Chartered Insurance Institute

AF4

Advanced Diploma in Financial Planning

Unit AF4 – Investment planning

October 2019 examination

SPECIAL NOTICES

All questions in this paper are based on English law and practice applicable in the tax year 2019/2020, 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), (g) and (h) which follow.

Nicolas, aged 35, is a higher-rate and Alessandra, aged 33, is a basic-rate taxpayer. They have just inherited £200,000 and are seeking advice on investing for the long-term. Both have personal pensions but no other retirement provision. As a consequence, they understand their existing provision is unlikely to meet their retirement objectives in full and they are considering using some of their inheritance for this purpose.

Nicolas and Alessandra each have an ISA. Nicolas' ISA is invested in a multi-asset fund, the most recent one-year performance of which is set out in **Table 1** below:

Table 1

	UK Equities	Global Equities	Frontier Markets	Fixed Interest
Asset Allocation %	50	25	10	15
Fund Performance %	6	3.5	9	-3.5
Benchmark Performance %	7	4.5	5	-2

Alessandra has fully funded her ISA for the 2019/2020 tax year and is holding cash while she decides whether to make three investments, as per **Table 2** below:

Table 2

Asset	Purchase method	Investment amount
FTSE 100 listed equity	Paperless, via CREST	£11,000
FTSE SmallCap listed equity	Paper, via stock transfer	£3,850
FTSE All-Share Exchange Traded Fund (ETF)	Online platform	£5,150

There are no initial charges on the above investments other than a flat dealing fee of £9 per transaction.

Alessandra's previous tax year's ISA contributions are invested in a UK equity open-ended investment company (OEIC). The OEIC's factsheet states the fund invests on a very concentrated basis, employs a high conviction approach and holds unlisted securities. Nicolas and Alessandra have asked their adviser how these factors may affect the risk.

Their financial adviser is constructing an investment portfolio for the inheritance and is considering allocations to a range of passive index tracking funds together with a discretionary fund management (DFM) service. The adviser has mentioned to Nicolas and Alessandra that the overall portfolio will be constructed using the principles of Modern Portfolio Theory.

Questions

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

(a) **(i)** Calculate, **showing all your workings**, the overall benchmark return to which Nicolas' multi-asset fund is compared. **(5)**

(ii) Calculate, **showing all your workings**, the overall performance of Nicolas' multi-asset fund. **(5)**

(iii) Identify and explain briefly, the asset class that has made the greatest impact on performance of Nicolas' portfolio relative to the benchmark. **(3)**

(iv) Calculate, **showing all your workings**, the fund's alpha. **(6)**
*Assume a risk-free rate of return of 0.25% and a beta of 1.3. Use the market return and fund return figures from your answers in parts **(a)(i)** and **(a)(ii)** above.*

(b) State **three benefits** and **three drawbacks**, of using a stocks and shares ISA as a long-term investment vehicle for Nicolas and Alessandra's retirement, compared to a personal pension. **(6)**

(c) Calculate, **showing all your workings**, the total costs and levies payable upon the transactions set out in **Table 2** on page 4. **(8)**

(d) **(i)** Explain the diversification rules for a retail Undertakings for the Collective Investment of Transferable Securities (UCITS) OEIC, based upon the minimum number of permissible holdings and their respective percentages. **(5)**

(ii) State the maximum exposure a retail UCITS OEIC may hold in unlisted securities. **(2)**

(e) **(i)** Explain to Nicolas and Alessandra the term 'capacity for loss'. **(4)**

(ii) List the non-financial factors that can influence an investor's attitude to risk. **(6)**

(iii) Explain why Nicolas' attitude to risk may be higher for a personal pension compared to a stocks & shares ISA. **(5)**

QUESTIONS CONTINUE OVER THE PAGE

(f) Describe the key principles of Modern Portfolio Theory, in respect of the construction of an investment portfolio. **(10)**

(g) **(i)** Outline to Nicolas and Alessandra why their financial adviser is considering using a discretionary fund manager (DFM) service as well as passive funds. **(5)**

(ii) State the potential risks of using a DFM service. **(6)**

(h) Alessandra's decision to hold cash within her ISA may be influenced by investor psychology.

State **two** reasons why she may be putting off the decision to invest, identifying **one** justification for **each** reason, from a behavioural finance perspective. **(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 client's circumstances as set out in the case study. Please carry out ALL of the tasks (a), (b), (c), (d), (e) and (f) which follow.

Efekan, aged 64, plans to retire during the next 12 months. He has accumulated £110,000 in a self-invested personal pension (SIPP) and £240,000 in a general investment account (GIA). The GIA is invested equally in UK fixed interest and UK equity collective funds.

Efekan has been recommended to an authorised advisory firm. As a result of an analysis of his financial position, Efekan's target income is £23,500 per annum gross from the overall portfolio after allowing for his State Pension and a deferred company pension. He has asked the financial adviser to assess the feasibility of generating income from his portfolio.

Efekan is aware that yields are low by historical standards but has read articles about alternative asset classes offering higher yields, such as aircraft leasing and leveraged loans. He is also interested in purchasing preference shares as an income producing asset within his SIPP.

Efekan has rarely reviewed the performance of his investments but is aware that most of the fund correspondence he receives mentions 'benchmarks' and 'over/under performance'. He also believes that the money supply can also be used as a benchmark and has asked the financial adviser to clarify this term.

The two existing products are held on a direct basis and the financial adviser is assessing the potential suitability of consolidating the SIPP and GIA onto a platform.

Questions

(a) State **five** main risks to which Efekan may be specifically exposed to if he invests in high yielding alternative income products. **(5)**

(b) State the **four** main types of preference share and identify the key characteristic for **each** type. **(8)**

(c) Identify **four** important considerations that could impact Efekan achieving his income objective in retirement. **(4)**

(d) State **five benefits** and **five drawbacks** to Efekan of transferring his existing assets to a platform, compared with holding them directly. **(10)**

(e) Identify the **three** main categories of benchmark used by fund managers. **(3)**

(f) **(i)** Describe the key differences between M0 and M4 as measures of money supply. **(4)**

(ii) Explain briefly how the Bank of England could reduce the money supply and state the effect on interest rates. **(4)**

(iii) State **two** reasons why the money supply is not suitable as a benchmark for Efekan's investment portfolio. **(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 client's circumstances as set out in the case study. Please carry out ALL of the tasks (a), (b), (c), (d) and (e) which follow.

Kathryn is a retail client who is about to have a review meeting with her financial adviser. She has been a higher-rate taxpayer for several years and her main investment asset has been residential buy-to-let property. Following changes to the tax regime, she has been disposing of properties and is about to sell her last one. Upon completion, she will receive £320,000 sale proceeds and wishes to re-invest this amount.

As a result of the changes to the tax treatment of property investing, Kathryn is keen to access products with tax concessions, both to mitigate the tax liability arising from the property sale as well as upon any future disposal of the product(s).

Kathryn has heard about Seed Enterprise Investment Schemes (SEISs) and is keen to know more about them.

The financial adviser is aware that Kathryn has strong views on socially responsible investment and in advance of the meeting Kathryn sent her adviser details of a company listed on the FTSE-SmallCap Index: Waternova plc. The company invests in micro projects involving water technology.

Financial information for Waternova plc is set out in **Table 1** below:

Equity	Waternova plc
Share price	43p
Dividend per share	2.25p
Dividend cover	1.29x
Profit before interest and tax	£1,600,000
Share capital	£12,000,000
Retained earnings	£2,000,000
Reserves	£450,000

Kathryn has a small existing investment portfolio, which is invested in a manager of managers fund. The fund has just announced a change in manager for two of its UK equity mandates. One of the new managers invests on a contrarian style basis and the other on a momentum style basis.

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 Price Earnings (P/E) ratio for Waternova plc. **(4)**

(ii) Calculate, **showing all your workings**, the return on capital employed (ROCE) for Waternova plc. **(7)**

(b) Describe the general limitations of using investment ratios, such as P/E or ROE/ROCE, when analysing a company's financial performance. ***Exclude** any limitations that are unique to a specific ratio.* **(5)**

(c) Identify **eight** main factors, **excluding** 'market movement**'** that could affect Watenova plc's share price. **(8)**

(d) **(i)** Explain briefly how Kathryn could use a Seed Enterprise Investment Scheme (SEIS) to mitigate her Capital Gains Tax liability. **(4)**

(ii) Explain briefly the initial Income Tax treatment of a new SEIS investment. **(4)**

(e) **(i)** Describe what is meant by a momentum investment style. **(4)**

(ii) Describe what is meant by a contrarian investment style. **(4)**

Total marks available for this question: 40

The tax tables can be found on pages 13 – 21

INCOME TAX

RATES OF TAX	2018/2019	2019/2020
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	£34,500	£37,500
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 of £5,000.*

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)	£11,850	£12,500
Married/civil partners (minimum) at 10% †	£3,360	£3,450
Married/civil partners at 10% †	£8,695	£8,915
Marriage Allowance	£1,190	£1,250
Income limit for Married Couple's Allowance†	£28,900	£29,600
Rent a Room scheme – tax free income allowance	£7,500	£7,500
Blind Person's Allowance	£2,390	£2,450
Enterprise Investment Scheme relief limit on £2,000,000 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.
*** Investment above £1,000,000 must be in knowledge-intensive companies.*

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)	£118
Primary threshold	£166
Upper Earnings Limit (UEL)	£962

Total earnings £ per week	**CLASS 1 EMPLOYEE CONTRIBUTIONS**
Up to 166.00*****	Nil
166.01 – 962.00	12%
Above 962.00	2%

**This is the primary threshold below which no NI contributions are payable. However, the lower earnings limit is £118 per week. This £118 to £166 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 166.00**	Nil
166.01 – 962	13.8%
Excess over 962.00	13.8%

*** Secondary earnings threshold.*

Class 2 (self-employed)	Flat rate per week £3.00 where profits exceed £6,365 per annum.
Class 3 (voluntary)	Flat rate per week £15.00.
Class 4 (self-employed)	9% on profits between £8,632 - £50,000. 2% on profits above £50,000.

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
2019/2020	£1,055,000

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
2015/2016	£40,000~
2016/2017	£40,000*
2017/2018	£40,000*
2018/2019	£40,000*
2019/2020	£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	2018/2019	2019/2020
	£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	2018/2019	2019/2020
Individuals, estates etc	£11,700	£12,000
Trusts generally	£5,850	£6,000
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 (2018/2019), two years (2019/2020).*

INHERITANCE TAX

RATES OF TAX ON TRANSFERS	2018/2019	2019/2020
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*	£125,000	£150,000
- 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 2019/2020:

- The percentage charge is 16% 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 19%.
- For cars with CO_2 emissions of 76g/km to 94g/km the percentage is 22%.
- Cars with CO_2 emissions of 95g/km have a percentage charge of 23% and thereafter the charge increases by 1% for every complete 5g/km to a maximum of 37% (emissions of 165g/km and above).

There is an additional 4% supplement for diesel cars not meeting Euro 6 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 (£24,100 for 2019/2020) e.g. car emission 90g/km = 22% on car benefit scale. 22% of £24,100 = £5,302.

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

	2018/2019 Rates	2019/2020 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

	2018/2019	2019/2020
Plant & machinery (excluding cars) 100% annual investment allowance (first year)	£200,000	£1,000,000
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%	6%
Energy & water-efficient equipment	100%	100%
Zero emission goods vehicles (new)	100%	100%
Electric charging points	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	6% reducing balance

**If new*

MAIN SOCIAL SECURITY BENEFITS

		2018/2019	2019/2020
		£	£
Child Benefit	First child	20.70	20.70
	Subsequent children	13.70	13.70
	Guardian's allowance	17.20	17.60
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 110.75	Up to 111.65
Attendance Allowance	Lower rate	57.30	58.70
	Higher rate	85.60	87.65
Basic State Pension	Single	125.95	129.20
	Married	201.45	201.45
Single Tier State Pension	Single	164.35	168.60
Pension Credit	Single person standard minimum guarantee	163.00	167.25
	Married couple standard minimum guarantee	248.80	255.25
	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
Jobseeker's Allowance	Age 18 - 24	57.90	57.90
	Age 25 or over	73.10	73.10
Statutory Maternity, Paternity and Adoption Pay		145.18	148.68

**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.*

CORPORATION TAX

	2018/2019	2019/2020
Standard rate	19%	19%

VALUE ADDED TAX

	2018/2019	2019/2020
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.

	Non residential
Value up to £150,000	0%
£150,001 and £250,000	2%
£250,001 and over	5%

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