

THE INSTITUTE OF CHARTERED FINANCIAL ANALYSTS, INC.

EXAMINATION III  
(June 15, 1963)

Section I - 9:45 A. M. - 12:00 P. M.

Four Questions

SECTION I

<u>Questions</u>	<u>Nature of Subject Matter</u>
No. 1 (required) . . . . .	Individual portfolio management
No. 2 (required) . . . . .	Valuation of stocks
No. 3 (required) . . . . .	Valuation of bonds
No. 4 (choice) . . . . .	Selection of securities
	<u>Either</u> . . . . . bonds
	<u>or</u> . . . . . stocks

***Candidates should accept all statistics contained in the questions as those prevailing at the time of the examination.***

Instructions to Candidate

1. Four questions must be answered. They have equal importance in grading. Arrange your time to spend, on the average, 30 minutes for each question.
2. Write legibly, and in ink.
3. Begin each question on a new page.
4. Write your Identification Number in the two spaces indicated on the front cover of your answer book. Fill in the other required information on the cover of your answer book.

### Question I (required) - Individual Portfolio Management

Mr. Joseph Cartman is 55 years old and now earns a salary of approximately \$62,000 annually as an executive of a leading chemical company. He has been earning in excess of \$25,000 per year for the past 10 years and during this time has accumulated a portfolio of securities as follows:

	Number Shares	Per Share		1963 Estimated	
		Cost	Current Mkt.	Earnings	Dividend
Avco Corp.	200	\$ 25	\$ 26	\$1.80	\$ .80
Bobbie Brooks	100	27	25	1.05	.40
Brunswick	250	40	16	1.25	.60
Crysler	200	35 (1)	53	6.00	1.00
Dupont	50	102	247	9.20	7.50
"	50	160	"	"	"
"	50	175	"	"	"
"	50	202	"	"	"

(1) Adjusted for 2 for 1 stock split in 1963

The above stocks were purchased between 1953 and the time of your analysis. Mr. Cartman subscribes to several "investment services" and has based his stock purchases on recommendations from these services.

Mr. Cartman is married and has two daughters in college. His salary and the income from the stocks listed above constitute the total of the family's annual income. He has adequate life insurance and liquid savings amounting to \$16,000. His pension benefits at age 65 will amount to \$12,000 per year.

At the close of 1953, the Dow-Jones Industrial Average was 275.04.

Following are selected market and yield statistics prevailing at the time of your analysis:

Dow-Jones Industrial Average	717.16
Standard and Poor's Index of 425 Industrials	73.19
Dividend Yield on Dow-Jones Industrial Average	3.25
Yield on municipal bonds	3.21
Yield on high grade corporate bonds	4.20
Yield on high grade preferred stocks	4.34
Yield on "growth" stocks	1.71

QUESTION: Mr. Cartman is dissatisfied with the results of this portfolio and has come to you for advice.

Assume Mr. Cartman's investment objective is maximum long-term after-tax return consistent with a reasonable degree of safety of principal. Outline briefly your advice to Mr. Cartman regarding his portfolio.

**Question II (required) - Valuation of Stocks**

"Retained earnings have value to stockholders only as a source of future dividends; thus, dividends, and not earnings, should be capitalized to arrive at stock valuations."

QUESTIONS:

1. Would the capitalization of dividends usually lead to a different valuation of a stock than the capitalization of earnings? Explain briefly.
2. If the capitalization of dividends leads to a different value than the capitalization of earnings, explain briefly the possible reasons for the difference.

**Question III (required) - Valuation of Bonds**

In determining the investment grade of bonds, it is common to use financial ratios for an industry and compare the bond under consideration with these ratios. Select a particular industry and give examples of at least three financial ratios for the industry. List and explain briefly the advantages and limitations of the ratios you have selected.

**Question IV - Selection of Securities (Choice of either (a) bonds or (b) stocks)**

N. B. Answer only (a) or (b)

(a) Bonds

Following are selected data pertaining to two public utility bond issues:

Cincinnati Gas & Electric Co. 1st 2 3/4's 1975  
Offered at 101 on October 18, 1945

	<u>1959</u>	<u>1960</u>	<u>1961</u>	<u>1962</u>
Interest and other fixed charge coverage after taxes	5.40	5.15	4.72	5.45
\$45,500,000 outstanding	Callable at 102 $\frac{1}{4}$			
Price range 1962-1963	82-86 $\frac{1}{2}$	Present Price	85 $\frac{1}{4}$ Bid	
Yield to maturity	4.18			
S & P's rating	AAA			
	Moody's rating Aaa			

Texas Electric Service Co. 1st 4½'s 1988  
 Offered at 101 5/8 on October 28, 1958

	<u>1959</u>	<u>1960</u>	<u>1961</u>	<u>1962</u>
Interest and other fixed charge coverage after taxes	5.71	5.63	4.11	4.52

\$10,000,000 outstanding      Callable at 105.31

Price range 1962-1963      99 3/4 - 103 1/2      Present Price      103 Bid

Yield to maturity    4.25

S & P's rating    AAA                      Moddy's rating    Aa

Standard and Poor's Utility Bond Yields

AAA = 4.30    AA = 4.34    A = 4.42

QUESTION: Based on the information given, which of the two bonds described above would you recommend for holding by a private financial institution with a sizable investment in public utility bonds? Explain briefly the basis for your selection.

(b) Stocks

Following are selected data pertaining to Ginn & Co. (NYSE GNN)

Current Price = 27¼	1962-1963 Price Range
Dividend = .65	16 3/8-32 3/8
Yield = 2.4%	Dow-Jones Industrial Average 717.16
	Price-Earnings Ratio for Dow-Jones
	Industrial Average 19.7
	Yield on Dow-Jones Industrial Average 3.25

Revenue & Earnings Statistics

	<u>Net Sales</u> (000)	<u>Net Income</u> (000)	<u>Per Share (1)</u> <u>Earnings</u>	<u>Per Share (1)</u> <u>Dividend</u>
1962	\$32,953	\$3,406	\$1.20	\$ .53
1961	32,665	3,179	1.12	.42
1960	27,088	2,468	.83	.30
1959	26,385	2,299	.82	.20
1958	25,710	1,666	.58	.20
1957	23,152	1,507	.52	.17
1956	20,141	1,296	.44	.17
1955	18,315	1,190	.39	.17

(1) Adjusted for 35-1 stock split in October, 1960.

## Balance Sheet Statistics

1962

Current Assets	\$23,089,000
Current Liabilities	7,340,000
Net Working Capital	<u>\$15,749,000</u>

Long-term debt -- None

Book value per common share

\$7.23

Common stock outstanding

2,835,745 Shares (\$1 par)

Approximately 12½% of the outstanding common stock is owned by officers and directors.

## Background Information

The company is one of the largest publishers of textbooks and related educational materials. Sales of the company are particularly strong at the elementary and high school levels with these institutions accounting for approximately 95% of the sales volume.

The staff of the college department has been increased and greater emphasis is being placed on the college market.

Within the past two years the company has entered the fields of standardized educational testing and audio-visual aids.

Sales representatives are used in the distribution of the company's products.

There are approximately 5,200 stockholders and 700 employees.

## Finances

817,391 shares of common stock were offered on November 29, 1960, at \$24.50, with 644,091 shares being sold for certain stockholders and the remaining shares representing new financing.

## Industry Outlook

Projections are for an expanding enrollment at all educational levels during the next decade. This increase in school enrollment should be reflected in increased textbook sales.

QUESTION: Mr. Robert Jones, 30 years of age, married and two children, has inherited a \$50,000 portfolio from his father. These securities consist of \$15,000 Government bonds, \$25,000 in municipal bonds, and \$10,000 in American Telephone and Telegraph common stock. Mr. Jones earns a salary of \$12,000 per year. He is considering selling the \$15,000 Government bonds and purchasing \$15,000 of Ginn & Company common stock.

Based on the information given, would you recommend the purchase of Ginn & Company stock for Mr. Jones? Explain briefly the reasons for your recommendation.

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THE INSTITUTE OF CHARTERED FINANCIAL ANALYSTS, INC.

EXAMINATION III  
(June 15, 1963)

Section II - 2:00 P. M. - 4:15 P. M.

Four Questions

SECTION II

<u>Questions</u>	<u>Nature of Subject Matter</u>
No. 1 (choice) . . . . .	Institutional portfolio management
Choose <u>one</u> of the following:	
(a) Investment companies	
(b) Endowment funds	
(c) Pension funds	
(d) Trust funds	
(e) Life insurance companies	
(f) Fire and casualty insurance companies	
(g) Commercial banks	
(h) Mutual savings banks	
No. 2 (required) . . . . .	Research organization and administration
No. 3 (required) . . . . .	Economic issues
No. 4 (required) . . . . .	Professional ethics

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**Question I - Institutional Portfolio Management (choose one of the following)**

(a) Investment Companies

The Income Mutual Fund is managed by the ABC Corporation. The fund was organized to serve investors primarily interested in current dividend income.

Primary objective of the Income Mutual Fund is to return as large an income as possible without undue risk of principal.

Net assets of the fund total \$125,000,000.

QUESTION: In relation to the stated investment objective of the fund, outline as specifically as possible a long-term investment policy to guide investment decisions. Explain the basis for the recommended policy.

(b) Endowment Funds

The national headquarters of a religious organization is responsible for the management of a \$50,000,000 endowment fund. The income from this fund is to be used for purchasing land to provide for the future growth of the organization.

The investment objective and certain aspects of the investment policies of the endowment as adopted by the trustees are as follows:

Objective: Maximum income consistent with preservation of principal.

- Policies:
- (1) No need for marketability as only the income from the fund is to be used in purchasing land.
  - (2) No need for municipal securities as the fund is tax exempt.
  - (3) All capital gains will be considered as a reserve for potential future losses.
  - (4) The fund will not consist of over 50% common stock at any time.
  - (5) All investment decisions will be made by the Investment Committee.
  - (6) All holdings of the fund will be reviewed annually by the Investment Committee.

The fund has never been more than 25% invested in common stocks with investments in corporate bonds currently at 60%, preferred stock at 15% and common stock 25%.

QUESTION: In view of the investment objective of the fund, would you recommend any changes in the policies stated above or in the execution of these policies? Explain fully your recommendations and the means for implementing any changes you recommend.

(c) Pension Funds

KLO Food Stores, Inc., has an uninsured pension fund amounting to \$5,000,000. Annual payments to the fund amount to \$500,000 and present claims amount to \$100,000 per year. The fund is expected to level off in 12 years.

Current investments of the fund are distributed as follows:

Cash	2%
U. S. Gov' t Bonds	10%
Corporate Bonds	60%
Preferred Stock	4%
Common Stock	19%
Other Assets	5%

QUESTION: Outline and explain briefly the investment objectives of this pension fund and the related investment policies you would recommend. Explain how these policies might be implemented.

(d) Trust Funds

The XYZ Bank & Trust Company is considering establishing a common trust fund. A careful study has been made of all trust accounts, and it has been determined that small trust accounts amounting in total to at least \$100,000 are likely candidates for the common trust fund.

QUESTIONS:

1. List and discuss briefly the advantages of a common trust fund to the participating trusts.
2. Discuss briefly the investment objectives of a balanced common trust fund and outline a suitable long-term investment policy for a fund of this type.

(e) Life Insurance Companies

Presented below is the financial condition of the Mutual Insurance Company.

<u>Assets</u>	<u>Amount</u>
Government Bonds	\$ 14,000,000
Corporate Bonds	56,000,000
Mortgages	16,000,000
Policy Loans	5,000,000
Other Assets	9,000,000
Total Assets	<u>\$100,000,000</u>
<u>Liabilities and Surplus</u>	
Insurance Reserves	\$ 64,000,000
Annuity Reserves	18,000,000
Policy Dividend Fund and Other Obligations	10,000,000
Surplus	8,000,000
Total Liabilities	<u>\$100,000,000</u>

Included in the stated investment policy of the Mutual Insurance Company are the following statements:

- (1) Mortgage investments will be only of the very best quality.
- (2) No direct placements will be made unless other investment opportunities are not available.
- (3) No funds will be invested in equity securities.

The directors of the above company are concerned over the low rate of return the company is getting on its investments. The average rate of interest earned on total invested assets was 3.50 per cent. before taxes in 1962. The Company has assumed an interest rate of 2.50 per cent. on policy reserves, etc., left with the Company for future disbursement.

Current yield on intermediate term government bonds is 3.78%, short-term government bonds 3.41%, AAA Industrial bonds 4.01%, and 30 Industrial Common Stocks 3.25%.

QUESTION: Based on the information given, state any changes you would recommend in the investment policies of the Mutual Insurance Company. Explain the basis for your recommendations.

(f) Fire and Casualty Insurance Companies

A large fire and casualty insurance company has included the following statements in its investment policy:

- (1) We will not invest in real estate.
- (2) We will not invest in mortgages.
- (3) We will not invest in long maturities.
- (4) We will not invest in corporate bonds.
- (5) We will not invest in speculative securities.

QUESTION: Examine each statement separately and explain the probable reasons why the company has taken the position as expressed in each of the statements.

(g) Commercial Banks

The MNO National Bank has been in business for one year. During this period deposits and loans have grown rapidly. However, bank officials expect the rate of growth of both loans and deposits to be only about 6% on the average for the next three to five years.

Reproduced below is the financial condition of the MNO National Bank:

Assets

Loans and Discounts		\$ 5,600,000
Investments:		
U. S. Treasury bills	\$5,500,000	
Other U.S. Obligations	2,500,000	
Municipal Securities	300,000	
Federal Reserve Bank Stock and Miscellaneous Investments	<u>100,000</u>	
	TOTAL INVESTMENTS	8,400,000
Cash & Due from Banks		2,000,000
Property		200,000
Other Assets		100,000
	TOTAL ASSETS	<u>\$16,300,000</u>

Liabilities

Demand Deposits		\$ 4,800,000
Time Deposits		7,500,000
Other Liabilities		500,000
Capital Stock		1,700,000
Surplus		1,300,000
Undivided Profits		400,000
Total Reserve Accounts		<u>100,000</u>
	TOTAL LIABILITIES	<u>\$16,300,000</u>

It is the opinion of the president of the MNO National Bank that a more positive investment program should now be initiated.

QUESTION: Based on the information given, outline and explain briefly a current investment policy for the MNO National Bank.

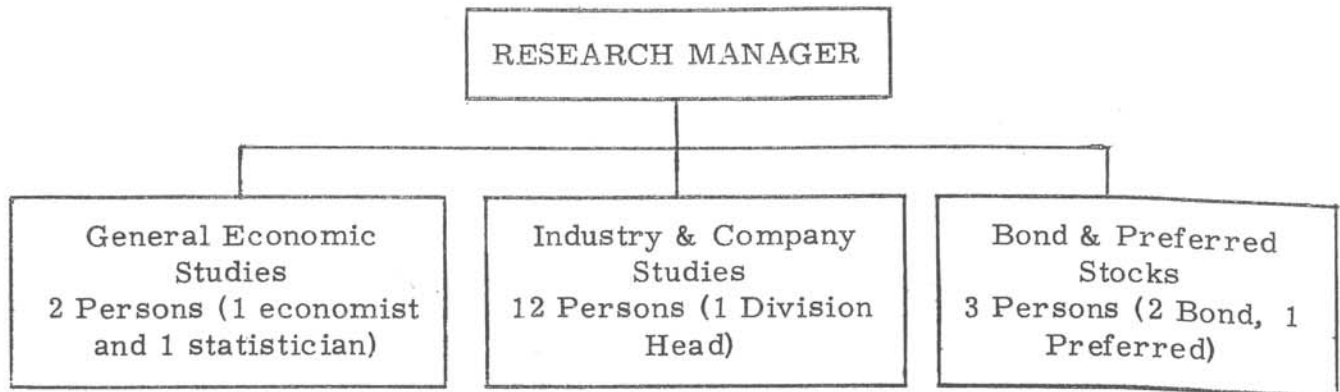
(h) Mutual Savings Banks

Outline and explain briefly an investment policy for a mutual savings bank with assets of \$100,000,000 and surplus accounts amounting to approximately \$9,000,000. Assume the state statutes permit 4% of total assets to be invested in preferred and common stocks which meet certain specified conditions.

**Question II (required) - Research Organization and Administration**

Batton and Burton is a financial firm employing 18 people in the area of investment research. The firm has experienced some difficulty in achieving efficient working relations between divisions of the research department.

The research department is organized as follows:



The general economic studies division is concerned with the analysis of general economic, social and political trends.

The industry and company studies division is further divided into small groups working with related industries. From these groups originate industry and company analytical studies.

The bond and preferred stock division concentrates on the analysis of government and municipal bonds and also on corporate bonds and preferred stocks. In the area of corporate issues, this division is assisted by the industry and company division.

**QUESTIONS:**

1. As the Research Manager in the organization described above, explain how you would improve the coordination of the three research divisions.
2. If the firm became interested in analyzing foreign securities, how would you organize research in this area? Explain the reasons for the recommended organization.

(please turn page)

**Question III (required) - Economics**

"I do not look for a resumption of inflation even in the face of the stimulus of the President's tax program in the next couple of years. I think that, once we get back to high levels of employment and production and investment, we will have to be ready to shift gears in monetary policy, and meet the problem of inflationary pressures as they develop."

Walter W. Heller, Chairman  
Council of Economic Advisors

QUESTIONS:

1. State the various assumptions underlying this statement.
2. What means could be employed to "shift gears in monetary policy"?

**Question IV (required) - Professional Ethics**

In a recent SEC ruling the Commission stated that a market letter written by an analyst "was designed to leave an impression with the reader that here was a recommendation produced by the 'research' department of a broker-dealer firm reflecting the objective weighing of significant developments in a new business."

QUESTION: What, in your opinion, constitutes "objective weighing" of factors affecting the operations of a company being analyzed by a professional financial analyst?

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