An introduction to investment: Assessment rationale

Question 1: Investment in sub-committees

At a meeting of the trustees of a medical research charity, the topic of an investment subcommittee was raised. The following comments were made by individual members of the board. Which **ONE** shows the best understanding of the position?

- 1) "If we set up an investment sub-committee, we will not need to consider investment matters at any main board meetings. We can concentrate on other matters."
- 2) "The board members who are not on the investment sub-committee will no longer have to concern themselves with investment matters."
- 3) "The investment sub-committee will make recommendations to the board on strategic matters, but the board must retain responsibility for strategic decisions and for the overall performance of the funds."
- 4) "The sub-committee will bring proposals to the board for consideration but its terms of reference are likely to give it responsibility for all major investment decisions."

Correct answer: 3

Rationale:

From Fiona James (Lawyer)

The general principle of trustees being jointly and severally liable is a fundamental element of trust law, so whilst they can delegate the **exercise** of their functions (e.g. to a subcommittee or administrator), they cannot generally absolve themselves of **liability** for them. I understand that the first time this common law principle was set out was in a case in 1674. There is a specific reference in the Pensions Act 1995 in relation to investment, which allows that trustees to exclude this liability in one specific way in relation to delegating the exercise of discretions in relation to investment management to their fund manager.

Question 2: Reviewing the statement of investment principles (SIP)

The trustees of the Tribond scheme are discussing when the SIP should be reviewed. The following statements are made during the discussion. Which **one** of them shows the best understanding of the position?

1) "Once we've set the SIP we only need to review it once every five years."

- 2) "The SIP will never change, we only need to review the investments supporting that SIP, taking into consideration the needs of active, deferred and pensioner members (in the case of DB schemes)."
- 3) "We must review the SIP at least every three years and also whenever there are events that would lead us to change our investment policy such as changes in the membership, sustained changes in market conditions, innovations in investment markets or significant changes with our investment managers."
- 4) "We should review the SIP regularly, taking into consideration the needs of active members only."

Correct answer: 3

Rationale:

Copied from the Occupational Pension Schemes (Investment) Regulations 2005:

Statement of investment principles

2.-(1) The trustees of a trust scheme must secure that the statement of investment principles prepared for the scheme under section 35 of the 1995 Act is reviewed—

(a) at least every three years; and

(b) without delay after any significant change in investment policy.

Question 3: Investment training session

Trustees of the Disabilitycare Pension Scheme are answering a quick quiz set by their investment consultant. They discuss the following statements. Which **one** of them should they select as being correct?

- 1) Equities can fall in value but fixed interest investments never do
- 2) Equities never rise or fall in value suddenly
- 3) If you invest in bonds you are guaranteed to get back the price you paid for them at maturity
- 4) Investing in gilts can provide the investor with either a fixed-rate of interest or one linked to an index such as the UK Retail Prices Index (RPI)

Correct answer: 4

Answer 1 is incorrect as fixed interest investments can fall in value and there is the possibility of the company defaulting on its obligations. For example, if the fixed rate of interest is 2% and when you bought it interest rates were lower than 2%, you may have paid a premium to buy an investment

with this rate. However, later when you choose to sell, if interest rates were higher, eg 4%, you might not get back what you paid for it as this now looks unattractive.

Answer 2 is incorrect as equity values can be very volatile and fall in value very quickly. For example on 22 October 2001 the shares of Enron lost almost three quarters of their value in one day falling from \$20.65 each to \$5.40.

Answer 3 is incorrect as you may have paid more or less for your bond investment than the maturity value. There is also the possibility of default, so no return can be guaranteed.

Answer 4 is correct – gilts can be both fixed rate and index-linked.

Question 4: Property

Which one of the following statements is true regarding investing in a property fund?

- 1) In a period of low demand, investments in property can be difficult to sell which can result in investors being unable to disinvest from the fund for a period of time
- 2) Investing in a property fund is more liquid than investing in gilts
- 3) The value of an investment in a property fund can never go down in value
- 4) The value of the units in a property fund will rise and fall primarily due to whether the fund is closed to new investors or not

Correct answer: 1

Rationale:

Answer 2 is incorrect because during periods of low demand, properties can be difficult to sell and this could lead to the fund being gated for a period, where investors are unable to disinvest – making it quite illiquid.

Answer 3 is incorrect as the value can fall. If underlying properties were bought at a higher price than they are sold for (or are left unrented) then the units in the fund can fall.

Answer 4 is incorrect as this is not the primary reason for the value of units to rise or fall – it is the value of the underlying properties that primarily determine the unit value.

Question 5: Economic cycles

Commentators are suggesting that a downturn in the economy is likely. The trustees of the Longlast Window Company pension scheme have already noticed a drop in the value of their

fund. They discuss their position and the following points are made. Which view is the most accurate?

- 1) "At the top of the cycle we should buy plenty of equities but now there is a downturn, we should sell them all."
- 2) "Because cycles are unpredictable and different asset classes respond differently, it is important at all times to have a balanced portfolio of investments."
- 3) "Because cycles develop their own momentum and most shares tend to rise and fall at the same time, we should be able to time the market to boost investment returns."
- 4) "There is no point in worrying about economic cycles. Assets which fall in value will rise in value eventually if we wait long enough."

Correct answer: 2

Rationale:

Answer 1 is wrong because equity values during a boom are generally at their highest value/most expensive. As the economy goes into a downturn/slow down they tend to start to fall and at the point of recession, where consumer confidence is at its lowest, they are generally at their lowest value/cheap. Buying at the top and selling on the way down is likely to lead to losses.

Answer 3 is wrong because you are relying on market timing to choose when to invest in equities. If your timing is wrong you could lose a substantial amount. No one can predict the market, otherwise we'd all be millionaires.

Answer 4 is wrong there is no guarantee that the assets will recover or reach the previous levels after a fall. Also schemes may not have the time horizon available to them to recover from falls meaning they may have to sell assets before any potential recovery in order to pay benefits to members at the required time.

Answer 2 is correct because cycles are unpredictable and from the learning you'll see that bonds, equities and other assets behave differently at different times – so it is best to have a good spread of different assets to smooth out volatility and take advantage of growth opportunities when they arise.

Question 6: Investment risks

In general the greater the risk an investor is willing to accept, the greater the expected reward will be.

Look at funds A, B, C and D which have difference asset mixes. Place them in order from the lowest risk of capital loss to the highest risk of capital loss, selecting the correct order from the four available.



Fund A: Eighty per cent UK equities, twenty per cent US equities.Fund B: Fifty per cent corporate bonds, fifty per cent equities.Fund C: Eighty per cent gilts, twenty per cent property.Fund D: One hundred per cent government bonds.

- 1) C, D, B, A
- 2) D, C, B, A
- 3) D, A, B, C
- 4) D, B, C, A

Correct answer: 2

Rationale:

Gilts are the lowest risk of the asset types shown. So Fund D should be first. Equities are the highest risk of the assets shown, so Fund A will be the highest risk and should be last. So this leaves us with answers 2 and 4. Fund C has 80% gilts and 20% property, fund B has 50% corporate bonds and 50% equities. Fund C therefore has a lower overall risk that Fund B. Meaning answer 2 is correct.

This is all in the toolkit. Risk, generally, goes from (low risk) cash, gilts, corporate bonds, property, equity (higher risk)

Question 7: Types of fund management

The trustees of the Corinium Pension Scheme are debating the relative merits of active and passive management. Which **one** of the following is correct?

- 1) If management charges are ignored, an active fund manager will always outperform the relevant index
- 2) Passive management should ensure that the gains made by the fund will be very close to the index being tracked if the market rises
- 3) There is no difference between the costs and charges for active or passive management
- 4) The returns for passive management will always be exactly the same as the index being tracked

Correct answer: 2

Rationale:

Answer 1 is wrong as active fund managers can underperform the relevant index. You are paying for the active manager's expertise to stock pick and actively buy and sell. Although they generally aim to outperform an benchmark, they don't always.

Answer 3 is wrong as the costs are higher in active management due to you paying for that expertise, actively buying and selling.

Answer 4 is wrong as it will never be exactly the same for example, there are costs to factor in which will lower returns. The fund may not fully replicate the index which can cause some tracking errors, or a significant deviation from the index may indicate an issue with the way in which the index is replicated.

Answer 2 is right as there will be little chance of outperforming the market, it should track any growth fairly closely.

Question 8: Asset allocation

Which of the following statements is true in respect of setting a scheme's asset allocation?

- 1) Trustees should choose a mix of asset types at the outset which will guarantee good returns for the members
- 2) Trustees should invest in different types of assets in equal proportions
- 3) By investing in a range of assets such as investing a proportion of the assets in lower risk asset types whilst taking advantage of the potential for growth in higher risk asset types, trustees could expect a greater stability of investment return
- 4) Once an asset allocation is set there is no need to review the asset allocation unless the economy moves into a different cycle

Correct answer: 3

Rationale:

Answer 1 is wrong as whilst trustees invest in assets that are expected to perform well they cannot guarantee good returns as with all investments comes an element of risk.

Answer 2 is wrong as different assets may be more or less appropriate to invest in given the scheme's unique circumstances. How much is invested in each asset class should be considered in light of objectives and risk appetites.

Answer 3 is correct as investing across a range of assets and diversifying a schemes investment should lead to a greater stability of returns.

Answer 4 is wrong as there are many events that should lead trustees to reviewing their asset allocation, such as material changes in the Scheme membership, change in covenant, change in the management of a fund etc.

Question 9: Monitoring investment performance

The most appropriate method of monitoring investment fund performance is by comparing the return achieved for...

- 1) all categories of investment should be measured by comparing the return achieved to interest rates available over the same period
- 2) all categories of investment with inflation over the period
- 3) each category of assets with that achieved by a representative index or the investment manager's benchmark and/or target
- 4) each category of investment with that achieved by other similar pension schemes

Correct answer: 3

Rationale:

Answer 1 and 2 are not correct as we learnt in previous modules that various assets do better or worse in differing conditions, including when interest rates and/or inflation are falling and rising. This is not comparing like with like.

Answer 3 is right. Here you are comparing like with like and also a fair representation of the assets held.

From the toolkit: Some investment managers set objectives to outperform a benchmark by a given percentage. This could for example be the FTSE index plus 2% and is called a performance 'target'.

Answer 4 is wrong as although you are comparing pension scheme like with like, the other pension schemes may be invested in different assets to you so may have more or less growth due to that, or they may have the same assets but are not performing well. Comparing to them may give a false sense of the scheme doing well or not so well. It is important to compare asset like with like, with a fair representation. Also covenant strength and liability profile are key components for setting a DB investment strategy which may mean more or less risk is being taken by what seems to be a 'comparable' scheme.