Chartered Insurance Institute

AF4

Advanced Diploma in Financial Planning

Unit AF4 – Investment planning

October 2018 examination

SPECIAL NOTICES

All questions in this paper are based on English law and practice applicable in the tax year 2018/2019, unless stated otherwise in the question, and should be answered accordingly.

It should be assumed that all individuals are domiciled and resident in the UK unless otherwise stated.

Instructions

- Three 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 AF4 – Investment planning

Instructions to candidates

Read the instructions below before answering any questions

- **Three hours** are allowed for this paper which carries a total of 160 marks as follows:

- Section A: 80 marks
- Section B: 80 marks

- You are advised to spend approximately 90 minutes on Section A and 90 minutes on Section B.

- You are strongly advised to attempt **all** questions to gain maximum possible marks. The number of marks allocated to each question part 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.

SECTION A

This question is compulsory and carries 80 marks

Question 1

Read carefully all information provided in the case study before attempting the questions. Your answers should take into account the clients circumstances as set out in the case study. Please carry out ALL of the tasks (a), (b), (c), (d), (e), (f) and (g) which follow.

Gavin, aged 56, and his spouse Sasha, aged 54, have recently sold their business and received net proceeds of £1,600,000.

Gavin and Sasha would like to generate a net income of £100,000 per annum, until Gavin reaches age 65, whereupon his State and private pension provisions will commence, and their net income requirement will reduce to £70,000 per annum. At that point Gavin and Sasha plan to withdraw a capital sum from the portfolio to purchase an additional property.

Sasha holds two Enterprise Investment Scheme (EIS) investments. She understands the basic concept of these investments and would like to invest some of the sale proceeds into similar, new investments.

Gavin holds a Stocks and Shares ISA, which contains two FTSE 250 Index listed equities. The current value of Gavin's ISA is £220,000, although he has not reviewed the plan for several years.

Financial details of the two equities are as per the following table:

Table 1

Security	Grey Square plc	Amber Triangle plc
Sector	Retailer	Retailer
Number of shares in issue	84,000,000	130,000,000
Profit attributable to shareholders	£13,250,000	£41,800,000
Share price	112p	267p
Dividend per share	6p	14p

Gavin also holds a property authorised investment fund (PAIF) on a non-ISA basis. Details of the PAIF's returns over the previous year are as per the following table:

Table 2

Value at 1 January	**New money invested on 31 March**	**Income paid out on 30 June**	**Value at 31 December**
£105,000	£20,000	£3,200	£122,800

Gavin and Sasha want to use the sale of their business as a catalyst to arrange a review of their investments, with particular attention paid to rebalancing the assets within Gavin's ISA and establishing an outline investment strategy for their current and planned future needs.

Both Gavin and Sasha believe that they have a good knowledge of financial markets although they are keen to understand more about how their investment needs can be achieved, as well as the related risks.

Questions

*To gain maximum marks for calculations you **must** show **all** your workings and express your answer to **two** decimal places.*

(a) Outline the main factors that a financial adviser would take into consideration when constructing an investment portfolio to meet Gavin and Sasha's needs. **(8)**

(b) **(i)** State the main conditions that must be met for a property fund to qualify as a property authorised investment fund (PAIF). **(6)**

(ii) State the tax treatment of the three income components of a PAIF, if the PAIF is used to generate some of the income requirement. *Assume Gavin is a higher rate taxpayer*. **(8)**

(c) **(i)** Calculate, **showing all your workings**, the basic earnings per share for Grey Square plc. **(3)**

(ii) Calculate, **showing all your workings**, the dividend cover for Amber Triangle plc. **(4)**

(iii) Comment on Amber Triangle's dividend cover, given in your answer to part **(c)(ii)** above, if the sector average dividend cover is 1.8. **(3)**

(d) **(i)** Identify **three** additional risks to which Gavin would remain exposed, if he retained the direct equities rather than sold them and re-invested into multi-asset collective funds. **(3)**

(ii) Explain to Gavin and Sasha what is meant by sequencing risk and its effects on an investment portfolio, given the need to generate an income from the investment of the sale proceeds. **(5)**

QUESTIONS CONTINUE OVER THE PAGE

(e) **(i)** Explain the main objectives of the rebalancing process. **(6)**

(ii) Identify **ten** main issues that a financial adviser should consider when rebalancing the portfolio once an investment portfolio is set up and generating an income in line with Gavin and Sasha's needs. **(10)**

(f) Explain the subscription rules and tax treatment of any new investment that Sasha might make if she decided to subscribe to a new Enterprise Investment Scheme. **(10)**

(g) **(i)** Calculate, **showing all your workings**, the money-weighted rate of return (MWR) for the PAIF over the twelve-month period shown in **Table 2.** **(10)**

(ii) Explain briefly why the MWR is not considered appropriate when evaluating and comparing different portfolio returns and suggest a more suitable alternative return measure. **(4)**

Total marks available for this question: (80)

Section B questions can be found on pages 8 – 11

SECTION B

Both questions in this section are compulsory and carry an overall total of 80 marks

Question 2

Read carefully all information provided in the case study before attempting the questions. Your answers should take into account the clients circumstances as set out in the case study. Please carry out ALL of the tasks (a), (b), (c) and (d) which follow.

John is recently widowed. His wife, Priya, had worked as an aid worker for a major charity and had a Stocks and Shares ISA investment portfolio within which she selected the funds using Socially Responsible Investment (SRI) principles.

John is considering whether he should sell two of the investments within the ISA, as shown in **Table 1** below.

Global Issues Trust is a UK listed investment trust which aims to invest in companies that are providing solutions to tackling global issues. Affordable Housing Trust is a UK listed Real Estate Investment Trust that owns and manages several affordable housing developments.

Table 1

	Beta	Actual 1 year return	Expected 1 year market return	Standard deviation	Risk free rate of return	Sharp ratio	Alpha
Global Issues Trust	1.4	12%	8%	22	0.25%	0.53	-
Affordable Housing Trust	-0.5	6%	8%	8	0.25%	-	9.63

Priya's ISA is valued at £45,000 of which £4,300 is held in an Innovative Finance ISA.

Priya also owned some 12% cumulative irredeemable preference shares, as shown in **Table 2** below. John would like to understand the features of this investment and the potential risks.

Table 2

Issuer	Holding	Issue price	Current price	Dividend
Ethical Insurance plc	10,000	100p	160p	6p, payable half-yearly

Questions

*To gain maximum marks for calculations you **must** show **all** your workings and express your answer to **two** decimal places.*

(a) **(i)** Explain briefly to John the difference between positive screening and negative screening with respect to socially responsible investing, and state which approach is being used by the Global Issues Trust. **(3)**

(ii) Explain to John **four** potential drawbacks of using Socially Responsible Investing other than investment performance. **(4)**

(b) **(i)** Calculate, **showing all your workings**, the Alpha for the Global Issues Trust. **(5)**

(ii) Calculate, **showing all your workings**, the Sharpe ratio for Affordable Housing Trust. **(3)**

(iii) Explain why you would recommend John retains Affordable Housing Trust rather than Global Issues Trust, given the Alpha, Beta and Sharpe ratios of Global Issues Trust and Affordable Housing Trust **(5)**

(c) **(i)** State the information John would have to provide when requesting an Additional Permitted Subscription in respect of Priya's ISA. **(6)**

(ii) State the qualifying investments that may be held within an Innovative Finance ISA. **(3)**

(d) **(i)** Explain to John the main features of preference shares compared to ordinary shares. **(3)**

(ii) Explain to John the investment implications of the three stated features of the Ethical Insurance plc preference shares. **(3)**

(iii) Calculate, **showing all your workings**, the dividend yield for the Ethical Insurance plc preference shares. **(3)**

(iv) Explain **two** risks of continuing to invest in the Ethical Insurance plc preference shares. **(2)**

Total marks available for this question: 40

QUESTIONS CONTINUE OVER THE PAGE

Question 3

Read carefully all information provided in the case study before attempting the questions. Your answers should take into account the clients circumstances as set out in the case study. Please carry out ALL of the tasks (a), (b) and (c) which follow.

Nazan, an investment adviser within an authorised advisory firm, has met with a new retail client who is seeking advice about her investments. Based upon the client's objectives, Nazan believes that a UK multi-asset fund may be suitable and is assessing Many Assets Fund as a potential investment.

Financial data for this fund is as per the following table:

	Many Assets Fund		
Beta	1.4		
Returns over previous 3 years	3.2%	-0.8%	4.1%

The fund is comprised of cash, fixed interest, equities and physical commodities.

The client believes that the UK economy is deteriorating and is concerned about the impact upon any potential investment in the fund of rising interest rates and higher inflation. The client is also concerned about the impact upon the UK's balance of payments of a worsening economic position.

Questions

*To gain maximum marks for calculations you **must** show **all** your workings and express your answers to **two** decimal places.*

(a) **(i)** Calculate, **showing all your workings**, the standard deviation using the returns data for the previous three years. **(10)**

(ii) Explain **six** relative differences between standard deviation and Beta in terms of how they measure risk. **(6)**

(iii) Explain briefly what Many Assets Fund's Beta means in terms of potential investment returns. **(3)**

(b) **(i)** Explain the potential impact of rising interest rates upon fixed interest and equities asset classes held within Many Assets Fund. **(4)**

(ii) Explain **two** reasons why Many Assets Fund may increase its exposure to its equities and commodities asset classes in response to rising inflation. **(4)**

(iii) State **three** reasons why the price of index-linked fixed interest securities may fall even if inflation is rising and expected to continue to rise. **(3)**

(c) **(i)** Describe briefly what is meant by current account and capital account. **(6)**

(ii) Outline **four** potential economic consequences of the current account and capital account being in deficit over the medium to long-term. **(4)**

Total marks available for this question: 40

The tax tables can be found on pages 13 – 21

INCOME TAX

RATES OF TAX	2017/2018	2018/2019
Starting rate for savings*	0%	0%
Basic rate	20%	20%
Higher rate	40%	40%
Additional rate	45%	45%
Starting-rate limit	£5,000*	£5,000*
Threshold of taxable income above which higher rate applies	£33,500	£34,500
Threshold of taxable income above which additional rate applies	£150,000	£150,000
Child benefit charge:		
1% of benefit for every £100 of income over	£50,000	£50,000

**not applicable if taxable non-savings income exceeds the starting rate band.*

Dividend Allowance		£2,000
Dividend tax rates		
Basic rate		7.5%
Higher rate		32.5%
Additional rate		38.1%
Trusts		
Standard rate band		£1,000
Rate applicable to trusts		
- dividends		38.1%
- other income		45%

MAIN PERSONAL ALLOWANCES AND RELIEFS		
Income limit for Personal Allowance §	£100,000	£100,000
Personal Allowance (basic)	£11,500	£11,850
Married/civil partners (minimum) at 10% †	£3,260	£3,360
Married/civil partners at 10% †	£8,445	£8,695
Transferable tax allowance for married couples/civil partners	£1,150	£1,190
Income limit for Married couple's allowance†	£28,000	£28,900
Rent a Room relief	£7,500	£7,500
Blind Person's Allowance	£2,320	£2,390
Enterprise Investment Scheme relief limit on £1,000,000 max**	30%	30%
Seed Enterprise Investment relief limit on £100,000 max	50%	50%
Venture Capital Trust relief limit on £200,000 max	30%	30%

§ the Personal Allowance reduces by £1 for every £2 of income above the income limit irrespective of age (under the income threshold).
† where at least one spouse/civil partner was born before 6 April 1935.
*** maximum for 'standard' investment but for 'knowledge intensive' investment, the limit is £2,000,000.*

	2017/2018	2018/2019
Child Tax Credit (CTC)		
- Child element per child (maximum)	£2,780	£2,780
- family element	£545	£545
Threshold for tapered withdrawal of CTC	£16,105	£16,105

NATIONAL INSURANCE CONTRIBUTIONS

Class 1 Employee	Weekly
Lower Earnings Limit (LEL)	£116
Primary threshold	£162
Upper Earnings Limit (UEL)	£892

Total earnings £ per week	CLASS 1 EMPLOYEE CONTRIBUTIONS
Up to 162.00*****	Nil
162.01 – 892.00	12%
Above 892.00	2%

**This is the primary threshold below which no NI contributions are payable. However, the lower earnings limit is £116 per week. This £116 to £162 band is a zero-rate band introduced in order to protect lower earners' rights to contributory State benefits e.g. the new State Pension.*

Total earnings £ per week	CLASS 1 EMPLOYER CONTRIBUTIONS
Below 162.00**	Nil
162.01 – 892	13.8%
Excess over 892.00	13.8%

*** Secondary earnings threshold.*

Class 2 (self-employed)	Flat rate per week £2.95 where profits exceed £6,205 per annum.
Class 3 (voluntary)	Flat rate per week £14.65.
Class 4 (self-employed)	9% on profits between £8,424 - £46,350. 2% on profits above £46,350.

PENSIONS

TAX YEAR	LIFETIME ALLOWANCE
2006/2007	£1,500,000
2007/2008	£1,600,000
2008/2009	£1,650,000
2009/2010	£1,750,000
2010/2011	£1,800,000
2011/2012	£1,800,000
2012/2013	£1,500,000
2013/2014	£1,500,000
2014/2015	£1,250,000
2015/2016	£1,250,000
2016/2017	£1,000,000
2017/2018	£1,000,000
2018/2019	£1,030,000

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.

ANNUAL ALLOWANCE

TAX YEAR	ANNUAL ALLOWANCE
2011/2012	£50,000
2012/2013	£50,000
2013/2014	£50,000
2014/2015	£40,000
2015/2016	£40,000~
2016/2017	£40,000*
2017/2018	£40,000*
2018/2019	£40,000*

~ increased to £80,000 for pension input between April - 8 July 2015. If not used, can be carried forward to pension input period of 9 July 2015 - 6 April 2016, subject to a maximum of £40,000.

**tapered at a rate of £1 for every £2 of adjusted income in excess of £150,000 where threshold income exceeds £110,000.*

MONEY PURCHASE ANNUAL ALLOWANCE	2017/2018	2018/2019
	£4,000	£4,000

ANNUAL ALLOWANCE CHARGE

20% - 45% determined by the member's taxable income and the amount of total pension input in excess of the annual allowance or money purchase annual allowance.

CAPITAL GAINS TAX

EXEMPTIONS	2017/2018	2018/2019
Individuals, estates etc	£11,300	£11,700
Trusts generally	£5,650	£5,850
Chattels proceeds (restricted to five thirds of proceeds exceeding limit)	£6,000	£6,000

TAX RATES		
Individuals:		
Up to basic rate limit	10%	10%
Above basic rate limit	20%	20%
Surcharge for residential property and carried interest	8%	8%
Trustees and Personal Representatives	20%	20%
Entrepreneurs' Relief* – Gains taxed at:	10%	10%
Lifetime limit	£10,000,000	£10,000,000

**For trading businesses and companies (minimum 5% employee or director shareholding) held for at least one year.*

INHERITANCE TAX

RATES OF TAX ON TRANSFERS	2017/2018	2018/2019
Transfers made on death after 5 April 2015		
- Up to £325,000	Nil	Nil
- Excess over £325,000	40%	40%
Transfers made after 5 April 2015		
- Lifetime transfers to and from certain trusts	20%	20%

A lower rate of 36% applies where at least 10% of deceased's net estate is left to a registered charity.

MAIN EXEMPTIONS

Transfers to		
- UK-domiciled spouse/civil partner	No limit	No limit
- non-UK-domiciled spouse/civil partner (from UK-domiciled spouse)	£325,000	£325,000
- main residence nil rate band*	£100,000	£125,000
- UK-registered charities	No limit	No limit

**Available for estates up to £2,000,000 and then tapered at the rate of £1 for every £2 in excess until fully extinguished*

Lifetime transfers		
- Annual exemption per donor	£3,000	£3,000
- Small gifts exemption	£250	£250
Wedding/civil partnership gifts by		
- parent	£5,000	£5,000
- grandparent/bride and/or groom	£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%

Quick succession relief:

- Years since IHT paid	0-1	1-2	2-3	3-4	4-5
- Inheritance Tax relief	100%	80%	60%	40%	20%

CAR BENEFIT FOR EMPLOYEES

The charge for company car benefits is based on the carbon dioxide (CO_2) emissions. There is no reduction for high business mileage users.

For 2018/2019:

- The percentage charge is 13% of the car's list price for CO_2 emissions of 50g/km or less.
- For cars with CO_2 emissions of 51g/km to 75g/km the percentage is 16%.
- For cars with CO_2 emissions of 76g/km to 94g/km the percentage is 19%.
- Cars with CO_2 emissions of 95g/km have a percentage charge of 20% and thereafter the charge increases by 1% for every complete 5g/km to a maximum of 37% (emissions of 190g/km and above).

There is an additional 4% supplement for diesel cars not meeting Euro IV emission standards. However, the maximum charge remains 37% 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 (£23,400 for 2018/2019) e.g. car emission 90g/km = 19% on car benefit scale. 19% of £23,400 = £4,446.

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 contribution's (Class 1A) of 13.8%.

PRIVATE VEHICLES USED FOR WORK

	2017/2018 Rates	2018/2019 Rates
Cars		
On the first 10,000 business miles in tax year	45p per mile	45p per mile
Each business mile above 10,000 business miles	25p per mile	25p per mile
Motor Cycles	24p per mile	24p per mile
Bicycles	20p per mile	20p per mile

MAIN CAPITAL AND OTHER ALLOWANCES

	2017/2018	2018/2019
Plant & machinery (excluding cars) 100% annual investment allowance (first year)	£200,000	£200,000
Plant & machinery (reducing balance) per annum	18%	18%
Patent rights & know-how (reducing balance) per annum	25%	25%
Certain long-life assets, integral features of buildings (reducing balance) per annum	8%	8%
Energy & water-efficient equipment	100%	100%
Zero emission goods vehicles (new)	100%	100%
Qualifying flat conversions, business premises & renovations	100%	100%

Motor cars: Expenditure on or after 01 April 2016 (Corporation Tax) or 06 April 2016 (Income Tax)

CO_2 emissions of g/km:	50 or less*	51-110	111 or more
Capital allowance:	100% first year	18% reducing balance	8% reducing balance

**If new*

MAIN SOCIAL SECURITY BENEFITS

		2017/2018	2018/2019
		£	£
Child Benefit	First child	20.70	20.70
	Subsequent children	13.70	13.70
	Guardian's allowance	16.70	17.20
Employment and Support Allowance	Assessment Phase		
	Age 16 – 24	Up to 57.90	Up to 57.90
	Aged 25 or over	Up to 73.10	Up to 73.10
	Main Phase		
	Work Related Activity Group	Up to 102.15	Up to 102.15
	Support Group	Up to 109.65	Up to 110.75
Attendance Allowance	Lower rate	55.65	57.30
	Higher rate	83.10	85.60
basic State Pension	Single	122.30	125.95
	Married	195.60	201.45
new State Pension	Single	159.55	164.35
Pension Credit	Single person standard minimum guarantee	159.35	163.00
	Married couple standard minimum guarantee	243.25	248.80
	Maximum savings ignored in calculating income	10,000.00	10,000.00
Bereavement Payment*		2,000.00	2,000.00
Bereavement Support Payment**	Higher rate - First payment	3,500.00	3,500.00
	Higher rate - monthly payment	350.00	350.00
	Lower rate – First payment	2,500.00	2,500.00
	Lower rate – monthly payment	100.00	100.00
Jobseekers Allowance	Age 18 - 24	57.90	57.90
	Age 25 or over	73.10	73.10
Statutory Maternity, Paternity and Adoption Pay		140.98	145.18

**Only applicable where spouse or civil partner died before 6 April 2017.*
*** Only applicable where spouse or civil partner died on or after 6 April 2017.*

C

CORPORATION TAX

	2017/2018	2018/2019
Standard rate	19%	19%

VALUE ADDED TAX

	2017/2018	2018/2019
Standard rate	20%	20%
Annual registration threshold	£85,000	£85,000
Deregistration threshold	£83,000	£83,000

STAMP DUTY LAND TAX

	Residential
Value up to £125,000	0%
£125,001 - £250,000	2%
£250,001 and £925,000	5%
£925,001 and £1,500,000	10%
£1,500,001 and over	12%

Stamp Duty Land Tax (SDLT) is payable in England and Northern Ireland only. Land Transaction Tax (LTT) is payable in Wales and Land and Buildings Transaction Tax (LBTT) is payable in Scotland. The rates for LTT and LBTT are different to the rates shown above.

Additional SDLT of 3% may apply to the purchase of additional residential properties purchased for £40,000 or greater.

SDLT is charged at 15% on interests in residential dwellings costing more than £500,000 purchased by certain corporate bodies or non-natural persons.

First-time buyers benefit from SDLT relief on purchases up to £500,000 when purchasing their main residence. On purchases up to £300,000, no SDLT is payable. On purchases between £300,000 and £500,000, a flat rate of 5% is charged on the balance above £300,000.

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