CHAPTER 1

THE PORTFOLIO MANAGEMENT PROCESS AND THE INVESTMENT POLICY STATEMENT

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LEARNING OUTCOMES

After completing this chapter, you will be able to do the following:

- Justify the importance of the portfolio perspective.
- Formulate the steps of the portfolio management process and the components of those steps.
- Compare and contrast the types of investment objectives.
- Contrast the types of investment constraints.
- Justify the central role of the investment policy statement in the portfolio management process.
- Review the elements of an investment policy statement and distinguish among the components within (1) the risk objective, (2) the return objective, and (3) the time horizon constraint.
- Compare and contrast passive, active, and semiactive approaches to investing.
- Discuss the role of capital market expectations in the portfolio management process.
- Discuss the role of strategic asset allocation in the portfolio management process.
- Discuss the roles of portfolio selection/composition and portfolio implementation in the portfolio management process.
- Contrast the elements of performance evaluation.
- Explain the purpose of monitoring and rebalancing.
- Formulate the elements of portfolio management as an ongoing process.
- Formulate and justify a risk objective for an investor.
- Formulate and justify a return objective for an investor.
- Determine the liquidity requirement of an investor and evaluate the effects of a liquidity requirement on portfolio choice.
- Contrast the types of time horizons, determine the time horizon for an investor, and evaluate the effects of the investor's time horizon on portfolio choice.
- Determine the tax concerns, legal and regulatory factors, and unique circumstances for an investor and evaluate their effects on portfolio choice.
- Justify ethical conduct as a requirement for managing investment portfolios.

SUMMARY OVERVIEW

In Chapter 1, we have presented the portfolio management process and the elements of the investment policy statement.

- According to the portfolio perspective, individual investments should be judged in the context of how much risk they add to a portfolio rather than on how risky they are on a stand-alone basis.
- The three steps in the portfolio management process are the planning step (objectives and constraint determination, investment policy statement creation, capital market expectation formation, and strategic asset allocation creation); the execution step (portfolio selection/composition and portfolio implementation); and the feedback step (performance evaluation and portfolio monitoring and rebalancing).

- Investment objectives are specific and measurable desired performance outcomes, and constraints are limitations on the ability to make use of particular investments. The two types of objectives are risk and return. The two types of constraints are internal (posed by the characteristics of the investor) and external (imposed by outside agencies).
- An investment policy statement (IPS) is a written planning document that governs all investment decisions for the client. This document integrates a client's needs, preferences, and circumstances into a statement of that client's objectives and constraints.
- A policy or strategic asset allocation establishes exposures to IPS-permissible asset classes in a manner designed to satisfy the client's long-run objectives and constraints. The plan reflects the interaction of objectives and constraints with long-run capital market expectations.
- In a passive investment strategy approach, portfolio composition does not react to changes in expectations; an example is indexing, which involves a fixed portfolio designed to replicate the returns on an index. An active approach involves holding a portfolio different from a benchmark or comparison portfolio for the purpose of producing positive excess risk-adjusted returns. A semiactive approach refers to an indexing approach with controlled use of weights different from the benchmark.
- The portfolio selection/composition decision concerns portfolio construction and often uses portfolio optimization to combine assets efficiently to achieve return and risk objectives. The portfolio implementation decision concerns the trading desk function of implementing portfolio decisions and involves explicit and implicit transaction costs.
- The elements of performance evaluation are performance measurement, attribution, and appraisal. Performance measurement is the calculation of portfolio rates of return. Performance attribution is the analysis of those rates of return to determine the factors that explain how the return was achieved. Performance appraisal assesses how well the portfolio manager performed on a risk-adjusted basis, whether absolute or relative to a benchmark.
- Portfolio monitoring and rebalancing use feedback to manage ongoing exposures to available investment opportunities in order to continually satisfy the client's current objectives and constraints.
- Portfolio management is an ongoing process in which the investment objectives and constraints are identified and specified, investment policies and strategies are developed, the portfolio composition is decided in detail, portfolio decisions are initiated by portfolio managers and implemented by traders, portfolio performance is evaluated, investor and market conditions are monitored, and any necessary rebalancing is implemented.
- The steps to determine a risk objective include: (1) specify a risk measure (or measures) such as standard deviation, (2) determine the investor's willingness to take risk, (3) determine the investor's ability to take risk, (4) synthesize the investor's willingness and ability into the investor's risk tolerance, and (5) specify an objective using the measure(s) in the first step above.
- The steps to determine a return objective include: (1) specify a return measure such as total nominal return, (2) determine the investor's stated return desire, (3) determine the investor's required rate of return, and (4) specify an objective in terms of the return measure in the first step above.
- A liquidity requirement is a need for cash in excess of the contribution rate or the savings rate at a specified point in time. This need may be either anticipated or unanticipated.
- A time horizon is the time period associated with an investment objective. Investment objectives and associated time horizons may be short term, long term, or a combination

of these two. A multistage horizon is a combination of shorter-term and longer-term horizons. A time horizon can be considered a constraint because shorter time horizons generally indicate lower risk tolerance and hence constrain portfolio choice, making it more conservative.

- A tax concern is any issue arising from a tax structure that reduces the amount of the total return that can be used for current needs or reinvested for future growth. Tax concerns constrain portfolio choice. If differences exist between the tax rates applying to investment income and capital gains, tax considerations will influence the choice of investment.
- Legal and regulatory factors are external considerations that may constrain investment decision making. For example, a government agency may limit the use of certain asset classes in retirement portfolios.

Unique circumstances are internal factors (other than a liquidity requirement, time horizon, or tax concerns) that may constrain portfolio choices. For example, an investor seeking to avoid investments in tobacco companies will place an internal constraint on portfolio choice.

PROBLEMS

1. A. An individual expects to save €50,000 during the coming year from income from non-portfolio sources, such as salary. She will need €95,000 within the year to make a down payment for a house purchase. What is her liquidity requirement for the coming year?

   B. Endowments are funds that are typically owned by nonprofit institutions involved in educational, medical, cultural, and other charitable activities. Classified as institutional investors, endowments are almost always established with the intent of lasting into perpetuity.

   The Wilson-Fowler Endowment was established in the United States to provide financial support to Wilson-Fowler College. An endowment's spending rate defines the fraction of endowment assets distributed to the supported institution. The Wilson-Fowler Endowment has established a spending rate of 4 percent a year; the endowment follows the simple rule of spending, in a given year, an amount equal to 4% × (Market value of the endowment at the end of the prior year). This amount is committed to the budgetary support of the college for the coming year. At the end of the prior year, the market value of the Wilson-Fowler Endowment's assets stood at $75 million. In addition, the Wilson-Fowler Endowment has committed to contribute $1 million in the coming year to the construction of a new student dormitory. Planners at the endowment expect the endowment to receive contributions or gifts (from alumni and other sources) of $400,000 over the coming year. What is the anticipated liquidity requirement of the Wilson-Fowler Endowment for the coming year?

2. The Executive Director of the Judd University Endowment estimates that the capital markets will provide a 9 percent expected return for an endowment portfolio taking above-average risk, and a 7 percent expected return for an endowment portfolio taking average risk. The Judd Endowment provides tuition scholarships for Judd University students. The spending rate has been 4 percent, and the expected tuition inflation rate is 3 percent. Recently, university officials have pressured the endowment to increase the spending rate to 6 percent. The endowment has an average to below-average ability to accept risk and only an average willingness to take risk, but a university official claims

that the risk tolerance should be raised because higher returns are needed. Discuss an appropriate return objective and risk tolerance for the Judd Endowment.

3. Stux (1994) describes a country allocation strategy across five major equity markets: the United States, the United Kingdom, Germany, France, and Japan. In this strategy, a measure of relative attractiveness among the five equity markets is used as a factor in determining the weights of the five equity markets in the overall portfolio. The investment in each country, however, whatever the country's weight, is an indexed investment in the equity market of that country. The weights of the five equity markets in the overall portfolio generally are expected to differ from benchmark weights (the weights of the countries in an appropriate benchmark for the international equity market), within limits.

   A. Characterize the two components (portfolio weights and within-country investments) of the country allocation strategy using the text's framework for classifying investment strategies.
   B. Characterize the country allocation strategy overall.

4. Characterize each of the investment objectives given below as one of the following: an absolute risk objective, a relative risk objective, an absolute return objective, or a relative return objective.

   A. Achieve a rate of return of 8 percent a year.
   B. Limit the standard deviation of portfolio returns to 20 percent a year or less.
   C. Achieve returns in the top quartile of the portfolio's peer universe (the set of portfolios with similar investment objectives and characteristics).
   D. Maintain a 10 percent or smaller probability that the portfolio's return falls below the threshold level of 5 percent per annum over a one-year time horizon.
   E. Achieve a tracking risk of no more than 4 percent per annum with respect to the portfolio's benchmark.

Questions 5 through 10 relate to James Stephenson. Select and justify the best answer.

James Stephenson, age 55 and single, is a surgeon who has accumulated a substantial investment portfolio without a clear long-term strategy in mind. Two of his patients who work in financial markets comment as follows:

- James Hrdina: "My investment firm, based on its experience with investors, has standard investment policy statements in five categories. You would be better served to adopt one of these standard policy statements instead of spending time developing a policy based on your individual circumstances."
- Charles Gionta: "Developing a long-term policy can be unwise given the fluctuations of the market. You want your investment adviser to react continuously to changing conditions and not be limited by a set policy."

Stephenson hires a financial adviser, Caroline Coppa. At their initial meeting, Coppa compiles the following notes:

Stephenson currently has a $2.0 million portfolio that has a large concentration in small-capitalization U.S. equities. Over the past five years, the portfolio has averaged 20 percent annual total return on investment. Stephenson hopes that, over the long term, his portfolio will continue to earn 20 percent annually. When asked about his

risk tolerance, he described it as "average." He was surprised when informed that U.S. small-cap portfolios have experienced extremely high volatility.

He does not expect to retire before age 70. His current income is more than sufficient to meet his expenses. Upon retirement, he plans to sell his surgical practice and use the proceeds to purchase an annuity to cover his postretirement cash flow needs.

Both his income and realized capital gains are taxed at a 30 percent rate. No pertinent legal or regulatory issues apply. He has no pension or retirement plan but does have sufficient health insurance for postretirement needs.

5. The comments about investment policy statements made by Stephenson's patients are *best* characterized as

	Hrdina	Gionta
A.	Correct	Correct
B.	Correct	Incorrect
C.	Incorrect	Correct
D.	Incorrect	Incorrect

6. In formulating the return objective for Stephenson's investment policy statement, the *most* appropriate determining factor for Coppa to focus on is

A. Return desires
B. Ability to take risk
C. Return requirement
D. Stephenson's returns over past five years

7. Stephenson's willingness and ability to accept risk can be *best* characterized as

	Willingness to Accept Risk	Ability to Accept Risk
A.	Below average	Below average
B.	Below average	Above average
C.	Above average	Below average
D.	Above average	Above average

8. Stephenson's tax and liquidity constraints can be *best* characterized as

	Tax Constraint	Liquidity Constraint
A.	Significant	Significant
B.	Significant	Insignificant
C.	Insignificant	Significant
D.	Insignificant	Insignificant

9. Stephenson's time horizon is best characterized as

A. Short-term and single-stage
B. Short-term and multistage