Core Unit 4 Examiners' Report

Overall the short answer papers were fairly well answered, although some questions revealed surprising gaps in candidates' knowledge, particularly in relation to Liability Driven Investment which the examiners found particularly disappointing. As usual, candidates who did well had clearly studied all areas of the manual while a number of candidates appeared to attempt the paper based on pre-existing knowledge, which results in marks being missed. Candidates are reminded to read the question carefully and answer the question asked.

1. Describe the information relating to pension arrangements which must be reported in an employer's company accounts. (10 marks)

The relevant part of the manual was Part 3 Chapter 2.6.

Many candidates failed to understand the difference between an employer's account and the pension scheme accounts. This meant many candidates failed to gain easy mark. Marks were available for explaining that for a DC scheme, unpaid contributions are the only liability reflected in the employer's account. Most candidates understood that for a DB scheme, the amount of any shortfall is reflected in the accounts. Good candidates explained this is shown as a creditor in the balance sheet. Marks were available for explaining that a surplus can only be shown in the balance sheet to the extent the company can be expected to obtain financial benefit from it. The examiners were also looking for candidates to mention the relevant accounting standards and the fact that the calculated liabilities will differ from those shown in the scheme's actuarial valuation.

Marks were also available for explaining that the objective is to provide sufficient information to enable an investor to form a view as to the impact of the pension scheme on the company's financial position.

2. List and briefly describe the elements of trustees' investment policy that the Statement of Investment Principles must cover. (10 marks)

The relevant part of the manual was Part 5, Chapter 3.1.

This question was reasonably well answered with many candidates able to list and describe the five areas set out in the manual, namely: Investment Objectives, Risk Management, Investment Strategy, Socially Responsible Investment and Corporate Governance. Marks were available for listing these and giving a brief description of each. Some candidates wasted time by describing the process required to consult with the employer before finalising a SIP or by describing in detail the content of the IPID which may accompany the SIP.

3. Describe the following money market instruments (i)Treasury Bills (ii) Floating Rate Notes (10 marks)

   The relevant part of the manual was Part 4, Chapter 3..2.1.

   This question was reasonably well answered. Candidates who had studied the manual did well although some candidates were muddled about the features of Floating Rate Notes and other forms of Money Market Instruments.

Marks were available for explaining that Treasury Bills are issued by the UK Government and repay a set sum of money at a specified date. Good candidates noted that this date is normally not more than 3 months in the future. Most candidates knew that T-bills are issued through a weekly auction and trade at a discount to face value. Candidates gained marks for noting that the minimum size of a trade is £25,000.

In relation to Floating Rate Notes, marks were available for explaining that these are debt securities paying a variable rate of index. Many candidates knew that they pay interest on a period basis and may include a spread over the money market index tracked. Good candidates gained marks for explaining the interest rate is reset periodically.

4. Explain what is meant by Liability Driven Investment (LDI) and describe this approach to investment, including the common components of an LDI strategy (10 marks)

The relevant part of the manual was Part 2 Section 3.2.

Candidates either did well, having clearly studied the relevant part of the manual, or very badly, having clearly not done so. The examiners were disappointed by how poorly this question was answered overall.

Candidates should have explained that LDI is an approach to investment which focusses closely on the least risk portfolio to remove interest and inflation risks. Marks were also available for describing what is meant by the least risk portfolio.

In relation to the common components of an LDI strategy, marks were available for describing a swap generally and interest rate and inflation swaps generally. Many candidates did this although some did not describe the two types correctly. Good candidates also explained how the increase in value of a swap compensates for the increase in liabilities and conversely if the value of a swap falls, that is offset by the reduction in liabilities.

Marks were also available for explaining that the difference in value only changes hand so that using swaps allows a scheme to hedge inflation and interest rate risks on an unfunded basis. Many candidates also mentioned that LDI does not preclude the retention of growth assets and gained marks for explaining there are now pooled LDI products making this accessible to smaller schemes.

5. (I) Explain what is meant by “alpha” and “beta” as terms used for judging an active manager’s performance; and (ii) Explain what is meant by “smart beta”. (10 marks)

The relevant part of the manual was Part 6, Chapter 1.1.

This question was answered quite well with most candidates able to explain that alpha refers to investment performance compare to a benchmark, with managers seeking to provide alpha through stock selection compared to a passive manager, and beta referring to the level of volatility compared to the market. Most candidates were aware trustees prefer an active manager to have high alpha and low beta.

Fewer candidates were able to describe smart beta correctly. Marks were available for explaining this is a form of passive management in that investment is based on a set of rules but that it uses criteria other than market capitalisation to take advantage of perceived inefficiencies or biases in the market. Most candidates knew smart beta is more expensive than passive management but cheaper than active management.