



PAPER 1 INVESTMENT ADVICE AND PORTFOLIO MANAGEMENT December 2015

Time Designated: 2 hours
Time allowed: 2 hours and 30 minutes

Examiners:
R North
WH Bowler (Moderator)

Total Marks: 120

PLEASE READ THE FOLLOWING INSTRUCTIONS CAREFULLY

- 1. This examination was designed to be completed within the allotted 2 hours. Candidates often do not demonstrate their full knowledge by panicking when faced with time constraints. Consequently on the advice of the external examiner: - 30 minutes READING TIME will be allowed before the start to read the paper. You may make notes on a designated piece of paper on the structure or flow of Question One during this 30 minutes. *You will be required to hand in the notes sheet on completion of the exam.***
- 2. Read each question carefully. There is no need to elaborate outside the scope of the question asked. Lengthy answers are not necessary - answers in note form, provided they are explicit, are preferred.**
- 3. Answer all Questions.**
- 4. There are three (3) sections to the examination.**

	MARKS
Section A	70
Section B	30
Section C	20
	<hr/> <u>120</u>

- 5. You may answer the questions in any order as long as they are CLEARLY NUMBERED.**
- 6. This is NOT an open book examination.**
- 7. A Profile's Stock Exchange Handbook, a recent business newspaper (English and Afrikaans) and SARS income tax tables for individuals will be provided for each candidate to be used in the examination.**
- 8. A calculator may be brought by each candidate to be used in the examination.**
- 9. In order to PASS candidates require a minimum of 50% (35 Marks) for Section A, PLUS an overall 50% (60 Marks) for the entire examination paper.**
- 10. An average of 65% for the two papers is required to pass the exam.**



SECTION A

Total marks for this section: 70.

Question 1

You have recently been hired at a Wealth Management and Stockbroking firm. Your boss is exceptionally busy and he has a number of bespoke client proposals to deliver to clients. He has asked for your assistance in finalising a client proposal.

Your firm has a specific process that it follows for all client proposals and it is important for regulatory and compliance to be happy with the proposal. It is also vital in terms of your mandate that you ensure coverage of all the client's needs and requirements.

You are lucky that your boss has already completed a number of the initial sections of the proposal.

He has completed the introduction, needs analysis and the regulatory issues

He asks that you complete the actual client investment proposal (Solution) and the solution needs to have a real return after all costs and taxes.

- Introduction
 - An existing client of the firm, Mr Bond, has visited the firm for his annual review. He has had recent changes in his risk profile, his investment objectives and his investment requirements. He has reached milestones in his life and it is time to ensure his investments are rebalanced to meet his new situation.
 - Mr Bond has taken a far sterner and more serious approach to his investments and is adamant in ensuring that his investments have a strong probability of reaching his required real returns. He is not interested in flowery hypothetical scenarios he would like a clearly defined approach and strategy to reach a proposed return.
 - Although Mr Bond feels his investment time horizon is getting significantly shorter as he gets older he also acknowledges that he needs to take on some risk to ensure his retirement is as comfortable as he would like it to be.
 - He is not entirely happy about the state of the economy locally or offshore for the next few years and he is deeply concerned about some sectors in the market, namely technology, retail and resources. He acknowledges resources have significantly underperformed the market but he is still concerned about their future performance. As an example technology and online retail shares have significantly out-performed the market and he is concerned about a pull back.
- Needs Analysis
 - Mr Bond has recently celebrated his 55th birthday and been promoted to executive director at the listed company he works at. Of his three children, two have left university and are starting their working careers and one is starting University in the New Year. Mr Bond's wife is a counselor at a local school.
 - Mr Bond would like to retire at 65.
 - He would like to achieve an annualized 11% after tax return for the next 10 years. (*is this realistic in light of the change in the client's risk profile?*)
 - His current portfolio is worth R5 million.
 - He does not like a cumbersome portfolio and would prefer to have a relatively concentrated share/bond allocation with diversity on sector allocation. No more than 10 - 12 holdings.
 - He believes inflation will increase significantly in South Africa.
 - Short term cash liquidity is not a major issue in his mind based on his recent promotion, however he will potentially need a lump sum to pay off his mortgage when he retires. He is also slightly concerned that he will have to fund his children's "start" in life.



- Regulatory Requirements (These are generic potential regulatory issues)
 - Capabilities in terms of managing assets
 - Licensed to trade in Equities / Bonds and Derivatives
 - Fiduciary Duties
 - TCF, Chinese Walls and segregation of Duties
 - FICA / FAIS
 - Ability to manage assets on behalf of clients and have the clients detail's changed recently, is there a requirement for new proof of residence etc
 - Disclosures
 - Past returns do not have a bearing on future returns
 - Pension Requirements
 - Not necessary in this example but need to know Reg 28 – Pension Funds Act
 - Existing Mandate and what it covers
 - Make decisions on behalf of client. Do not step outside legally binding mandate conditions and client requests
 - Juristic Requirements or Regulation
 - Exchange Controls, Tax clearances, Foreign investment allowance, Asset swap if necessary
 - Communication
 - How and when will you communicate?
 - Duties and responsibilities of all parties
 - What will be your function (manage assets, inform client of any circumstances that have changed and meet with the client for a minimum of one annual review)
 - Client is required to notify of any changes to his / her situation
 - Operational Process
 - Flow of funds, tax reporting and risks
 - Custody of Assets
 - Assets held in nominee
 - Cash held in JSET

70 Marks

SECTION B

Total marks for this section: 30.

Question 1 (7 Marks)

A friend at university notes that you are studying Finance and Investment Management. He asks why (FSR) the First Rand Group was trading at a share price of 47.33 and (NED) Nedbank 206.50

He would like to know if this means that NED is much more valuable than FSR.

- 1) Describe Market Capitalisation of companies giving an example of the two companies above. Which company has a greater equity value?
- 2) Describe a number of brief benefits of a listed company?



Question 2 (8 Marks)

Warren Buffet described derivatives as weapons of mass destruction. However according to your lectures you note that if derivatives are used for hedging purposes you can actually reduce risk.

Describe 2 techniques for hedging:

One on a single listed company and one on a basket of shares. Please include a graphical representation of the hedge.

Question 3 (15 Marks)

At your first job interview you are asked how you evaluate stocks.

The person doing the interview would like you to simply reference three different valuation techniques. He would also like to know what type of companies or sectors the valuation technique would be suited to and why. Give an example of a listed company in that sector.

30 Marks

SECTION C

Total marks for this section: 20. (Please keep answers short and to the point, in many cases they are one word answers 1 Mark per question)

- 1) If an investor has bought a Bond with a 10 year duration but plans to sell it to buy a house in 5 years what risk is he / she partaking in?
- 2) Money loses its value over time for two reasons state one?
- 3) The net present value is the present value of all incremental cash flows, discounted to the present, less the?
- 4) You are an investor in a listed company that raises an additional R2 billion in Equity. If you do not follow the rights what happens to your existing holdings?
- 5) Companies finance their operations through issuing equity or?
- 6) Depository receipts are securities that trade like an ordinary share on a local exchange and represent an economic interest in what type of listed company?
- 7) Cash received and cash spent by a firm is reported in a statement of?
- 8) When evaluating the performance of a portfolio a portfolio manager or investor will compare the results against a?
- 9) When the needs and wants of a society exceed the resources available to satisfy them it is referred to as?
- 10) What is another name of Bonds?



- 11)** When estimating intrinsic value, which of the following techniques do NOT form part of the Present Value of Cash Flows (PVCF) method?
- a- Present value of dividends (DDM)
 - b- Present value of free cash flow to equity (FCFE)
 - c- Present value of cash flow to current liabilities (FCCL)
 - d- Present value of free operating cash flow to the firm (FCFF)
- 12)** In addition to the investment objective that sets limits on risk and return, certain other constraints also affect the investment plan. Which of the following are constraints in the investment process?
- 1. Liquidity needs
 - 2. Price collusion
 - 3. Tax concerns
 - 4. Legal and regulatory factors
- a- 1,2 & 4
 - b- 1,3 & 4
 - c- 2,3 & 4
 - d- 1 & 4 only
- 13)** Which of the following two statements is true?
- 1- Covariance is an absolute measure of the extent to which two or more sets of numbers move together over time.
 - 2- The covariance of a variable with itself is its variance
- a- 1
 - b- 2
 - c- 1&2
 - d- Neither of the above
- 14)** In security valuation, there is a three- step valuation process. Which of the following is NOT a step in that process?
- a- Analysis of individual companies and stocks
 - b- Analysis of alternative industries
 - c- Analysis of alternative economies and security markets
 - d- Analysis of the local regulatory environment
- 15)** Calculating the value of bonds is relatively easy because the size and time pattern of cash flows from the bond over its life are known. Which of the following does a bond typically promise?
- 1- Interest payments
 - 2- The payment of the principal on the bond's maturity date
 - 3- Capital appreciation
 - 4- Variable term
- a- 1 & 3
 - b- 2,3 & 4



- c- 1 & 2
d- None of the above
- 16)** Assuming all other factors remain unchanged, what would increase a firm's price/ earnings ratio?
- a- An increase in the dividend payout ratio
 - b- A reduction in investor risk aversion
 - c- An expected increase in the level of inflation
 - d- An increase in the yield on treasury bills
- 17)** An underpriced stock provides an expected return which is _____ the required return based on the capital asset pricing model (CAPM).
- a- Less than
 - b- Equal to
 - c- Greater than
 - d- Great than or equal to
- 18)** If the interest rate on debt is higher than the ROA, then the firm will _____ if it increases the use of debt in its capital structure.
- a- Not change its ROE
 - b- Change its ROE in an indeterminate manner
 - c- Decrease its ROE
 - d- Increase its ROE
- 19)** The rate of return that shareholders require as compensation for their contribution of capital is known as the?
- 20)** Short sellers attempt to Sell high and Buy _____?

30 Marks