CHARTERED INSTITUTE FOR SECURITIES & INVESTMENT

CISI Chartered Wealth Manager Qualification

Winter 2014

CHIEF EXAMINER'S REPORT- FINANCIAL MARKETS

General Comments

Overall, the percentage of candidates passing this exam was not good. It has to be reported that questions 7-9 all had parts which could not be attempted by some candidates, plus all had some candidates who attempted a question but scored ZERO. It is acknowledged that some of the parts which were badly answered were specific items and if it was only one item that was unknown then that would not prevent a pass. However the worrying aspect was that too many candidates could not answer a few areas thus struggling to score well as they perhaps only had a maximum mark of 80-90 thus requiring to score 60% of the available marks to get 50%.

It was satisfying to see that only one candidate scored in the teens this time (the lowest mark was 12.5%) and only 8 scored between 20-29% a vast improvement over past papers. In fact approximately 50% of candidates scored within 5% (+/-) of 50% which is much better than has ever been seen before. Regrettably this did not transfer into a high pass mark.

As has been mentioned so many times before, it was disappointing to see that there were still far too many candidates who thought that a few lines or bullet points were all that was required for a discursive question. This is said in virtually every examiner's report,

> **"it is vital to read the question in total and to look at the marks available for each part. This should allow candidates to see how much they require to write for each part".**

Yet again, it was clear that some candidates had not really read the question and thus lost marks. It really is vital that the question is read and thought about before any answer is attempted. It has been suggested before but yet again please try using a highlighter to ensure that you have read the important parts of the question.

As has been mentioned before, it was obvious that a number of candidates had not watched their time management and were having to rush their answer for their last question(s) with the resultant reduced marks from a short list of bullet points. Please watch the time taken for each part of a question and if necessary leave a space at the end to return to IF you have sufficient time after completing the paper and checking each question is correct. Some had obviously done this.

In exam conditions, it is easy to not be as clear as you would like, so well done to those who used diagrams, examples, etc to illustrate their answer and who obtained marks from that use because it demonstrated what they were trying to say. To the one candidate who apologised for the writing, it was actually not too bad and a number of others were much worse. Again try to ensure it can be read, where it is unreadable, I have to assume it is wrong and you lose marks. I will read it a number of times to try to see what is being said –especially as you read the entire paper- AND will ask the second marker to try as well to ensure that NO candidate is failed because of their writing although sometimes it is impossible to read.

A number of candidates (approx 10% of the total) did exceptionally well, scoring over 60%, and they are to be congratulated on their high scoring.

Detailed Comments per Section

Section A This is designed to test smaller aspects of the syllabus, not included in other questions, although it can include items which are part of larger aspects. It was pleasing to see that almost every candidate attempted four questions with only four attempting fewer (two did attempt six but only received their best four marks). A disappointing aspect was that the average marks were not high at all, only one question actually achieved above 50% with one other being close BUT two were very poor indeed. It was noted that in some cases all four questions did not even take up one page, please ensure that you give enough detail to achieve the marks. The actual average for the section was also not high at just over 8 out of a possible 20. The highest mark was 13.5% with a number not far behind. So well done those who scored well,

Question No 1 (attempted by approximately 90% of candidates) and its average mark was almost 50%. The main problem was that although some answers demonstrated that candidates knew what the theory was (to some extent), too many did not seem to know (or forgot to read the question) the way it is used in the bond market. No candidate scored ZERO. There were some very good answers where the candidates scored four or more out of five, and to them very well done.

Overall, a fair attempt at this question.

Question 2 was not a popular question with only approx 53% attempting it it. It did not however have the lowest average mark, in fact it had the third highest average mark of all questions in Section A. Some candidates scored excellently. Marks tended to be lost because either candidates did not explain what the concept is (briefly) or did not actually mention any problems (which was the question).

Question 3 was least popular with only about 45% of candidates attempting it. This was not well answered by many (although it did score 2.15 out of 5 as an average AND no one scored ZERO). Here the problem was that not enough answers actually knew what a Eurobond actually is (IT IS NOT A FOREIGN BOND) and obviously then did not describe dealing and settlement correctly.

Question 4 was attempted by approximately 75% of candidates, and the average mark scored was the poorest in Section A. The problem was that although candidates knew what the Directive is, too few knew what "misuse of information is" in relation to the Directive tending to just say what the directive does generally.

Question 5 was the most popular (by 2 scripts) but was the second poorest average mark. Here again candidates tended to know what it meant in very loose terms but could not give a detailed explanation as to what it was or how it comes about. I would stress that there were some very good answers who mentioned different legislation and obviously knew what the concept means.

Question 6 was attempted by approximately 63% of candidates but had the highest

average mark with a score of 2.78 out of 5. The failing of some answers was that they did not actually discuss the disadvantages of offshore banking which was what was asked.

<u>Section B</u> was intended to test the abilities of the students concerning Economics with a part looking at a specific SWAP (Question 7) whilst Question 8 was looking at shares from various aspects. Overall it was a reasonable section with an average of almost 20 out of 40.

Question 7 was not answered too badly overall. (average was slightly less than 50%)

Part a) was quite well answered (approximately a 50% average) The problem really was the depth of answer eg some were only two or three lines

Part b) both parts. The break into two parts was designed to help students by guiding them as to the amount of answer required. The problem was that too few candidates even knew what a SAFE was, (approx 20% did not attempt part i and ii at all). And many others only had a limited knowledge, at best, of a SWAP thus they could not attempt part ii however the total of 6 marks should not have been critical to a pass or fail overall.

Part c) was very well answered with no one scoring zero and an average mark of 6.32 out of 10. The only real problem was the depth of some answers.

Question 8 was answered fairly well. The overall average was again almost 50%.

Part a) was handled quite well with an average of more than 50% the only real problem was the depth of answer, although some did score full marks.

Part b) was also reasonably well answered. The problem was that candidates did not explain what EMH was (briefly) and then found it harder to put their answer in context and explain why it might not work in this scenario (or generally really).

Part c) was another that was not badly handled. (an average of almost 50%) The real problem was that candidates did not seem to explain the implications and/or did not explain the ratios which could be affected to any extent and thus restricted their marks.

Section C was a larger question, which was intended to test knowledge and understanding of various aspects of the syllabus. Plus it allowed candidates to put forward their ideas (in part b and e) and argue for them.

Part a) was poorly answered. The biggest problems was that it did not ask how to value a share (which seemed to be what some thought) but rather how to assess the variability of returns. Some did discuss VaR which is only a downside risk assessment BUT as it includes standard deviation those candidates were able to get some marks (depending upon what they had said).

Part b) was dealt with much better (scoring an average of 6.83 out of 12) The marks tended to be lost because no explanation was given as to what they were talking about eg buying a put option is a possible answer but what is an option and what is a put, another problem was suggesting a strategy eg a straddle/strangle but not saying how it would meet the criteria. Yes, they picked potential solutions but did not then explain them fully or justify them as meeting what was required.

Part c) was also handled well BUT some did not read the question and tried to value a bond using the dividend growth model (which is for shares) thus losing marks. As this is a relatively simple question, the wording was chosen to supply all of the required information BUT not necessarily in the obvious place to ensure that candidates knew what to apply where.

Part d) was intended to give candidates the chance to show that they understood the methods available to value a convertible bond however too many only thought of one method and approximately 10% did not even attempt the question. This resulted in a relatively low average mark.

Part e) was handled reasonably well with an average of 5.5 out of 10. The aim was to allow candidates to show they understood hedge funds and the two types being considered in particular. The biggest problems was not explaining what a hedge fund is and not critically appraising the particular types to any degree. It should be said that some candidates scored 75% or more so well done to those who scored well.

Student Guidance

- As is stated in almost every report, TRY to spend more time preparing for the exam. It must be stressed that the paper is intended to test the knowledge of students, by being unpredictable as to content, thus any aspect can be included in the paper and no pattern is followed. Therefore it is essential that every part of the syllabus is studied.
- It was noted that over 10% of registered candidates did not sit the paper. Please employers, do try to assist your candidates by giving them the necessary time to prepare and sit the exam.
- Look at the marks available for the question and try to answer accordingly, if seven marks then a more detailed answer than one sentence will be expected.
- NB If your writing is LARGE or you double space lines then you will write more than someone with small writing (Although it is the quality that gets the marks NOT just quantity)
- Do not be afraid to use diagrams etc. to highlight your answer as they can be awarded marks even if the answer is not fully comprehensive. However they do need to be explained. E.g. in a derivative answer. This explanation rule also applies to formulae.
- Try to think about the question and what it is asking before you start answering it, and then apply your knowledge. There will be occasions when your basic knowledge will allow you to answer, (eg "what affects share

prices”) but you do need to think about it first eg value a share using xxx method DO NOT THEN TRY TO VALUE A BOND, this can be intended to be a tricky part of the question. If need be, use a highlighter to mark the question paper with the words you think are important to ensure that you are answering what is asked.

- Ensure that you have read the question more than once and have thought about what is being asked before you attempt to answer it. The wording is very specifically chosen to guide students to an answer, thus a quick glance and then a general answer can mean lost marks, whereas reading it carefully can allow you to realise that you only need one aspect of a topic to answer it. (or more than one is needed).
- Do not concentrate on learning only the mathematical calculations and ignoring the theory that goes with them BUT do not ignore the mathematical aspects.
- Watch your time for each question. This is a three hour paper. If we assume twenty minutes to read the questions and deciding how to answer, that leaves approximately 1.5 minutes per mark in your answer. Therefore DO NOT spend twenty minutes on the five mark questions and run out of time for question 9 which totals 40 marks. (In the December 2014 paper, some candidates admitted that they had run out of time).
- Ensure that you keep up to date with financial news (inc economy) as this may help you to recall something which you have read and thus give examples of what you are answering eg in December 2014, the BRIC economic question.
- Please ensure that you have the support from your employer to allow you to prepare properly and the time to devote to study and sitting the exam.

These questions and answers were based on the syllabus which was in place at the time of the exam. Anyone who is looking at them as an aid for future exams must be aware that the syllabus may change over time, thus some areas may no longer be covered in the same way. However the style of exam has not been changed.

The suggested answers are not intended to be comprehensive but merely to provide a guide to the areas which could have been covered. The questions seek a demonstration of understanding and knowledge of the question and not every item in the suggested answer was essential to get a good mark (and any other relevant answers were also given credit).

For ease of student use, all of the suggested answers have been taken from the CISI workbook which was in use at the time of the exam (again this changes over time and may not be the same as the one that a future student is using).

Section A- answer any four questions (5 marks each)

1- Explain how the "expectations theory" is used in the bond markets

Answer could cover the following, although this is not necessarily a definitive answer

- The shape of the yield curve varies according to investor's expectations of future interest rates.
- A steep upward sloping curve suggests investors expect rates to rise in the future.
- Buyers of bonds will defer purchase of longer dated securities as they will expect to receive higher coupons in the future.
- A downward sloping curve or inverted curve suggests that markets believe that rates will fall.
- Bond purchases will be keen to lock in higher coupons now as the expectation is that coupons will decline in the future.
- A flat yield curve suggests that the market thinks that rates will not materially change in the future.

2- Discuss the potential problems with the accounting concepts of "true and fair" value

Answer again could discuss the following but is not everything that could be covered

- How much sense it makes and are forecasts reasonable?
- Whether assumptions are reasonable (managements and industry peers)?
- Evidential weight and whether this is clear or contradictory?
- Is more time required to form a view?
- Does the reporting reflect the substance of what has happened?
- Are there review and/or scoping or procedural limitations?
- Is there a suitable focus on the things that are there but there might be critical factors missing?

- Understanding the business, its current state and outlook, given the current economic climate
- Evidence of Bias

3- Explain the dealing and settlement system for Eurobonds

Answer could cover the following but marks would be awarded for all correct aspects being explained.

- There is no formal market place for eurobond trading. The market is based on electronic and telephone contact between the main investment houses which are primarily based in London.
- The market is regulated by the International Securities Market Association (ISMA), which operates rules regulating the conduct of dealers in the market place.
- Settlement is conducted for the market by two independent clearing houses, Euroclear and Clearstream. which immobilise the bonds in their vaults and then operate electronic registers of ownership.
- Settlement in the eurobond market is based on a three-business-day settlement system. The important feature about the registers maintained by the two clearing houses is that they are not normally available to any governmental authority, thereby preserving the bearer nature of the documents.
- The methods of eurobond issuance are identical to those of corporate bond issues in the domestic markets discussed above

4- The Market Abuse Directive covers the “Misuse of Information”. Discuss exactly what the misuse of information means.

Answer could cover to varying degrees the following plus anything else which was correct

Market abuse can arise from the misuse of information. This occurs where behaviour:

- Is based on information which is not generally available to those using the market but which, if available to a regular user of the market, would be, or would be likely to be, regarded by him as ‘relevant’ when deciding the terms on which transactions and qualifying investments should be effected.
- Is likely to be regarded by a regular user of the market as a failure on the part of person concerned to observe the standard of behaviour reasonably expected of the person in his position in relation to the market.
- ‘Regular user’ is defined, in relation to a particular market, as a reasonable person who regularly deals on that market in investments of the kind in question.
- An example of this behaviour is where an employee of a company informs a friend over lunch that the company has received a takeover offer and the friend then places a spread bet with a bookmaker that the same company will be the subject of a bid within a week.

- The person making the bet would not be guilty of insider dealing as he would not be 'dealing' in qualifying investments which is a requirement of the insider dealing behaviour.

5- Explain "purchased goodwill" as an intangible non-current asset.

Answer would consider the following

- **Intangible** non-current assets are those assets that, although without physical substance, can be separately identified and are capable of being sold.
- Ownership of an intangible non-current asset confers rights known as intellectual property.
- These rights give a company a competitive advantage over its peers and commonly include brand names, patents, trade-marks, capitalised development costs and purchased goodwill.
- P**urchased goodwill** arises when the consideration, or price, paid by the acquiring company for the target exceeds the fair value of the target's separable, or individually identifiable, net assets.
- This is not necessarily the same as the book, or balance sheet, value of these net assets:
- **Purchased goodwill = (price paid for company – fair value of separable net tangible and intangible assets)**
- Purchased goodwill is capitalised and included in the balance sheet.
- Purchased goodwill, once capitalised, cannot be re-valued..

6- Discuss the disadvantages of off shore banking for an investor

Answer would discuss any disadvantage but could include the following

- The same inherent interest risk applies to variable accounts, ie, that the bank lowers the interest rate. If the deposit is held in another currency, there is the additional risk of currency exposure.
- Another risk to think about is that of the security of the financial institution. Deposits might be held with only a partially owned subsidiary of a major UK bank or building society. Where investments are in Jersey, Guernsey or Isle of Man, a compensation scheme similar to the FSCS is available, but this only secures the first £50,000 per person.
- Offshore banking has been associated in the past with the underground economy and organised crime, through money laundering. There are now regulations within the UK onshore banking system designed to detect money laundering.
- Offshore banks and tax havens, along with clearing houses, have been accused of helping various organised crime gangs, terrorist groups and other state or non-state actors. However, offshore banking is a legitimate financial exercise undertaken by many expatriate and international workers.
- Offshore private banking is usually more accessible to those on higher incomes, because of the costs of establishing and maintaining offshore accounts. However, simple savings accounts can be opened by anyone and maintained with scale fees equivalent to their onshore counterparts.
- In 2009 the G20 countries, at a summit in London, announced that they would be clamping down on the abuses which are prevalent in offshore finance. For

example, the US government has concluded an arrangement with Union Bank of Switzerland (UBS) to divulge the names of about 50,000 US residents who had bank accounts in Switzerland.

- The US government threatened to close down UBS branches operating in the US unless the Swiss authorities, renowned for their banking secrecy laws, complied with the request for full disclosure of the identities of the US citizens holding such accounts. Under US tax law, citizens have to declare their worldwide income to the IRS even if they are not ordinarily resident in the US.

Section B - Answer both questions (20 marks each)

7- Mr Whyte has inherited investments in many countries of the world, denominated in various currencies, and has some questions for you about international investments

a) Can you explain to him comments he has seen that the Euro should **not** be considered a "Reserve Currency" **Marks 4**

Answer would consider numerous aspects and could include the following

- The euro is widely perceived to be one of two, or perhaps three, major global reserve currencies, making inroads on the widely used US dollar (USD), which has historically been used by commercial and central banks worldwide as a stable reserve on which to ensure their liquidity and facilitate international transactions.
- A currency is attractive for foreign transactions when it demonstrates a proven track record of stability, a well-developed financial market to dispose of the currency in and proven acceptability to others.
- While the euro has made substantial progress toward achieving these features, there are a few challenges that undermine the ascension of the euro as a major reserve currency.
- Persistent excessive budget deficits of EU member nations, economically weak new members and serious questions regarding expansion threaten the place of the new currency.
- As a new reserve currency, governments sponsoring the euro do receive some substantial benefits.
- Since money is effectively an interest free loan to the government by the holder of the currency – foreign reserves act as subsidy to the country minting the currency.

b) He is also aware that his portfolio now includes Synthetic Agreements for Foreign Exchange (SAFEs). *(the original wording in the question paper was "Synthetic Arrangements")*

i) Explain to Mr Whyte what these are. Marks 3

ii) Discuss the reasons why they would be included in his portfolio. Marks 3

Anwer to both parts (Some candidates showed it as one answer, some did not divide it exactly as asked BUT all got marks if they covered the points) It was possible to use a diagram)
The answer could cover

- A **synthetic agreement for forward exchange (SAFE)** is a transaction between parties seeking to protect themselves against future movements in foreign exchange swap spreads.
- A SAFE can either be an exchange rate agreement (ERA) or a forward exchange agreement (FXA).
- ERAs and FXAs were developed by Barclays Bank and Midland Montagu, respectively, to overcome the capital adequacy problems of foreign exchange forwards highlighted by Bank for International Settlements regulations.
- Safes are treated as interest rate, rather than foreign exchange, instruments in BIS regulations, so banks have to provide less capital to support outstandings.
- FXAs are settled with reference to both the spot rate and the forward premium/discounts; ERAs with reference only to the forward.
- A SAFE is a variation on the short-term currency swap, in which there is no actual exchange of principal at inception or at maturity, the arrangement being a contract for differences based on notional cash sums.
- In this case, large notional sums may be referenced in the swap agreement but the resulting cash flow may be relatively small, especially if there has been only a slight variation between the rates at the time of inception and at the time of maturity.
- When the two parties agree to execute a SAFE, they agree the exchange rates at which the notional deals will be executed at inception and maturity. At maturity, one party pays to the other the difference in the value of the secondary currency between the rate originally contracted and the rate actually prevailing. In essence, this is exactly how a CFD works for any asset purchase
- Aspects of protecting a portfolio eg, mention concept of hedging
- illustrations of hedging against foreign loss
- Speculation could also be covered

c) He is worried about reports that the BRIC economies are not necessarily such good investments as they once were thought to be. Briefly discuss the attractiveness and subsequent worries about the BRIC economies. Marks 10

Answer could discuss aspects of the following PLUS any up to date information that the candidate wanted to introduce.

- B = Brazil, R = Russia, I = India, C = China
- Invest via emerging markets fund, costs, risk
- Emerging markets have seen GDP growth rates which are far in excess of those seen in the developed economies,
- Eg in 2010 this was even more in evidence.
- The BRIC economies, in particular, have enjoyed strong economic growth, with
- China leading the way at an annual rate of nearly 10 per cent.
- India, too, has a large and growing middle class is making large investment in capital infrastructure.

- Russia's wealth is very dependent on oil and gas prices but its economy has enjoyed fairly consistent growth in recent years (Can mention recent sanctions)
- Brazil benefits from strong demand for its agriculture and commodities from countries such as China.
- However, there are negatives to consider. In all four BRIC nations there are some indications that growth has brought about inflationary pressures and 'overheating'
- and there are concerns over the future political direction of Russia and China in particular.
- The equity markets in the BRIC countries and other emerging economies can also be very volatile,
- for example, the Chinese stock market in mid 2010 fell by about 60% from its peak in 2007.
- Current problem with Russian rouble – Putin/Ukraine v Nato, dependency on gas/oil
- World oil price slump to current $70 per barrel – v $110 = 40% drop in exchange rate of rouble
- Brazil = high inflation – economic/social issues – political fallout – economic slowdown
- China – economy slowing down
- Issue of world economic slowdown which is affecting BRIC – are BRIC funds as attractive as previous?

Q8 Mr Mason has been informed that a company in his portfolio intends to initiate a " reverse stock split" and that this will have no effect on his overall position. He does not understand what this means and has asked you for information.
a) Explain what a "reverse stock split" is and the reasons why a company might choose to do this. (Marks 3)

Answer would explain the following

- A reverse stock split, or consolidation, reduces the number of shares and increases the share price proportionately. For example, if you own 10,000 shares of a company and it declares a one for ten reverse split, you will own a total of 1,000 shares after the split.
- A reverse stock split has no effect on the value of what shareholders own.
- Companies often split their stock when they believe the price of their stock is too low to attract investors to buy their stock.
- Some reverse stock splits cause small shareholders to be **cashed out** so that they no longer own the company's shares.
- A company's board of directors may declare a reverse stock split without shareholder approval.
- The company's share capital remains the same at £1 million but the stock price would have effectively doubled as there are now only half the shares outstanding compared to those before the reverse split.

b) The efficient market hypothesis (EMH) says that a reverse stock split would have no effect on overall value. Discuss why this may not be the case

(Marks 10)

Answer would cover at least some of the following although other points also got marks

- What EMH is (inc the 3 forms) and its assumptions
- Empirical analyses have consistently found problems with the efficient market hypothesis, the most consistent being that stocks with low price to earnings (and similarly, low price to cash-flow or book value) outperform other stocks. Warren Buffett, whose investment strategy focuses on undervalued stocks, has made billions of dollars for himself and his co-investors. There are portfolio managers who have better track records than others, and there are investment houses with more renowned research analysis than others. So how can performance be random when people are clearly profiting from and beating the market?
- Studies in behavioural finance, which look into the effects of investor psychology on stock prices, also reveal that there are some predictable patterns in the stock market. Investors tend to buy undervalued stocks and sell overvalued stocks and, in a market of many participants, the result can be anything but efficient. Advocates of behavioural finance have proposed that cognitive biases also cause markets to be inefficient, leading investors to purchase overpriced growth stocks rather than value stocks.
- The tendency of returns to reverse over long horizons (ie, for losers or under-performing stocks to eventually become winners) is yet another contradiction of EMH. Losers would have to have much higher betas than winners in order to justify the return difference. The study showed that the beta difference required to save the EMH is just not there.
- Speculative economic bubbles are an obvious anomaly, in that the market often appears to be driven by buyers operating on irrational exuberance, who take little notice of underlying value. These bubbles are typically followed by an overreaction of frantic selling, allowing shrewd investors to buy stocks at bargain prices. Rational investors have difficulty profiting by taking up short positions in irrational bubbles because, as John Maynard Keynes commented, '*Markets can remain irrational longer than you can remain solvent*'.
- Sudden market crashes, as happened in October 1987, and to a lesser extent in October 2008 are mysterious from the perspective of efficient markets, but might possibly be treated as a rare statistical event under the weak-form of EMH. Paul Krugman, MIT economics professor, and a recent Nobel laureate, has suggested that because of the **herding** mentality often exhibited by short-term shareholders, investors pull in and out of the latest and hottest stocks. As a consequence prices no longer reflect all available information in the market.
- A corollary, view is that many large traders are practicing strategies which are based on a form of **market timing** which according to the EMH is not a viable approach to investing since there would be no discernible basis on which to 'time' the market. Professor Andrew Lo, currently at MIT and Craig MacKinlay published *A Non-random Walk Down Wall Street* in 2001 in which very convincing arguments were presented that asset prices do not follow a random walk and many academics have now become persuaded that even if a version of the EMH is valid that to go the extra distance and talk about prices and asset returns behaving randomly just does not fit the facts.
- The 2008/09 global financial crisis has led to renewed scrutiny and criticism of the hypothesis. Market strategist Jeremy Grantham has stated flatly that EMH is responsible for the current financial crisis, claiming that belief in the

hypothesis caused financial leaders to have a ‘chronic underestimation of the dangers of asset bubbles breaking’.

- A noted author, Roger Lowenstein, who wrote a definitive account of the long-term capital management debacle of 1998, declared in early 2009 ‘*The upside of the current Great Recession is that it could drive a stake through the heart of the academic nostrum known as the efficient-market hypothesis’*.
- Information is not just financial news and research but also political, economic and social events , combined with how investors perceive such information

c) He wonders if a “share repurchase” might be better for him and the company. Discuss the implications of a repurchase (including the impact on any financial ratios). (Marks 7)

Total Marks 20

Answer would discuss aspects of the following

- What is a share repurchase
- What are the rules eg A company can purchase its own shares provided that it is authorised to do so by its Articles of Association
- Companies do this when they believe them to be undervalued
- Theoretically when a company repurchases, the market price(cap) will be below net asset value
- Repurchasing increases earning capacity and net asset backing of the remaining shares i.e. does not have to pay out dividends in short term
- Benefit for shareholders in form of capital gain which may have tax advantage for some
- Longer term benefit of increased dividends on lesser share holding
- Income from repurchasing can allow mason to invest in alternatives
- How can it be done eg market, percentage etc
- Tax implications for shareholders
- Ratios which use equity, assets, EPS etc could all be mentioned

Section C Answer the whole question for 40 marks

9- Ms Hart owns 100,000 shares in Ocset Plc, which have a market price of £2.25. The dividend is 14.7p and the growth rate is 2%. She has seen that the value of Ocset Plc’s shares have been falling recently and believes that they will continue to fall for the near future. She is aware that she can take advantage of this potentially falling market price by using derivative solutions.

a) Explain how, in her review of the share price, she can evaluate the variability of its returns (marks 5)

Answer would consider a discussion of

- Standard Deviation (possibly inc diagram)
- How it is calculated
- Problems with it
- Uses

b) Critically discuss which derivative instruments Ms Hart could **best** use to benefit from the projected share price movement. (Marks 12)

Answer can consider any of the following

Futures
Options
Swaps
CFDs
Etc

All answers have to explain how they work, how they meet her remit and any problems, assumption s being made etc
i.e Student can argue for any strategy that meets the criteria

Ms Hart has seen that she could purchase an Ocset issued 10 year Convertible Bond which allows her to convert to shares at a rate of £2.50 per share and pays a coupon of 6.5% (she would wish to receive a return of at least 7.5% on all of her investments). It is trading today at £90, having just pad its last coupon yesterday.

c) Using the dividend growth model, what should the share price be? Show your working (Marks 5)

Answer
Last Dividend 14.7p
Therefore next dividend is 14.7*1.02 = 14.994p (rounding is acceptable)
Formula is next Dividend/required return –growth rate)
So 14.994/ .075-.02
14.994/.055
Price is therefore £2.726 (again rounding is acceptable)

d) Discuss how she could price the convertible bond to see if the current market price would allow her to make her desired return Marks 8

Answer would discuss the methods of convertible bond pricing

- Dividend valuation model
- Crossover method
- Option/Warrant method

e) Ms Hart thinks that the entire market may be going to go through a volatile period for a few years and is therefore considering investing in a hedge fund, in distressed companies or infrastructure funds. Critically appraise these potential investments for her (marks 10)

Answer should include
Explanation of hedge funds ie what they are, how they operate etc
Also discussion of
Distressed company funds
And Infrastructure funds
Ie what are they, what do they invest in, how do they operate, advantages/disadvantages/risks etc