



SII MASTERS SAMPLE EXAM QUESTIONS

FINANCIAL MARKETS

DATE OF EXAM

3 HOURS

RUBRIC

SECTION A – answer **FOUR** questions in this section

SECTION B – answer **ALL** parts of the question 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 panel 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

SECTION A**TOTAL 20 MARKS**

There will normally be SIX questions in this section from which candidates should answer FOUR. Each question carries 5 marks.

- 1 Define Monetary Policy and Fiscal Policy and list any two instruments used to implement each of these policies. **(5 marks)**
- 2 Define a zero coupon bond. How does it differ from an index-linked bond? **(5 marks)**
- 3 What are redeemable preference shares? Are there any differences between cumulative and convertible preference shares? **(5 marks)**
- 4 Differentiate between an interest rate swap and a long term currency swap. **(5 marks)**

SECTION B**TOTAL 20 MARKS**

Answer ALL parts of the question in this section

Verity Jones has just started working as a financial analyst at an investment bank. She is required to value stocks. She is asked to use a risk free rate of 4.50% and an expected market return of 14.50% for the UK. Using these measures Verity has valued YUKA PLC, whose beta is 1.35 and whose market price is £45 per share and calculated an intrinsic value of £63 per share for the company. Now, she has to value MAL PLC, a company that has a beta of 1.15 and a current market price of £35 She came to see you to ask you the following questions:

- a) What is the required rate of return she should use for MAL PLC? **(5 marks)**
- b) She has estimated the growth rates in dividends for MAL PLC of 12% per year for the first three years and 9% per year in the years thereafter. MAL PLC pays a constant dividend of £1.72 per annum. Estimate the intrinsic value of MAL PLC. **(10 marks)**
- c) Based on these results and the data given above, should she recommend YUKA PLC or MAL PLC for purchase? Why? **(5 marks)**

SECTION C**TOTAL 40 MARKS**

Answer ALL parts of the question in this section.

You are the finance manager of a small family-owned airline company. Your main line of business is international dry cargo shipping. Your company is based in Monte Christi, an imaginary small country on the Mediterranean coast of Europe. You own a fleet of a dozen aircraft to carry cargo to short-haul destinations such as Birmingham, Rotterdam, Lisbon and Milan.

Your boss is considering expanding the business and buying new cargo planes but he has not yet decided if he should purchase new planes and expand the business. He thinks that there is great scope for expanding business in the routes that your company is operating. The company transports cargo to and from all major industrial hubs in Europe. However, he is also very sceptical about the uncertainty in the face of a worldwide recession as this might lead to a slowdown in this line of business.

One of his former business associates has told him that he can buy an option to buy cargo planes in three years' time, rather than ordering the planes to be delivered in three years' time. He is considering this idea but has three main concerns. He shares his concerns with you and asks three questions that need to be answered so that he can make a decision.

“First, the volatility in this business is high. The standard deviation of our revenues is about three times higher than any other business in this country. So, in this context, is it a good idea to buy an option rather than the cargo plane itself?”

“Second, I am also worried that three years is a long time, would it not be better to buy an option for one year only?”

“And thirdly, considering that interest rates are falling in Europe in general and I expect them to fall further, is it a good idea to buy an option rather than the cargo plane itself?”

He wants you to prepare a report that includes a clarification of the concerns he has and answers his questions. He also wants you to make a suggestion about if he should buy the option or the cargo plane itself.

Required:

Give an answer to each of the three questions that your boss asks above. Justify your answers, discussing the details of option valuation with reference to formulae and examples where appropriate. **(10 marks each, total 30 marks)**

Finally, advise your boss whether he should buy the cargo plane or the option on the plane and discuss the reasons for your recommendations in detail. **(10 marks)**