THE CHARTERED INSURANCE INSTITUTE

J06

Diploma in Financial Planning

Unit J06 – Investment principles, markets and environment

July 2011 examination

SPECIAL NOTICES

All questions in this paper are based on English law and practice applicable in the tax year 2010/2011, unless stated otherwise in the question, and should be answered accordingly.

Assume all individuals are domiciled, resident and ordinarily resident in the UK unless stated otherwise.

Candidates should answer based on the legislative position immediately BEFORE the 2011 budget.

Instructions

- Two hours are allowed for this paper.
- **Do not begin writing until the invigilator instructs you to.**
- **Read the instructions on page 3 carefully before answering any questions.**
- Provide the information requested on the answer book and form B.
- You are allowed to write on the inside pages of this question paper, but you must **NOT** write your name, candidate number, PIN or any other identification anywhere on this question paper.
- The answer book and this question paper must **both be handed in personally by you** to the invigilator before you leave the examination room. **Failure to comply with this regulation will result in your paper not being marked and you may be prevented from entering this examination in the future.**

Unit J06 – Investment principles, markets and environment

Instructions to candidates

Read the instructions below before answering any questions

- **Two hours** are allowed for this paper which consists of 15 short answer questions and carries a total of 130 marks.
- You are strongly advised to attempt **all** questions to gain maximum possible marks. The number of marks allocated to each question is given next to the question and you should spend your time in accordance with that allocation.
- Read carefully all questions and information provided before starting to answer. Your answer will be marked strictly in accordance with the question set.
- You may find it helpful in some places to make rough notes in the answer booklet. If you do this, you should cross through these notes before you hand in the booklet.
- It is important to show all steps in a calculation, even if you have used a calculator.
- If you bring a calculator into the examination room, it must be a silent battery or solar-powered non-programmable calculator. The use of electronic equipment capable of being programmed to hold alphabetic or numerical data and/or formulae is prohibited. You may use a financial or scientific calculator, provided it meets these requirements.
- Tax tables are provided at the back of this question paper.
- Answer each question on a new page and leave six lines blank after each question part.

Subject to providing sufficient detail you are advised to be as brief and concise as possible, using note format and short sentences on separate lines wherever possible.

Attempt ALL questions

Time: 2 hours

1. **(a)** Define the term 'net asset value' of an investment trust share. **(3)**

(b) Explain how supply and demand affect the price of an investment trust share in relation to its net asset value per share. **(6)**

2. John, a UK resident, intends to invest in the Ukrainian currency (Hryvnia) in a Ukrainian bank because of the high current interest rate available. List **five** kinds of risk of which John should be made aware. **(5)**

3. **(a)** State the main principles of modern portfolio theory. **(4)**

(b) Identify the vertical and horizontal axes of an Efficient Frontier graph. **(2)**

(c) Explain briefly how the Efficient Frontier can assist the adviser in choosing a suitable fund for a particular client. **(3)**

(d) List **four** criticisms of Modern Portfolio Theory. **(4)**

4. On 1 January, John invests £1,000 in Bongo Ltd. After 12 months, the holding is worth £1,250.

On 1 January, Harry invests £500 in Timps Ltd. After six months the value is £650. At that point, Harry invests a further £500 in Timps Ltd. After 12 months, the total value is £1,300.

Neither John nor Harry has received any dividends.

(a) Using the Time-Weighted Rate of Return, calculate, **showing all your workings**:

(i) John's return; **(2)**

(ii) Harry's return. **(5)**

(b) State which of John or Harry achieved the higher return. **(1)**

5. John is a 40% taxpayer with no remaining Capital Gains Tax exemption for the tax year 2010/2011. He has just lost a court case and needs to raise funds immediately to settle costs.

He has the following investments:

- an offshore insured bond purchased ten years ago for £10,000, now valued at £30,000;
- a zero dividend investment trust, also purchased ten years ago for £10,000 and now valued at £30,000;
- undated government stock, war-loan, purchased 14 years ago for £21,425 and now valued at £30,000.

John has decided to sell immediately the investment on which he will pay the least tax. Calculate, **showing all your workings**, the net proceeds from each investment and advise John as to which one he should sell. **(9)**

6. **(a)** Explain what is meant by the term 'deflation'. **(2)**

(b) State the impact of deflation on the following:

(i) a mortgage; **(2)**

(ii) fixed interest investment; **(2)**

(iii) investment in shares in the retail sector; **(2)**

(iv) consumer behaviour. **(2)**

7. Company XYZ is capitalised at £200,000,000 with 40,000,000 ordinary shares issued. It has fixed assets of £250,000,000, current assets of £80,000,000, current liabilities of £50,000,000 and long-term liabilities (loans) of £40,000,000. It has no preference share capital.

(a) Calculate, **showing all your workings**, the price to book ratio of the company. **(3)**

(b) Comment on the price to book ratio in terms of the value of the company from the point of view of a prospective shareholder. **(3)**

(c) Calculate, **showing all your workings**, the current ratio of the company. **(2)**

(d) Explain what is meant by the term 'liquidity'. **(2)**

(e) State how the current ratio differs from the liquidity ratio and why the liquidity ratio can give a better indication of the potential risks facing the company. **(2)**

8. **(a)** Explain what is meant by the terms:

(i) 'normal yield curve'; **(3)**

(ii) 'reverse yield curve'. **(3)**

(b) State the main factors that influence the shape of a yield curve. **(3)**

Questions continue over the page

9. **(a)** Explain the process involved in writing covered call options. **(3)**

(b) State the usual reason for writing a covered call option. **(2)**

(c) Explain the effect of a subsequent price increase in the underlying stock. **(4)**

10. **(a)** Describe briefly what is meant by the term 'private equity'. **(2)**

(b) List **four** ways in which a private equity firm might exit a position and realise the gain on its investment. **(4)**

(c) Identify **four** ways in which an individual can gain access to the private equity asset class. **(4)**

11. Hugo has received a substantial inheritance and has asked you to create a portfolio for him.

List **five** factors you would take into account when constructing the portfolio on a discretionary managed basis. **(5)**

12. Simon currently holds various balanced managed and adventurous managed funds in a Stocks & Shares ISA, OEICs and an Onshore Unit Linked Life Assurance Bond.

(a) Explain the potential taxation and charge implications, if any, if Simon switches his investments to cautious funds within these products. **(8)**

(b) Explain the potential taxation and charge implications, if any, of Simon moving his OEIC funds across in specie to a discretionary fund manager. **(3)**

13. Harold runs a discretionary fund. The asset allocation and performance of the fund and its benchmark over the period are shown in the table below.

	Asset Allocation %	**Percentage gain/loss within portfolio**	**Benchmark Allocation %**	**Percentage gain/loss within the benchmark portfolio**
UK Equity	40	15	35	14
International Equity	10	20	15	15
Fixed Interest	30	12	25	9
Property	15	5	20	12
Cash	5	1	5	1
Performance	100	-	100	11.85

(a) Calculate, **showing all your workings**, the overall return achieved by Harold's portfolio and state whether or not he has outperformed the benchmark. **(7)**

(b) Explain briefly the purpose of using a benchmark. **(3)**

14. Jenny is concerned about the initial and ongoing charges levied if she invests in a unit trust.

State **five** ways in which she might achieve a reduction in charges. **(5)**

15. Brian opens a bank account paying 0.3% per month, compound. James opens a bank account paying 4% per annum, compound.

Each invests £10,000. Assuming no tax applicable, calculate, **showing all your workings**, which of Brian or James has more money in his account at the end of three years. **(5)**

The tax tables can be found on pages 9 - 13

INCOME TAX

RATES OF TAX	2009/2010	2010/2011
Starting rate for savings*	10%	10%
Basic rate	20%	20%
Higher rate	40%	40%
Additional rate	N/A	50%
Starting-rate limit	£2,440*	£2,440*
Threshold of taxable income above which higher rate applies	£37,400	£37,400
Threshold of taxable income above which additional rate applies	N/A	£150,000

**restricted to savings income only and not available if taxable non-savings income exceeds starting rate band.*

MAIN PERSONAL RELIEFS

Income limit for Personal Allowance §	N/A	£100,000
Personal Allowance (basic) §	£6,475	£6,475
Personal Allowance (age 65-74) §	£9,490	£9,490
Personal Allowance (aged 75 and over) §	£9,640	£9,640
Married/civil partners (minimum) at 10% †	£2,670	£2,670
Married/civil partners (age 75 and over) at 10%	£6,965	£6,965
Income limit for age-related allowances	£22,900	£22,900
Blind person's allowance	£1,890	£1,890
Enterprise Investment Scheme relief limit at 20%	£500,000	£500,000
Venture Capital Trust relief limit at 30%	£200,000	£200,000

§ *the Personal Allowance reduces by £1 for every £2 of income above the income limit irrespective of age from 2010/2011.*

† *where at least one spouse/civil partner was born before 6 April 1935.*

Child Tax Credit (CTC)		
- family element	£545	£545
- family element baby addition	£545	£545
CTC usually reduced by 6.67% of joint income over	£50,000	£50,000

NATIONAL INSURANCE CONTRIBUTIONS

Class 1 Employee	Weekly	Monthly	Yearly
Lower Earnings Limit (LEL)	£97	£421	£5,044
Primary threshold	£110	£477	£5,715
Upper Earnings Limit (UEL)	£844	£3,656	£43,875
Upper Accruals Point	£770	£3,337	£40,040

Total earnings £ per week	CLASS 1 EMPLOYEE CONTRIBUTIONS	
	Contracted-in rate	Contracted-out rate
Up to 110.00*	Nil	Nil
110.01 – 770.00	11%	9.4%
770.01 – 844.00	11%	11%
Above 844.00	1%	1%

Total earnings £ per week	CLASS 1 EMPLOYER CONTRIBUTIONS		
	Contracted-in rate	Contracted-out rate	
		Final salary	*Money purchase*
Below 110.00**	Nil	Nil	Nil
110.01 – 770.00	12.8%	9.1%	11.4%
770.01 – 844.00	12.8%	12.8%	12.8%
Excess over 844.00	12.8%	12.8%	12.8%

** This is the primary threshold below which no NI contributions are payable. However, the lower earnings limit is £97 per week. This £97 to £110 band is a zero rate band introduced in order to protect lower earners' rights to contributory State benefits e.g. Basic State Pension.*
*** Secondary earnings threshold.*

Class 2 (self-employed)	Flat rate per week £2.40 where earnings exceed £5,075 per annum.
Class 3 (voluntary)	Flat rate per week £12.05
Class 4 (self-employed)	8% on profits between £5,715 - £43,875 plus 1% on profits above £43,875

PENSIONS

TAX YEAR	LIFETIME ALLOWANCE	ANNUAL ALLOWANCE
2006/2007	£1,500,000	£215,000
2007/2008	£1,600,000	£225,000
2008/2009	£1,650,000	£235,000
2009/2010	£1,750,000	£245,000
2010/2011	£1,800,000	£255,000

NOTIONAL EARNINGS CAP
£123,600 – (For schemes that require post-1989 benefits to be still subject to a cap).

ANNUAL ALLOWANCE CHARGE
40% member's tax charge on the amount of total pension input in excess of the annual allowance.

LIFETIME ALLOWANCE CHARGE
55% of excess over lifetime allowance if taken as a lump sum.
25% of excess over lifetime allowance if taken in the form of income, which is subsequently taxed under PAYE.

INHERITANCE TAX

RATES OF TAX ON DEATH	2009/2010	2010/2011
Transfers made after 5 April 2010		
- Up to £325,000	Nil	Nil
- Excess over £325,000	40%	40%
- Lifetime transfers to and from certain trusts	20%	20%

MAIN EXEMPTIONS		
Transfers to		
- UK-domiciled spouse/civil partner	No limit	No limit
- non-UK-domiciled spouse/civil partner (from UK domiciled spouse)	£55,000	£55,000
- UK-registered charities	No limit	No limit
Lifetime transfers		
- annual exemption per donor	£3,000	£3,000
- small gifts to same person	£250	£250
Wedding/civil partnership gifts by		
- parent	£5,000	£5,000
- grandparent/party to marriage/civil partnership	£2,500	£2,500
- other person	£1,000	£1,000

100% relief: businesses, unlisted/AIM companies, certain farmland/building
50% relief: certain other business assets

Reduced tax charge on gifts within 7 years of death:

- Years before death	0-3	3-4	4-5	5-6	6-7
- Inheritance Tax payable	100%	80%	60%	40%	20%

CAR BENEFIT FOR EMPLOYEES

The charge for company car benefits is based on the carbon dioxide (CO2) emissions. There is no reduction for high business mileage users.

For 2010/2011:
The percentage charge is 15% of the car's list price for CO2 emissions at or below the qualifying level of 130g/km.
The base percentage charge of 15% increases in 1% steps for every additional full 5g/km over the 130g/km threshold, up to a maximum of 35% of the car's list price.
A lower percentage charge of 10% of the car's list price applies for emissions at or below 120g/km and 5% for emissions at or below 75g/km.

If price of car exceeds £80,000 then its price for tax purposes will be fixed at £80,000.

There is an additional 3% supplement for diesel cars not meeting Euro IV emission standards or registered after 31 December 2005. However, the maximum charge remains 35% of the car's list price.

Car fuel The benefit is calculated as the CO_2 emissions % relevant to the car and that % applied to a set figure (£18,000 for 2010/2011) e.g. car emission 160g/km = 21% on car benefit scale. 21% of £18,000 = £3,780.

1. **Accessories** are, in most cases, included in the list price on which the benefit is calculated.
2. **List price** is reduced for capital contributions made by the employee up to £5,000.
3. **Car benefit** is reduced by the amount of employee's contributions towards running costs.
4. **Fuel scale** is reduced only if the employee makes good **all** the fuel used for private journeys.
5. **All car and fuel benefits** are subject to employers National Insurance Contributions (Class 1A) of 12.8%.

PRIVATE VEHICLES USED FOR WORK

2010/2011 Rates

Cars	
On the first 10,000 business miles in tax year	40p per mile
Each business mile above 10,000 business miles	25p per mile
Motor Cycles	24p per mile
Bicycles	20p per mile

MAIN CAPITAL AND OTHER ALLOWANCES

	2010/2011
Plant & machinery 100% annual investment allowance (first year)	£100,000
Plant & machinery (reducing balance) per annum	20%
Patent rights & know-how (reducing balance) per annum	25%
Certain long-life assets, integral features of buildings (reducing balance) per annum	10%
Industrial & agricultural buildings (straight line)	1%
Energy & water-efficient equipment	100%
Zero emission goods vehicles (new)	100%
Qualifying flat conversions, business premises & renovations	100%

Motor cars: Expenditure on or after 01/04/09 (Corporation Tax) or 06/04/09 (Income Tax)

CO_2 emissions of g/km:	110 or less *	111-160	161 or more
Capital allowance:	100% first year	20% reducing balance	10% reducing balance

* If new

Research & Development:	Capital expenditure	100%
Revenue expenditure:	Small/medium companies:	175%
	Large companies:	130%

MAIN SOCIAL SECURITY BENEFITS

		2009/2010	2010/2011
		£	£
Child Benefit	first child	20.00	20.30
	subsequent children	13.20	13.40
Incapacity Benefit	short-term lower rate*	67.75	68.95
	short-term higher rate*	80.15	81.60
	long-term rate	89.80	91.40
Attendance Allowance	lower rate	47.10	47.80
	higher rate	70.35	71.40
Retirement Pension	single	95.25	97.65
	married	152.30	156.15
Pension Credit	single person standard minimum guarantee	130.00	132.60
	married couple standard minimum guarantee	198.45	202.40
	maximum savings ignored in calculating income	6,000.00	10,000.00
Bereavement Benefit (lump sum)		2,000.00	2,000.00
Widowed Parent's allowance		95.25	97.65
Jobseekers Allowance		64.30	65.45

** under State Pension Age*

CAPITAL GAINS TAX

RATES OF TAX

Chargeable gains, less allowable losses, are charged to tax as follows from 23 June 2010:

- for individuals who are non-taxpayers or basic-rate taxpayers, the rate chargeable is 18%.
- for individuals who are higher-rate taxpayers or additional-rate taxpayers, the rate chargeable is 28%.
- for trustees of trusts and personal representatives the rate chargeable is 28%.
- Entrepreneurs' Relief reduces the rate to 10% on qualifying assets subject to a lifetime limit of £5,000,000.

ANNUAL EXEMPTION

- The annual exemption is £10,100.
- Most trusts have an annual exemption of £5,050.

CHATTELS EXEMPTION

- Gains on chattels are exempt if proceeds do not exceed £6,000 per item.

CORPORATION TAX

	2009/2010	2010/2011
Full rate	28%	28%
Small companies rate	21%	21%
Small companies limit	£300,000	£300,000
Effective marginal rate	29.75%	29.75%
Upper marginal limit	£1,500,000	£1,500,000

VALUE ADDED TAX

Standard rate to 03/01/11	17.5%
Standard rate from 04/01/11	20%
Annual Registration limit	£70,000