plant & Equip.	6	3.75	2.25
Total			<u>24.25</u>

Current Assets

Stock	4		
Debtors	3.2		
Bank	5		<u>12.2</u>

Current Liabilities

Creditors	6.1		
Dividend	8		
Tax	2.85		
Interest on Loans	2		
Preference Dividend	2		(20.95)
Total current assets			<u>(8.75)</u>

Long Term Liabilities

Loan stock	5.6		(5.6)
Total Net Assets			<u>9.9</u>

Financed by:

Ord. Shares (5p)	1.9
Preference Shares	5
Retained Profit	3
	<u>9.9</u>

The P/E in the FT is 14:1 (Sector average is 8:1) and the dividend yield in the FT (at 30th April) was 5% (gross). Shareholders want a return of 9% per annum. In the 6 months interim accounts (dated 31st October 2008) the following data was noted as having changed:

	<u>£m (now)</u>
Fixed Assets	8
Plant	1.3
Bank	1.4
Creditors	6.3
Dividend	0
Pref. Dividend	0

- a) Calculate the share price using the following methods:
- i) The net asset value method (as at 31st October 2008). (5 marks)
 - ii) The dividend valuation model (assuming holding indefinitely). (3 marks)
 - iii) The Price Earning Ratio. (2 marks)
 - iv) The dividend growth model (assuming a constant growth rate of 3%). (3 marks)
 - v) The dividend yield (as at 30th April). (2 marks)
- b) What would be the required selling price of the share if it is to be sold after 3 years (using the dividend yield price calculated in v) above as the purchase price)? (5 marks)

(Total 20 marks)

- 8 You have been asked to evaluate a possible four year investment. The following information has been supplied:

Initial Outlay:	£109,000
Projected Net Cash Flows:	
Year 1	£50,000
Year 2	£40,000
Year 3	£45,000
Year 4	£19,000

The project is deemed to be of medium risk and the company classifies risk on the following basis:

Modest risk	8%
Medium risk	12%
High risk	20%

- a) Calculate the Net Present Value (NPV). *(5 marks)*
- b) Another strategy would be to calculate the Internal Rate of Return (IRR) but the company is unsure if this is a wise alternative to use. Advise on the merits and demerits of this alternative evaluation strategy. *(7 marks)*
- c) An alternative investment is to purchase “Zero Coupon” bonds for £40,000 which will mature with a value of £50,000 in four years (rated as high risk by the company) and to invest the remaining £69,000 in a term account paying 9% compound (rated as modest risk by the company).
- i) Calculate the total NPV of this alternative investment. *(4 marks)*
- ii) An alternative bond from the same company costs £43,000 but pays interest at 5% and matures in four years. What is the holding period return for this bond? *(4 marks)*

(Total 20 marks)

Answer ALL parts of the question in this section.

- 9 Dastardly Investments Ltd is debating ways to protect part of its portfolio using various derivative products. It has shares in Blatto plc which its advisors believe may suffer from a period (up to one year) of high volatility in the share price caused by political instability in its main source of raw materials. Dastardly wishes to ensure that the portfolio retains as much of its existing value as possible during this problematic time. It is not sure of the best way to do this and has a number of questions which it wants you to advise it on.

The data you have is as follows:

- The share price in Blatto plc is presently £2.60 and it is thought it could vary by 25% up or down in the period (ie, possibly moving by up to 50% in a very short period of time)
- The holding is 5 million shares
- Dividend has just been paid and no further dividend is normally paid until October next
- Derivative contracts are per 1,000 shares
- Calls at £2.60 exercise due in 12 months are selling for £160 per contract (European style, American are an extra £100)
- Puts at £2.60 exercise due in 12 months are selling for £140 per contract (European style, American are selling at plus £100)
- Warrants at £2.60 exercise dated November 2010 are selling at 1.6p each
- Convertible bonds are paying 4% pa dated November 2011 and have a conversion detail of 45 shares for the bond plus a payment of £1.00 per share
- The various prices are deemed at present to be fair
- Government bonds due on 1st November 2009 cost £100 and pay 6% at maturity

Answer the following questions (actual numeric calculations are not essential but may well assist the explanation of the answer):

- a) As it is possible to purchase both American and European style options, explain how each works. *(4 marks)*
- b) As the shares in Blatto plc may fall dramatically in the next twelve months, according to Dastardly's analysts, Dastardly is unsure whether to long or short an option on the shares. Both are thought to offer some protection (both puts and calls). Discuss how the different strategies could offer some protection using:
- i) Long puts *(4 marks)*
 - ii) Short calls *(4 marks)*
 - iii) Short puts *(6 marks)*
 - iv) Long Calls *(6 marks)*
 - v) A mix of the above *(6 marks)*

- c) Someone has suggested that Dastardly Investments Ltd sells the shares and buys either warrants or convertible bonds. Discuss the merits of this strategy. *(6 marks)*
- d) Recommend to the company which you think might be a reasonable solution and say why. *(4 marks)*

(Total 40 marks)