BASICS OF PORTFOLIO PLANNING AND CONSTRUCTION

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INTRO

1. Impossible to do a good job if you don't understand the needs, constraints and circumstances of the client

2. The IPS begins with objectives of the investor in terms of return and risk

   - Return and risk objectives should be congruent
   - Return expectations should be compatible too with the investor's risk tolerance

Describe the major components of an IPS;

1. Description of the **circumstances** of the Client
2. Purpose of the IPS
3. Duties and responsibilities of all parties
4. Procedures to update the IPS, and to resolve problems if appear
5. Investment objectives and constraints
6. Investment guidelines — Level of Leverage, Asset Classes Permitted, etc ...
7. Evaluation of performance → Benchmark, fees, taxes
8. Appendices → Strategic Asset Allocation, rebalancing procedures, permitted deviations from target asset allocation

Describe risk and return objectives and how they may be developed for a client;

Distinguish between the willingness and the ability (capacity) to take risk in analyzing an investor's financial risk tolerance;

Describe risk and return objectives and how they may be developed for a client;

PORFOLIO RISK CONGRUENT WITH INVESTOR'S RISK TOLERANCE

Distinguish between the willingness and the ability (capacity) to take risk in analyzing an investor's financial risk tolerance;

RISK

1 ABSOLUTE

σ, VAR, σ^2

- No drop in value greater than 3% over the next 12 months
- No greater than a 6% probability of a loss of more than $30,000 over the next 12-months

2 RELATIVE

$TE = R_P - R_B$

$$TE = \sqrt{\frac{\sum(R_P - R_B)^2}{n-1}}$$

RETURN

1 ABSOLUTE

Pre or post

- MFs
- Taxes
- Inflation

2 RELATIVE

Realistic and congruent with Risk

INVESTMENT OBJECTIVES

Should include both risk and return objectives → Trade off between risk and return

FACTORS AFFECTING THE RISK TOLERANCE OF AN INVESTOR

1. PSYCHOLOGICAL FACTORS

2. PERSONAL FACTORS
   - Age
   - Family circumstances
   - Level of current wealth
   - Cash Reserves
   - Current Income
   - Existence of Insurance

Distinguish between the willingness and the ability (capacity) to take risk in analyzing an investor's financial risk tolerance;

WILLINGNESS TO TAKE RISK

Depends on psychological factors

- Attitudes, Believes, etc…

ABILITY TO TAKE RISK

Depends on actual circumstances

- Level of wealth
- Level of current income
- Liquidity needs
- Time Horizon

IF	Willingness > Ability	→	Advise according to Ability
IF	Ability > Willingness	→	Educate the Investor about investment risk without trying to influence his/her personality or psychological characteristics

WILLINGNESS
High
Low
LOW RISK TOLERANCE
HIGH RISK TOLERANCE
LOW RISK TOLERANCE
LOW BUT EDUCATE
Low
High
ABILITY

Describe the investment constraints of liquidity, time horizon, tax concerns, legal and regulatory factors, and unique circumstances and their implications for the choice of portfolio assets;

1. **LIQUIDITY** → Potential Need for cash

Tuition, parental care, medical expenses

2. **LEGAL & REGULATORY** → More to institutional investors and banks and insurance companies
3. **TIME HORIZON** → Time until the money is needed
4. **TAX ASPECTS** → Tax exempt? Tax deferred? Taxable
5. **UNIQUE CIRCUMSTANCES** → Other aspects not included in #1 - #4

ESG, Ethical considerations

Explain the specification of asset classes in relation to asset allocation;

Asset Class	Subtype I	Subtype II
Cash	comm. paper t-bills	
Equities	Large Caps small caps	Developed Developing
Fixed-Income	Corporate Sovereign	High Yield Inv. Grade
Real Estate	Residential Commercial	
Alternative Investments		

1. Based on the expected returns, risks and correlations of the different asset classes
2. The correlation of returns of the assets within an asset class tend to be relatively high
3. The correlation of returns between different asset classes should be low

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Alternative Investments		

1

Historically, only cash equities, bonds, and RE.
Recently →collectively as alternative investments.(HFs , PE, commodities, etc…)

2

Further divisions withing Equities and Fixed-Income

1. Construct an efficient frontier based upon the risk, expected returns, and correlations of different asset classes

2. Use the objectives and constraints from the IPS to select and optimal portfolio (strategic asset allocation)

3. Take advantage of tactical deviations from the strategic asset allocation if permitted and appropriate (and of security selection)

   - 3.1. Tactical Asset Allocation
   - 3.2. Security Selection

4. Risk Budgeting → Process of allocating the agreed upon risk to the strategic asset allocation, tactical asset allocation and security selection

Asset Class	E(r)	Risk
Cash	1%	0%
Equities	9%	15%
Fixed-Income	3%	2%
Real Estate	12%	20%
Alternative Investments	15%	40%

IPS. E(r)=7%. σ= 11%

Asset Class	E(r)	Risk	Weight	E(r)	Risk
Cash	1%	0%	10%	0%	0%
Equities	9%	15%	30%	3%	5%
Fixed-Income	3%	2%	40%	1%	1%
Real Estate	12%	20%	10%	1%	2%
Alternative Investments	15%	40%	10%	2%	4%
			Total	6,7%	11,3%

ISSUES RELATED TO ACTIVE PORTFOLIO MANAGEMENT

1. It is possible that an investor has different PMs using active strategies (one underweights one stock and the other overweight's), with the possibility of eliminating active exposure

2. Excessive trading leading to very high commissions, taxes and underperformance

SOLUTION

CORE-SATELLITE APPROACH

CORE PORTION OF THE PORTFOLIO INVESTED PASSIVELY

SATELLITE PORTION OF THE PORTFOLIO INVESTED ACTIVELY

1. **Negative Screening:** (ie You can't invest in tobacco and oil & gas companies)

   If the investment universe where the PM can choose securities is limited by negative screening, using as benchmark a broad index is not fair. The use of an Index that excludes excluded is more appropriate (and commonly available).

2. **Positive Screening: (aka best-in clase invesing).** Investing in the securities of companies that have positive ESG practices

   The way investors define the criteria to choose which companies to invest in differ among investors and hence both the portfolios and the benchmarks must be customized

3. **Thematic Investing:** Invest in companies or industries in order to promote best practices in ESG terms.

   Oftentimes it requires a PM that specializes in this kind of investing.

4. **Engagement/active ownership investing:** Using the rights attached to owning shares (influencing Board Members and Managers) to influence the Company towards the improving its ESG practices.

   When active ownership investing is the case, the PM should clarify whether the client will directly vote her shares or whether the PM should vote her shares according to ESG factors specified beforehand.

Irrespective of the ESG approach chosen by the investor, the PM should make clear to the investor that:

- ESG constraints will likely affect performance.
- Reducing the investment universe for choosing securities is likely to decrease returns,
- However, investing in Companies with good Corporate Governance has proven to increase returns