Financial Markets & Risk

Practice Questions
Session 5 and 6

2014

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1. Discuss the crucial risks that a typical Defined Benefit (DB) pension scheme faces. **(L)**

2. Short selling of equities has attracted much criticism of late. Explain the nature of short selling and the theory and recent evidence on the impact of short selling. Do you think it should be banned? Why?

3. Do you believe that alternative assets should play a role in portfolio construction for underfunded pension schemes? Why?

4. What are the pros and cons of both passive and active fund management techniques? Are there asset classes that lend themselves more obviously to one of these approaches?

5. What is the relationship between SAA and Tactical Asset Allocation (TAA)?

6. What risks does a typical Defined Benefit (DB) pension plan face? What are the sources of these risks?

7. What are the main features of typical mortgage backed securities, of CDSs and of CDOs?

8. How can credit derivatives (particularly CDSs) help in the management of corporate bond portfolios? What strategies can they be used to enhance?

9. What risks do investors face when using credit derivatives?

10. What is extension and contraction risk?

11. Why are institutional investors interested in buying ABSs and mortgage-backed securities when they are widely perceived to have been the source of the credit crisis and where many fell dramatically in value after the collapse of Lehman's?

12. How can CDSs be used by corporate bond fund managers to manage credit risk in their portfolios more efficiently compared with using the underlying cash market instead?

13. Describe the main features of both Mortgage Backed Securities (MBS) and Collateralised Mortgage Obligations (CMO) and explain where the main risks lie within these bonds.

14. How does contraction and extension risk arise in the context of MBSs and how what features have been incorporated in mortgage-backed securities in order to help mitigate these risks for some investors?

15. Describe the main features and risks embedded in a synthetic Collateralised Debt Obligation (CDO).

16. What are the pros and cons of passive versus active portfolio management?

17. Explain how *Defined Benefit* pension liabilities arise and how they are, in essence, analogous to the commitments made by issuers of both fixed coupon and index-linked bonds. **(M)**

18. What role can swaps play in reducing the impact of both inflation and interest rate risk inherent in a Defined Benefit pension scheme?