EXAMINATION

22 September 2008 (am)

Subject SA6RSA – Investment Specialist Applications

Time allowed: Three hours

INSTRUCTIONS TO THE CANDIDATE

1. Enter all the candidate and examination details as requested on the front of your answer booklet.

2. You have 15 minutes at the start of the examination in which to read the questions. You are strongly encouraged to use this time for reading only, but notes may be made. You then have three hours to complete the paper.

3. You must not start writing your answers in the booklet until instructed to do so by the supervisor.

4. Mark allocations are shown in brackets.

5. Attempt both questions, beginning your answer to each question on a separate sheet.

6. Candidates should show calculations where this is appropriate.

AT THE END OF THE EXAMINATION

Hand in BOTH your answer booklet, with any additional sheets firmly attached, and this question paper

In addition to this paper you should have available the 2002 edition of the Formulae and Tables and your own electronic calculator from the approved list.

PLEASE TURN OVER

Question 1

You are a newly appointed asset consultant advising a large South African defined contribution pension fund. The fund offers members a choice of investment products, which are managed by several external asset managers. At the time of their appointment extensive investigations were undertaken to prove their capabilities and suitability. Since then only comparative investment returns and compliance with their individual mandates have been monitored.

You recommend that the fund undertakes regular reviews of its existing asset managers.

(i) Explain why periodic reviews are necessary even when published investment performance is satisfactory. [8]

(ii) List the matters that would routinely be dealt with in such a review. [6]

One of the trustees has heard that absolute return funds provide good, stable returns and protection from market volatility and proposes that the fund includes such a product in the members' menu of investment choices. The board of trustees requests your guidance.

(iii) Draft a response to the board of trustees explaining the characteristics of absolute return funds and their advantages and disadvantages in this context. [15]

The fund currently offers a market-linked, balanced portfolio choice that is performing well and the asset manager for this portfolio has recently introduced an absolute return product. The results of back testing show that the new product will produce very competitive returns while sacrificing little in terms of return compared to the balanced portfolio. The trustees suggest that this product be immediately included among the members' options since it is offered by a reputable manager that has been subjected to thorough due diligence by the fund.

(iv) Explain why the existing due diligence will not be a sufficient basis on which to include this product and outline the additional information that would be required. [12]

(v) Explain what performance and risk related statistics you would recommend that the fund should monitor for an absolute return product. [9]

[Total 50]

PLEASE TURN OVER

Question 2

You work for the asset management division of a large life assurance company. Your company has been presented with an opportunity to partially fund an empowerment company, XYZ Capital, for its purchase of an equity stake in another company, Auto Manufacturing, which specializes in the manufacture of valves for the automotive industry. The valves are sold both locally and abroad. XYZ Capital is a well-diversified investment holding company with equity stakes in companies exposed to a broad range of industries. It plans to purchase 70% of the equity in Auto Manufacturing from the existing majority shareholder, its CEO, for R50 million. The balance of Auto Manufacturing remains in the hands of the existing management team of Auto Manufacturing. XYZ wishes to fund the purchase by raising debt, which will be serviced and secured by the profits and assets of Auto Manufacturing. The CEO has agreed to fund R20 million of the purchase price by means of a vendor loan. The opportunity presented to your company is to fund the remaining R30 million under the following conditions:

- it will be a five year loan;
- the loan is secured by Auto Manufacturing which has no debt prior to the transaction;
- the capital is repayable in 5 equal instalments starting at the end of the 2009 financial year;
- interest on the outstanding capital will be charged at prime and will be payable annually, the first payment due at the end of September 2009; and
- in addition your company will receive 10% of the equity of Auto Manufacturing once the loan is repaid.

You are required to make a recommendation to the Investment Committee of your firm on whether your company should proceed with the partial funding of the purchase of Auto Manufacturing.

(i) Set out the additional information, both financial and otherwise, you will require to make an informed recommendation to the Investment Committee. [23]

(ii) Discuss the implications of securing the loan against Auto Manufacturing rather than XYZ Capital. [12]

PLEASE TURN OVER

You are presented with the following information from Auto Manufacturing's financial accounts for the five years ending September 2008:

R' millions	2004	2005	2006	2007	2008 (estimate)
Sales	585	593	655	713	779
Cost of Sales	463	487	564	600	630
Gross Profit	122	106	91	113	149
Gross profit margin	21%	18%	14%	16%	19%
Operating costs	75	67	62	69	92
EBIT	47	39	29	44	57
EBIT margin	8%	7%	4%	6%	7%

In addition, after detailed discussions with the management teams of both XYZ Capital and Auto Manufacturing as well as an expert from the automotive industry you glean the following information:

The first instalment of the vendor loan is due September 2014.
The vendor loan is subject to interest at prime payable annually in arrears.
You expect prime to average 12% pa over the next 5 years.
Sales are expected to grow at 5% pa for the next 5 years.
The industry expert suggests that the best estimate of the EBIT margin going forward would be the average margin achieved over 5 years ending September 2008.
Auto Manufacturing can be valued at 4 times after tax earnings.
Tax is payable at 29%.

(iii) Calculate the Internal Rate of Return (IRR) your company can expect should they proceed with providing the R30 million partial funding.

[6]

(iv) Explain what else you should take into account in reaching your recommendation to the Investment Committee. [9]

[Total 50]

[Total 100]

END OF PAPER

