

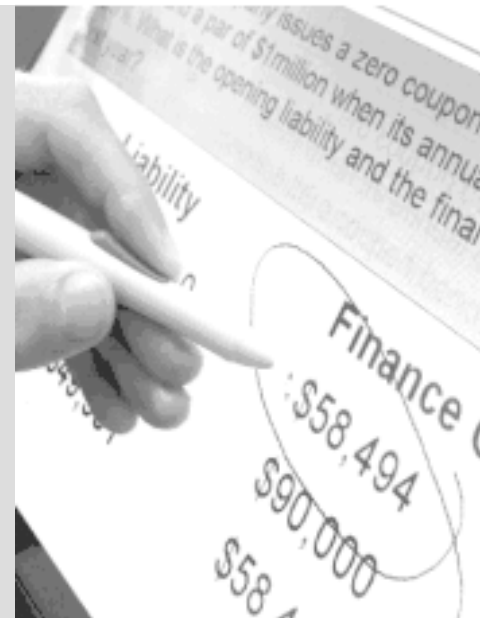
# Diploma in Investment Planning



## Solutions to Specimen Examination

2010/2011

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## Solution to Section 1

### Susan McLean

- (a) Assets summarised thus - £90,000 cash; £80,000 Ferrari car. Suggested division of available funds:- 2.5% Liquid cash reserve; 7.5% Bonds; 47.5% UK equities; 32.5% invested in overseas Markets; 2.5% in Commercial Property and 7.5% in Hedge Funds. **(3 marks)**

- (b) Clearly income is not a priority and dependent on Susan's ATR. which should be discussed and agreed with her, she can invest to maximise growth potential of her portfolio given retirement is some 20 years or so hence. **(1 mark)**

Susan is a UK investor with income and expenditure both in sterling – it is natural then that her assets should be invested predominantly in her home country. **(1 mark)**

Cash can be held to a reasonably small reserve – at 2.5% of her total investable assets, given her objective for growth, this will equate to around £2,000 to £3,000. Also current low rates of interest will in all likelihood mean negative returns for HRTs. **(1 mark)**

Bond commitment to provide some sense of stability to the portfolio – UK gilt exposure could be via Index Linked as these will be more appropriate given her tax status whilst if she felt that this portion of her capital too could be put more “at risk”, then Investment Grade corporate bonds may better fit the bill. **(1 mark)**

Equity commitment here in the UK- with around £45-50K, she could consider the direct route – perhaps through a discretionary agreement with a Fund Management Group – alternatively and given the funds available a more cost effective and slightly more passive approach via Collectives. **(1 mark)**

Overseas exposure – sensible here to adopt a fund-based exposure – split between markets which offer sound longer term prospects – difficult to satisfy the requirements of sufficient market coverage and diversity by going the direct route here whilst Funds – possibly OEIC's, Investment Trusts or Unit Trusts – perhaps even a suitable ETF. will give her both – also less expensive to go the IT route. **(1 mark)**

Commercial property through a collective investment, e.g. REIT **(1 mark)**

Hedge funds, again through a collective investment, say a Fund of hedge fund **(1 mark)**

**(maximum of 6 marks)**

- (c) Situation will change somewhat if Susan achieved (albeit there would be no certainty of this) the value attached to her car. An additional £80,000 liquid cash would provide a total sum available for investment of £170,000.

Suggest she retains a focus on growth given where we are in the economic cycle, her time horizons and the relative attractiveness on valuation grounds of equities.

Could consider a discretionary arrangement with a private client fund manager rather than through the collective route.

She should continue to diversify her funds across several asset classes as before. This is vital to the long term success of her investment portfolio in terms of performance.

After discussion it will be necessary to agree with Susan:

- What asset classes she should consider for investment – within the broad framework of the division mentioned above.

- What weightings might be assigned to each class – this may vary if she decides, as an example, that security of capital, or at least some of the capital, is of paramount importance – this may lead to a re-weighting of cash and bonds.
- What specific markets and sectors should be considered for the portfolio.
- Within those markets and sub-sectors, what specific securities are attractive for the growth investor.

Attitude to risk will have a major influence on the portfolio construction – this is a vital area for the adviser to discuss with the client in terms of her needs and objectives and how this undoubtedly will influence the adviser’s recommendations.

(I’ve touched upon the broad remit of the “direction” I’d like the students to take here and there is one mark allocated per point made – it is not however a totally finite solution and flexibility in the way the student prepares their answer is needed.)

- (d) There are many types of risk which may affect the return on an investment or portfolio. The first two are the basic forms of risk, but there are also additional investment risks.

- Non-systematic (specific risk)
- Systematic (market risk)
- Market timing risk
- Regulatory risk
- Gearing risk
- Currency or exchange rate risk
- Interest rate risk
- Liquidity risk
- Default risk
- Credit risk
- Inflation risk
- Political risk
- Counterparty risk
- Fraud risk

**1 mark awarded for identifying and explaining each risk up to a maximum of 6 marks. The first two must be included in the list to gain full marks.**

- (e) Vital that client’s tax position can be ascertained so that tax-efficient investments can be considered. We can be pretty sure of Susan’s marginal rate of tax given her salary position and she seems fairly certain (or as certain as certain can be) that in the short to medium term there is very little likelihood of this changing. **(1 mark)**

Growth of capital should be emphasized once more – there seems, apparently, little need to generate income to be highly taxed – growth investments should form the majority of any recommendations given. Increased Pension provision may be a fantastic starting point and Susan may wish to discuss with her employer the possibility of her increasing her contribution level – bearing in mind every £100 invested in her pension has a cost to her of only £60. **(1 mark)**

Maximise ISA allowances each year – taken in conjunction with her non-wrapped investment it could provide a valuable addition to her annual CGT allowance, not now, but at some point in the

future. Again, the tax sheltering of future gains may be valuable in addition to her annual CGT allowance at some point. **(1 mark)**

A single premium investment bond may be an option for HRTs albeit some may regard investing via an insurance company, a second choice behind a discretionary managed arrangement. Unquestionably, however, the 5% tax free deferred facility may have its attractions for Susan. **(1 mark)**

Income from her investments need not be utilized – accumulation and reinvestment of same, whilst not readily identifiable as tax efficiency will have the advantage that any income with tax already deducted would then be reinvested for growth purposes. **(1 mark)**

National Savings and Investments – although hardly dynamic, may also serve a purpose for Susan if tax efficiency were placed higher in importance than the prospective returns on her investments – there is the old adage which still holds true that the “tax tail should never wag the investment dog !” **(1 mark)**

Students may be tempted to propose higher risk tax efficient investing via VCTs or EIS but whilst not necessarily the answers I would be looking for, if the arguments put forward are well founded I would award marks for this but essentially the direction I would prefer be taken is per the points made above.

- (f) Susan is building up a pension pot for her ultimate retirement in possibly twenty years time. At that time, she will have worked with Sheraton Bros. for something in the region of 30 years. Most company (Defined Benefit) Schemes are based on a maximum retiral salary illustration of 40 years. The 30 years service at aged 55 will therefore leave her short of what would be deemed to be a “full” pension were she fortunate enough to have been a member of a Final Salary Scheme. **(2 marks)**

The precise nature of the terms offered at retirement will depend on the Company Scheme rules but there is the option to use up to 25% of the pension fund at retirement as a pension commencement lump sum which is currently tax-free. **(1 mark)**

The amount of pension payable through her Company Scheme will be dependent on

- The level of her and her employers’ contributions (increase if possible?)
- The investment performance of the pension fund
- Annuity rates when Susan does retire. **(3 marks)**

Her current pension is likely to provide no guaranteed pension amount, no guarantee of a lump sum amount, no pension linked to her retiral salary – but recognizing that there is risk, the timescale is in her favour and so she can look to fund additional growth

Additional pension income may be provided by:

- Making AVCs or FSAVCs
- Purchasing added years
- Investing in a stakeholder pension
- Investing in a personal pension plan
- Investing in unapproved schemes
- Using capital (expensive and not recommended!) to buy an annuity

**(1 mark to be awarded for the identification and brief explanation of same).**

**(Total 40 marks)**

## Solution to Section 2

### Jack Blackwell

- (a) An actively managed fund is one where the Fund Manager buys and sells holdings with the intention of maximising gains and minimising losses. Active fund managers start with a disadvantage in attempting to beat a Stock Market index as their costs are greater **(1 mark)**, because they have to pay the salaries of expensive fund managers and research analysts and, dealing costs. These higher charges represent a drag on the performance of the fund making it more difficult to beat the index. **(1 mark)**

Where portfolio managers adopt an active management approach, then in constructing their portfolio they may select anything up to between 60 and 80 individual holdings albeit the size of the fund and the resultant investment policy. For example, a growth/income or balanced approach will also be determinant of the exact quantity of portfolio constituents. The aim is to create broad, diversified approach to investment although most active fund managers will look to add value or outperformance of a benchmark by concentrating their efforts and adopting a position in more volatile small and mid cap stocks which can present opportunities to exploit undervalued situations rather than concentrate, like many institutional investors, on large cap stocks, where it could be argued there are less opportunities for value creation. An active fund management style is one where the managers feel that their expertise will allow them to make their own judgement about stocks. Sectors and market movements rather than a more indexed or passive approach. Students with a greater depth of understanding may choose to explain alpha in their answer – essentially a risk-adjusted measure of the active return on an investment. **(1 mark)**

Passively managed or tracker funds are relatively new and often have much lower charges than most unit trusts. **(1 mark)**

Rather than an investment fund manager researching individual companies with a view to investing in them, with tracker funds the manager uses a computer programme to track the performance of one of the major share indices, such as the FTSE 100, the Dow Jones Industrial Average in the USA or the Nikkei in Japan. His portfolio in essence attempts to replicate the selected index. **(1 mark)**

The theory behind **Tracker Funds** is that:

- Actively managed funds do not always perform as well as, or better than, the share index with which they compare themselves
- If fund investments follow (track) the make-up of a particular share index then it should perform as well as that index
- Because the tracker fund manager doesn't have to carry out research and buys and sells shares less frequently, charges can be lower and the return can better most managed funds
- The law of averages dictates that not all actively managed funds can outperform the market

**(1 mark to be awarded for any of the above)**

- (b) A regular saver can take advantage of something called Pound Cost Averaging and can mean that in certain market conditions a small regular monthly contribution will produce a better result than the same total amount invested as a lump sum payment. **(1 mark)**

Pound Cost Averaging works because the monthly contribution buys more units when the price is low than when the price is high. **(1 mark)**

This continuous drip-feed method of purchasing investment means that the average purchase price paid over any given period may turn out to be lower than the arithmetical average of the market price **(1 mark)**

(c) Example:

	Price of units	£100 per month buys	£1200 Lump sum buys
Jan	100p	100	1200
Feb	90p	111	
Mar	85p	118	
Apr	85p	118	
May	78p	128	
June	82p	122	
July	90p	111	
Aug	100p	100	
Sept	110p	90	
Oct	125p	80	
Nov	100p	100	
Dec	95p	105	
Average Price	95p		
Totals		1283	1200
Value at end Dec		£1219	£1140

**3 marks for the calculation of individual monthly totals, 1 mark for the lump sum allocation and also 1 mark for showing the difference in the units bought via the arithmetical full year totals. The last mark to be reserved for the proper presentation of the data.**

(Total 15 marks)

### Solution to Section 3

#### Nigel and Joanna Tutt

- (a) Nil rate band available = £325,000 re Joanne's estate plus 100% of Nigel's unused nil rate band allowance i.e. £325,000 **(1 mark)**

**(2 marks)**

- Total £650,000
- The transfer of £30,000 of unit trust investments should be ignored, as it is between spouses it is an exempt transfer **(1 mark)**
- First £94,000 of nil rate band to be applied to:
- $2 \times £50,000$  PETs = £100,000 **(1 mark)**
- Less  $2 \times$  annual exemption of £3,000 **(2 marks)**
- Nil rate band still available is £556,000 (£650,000 - £94,000)
- Value of estate:
 

Main home in Joanne's sole name	475,000	
Equity ISAs	58,000	
Cash ISAs	33,000	
Unit trust and investment trust holdings	42,000	
Gilts	96,000	
Corporate bonds	52,000	
Bank account	<u>2,000</u>	
	758,000	<b>(1 mark)</b>
	<u>25,000</u>	<b>(2 marks)</b>
	733,000	
	<u>556,000</u>	<b>(1 mark)</b>
Liable to IHT	177,000	

- (b) Small gifts up to £250  
£3,000 annual allowance (but must be included in Part (a) as well

If appropriate, wedding gifts

Gifts from regular income.

Use of trusts

**(Maximum 3 marks)**

**(Total 15 marks)**

## Solution to Section 4

### Duncan Stewart

- (a)
- Should Duncan decide to purchase an annuity with his pension fund on retirement, he will not have to purchase an annuity with the pension plan provider **(1 mark)**
  - Instead, he can look at the market as a whole to select an annuity provider **(1 mark)**
  - Thus, securing the best terms for his annuity **(1 mark)**
- (b)
- Charges are capped at 1.5% a year for the first ten years and 1% a year after that **(1 mark)**
  - There can be no penalties on stopping contributions or on transferring benefits to another scheme **(1 mark)**
- The minimum contribution is £20. **(1 mark)**
- (c)
- 30% tax relief on the full £150,000 investment **(1 mark)**
  - Provided sufficient tax has been paid on other income **(1 mark)**
  - Provided that the shares are held for at least five years **(1 mark)**
  - Dividends are paid tax-free **(1 mark)**
- (d) Moira, as beneficiary, has:
- An immediate right **(1 mark)**
  - And an absolute right **(1 mark)**
  - To the capital **(1 mark)**
  - And the income **(1 mark)**
  - And the right to take possession of the trust property  
(i.e. capital and any accumulated income) **(1 mark)**
- (Total 15 marks)**

## Solution to Section 5

### Emma and Paul

- (a) What, if anything, does his employer provide by way of Sickness and Death benefit

Possible products

- Life Policy
- Income Protection
- Critical Illness
- Mortgage payment protection (ASU)/
- Mortgage repayment protection policy – decreasing term **half mark each (2 marks)**

Given income and circumstances – Life Policy probably a term policy to give a lump sum on death.

Term to cover children growing up **(2 marks)**

Mortgage payment protection Policy – to cover mortgage in case of accident, sickness, unemployment and redundancy **(1 mark)**

Income protection but depends on free funds **(1 mark)**

- (b) Life policy – cover large enough to cope with care arrangements

- Level or increasing
- Family Income Benefit policy
- Perhaps and accident/sickness policy, again to cover care arrangements **(3 marks)**

But this will depend on costs and what they can afford. **(1 mark)**

- (c) Investment of £15,000.

Do they have any specific plans for the money – short or long term investment – assume short-term i.e. access to funds should be relatively easy.

Are they looking for income or capital growth – question suggests capital growth

Are they looking for a tax free investment – he is a taxpayer but Emma isn't – could put the money in an investment in her name.

As sum is relatively small possible answers are likely to centre around ISA – either cash or equity or both. Could put

£10,200 into an equity ISA in Paul's name, £4,800 into a cash ISA in Emma's name. Alternative gross paid investment for Emma would be acceptable. **(5 marks)**

**(Total 15 marks)**

**END OF EXAM**