The Governance Institute

Subject no. 51B

Level 4 Subsidiary Certificate in International Finance, Investment and Administration
Level 4 Certificate in International Finance and Administration

Paper 3
Investment

Sample mark scheme

January 2015

Section A

Question number	Answer	Mark
1	B – Covered warrants	(1)

Question number	Answer	Mark
2	Futures	(1)

Question number	Answer	Mark
3	Arbitrage	(1)

Question number	Answer	Mark
4	**Award 2 marks for the following:** ITCs are quoted companies (1) which invest in a range of shares and other securities in other quoted companies (1). **Award only 1 mark for:** ITCs are closed-ended investment funds (1).	(2)

Question number	Answer	Mark
5	**Any one of the following answers:** The extra money provided by the central bank could eventually boost spending (1). If it is effective, it could shorten a recession and prevent deflation (1). Unlike interest rates (which can only drop to zero), there is no limit to the amount of money a central bank can provide but the chance of inflation has to be monitored (1). **Reward other valid responses.**	(1)

Question number	Answer	Mark
6	True	(1)

Question number	Answer	Mark
7	The International Capital Markets Association (ICMA). **Do not award marks for Financial Conduct Authority (FCA).**	(1)

Question number	Answer	Mark
8	The company may have seen its share price increase to levels that are too high or beyond the price levels of similar companies in the sector (1). The stock split will make shares seem more affordable to small investors, even though the underlying value of the company has not changed (1). **Award only 1 mark for stating that the decision may have been made because of an increase in share price (e.g. too high or not competitive) and a further 1 mark for outlining what effect the stock split has (e.g. making shares more affordable to small investors).** **Reward other valid responses.**	(2)

Question number	Answer	Mark
9	T-bills can be issued to finance a government's short-term funding requirements. **Reward other valid responses,**	(1)

Question number	Answer	Mark
10	Gross domestic product (GDP) is the measure of the total value of goods and services produced in an economy (1). Gross national product (GNP) is the market value of all the products and services produced in one year by labour and property supplied by the citizens/members of a country (1). GDP defines production based on the geographical location of production (1) whereas GNP allocates production based on ownership (1).	(4)

Section B

Question number	Answer	Mark
11	**Any three of the following answers.** • The original founders of the company may wish to release some or all of their original capital (1). This may be difficult while their shares are held within a private limited company structure (1). • The company may need to raise additional capital in order to finance expansion (1) which may not be possible through bank finance (1). • Existing venture capitalists may want their stake returned and be looking for an exit strategy (1) as their focus is always short term (1). • The previous sources of capital, for example bank borrowing, may no longer be available (1) because the existing shareholders are unable or unwilling to commit any additional capital (1). • The directors may wish to retain key staff through share ownership schemes (1). Consequently the company shares need to be marketable (1). **Award up to 2 marks for identifying and explaining one reason.** **If the candidate only lists six reasons without explaining them, award up to a total of 5 marks.** **Reward other valid responses.**	
	Total	**(6)**

Question number	Answer	Mark
12	**Any three of the following answers.** • There will not be a loss of control within the company (1) because the preference shareholders do not have the voting right (1). • It can be raised for a specific time period at the end of which it can be repaid (1). Thereafter the company need not pay the preference dividend (1). • The risk of financing will be less when compared to updating a loan (1) because the preference dividend will be paid only if distributable profits are available (1). • The company can collect financing through issue of preference shares (1) because the company can pay an attractive dividend to attract funds in to the company (1). **Award up to 2 marks for identifying and explaining three advantages.** **Award 3 marks for a detailed explanation of two advantages.** **If the candidate only lists six advantages without explaining them, award up to a total of 5 marks.** **Reward other valid responses.**	
	Total	**(6)**

Question number	Answer	Mark
13	The Stock Exchange Trading System (SETS) posts buying and selling prices (1) and is used for the trading of shares in large companies with high liquidity (i.e. lots of buying/selling activity) (1). Those who have access to the SETS order book and have shares for sale will enter a sell order on to the book (1). Those who wish to buy will enter a buy order into the order book and the system will automatically match up buyers and sellers who tally on price (1). Matched orders are removed from the book and a transaction is executed between buyer and seller (1). Often one large order can be matched up with several smaller orders on the 'other side'. Each transaction is both buy and sell, with only one transaction report required (1). **Award up to 2 marks for only describing what SETS is.** **Reward other valid responses.**	
	Total	**(6)**

Question number	Answer	Mark
14(a)	The purpose of a futures clearing house is to reduce the risk of one (or more) clearing firm failing to honour its trade settlement obligations (1) by stepping between the two original traders' clearing firms and assuming the legal counterparty risk for the trade (1). **Reward other valid responses.**	(2)

Question number	Answer	Mark
14(b)	A clearing house reduces the settlement risks by netting (or offsetting) transactions between multiple counterparties (1), by requiring collateral/margin deposits (1), by providing independent valuation of trades and collateral (1), and by monitoring the credit worthiness of the clearing firms (1). **Reward other valid responses, e.g.:** A clearing house provides a guarantee fund that can be used to cover losses that exceed a defaulting clearing firm's collateral on deposit (1).	(4)

<table>
<tr><th>Question number</th><th>Answer</th><th>Mark</th></tr>
<tr><td>15</td><td>When calculating the GRY, the first thing to do is calculate the interest yield that is based on the actual price paid by the purchaser (1). This is then adjusted to take into account any gains or losses over the life of the bond (1). Any such capital gain or loss is then divided by the number of years or part-year to maturity (1) in order to show the true yield to maturity (1).

This is added in the case of a capital gain (1) or subtracted in the case of a capital loss to show the GRY (1).

Assumptions that need to be made when calculating the GRY:
• all coupon payments and the repayment of principal will be made promptly and are reinvested at the same rate (1)
• calculations are made without making any adjustments for tax liabilities (1)
• dealing costs incurred by either the seller or the purchaser are not considered (1).
Responses can be awarded based on either a detailed explanation of how to calculate the GRY OR a combination of a brief explanation of how to calculate the GRY along with the assumptions that need to be made when making those calculations.

Award up to only 3 marks for an explanation of the assumptions that need to be made when calculating the GRY.

Reward other valid responses.</td><td></td></tr>
<tr><td colspan="2" align="right">Total</td><td>(6)</td></tr>
</table>

Section C

<table>
<tr><th>Question number</th><th colspan="2">Indicative content</th></tr>
<tr><td>16</td><td colspan="2">
The answer needs to refer to the obligations and risks for the purchasers and writers of the two different types of options contracts available.
Definition of options
Options are standardised derivative contracts purchased by a holder (the purchaser) from a writer (the seller) or third parties that give the holder the right (without any obligation) either to buy or to sell standard quantities of an underlying asset on or before a specified fixed future date. The writer is the original seller of an options contract providing the purchaser with a right without any obligation to buy or sell an underlying asset.
Definition of options contracts
The two types of option contract are:

call options – which give the holder the right (without obligation) to buy an underlying asset
put options – which give the holder the right (without obligation) to sell an underlying asset.

Obligations
At the point where the holder pays the option premium to the writer (or a broker in the secondary market), they are in possession of an option without any obligation.
A contractual obligation is created in that, in the event of exercise of the option by the holder, the writer must deliver in the case of call options and must buy in the case of put options.
Risks for purchasers
Purchasers of either call or put options will always know their maximum potential downside. The risk is limited to the price paid for the option premium plus any transaction costs incurred. For both types of option contract, if the market does not move as anticipated then option holders may simply decide to abandon their option.
An option holder will not exercise a call option if the strike price is higher than the market price because they can buy the underlying asset cheaper in the market. They will not exercise a put option if the strike price is lower than the market price because they can obtain a better price in the market.
Risks for options writers
For option writers, the risks vary depending on whether the writers create covered options or naked options.
If the writers have covered themselves by perhaps already holding the security, then matters may not be so bad and at least they still receive the option premium. However, if writing naked options the risks can be quite considerable. For call options, writers will have to go into the equities market to buy shares to sell to the holder.
With put options, writers will be committed to buying the underlying security and can then either sell at a loss in the market or hold and hope that the price will recover.
</td></tr>
<tr><th>Level</th><th>Mark</th><th>Descriptor</th></tr>
<tr><td></td><td>0</td><td>No rewardable material.</td></tr>
<tr><td>Level 1</td><td>1–5</td><td>
A few key points regarding both types of contract are discussed or one type of contract discussed in some detail. The answer is likely to be in the form of a list. Only one viewpoint is considered (purchaser or writer) and only risks or obligations are mentioned. Points made are superficial/generic and not applied/directly linked to the requirements of the question.
Award up to a maximum of only 5 marks if the answer comprises a list of recalled knowledge on the topic and does not attempt to address the requirements of the question.
</td></tr>
</table>

Level	Mark	Descriptor
Level 2	6–10	Some points are discussed **or** a few key points relating to each contract are discussed in some detail. There is consideration of both viewpoints (purchaser and writer) but there is more emphasis on one of them. Likewise, there is more emphasis on risks **or** obligations. The answer is unbalanced. Most points made are relevant to the requirements of the question but the link is not always clear.
Level 3	11–15	A range of points are discussed **or** a few key points relating to each contract are discussed in depth. The answer is well-balanced, with equal weight given to the purchasers and writers of both types of contract, and risks **and** obligations are covered for each type of contract. The majority of points made are relevant and there is a clear link to the requirements of the question.

<table>
<tr><th>Question number</th><th colspan="2">Indicative content</th></tr>
<tr><td>17</td><td colspan="2">Answers should detail how a hedge fund works and give consideration to the risks and disadvantages investors should consider before investing in them.

How hedge funds work

There is no particular definition of what constitutes a normal hedge fund because the name describes the way a fund of investments is managed rather than the sectors or commodities into which it invests.

However, a hedge fund might be described as a fund that invests in a range of investments with the objective of obtaining an absolute return for its investors. The aim of a hedge fund is to achieve a positive return for investors regardless of the prevailing market conditions.

The role of the hedge fund manager is to manage a portfolio of investments in such a way that the downside risk (fall in value) is reduced or eliminated. This usually involves the use of derivative funds.

Assessing risk

Hedge funds can be a very high-risk investment.

Some hedge funds use short selling, and have often been accused of manipulating markets because of this. Short selling involves the selling of shares the fund does not own with the expectation of purchasing the shares in the immediate future at a lower price. This assumes that the price of the share will fall. If the manager's calculations are wrong, it can be expensive to correct.

However, hedge funds take sizeable short positions, expecting a fall in the share price or market to enable them to close their short position by buying shares in the market at a price lower than they sold.

To improve a fund's return, a hedge fund manager borrows money to increase the amount available for investment – that is, they use gearing (leverage). Hedge funds do give investors an indication of the strategy they will follow and level of gearing the fund will use in their documentation.

Disadvantages for investors to consider before investing in a hedge fund

Hedge funds are not subject to the same regulation that applies to open-ended funds and there is no easy way to determine the level of portfolio risk to which the fund is exposed through its investments. This lack of transparency is a criticism that is often used against hedge funds.

Another area of criticism is the fee structure used as this involves a management fee (usually around 2%) and a performance fee based on the fund's profits (which can be around 20% or higher of the fund's returns).</td></tr>
<tr><th>Level</th><th>Mark</th><th>Descriptor</th></tr>
<tr><td></td><td>0</td><td>No rewardable material.</td></tr>
<tr><td>Level 1</td><td>1–5</td><td>A few key points regarding the risks and disadvantages of hedge funds are discussed, or a risk and/or a disadvantage are discussed in some detail. The answer is likely to be in the form of a list. How a hedge fund works is described in very little detail and may only state what a hedge fund is rather than how it works. Only one viewpoint is considered (risks or disadvantages). Points made are superficial/generic and not applied/directly linked to the requirements of the question.

Award up to a maximum of only 5 marks if the answer comprises a list of recalled knowledge on the topic and does not attempt to address the requirements of the question.</td></tr>
</table>

Level	Mark	Descriptor
Level 2	6–10	Some points are discussed, **or** a few key points regarding the risks **and** disadvantages of hedge funds are discussed in some detail. How a hedge fund works is described in some detail but may lack clarity. There is consideration of **both** the risks and disadvantages, but there is more emphasis on one of them. The answer is unbalanced. Most points made are relevant to the requirements of the question but the link is not always clear.
Level 3	11–15	A range of points are discussed **or** a few key points regarding the risks and disadvantages of hedge funds are discussed in depth. How a hedge fund works is explained clearly and logically. The answer is well-balanced, with equal weight given to **both** the risks and disadvantages. The majority of points made are relevant and there is a clear link to the requirements of the question.

Question number	Indicative content
18	Answers should focus on the two types of pension available to employees and what they need to consider before investing in them. **Definition of a pension** A pension is a saving put aside from money earned over a working life to pay for the saver to live on in retirement. Pension holders hope that the money received from a pension will be adequate to support their lifestyle in retirement. The amount that can be contributed to a personal pension throughout a person's working lifetime is controlled by the government because of the tax breaks available to such savings. Personal pension savings are a feature in many countries because they relieve governments of the commitment to provide completely for pensioners in their later years. **Issues that employees need to consider** The topic of pensions is a complex issue and it is important for an employee to compare the benefits of a company scheme, if there is one, with those of a personal scheme. Some points that an employee should consider before becoming a member of a company pension scheme are: • if the type of pension offered is suitable to meet their needs (i.e. is it a defined benefit or defined contribution pension) • the level of the employer's contribution • stability of employment • financial security of employer's scheme • the nature of benefits • assessment of investment prospects • early retirement provisions • whether their company reinvests pension contributions into the company. **Defined benefit (DB) pensions** DB is a pension plan that commits to paying a specified amount to each employee on retirement, depending on the number of years of work and salary level. The amount a retiree receives depends on the amount contributed by the employer under the pension contract between the individual and the company. All or most of the contribution is provided by the company. The company may have to top up the fund if an analysis by an actuary indicates that a shortfall in funding is likely to occur. In the UK, most DB schemes are closed to new employees because of the cost of funding them. This is as a result of the longer life expectancy of former employees, coupled with lower investment returns. **Defined contribution (DC) pensions** DC pensions are where the amount the retiree receives depends on the contributions made by the employer and employee (as defined in the pension contract). DC pensions are plans for which contribution amounts are specified. On retirement, the amount received by the employee depends on how much has been invested and how the fund has performed. The investment returns achievable both during the time the funds are invested in the pension scheme and at the employee's retirement will also affect the amount they can receive in retirement.

Level	Mark	Descriptor
	0	No rewardable material.
Level 1	1–5	A few key points regarding both types of pension are discussed **or** one type of pension is discussed in some detail. Issues which employees should consider will be omitted or mentioned only briefly. The answer is likely to be in the form of a list. Points made are superficial/generic and not applied/directly linked to the requirements of the question. **Award up to a maximum of only 5 marks if the answer comprises a list of recalled knowledge on the topic and does not attempt to address the requirements of the question.**
Level 2	6–10	Some points are discussed **or** a few key points relating to both types of pension scheme are discussed in some detail. The answer is unbalanced, with one type of pension given more weight than the other. Issues which employees should consider are discussed in some detail but not always relevant to the type of pension being discussed. Most points made are relevant to the requirements of the question but the link is not always clear.
Level 3	11–15	A range of points are discussed **or** a few key points relating to types of pension are discussed in depth. The answer is well-balanced, with equal weight given to each type of pension discussed. Issues which employees should consider are discussed in depth and are relevant to the type of pension being discussed. The majority of points made are relevant and there is a clear link to the requirements of the question.