

21. Investment Process (3 Steps)

- This section provides a framework for formalizing the investment process.
- Investment Policy Statement – describes objectives and constraints, portfolio mgt strategy; schedule for monitoring. Familiarizes investors with process and disciplines mgr. Specifies benchmark and itemizes acceptable risks
- 1. Planning –
 - Determine Objectives – for required return and risk tolerance
 - Determine Constraints – 5 categories
 - Develop Strategy – consistent with objectives. Strategic asset allocation.
- 2. Execution – portfolio selection/composition and implementation
 - Tactical asset allocation and trading costs.
- 3. Feedback – performance evaluation and monitor.

Portfolio Mgt (1/2): Planning

- 1. Planning: Investment Policy Statement – describes objectives and constraints, portfolio mgt strategy; schedule for monitoring. Familiarizes investors with process and disciplines mgr. Specifies benchmark and itemizes acceptable risks.
 - Determine objectives – include % value for expected return and risk tolerance.

Return obj (3-15%) – cap preservation, cap appreciation, income, total return. Should be consistent to fund expected liabilities, such as retirement.

Risk tolerance (0-20%+) – depends on life cycle, wealth, cash, personality.

Common lifecycle:

- Accumulation phase (20-40) – Long time horizon and growing earnings.
- Consolidation phase (50-60) – Fairly long horizon and earnings exceed needs.
- Spending phase - No earnings and shorter horizon.
- Gifting phase - estate planning and tax minimization.

Asset Allocation Examples

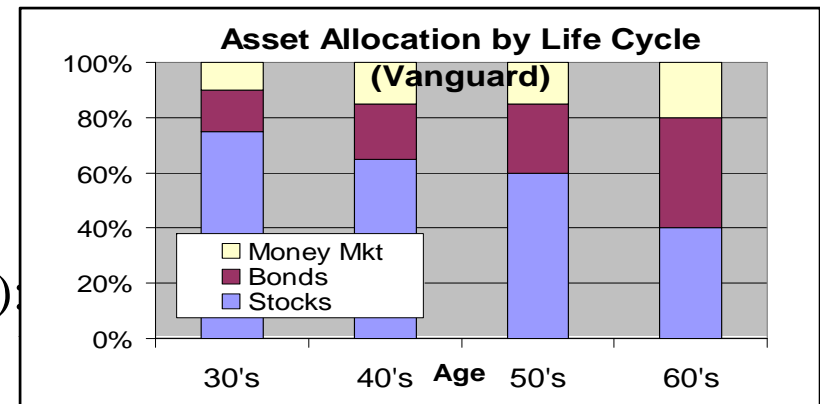
- Return Objective and risk tolerance will determine benchmark asset allocation.

Asset Classes Ranked by Risk:

- Cash (money market)
- Bonds (short to long maturity)
- Stocks (large/value to small/growth)

- Examples (from financial institutions web sites)

- Vanguard



- Conservative – income is top priority, low volatility is important.
 - Cash 10%
 - Bonds 70% (short-term 30%, intermediate 30%, long-term 10%)
 - Stocks (large cap) 20%
- Very Aggressive – growth is very important and extreme volatility is tolerable.
 - Cash 0%
 - Bonds 0%
 - Stocks 100% (large cap 60%, small cap 20%, international 15%, emerging mkts 5%)

Portfolio Mgt (2/2): Strategy & Execute

- 1. Planning (continued) – Objectives on slide1
 - Constraints (5) – liquidity, time horizon, unique, legal/regulatory, tax.
In addition, prudent investor rule constrains professional investors.
 - Develop strategy – to be consistent with return objective and risk tolerance.
Strategic asset allocation – benchmark based on long-term (5 yr +) forecast.

Management may be passive (avg return with specified risk) or active (pick asset class or securities to earn above avg returns).
- 2. Execution – portfolio selection/composition and implementation
 - Tactical asset alloc – deviate from strategic based on current (1 yr) environ.
Ex: deviate from strategic asset allocation by 10%.
Ex: sector rotation within asset class (corp/govt bonds, value/growth stocks).
 - Implementation – min trading costs (spread, price impact, commissions)
- 3. Feedback – Performance evaluation and monitoring
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Investor Objectives and Constraints

- Individual Investors – an example of an IPS for an individual is on next slide.
- Pension Funds – Defined benefit (vs defined contribution).
 - Obj: Fund liabilities actuarially, low risk. Constraint: long horizon, tax deferred
- Endowment Funds – Gifts to nonprofits that are invested and utilized.
 - Obj: Usually above avg risk. Constraint: low liquidity, long horizon, no taxes
- Personal Trusts – Individual confers legal title to agent, who manages property.
 - Obj: Usually narrow and risk adverse. Constraint: liquidity, variable taxes.
- Life Insurance Co – Investments hedged against claims.
 - Obj: Low risk, actuarial return. Constraint: long horizon, complex reg.
- Banks –
 - Obj: Spread on assets over deposits. Con: sufficient liquidity; short horizon
- Mutual Funds – Policy statement prospectus.
 - Obj: Variable risk tolerance. Con: liquidity, horizon, taxes

Ex. Personal Investment Policy (1/2)

- Planning
 - Investment Policy Statement – the subject is in accumulation phase and
 - seeks to provide for retirement and college for two children.
 - has sufficient cash reserves to replace auto and other immediate needs.
 - personality analysis indicates a moderate risk tolerance, which is consistent with previous trading behavior, stated tolerance for risk, and survey results.
 - Contributes about 12% of salary to tax-deferred accounts annually.
 - (Could add more detail, such as present value of liabilities)

Objectives –

Return of 8% is sufficient to fund indicated liabilities, via total return.

Risk tolerance –

Constraints –

Liquidity - Some (e.g., pay cash for autos);

Horizon -

Taxes -

Ex. Personal Investment Policy (2/2)

- Investment Policy Statement –
- Planning (cont'd)
 - Objectives –
 - Constraints –

 - Develop Strategy – for asset allocation
Strategic – 70% US stocks; 10% T-bonds, 10% Corp bonds; 10% cash;
Benchmark:

Security Selection (non-401k) – Top-down analysis with enhanced indexing.

Life insurance – 0-10 times salary, depending on family and savings.
Cash Reserve –
- Execution – choose actual securities/asset classes.
 - Tactical asset alloc – based on current mkt overweight corporate bonds.
- Feedback – Monitor at Morningstar X-ray. Modify/Rebalance annually