Core Unit 4 - Financing and Investing for Retirement Provision

Assignment 2

*(Part 2 – Risk Management)*

*Recommended Time: 1 hour*

1. **In the context of equity markets, list the ways in which a company can issue shares in order to raise capital, and give a short statement regarding how each method operates.**

**10 marks**

Relevant section of the manual is Part 2 Chapter 1.3.

Format: descriptive

Answer should cover:

* Offer for subscription. A company issues shares directly to the public. This is rare, as most companies do not have the expertise or resources to carry out such an operation.
* Offer for sale. An issuing house (often a broker) is appointed to manage the process, from advertising the shares to paying the proceeds back to the issuer (minus a fee)
* Placing. A company simply hands its shares to a broker, which then sells them to its clients. If more than one broker is used, this is known as an ‘intermediaries offer’.
* Introduction. This is not designed to raise money for the issuing company, unlike the above methods, but involves bringing the shares already held by shareholders to the marketplace.
* Rights issue. A company with existing shares in issue may issue new shares to raise capital, giving existing shareholders right of first refusal (‘pre-emption rights’).

1. **Managing currency risk is important in order to mitigate the impact of adverse currency movements. Outline the following:**
2. **The two main methods of managing currency risk**
3. **The techniques active managers may use to manage currency risk**

**10 marks**

Relevant section of the manual is Part 2 Chapter 3.3.

Format: explain/describe

Answer should cover:

* Key features of active management and passive management. Passive currency management is more often referred to as hedging. This strategy does not seek to enhance returns from the portfolio but simply aims to remove the risk in holding securities based in another currency. In effect, it removes the uncertainty concerning which direction exchange rates might move. Hedging is usually achieved through using derivatives, such as a forward, a currency option or a currency swap. Active currency management actually seeks to profit from trading in currencies by exploiting changes in exchange rates. Uniquely among financial markets, this puts it at odds with the majority of participants in the market who do not seek a profit through buying and selling currency. Among the biggest traders of foreign currency are central banks, which may enter the market to limit volatility in the exchange rate. Other participants, such as tourists or companies and institutional investors hedging their currency risk, are also not seeking to generate profits
* Methods used to predict the course of currency movements.

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1. **Pension schemes typically hold the majority of their assets in equities and bonds.**

**Briefly describe:**

1. **how bonds compare to equities in terms of risk and return**
2. **the factors that affect bond values**

**10 marks**

Relevant section of the manual is Part 2 Chapter 2.1.

Format: descriptive, with use of bulleting acceptable in part b)

Answer should cover:

* lower risk but lower return
* interest rates and inflation
* Economic outlook
* Credit environment
* Supply and demand

The return on a bond investment is typically measured by its yield. Specifically, the performance of a bond from purchase to its maturity is stated as its yield to maturity. This is the bond’s internal rate of return, which takes into consideration all interest payments during the life of the bond and its maturity/redemption payment. The yield has an inverse relationship with the price of a bond: when a bond’s price rises, its yield falls and when a bond’s price falls, its yield rises. The total return on a bond consists of two components: the income return (the income generated by the bond holding) and the capital return (the gain or loss on the initial investment).

1. **Describe the characteristics of infrastructure investment.**

**5 marks**

Relevant section of the manual is Part 2 Chapter 3.6.

Format: descriptive prose

Answer should cover:

* Economic infrastructure – how it operates, how it is financed, sector example
* Social infrastructure – how it operates, how it is financed

1. **Why might a company choose to list its shares in a different country to the one in which it is headquartered and what factors would it take account of?**

**5 marks**

Relevant section of the manual is Part 2 Chapter 1.2.

Format: list or describe

Answer should cover:

* Access to wider/larger investor base
* Dual listing
* Risk and volatility
* Emerging markets
* Currency fluctuations

1. **Briefly describe four common types of derivatives and explain why derivatives are different in nature to the main asset classes.**

**10 marks**

Relevant section of the manual is Part 2 Chapter 4.1.

Format: descriptive

Answer should cover:

* Futures and forwards. Futures are contracts where a buyer agrees with a seller to purchase an asset at a specified date in the future, at a price agreed upon today. Futures are standardised products, traded on an exchange. Forwards are contracts similar to futures, but they are customisable and traded ‘over the counter’ (OTC) i.e., through private agreements rather than via an exchange
* Options. Options are a type of derivative that gives the buyer the right, but not the obligation, to buy (a ‘call’ option) or sell (a ‘put’ option) an underlying asset at an agreed price on a specified future date.
* Swaps. Swaps are contractual agreements where two parties agree to exchange (swap) either single payments or a series of payments in the future
* Contracts for difference is a contract between two parties, whereby the seller agrees to pay the buyer the difference between the value of an asset now and its value at the contract expiry. This enables fund managers to benefit from changes in the price of an asset without actually owning it
* Buy/sell derivative linked to the underlying asset rather than buy/sell the asset itself
* Derivatives provide exposure to a market or sector