Investment Planning Answer Book by Jay L. Shein, Investment Planning Essentials

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Investment planning is a process. This process begins with gathering client data whether it be a private investor, a trust, or institution. Before the advisor can make recommendations regarding an investment portfolio, they must gather data to determine the client's investment goals and priorities. This process will culminate with the writing of an investment policy statement which will function as the roadmap for the client and adviser for portfolio management and design. The advisor must gather as much data as possible in order to adequately design portfolios that accomplish the investor's goals.

Investment Planning Answer Book by Jay L. Shein, Q 1:1, What is the data gathering process for the investor and advisor?

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In order to formulate an investment plan for an investor, the advisor must gather sufficient information. The process begins with a meeting with the investor(s) where data is gathered, preferably with the use of an investment policy questionnaire (IPQ). It is important that all parties involved be present at this meeting (e.g., spouse or co-trustee). Some of the basic information that should be gathered includes the following: their names, address, phone number, place of birth and citizenship, social security number, marital status, occupation, employer, business address and phone number, cell phone number, and e-mail address. The same information should be gathered for the children and grandchildren. Because the advisor should always be tax aware, it is important to note the tax bracket of the investors. The best practice for gathering tax information is to make sure investors bring their tax returns for at least the last two years. The investment advisor would be well off if his focus is being tax aware and not tax efficient. Being aware of how investment decisions are affected by taxes is important, but it is equally important not to let tax decisions overshadow good economic investment decisions.

Investment Planning Answer Book by Jay L. Shein, Q 1:2, What is some of the information needed regarding goals and priorities for the investment policy statement?

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At this point, a description of the investor, trust, or institution's financial goals would be appropriate. This should include the beginning and ending date of these goals and what inflation rate should be assumed when designing a portfolio to meet these financial goals. The investor/client may have multiple goals. An investor may need to plan for both retirement funding, education goals for children or grandchildren, and the purchase of another home at some future date. A trust may need to provide income to beneficiaries and their descendents for many years. Institutions such as endowments and pension plans may have spending policies or future liabilities that need to be taken into account. Each of these goals needs to be taken into consideration when designing an investment portfolio and writing an investment policy statement.

If the investor or institution has unrealistic goals, it is important to point that out to him. It may be required for him to reduce his financial goals, increase his contributions, or, in the case of retirement planning, work longer. An example of an unrealistic goal might be as follows: Mr. and Mrs. X have a one million dollar portfolio and plan on retiring in ten years with no additional contributions and are expecting nine percent return on their portfolio. They would like to receive a retirement income from their portfolio of 200,000 dollars per year, while maintaining the purchasing power of their income stream and principle. They also wish to leave one million in today's dollars to their heirs. However, this is probably an unrealistic and unattainable goal for Mr. and Mrs. X.

Investment Planning Answer Book by Jay L. Shein, Q 1:3, How do risk and return function in portfolio design?

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In order for investors to meet their goals, certain assumptions will have to be made regarding expected return and risk. Each investor will have a different tolerance for risk, which will change over time. It is important for the advisor and investor to come to an agreement on the amount of risk an investor can tolerate in order to reach their respective goals. Investors typically look at nominal return but should focus on inflation-adjusted rates of return. If the expected return of an investor does not maintain its purchasing power over time, the investor will have difficulty meeting her goals. If the risk is too great, the investor might not be able to stay with the portfolio over time. For example, one investor might be able to tolerate a drop in her portfolio twenty-five percent in any given year, while another investor might be only able to tolerate ten percent.

Part of the process of portfolio design will require the advisor to discuss and educate the investors regarding capital market expectations and portfolio volatility. Using capital market history for investment education is a valuable tool. While history gives no indication of the future, without studying it, everything is conjecture and speculation. One caution that should be noted here is that relying too much on history can result in portfolio design that will be inappropriate for the investor. One strategy that can be used to demonstrate the difference between risk and return amongst different portfolios would be to show an investor a few different portfolios with a minimal number of asset classes. This will at least reveal the trade-offs between risk and return. One tool that can be used in this education process is a mean-variance optimizer. The mean-variance optimizer should not be completely relied on for portfolio design but functions as an excellent educational tool.

Risk can have many definitions including the following: the inability to reach one's goals, the fluctuation in portfolio values, or the risk that the purchasing power of the investment portfolio will be eroded over time. Each one of these is an important component of investment planning.

Investment Planning Answer Book by Jay L. Shein, Q 1:4, Why are time horizons important?

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The concept that above-average returns can offset below-average returns over long periods of time is known as time diversification. This is based on the concept that returns are independent from each other from year to year. Because of this, the annualized standard deviations diminish over time. As a result, the probability that returns will be negative in any one year is very high, but the probability that returns will be negative over long periods of time is very low. This is why many investors are comfortable with a portfolio of risky assets over long periods of time but are not comfortable with this in shorter periods of time.

Paul Samuelson, the 1970 Nobel Prize recipient for economics, disagreed with this concept and argued that the most important issue was the terminal wealth of the investor, not the annualized return. With this assumption, the magnitude of the potential loss in portfolio value increases over long periods of time, while the chance of losing money over long periods of time decreases. Because of the risk to an investor, portfolios should be designed to deal with short, intermediate and long-term investment volatility.

With the recent history of portfolio volatility such as that which occurred from 2000 to 2002 and in 2008, it might be difficult for individual investors to stay with their investment policies when it experiences so much fluctuation in value. Therefore, investment advisors must manage investor expectations, especially in the shorter and intermediate periods of time.

Investment Planning Answer Book by Jay L. Shein, Q 1:5, What are the differences in time horizons for private investors versus institutional investors?

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Many individual investors seem to have a long-term investment horizon but a short-term evaluation horizon. Trusts that live in perpetuity may have a longer-term evaluation horizon. When the investor is an institutional investor, such as an endowment, its investment horizon and evaluation horizon may be more congruent. Institutional investors may have time horizons that stretch out fifty years or more, with contributions added to the portfolio on a continuous basis.

Large institutional investors are typically investing for longer periods of time than the private investor. Because of this, the institutional investor's liquidity restraints are less. For instance, an institutional investor might invest in timberland, which may not be profitable for many years. However, the private investor might not be able to wait ten or fifteen years for adequate profits with an investment that could be difficult to sell if needed.

Investment Planning Answer Book by Jay L. Shein, Q 1:6, Are there different definitions of risk?

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Many advisors and investors think of risk as a probability of losing all of their money. Advisors might just think of risk in the context of standard deviation or the volatility of portfolio values. Portfolio volatility is a concern for both individual and institutional investors. Many times, investors feel that if their portfolio is up in value, they have made money, and if their portfolio is down in value, they have lost money. Yet in neither case has a gain or loss been realized.

There is no such thing as a riskless portfolio. A portfolio of insured certificates of deposits (CDs) can seem to be riskfree, yet it has a tremendous amount of purchasing-power risk. Additionally, when CDs are held in taxable accounts, their earnings are taxed at the highest marginal income tax bracket for individuals and trusts. For example, let's assume that a CD pays three percent, inflation is three percent, and the investor's marginal tax bracket is thirty-five percent. In this example, the inflation-adjusted, after-tax return is approximately negative two percent. This obviously is not risk free.

It is important for investors to focus on real rates of return (inflation adjusted), not nominal returns. It is apparent that investors face many risks. Over longer periods of time, the erosion of the purchasing power can be significant. In shorter periods of time, the portfolio fluctuations can cause concern. Riskier assets such as stocks are more likely to maintain purchasing power over long periods of time. When investors are more familiar with a particular investment, they seem to view that investment as less risky. An investor may own a business that is highly leveraged, but they might not view that business as a high risk investment. The more familiar an investor becomes with the capital markets, the less risky he may view them. Investors tend to become risk-takers when capital markets are doing well and risk-avoiders when capital markets are doing poorly. This is more likely to be the opposite of the position they should take. The investors' risk tolerance will change over time and may be very dependent on their understanding of the capital markets and the fluctuations they observe in their portfolio values. Simply discussing capital market history might not be sufficient. History does not necessarily repeat itself, so some discussion should be based on expected outcomes, not historical ones. While history may have some value when explaining these concepts to investors, it should not be explained as being an indication or guarantee of the future.

Investment Planning Answer Book by Jay L. Shein, Q 1:7, What questions can help elicit an investor's tolerance for risk?

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Using more than one question to evaluate an investor's tolerance for risk is the best approach. Before asking risk tolerance questions, a brief discussion on return versus volatility will help frame the questions with the proper perspective. Example: Achieving the highest returns over time has typically involved higher risk (fluctuation of principal value). The higher return that an investor expects, the higher the fluctuations in portfolio value that can be expected. Investors willing to weather short-term fluctuations of usually a year or less, at least in the past, have been well rewarded. The following questions can be used:

- On a scale from 1 to 100, what would you consider yourself in regards to your risk tolerance (1 being low risk tolerance, 100 being high risk tolerance)?
- If you could achieve your expected investment returns, how much decline are you willing to tolerate in any one year period in your investment portfolio (Choices: None, 0-5%, 5-10%, 10-15%, 15-20%, greater than 20%)?
- An all stock portfolio can take as much as four years or more to recover from a bad market decline and bonds can take two years or more to recover. Understanding that it is impossible to protect from occasional losses, fill in the blank in the following statement: If my portfolio could produce the long term returns that allow me to accomplish my goals and objectives, I can live with a recovery period of _______ (Choices: less than 1 year, 1-2 years, 2-3 years, or greater than 3 years).
- If your choice was less than 1 year or between 1 and 2 years, are you prepared to significantly lower your goals?
- Each investor may define risk differently. Rank the following statements using the following scale (1 would mean it worries you the most and 4 would mean it worries you the least):

    - I would be very concerned if I did not achieve the return on my portfolio that I expected. 1 2 3 4
    - I would be very concerned if my portfolio was worth less in "real" dollars because of inflation eroding the purchasing power. 1 2 3 4
    - I would be concerned if my portfolio dropped substantially in value over a one-year period of time. 1 2 3 4
    - I would be very concerned if my portfolio dropped substantially in value over a longer period of time, such as five years or more. 1 2 3 4

Investment Planning Answer Book by Jay L. Shein, Q 1:8, Can investment portfolios have restrictions or diversification restraints?

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Having multiple asset classes in a portfolio can lower the volatility of a portfolio since each asset class can react differently to different economic stimuli. Investors should stipulate any asset type or class that they are not willing to consider. Prudent diversification strategies would typically have a minimum of three asset classes such as stocks, bonds, and cash equivalents. In most cases, the investment advisor will be managing a portfolio with discretionary authority subject to investment policy. Except for the situation in which the investor has an aversion to a specific asset type, all asset types should be considered. When an investment advisor is managing the wealth of an investor, they should review the investment vehicles that can be considered in a portfolio to make sure the investor is comfortable with all the investment vehicles. Usually, the investor will leave this decision up to the wealth manager and many or all investment vehicles will be considered.

Investment Planning Answer Book by Jay L. Shein, Q 1:9, Do investment portfolios have liquidity constraints?

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Depending on the goals, objectives, and current situation of an investor, they may require some of their funds to be kept in a cash or cash equivalent type of investment. In most investment portfolios, cash will be handled separately, and there will be no liquidity needs in the investment portfolio. It should be determined what percent of an investor's portfolio can be invested in longer term illiquid investments. Illiquid investment may include long-term CDs, mutual funds with redemption charges, and alternative investments such as hedge funds or private equity with lockup periods or redemption limitations. Most long-term investors will be comfortable with fifty percent or more of their portfolio in illiquid investments.

Determining whether large cash withdrawals or significant contributions will be made to the investment portfolio in the foreseeable future will also help determine liquidity needs or additional cash flow that will be required to be invested in the portfolio. Cash withdrawals may include things such as the purchase of a second home or paying for college costs for children or grandchildren. Future contributions such as an inheritance or exercise of stock options are also important considerations.

Investment Planning Answer Book by Jay L. Shein, Q 1:10, What are some other questions that should be asked in the data gathering process?

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The advisor should ask for any and all pertinent information that the investor thinks is important that was not previously covered. For instance, there may be legal or tax considerations that were not previously discussed. The data gathering process may take more than one meeting between the wealth manager and the investor. Typically, at a minimum, there will be an initial meeting where some data gathering will take place, a data gathering meeting, and a final meeting where the investment policy is explained and reviewed before beginning to invest the portfolio assets.

Investment Planning Answer Book by Jay L. Shein, Q 1:11, Why should advisors write an investment policy statement?

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An Investment Policy Statement (IPS) is part of a prudent investment management process. It helps establish policies, procedures, objectives and constraints, and can reduce the tendency for panic selling and excessive risk-taking or optimism. The IPS is not a contract; it is a statement of philosophy. It is intended to provide a roadmap to guide and assist investors, trusts, advisors and plan sponsors to meet their objectives and goals. Using an IPS is beneficial for all types of investment clients including, but not limited to, private clients, trusts, plan sponsors, and retirement plans.

When a person or group of people is making investment decisions that would benefit others, an IPS is warranted. Persons acting in a fiduciary capacity, such as a trustee, should also have an IPS. The idea of using an IPS as an investment portfolio guide is a prudent idea for individual or private investors, even though it is not currently required or mandated by any rules or laws. The Uniform Prudent Management of Institutional Funds Act (UPMIFA) states that the institution's investment policy—along with other factors—should be considered when a decision is being made regarding expenditures or accumulations of an endowment fund. When the Department of Labor (DOL) audits a qualified retirement plan, they will want to see a sufficient IPS that includes such items as: the evaluation of the specific needs of the plan and its participants, the investment objectives and goals of the plan, the standards or benchmarks of investment performance to which the plan investments or portfolio is to be evaluated, the classes of plan investments authorized, the styles of investment authorized, the required diversification of the portfolio among and within classes of investment, and the restrictions on investments.

Investment Planning Answer Book by Jay L. Shein, Q 1:12, What are some of the components of the Investment Policy Statement (IPS)?

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Advisors and consultants should use a questionnaire when meeting with the client to help develop the Investment Policy Statement (IPS). This is sometimes referred to as an Investment Policy Questionnaire (IPQ). This IPQ will allow the advisor to gather data and facts in addition to client attitudes, goals, wishes and any restrictions for the IPS. This information can then be used to write an IPS. The actual process of writing the IPS is probably more art than science. An IPS will typically include the following:

- Important background and factual data on the client or plan sponsor
- Asset allocation
- Goals and investment objectives
- Time horizon
- Tolerance and capacity to take risk
- Asset class restrictions and constraints
- Variability of asset allocation and rebalancing limits
- Procedures for monitoring and reporting the portfolio

The IPS may also address the following:

- Downside risk
- Cash flow requirements
- Tax concerns
- Spending policy
- Liquidity needs
- Education on investment principles
- Rebalancing
- Passive/active approach
- Tactical/timing moves
- Tax management issues
- Disclosures
- May reference assets not managed under the IPS

Investment Planning Answer Book by Jay L. Shein, Q 1:13, What are some questions the Investment Policy Questionnaire might contain?

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The purpose of an investment policy questionnaire (IPQ) is to gather investor data. This will include quantifying some of the investor's objectives and tolerance for risk. It will also likely include gathering personal information, such as names, addresses, occupation, dates of birth, financial and estate information, and information on other family members. Plan sponsors—such as endowments and pension plans—would also likely need to obtain sponsor and trustees' names, trust data, name of investment advisor, and information on employees covered. Much of the data recorded in the IPQ will be more specific to investing.

Many IPQs inquire about the investor's general investment goals by asking the investor to prioritize objectives into categories such as capital appreciation, growth and income, and maximum capital appreciation. This author currently feels that these questions are too subjective for investors. Even when the advisor explains the meaning of these terms, the investor still may not really understand, and the advisor's explanation or interpretation of these terms may vary from that of other advisors. While the IPQ may have some subjective questions that can be beneficial in the development of the IPS, this particular question does not seem to add value.

Finding out the amount of income or other current and future cash flows expected seems to be of more value. For private investors, this could include a discussion of the expected contributions with details on the reason, timing and amount of those contributions. The frequency, timing and amounts of expected distributions could also be outlined here. Pension plans will also need to determine expected contributions and the outflows to vested employees whose employment is scheduled to terminate.

Investment time horizon and rate of return objectives should be part of the IPQ. For instance, how long an investor plans to be invested in this strategy/portfolio before making any substantial changes is important for trying to describe the investor's tolerance and capacity to take risk. An advisor could determine this by asking the investor if his or her time horizon is between one to five years, five to 10 years, 10 to 15 years, or greater than 15 years. When asking about an investor's return objective, a return number tied to inflation or some other benchmark may be appropriate. Many investors desire high returns, but do not want to take significant risks. This is an appropriate time for an educational discussion with the investor on the risk/return tradeoff, as well as some historical perspective on stocks, bonds, treasury securities and inflation. None of the information in the IPQ or IPS is meant to indicate or guarantee any specific result. They just help in the development of a guide and roadmap for the investor's portfolio.

IPQ questions on risk tolerance should be asked in different ways. Most investors are fearful of investment risk because they do not understand it. This is where the advisor can help mitigate some of those fears. Investors need to understand there is a relationship between risk and reward. Asking clients how much decline in portfolio value they would be willing to tolerate helps identify some of their tolerance for risk relative to the returns they wish to achieve. Questions on diversification are also needed. Review any investment choices and investment vehicles that investors do not want to consider even if these would help them achieve their goals. Also, find out what liquidity requirements are needed, such as what percentage of the portfolio needs to be held in cash, how much can be illiquid, or any special liquidity requirements. Information on tax brackets as well as existing gains and losses should be gathered. For taxable investors, obtaining a copy of tax returns is important. Those that provide wealth management and financial planning is anything else that he or she thinks the advisor should know on the IPQ. Clients should sign the IPQ and IPS, but the advisor does not typically sign. Remember that the IPS is a statement of philosophy, not a contract. The IPS is the client/investor's guidelines to direct and guide investment counsel.

Services will typically have more information than a typical IPQ would require and may assist in developing a better IPS. Always ask if anything was missed or if the investor feels there is anything else that he or she thinks the advisor should know on the IPQ. Clients should sign the IPQ and IPS, but the advisor does not typically sign.

Remember that the IPS is a statement of philosophy, not a contract. The IPS is the client/investor's guidelines to direct and guide investment counsel.

Investment Planning Answer Book by Jay L. Shein, Q 1:14, In summary, what does an Investment Policy Statement (IPS) Provide?

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The IPS should help establish reasonable expectations, objectives, and guidelines in the investment of the portfolio's assets. When the IPS is completed, it should contain, among other items, the portfolio allocation and strategy designed with consideration for the investor's tolerance and capacity for risk, as well as liquidity and diversification requirements. The IPS will also outline the advisor or consultant's responsibilities, such as the frequency of client reporting and monitoring of the portfolio. The IPS is an important component to investment success. It highlights important items such as:

- Why the investor is investing
- Staying focused on goals and objectives
- Understanding the investor's risk tolerance
- Being patient with a longer term view
- Staying with the IPS during times of volatility
- Diversifying investments

Investment Policy Statements should be reviewed periodically to ensure they adequately reflect any changes related to the portfolio, the investor, or the capital markets. Investors and plan sponsors need to understand that there can be no guarantee about the attainment of the goals or investment objectives outlined in the IPS. The IPS encourages effective communication between the advisor and the investor which should assist investors in staying focused on their goals and objectives.