

Portfolio Management

Basics of Portfolio Planning and Construction



Exam Focus

- Investment policy statement
- Risk and return objectives
- Investment constraints
- Asset allocation decision
- ESG considerations

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Investment Policy Statement: Components

- Description of Client
- Statement of the Purpose
- Statement of the Duties and Responsibilities
- Procedures

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Investment Policy Statement: Components

- Investment Objectives
- Investment Constraints
- Investment Guidelines
- Evaluation of Performance
- Appendices

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Investment Policy Statement: Example

Which of the following is the *most* important reason for the development of an investment policy statement (IPS)?

A written IPS:

- A. provides documentation to protect portfolio managers against litigation.
- B. contains a clear statement regarding an investor's needs, circumstances, and constraints.
- C. guarantees positive investment performance.

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Risk and Return Objectives

- Absolute risk objectives
- Relative risk objectives
- Ability to bear risk
- Willingness to bear risk

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Risk Objectives: Example

A Japanese institutional investor has a portfolio valued at ¥10 billion. The investor expresses her first risk objective as a desire not to lose more than ¥1 billion in the coming 12-month period. She specifies a second risk objective of achieving returns within 4% of the return to the TOPIX stock market index, which is her benchmark.

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Risk Tolerance: Example

Marie Gascon is so pleased with the services provided by her financial adviser that she suggests to her brother Jacques that he should also consult the adviser. Jacques thinks it is a good idea. Jacques, a self-employed computer consultant also based in Paris, is 40 years old and divorced with four children, aged between 12 and 16.

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Risk Tolerance: Example

The financial adviser notes the following aspects of Jacques' situation:

- Jacques' consultancy earnings average €40,000 per annum but are quite volatile.
- Jacques is required to pay €10,000 per year to his ex-wife and children.
- Jacques has a mortgage on his apartment of €100,000 and €10,000 of savings.
- Jacques has a good knowledge of financial matters and expects that equity markets will deliver very high returns over the long term.
- In the risk tolerance questionnaire, Jacques strongly disagrees with the statements "I am more comfortable putting my money in a bank account than in the stock market" and "When I think of the word 'risk', the term 'loss' comes to mind immediately."
- Jacques expects that most of his savings will be required to support his children at university.

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Risk Tolerance: Example

Based only on the information given, which statement is correct?

- A. Jacques has a low ability to take risk but a high willingness to take risk.
- B. Jacques has a high ability to take risk but a low willingness to take risk.
- C. Jacques has a high ability to take risk and a high willingness to take risk.

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Investment Constraints

- Liquidity
- Time horizon
- Tax situation
- Legal and regulatory
- Unique circumstances

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Investment Time Horizon: Example

Frank Johnson is investing for retirement and has a 20-year horizon. He has an average risk tolerance. Which investment is likely to be the *least* suitable for a major allocation in Johnson's portfolio?

- A. Listed equities.
- B. Private equity.
- C. US Treasury bills.

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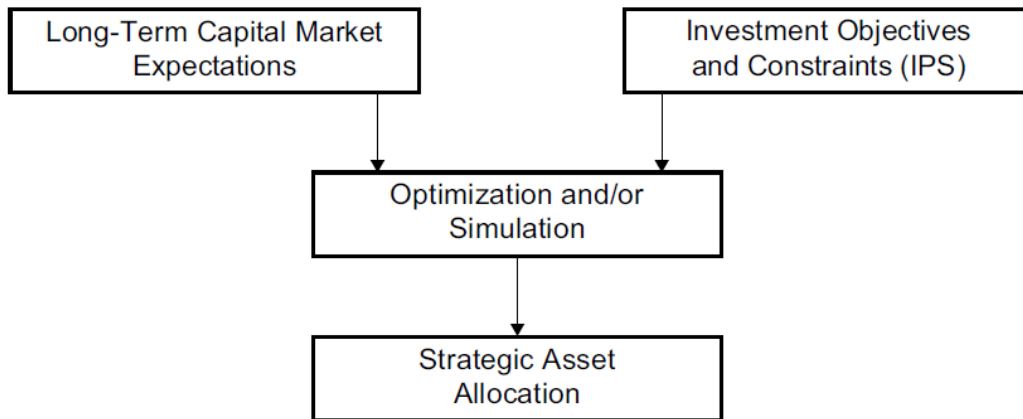
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Asset Allocation Decision

- Strategic asset allocation
- Tactical asset allocation
- Core-satellite approach

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Strategic Asset Allocation Process



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ESG Considerations

- Approaches to ESG investing
 - Negative screening
 - Positive screening
 - Thematic screening
 - Impact investment
 - Engagement/active ownership

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Solutions

Investment Policy Statement: **Example**

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A written IPS contains a clear statement regarding an investor's needs, circumstances, and constraints.

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Risk Tolerance: Example

Based only on the information given, which statement is correct?

- ☒ A. Jacques has a low ability to take risk but a high willingness to take risk.
- B. Jacques has a high ability to take risk but a low willingness to take risk.
- C. Jacques has a high ability to take risk and a high willingness to take risk.

Jacques does not have a particularly high income, his income is unstable, and he has reasonably high outgoings for his mortgage and maintenance payments. His investment time horizon is approximately two to six years given the ages of his children and his desire to support them at university. This finely balanced financial situation and short time horizon suggests a low ability to take risk. In contrast, his expectations for financial market returns and risk tolerance questionnaire answers suggest a high willingness to take risk. The financial adviser may wish to explain to Jacques how finely balanced his financial situation is and suggest that, despite his desire to take more risk, a relatively cautious portfolio might be the most appropriate approach to take.

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Investment Time Horizon: Example

Frank Johnson is investing for retirement and has a 20-year horizon. He has an average risk tolerance. Which investment is likely to be the *least* suitable for a major allocation in Johnson's portfolio?

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- B. Private equity.
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With a 20-year horizon and average risk tolerance, Johnson can accept the additional risk of listed equities and private equity compared with US Treasury bills.

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