

# CHAPTER 16

## INVESTORS AND THEIR NEEDS

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## LEARNING OUTCOMES

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

- a** Describe the importance of identifying investor needs to the investment process;
- b** Identify, describe, and compare types of individual and institutional investors;
- c** Compare defined benefit pension plans and defined contribution pension plans;
- d** Explain factors that affect investor needs;
- e** Describe the rationale for and structure of investment policy statements in serving client needs.

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## INTRODUCTION

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# 1

The investment industry provides a range of services—including financial planning, trading, and investment management—to a wide variety of clients. Individual investor clients range from those of modest means to the very wealthy. The investment industry also provides services to many types of institutional investors, such as pension funds, endowment funds, and insurance companies. Because investors are all unique, it is important to understand each of their specific circumstances in order to best meet their financial needs. It is not possible to act in a client's best interests if those interests are not understood and incorporated into the chosen investment strategy.

Clients differ in terms of their financial resources, personal situations (if they are individual clients), objectives, attitudes, financial expertise, and so on. These differences affect their investment needs, what services they require, and what investments are appropriate for them. For example, elderly clients with significant resources may be very concerned with estate (inheritance) planning, but elderly clients with modest resources may be more concerned about outliving their resources. A shortfall in investment returns may have significant consequences for the latter but have less impact on the former.

Investors can hold securities, such as shares and bonds, directly, or they can invest in professionally managed funds to get exposure to the assets they want to hold. Investors may choose securities or funds themselves or engage an investment professional to assist in the selection. Investment professionals must get to know their clients well if they are to provide appropriate investment services to meet the clients' needs.

The most basic distinction among investors is that between individual and institutional investors. Individual investors trade (buy or sell) securities or authorise others to trade securities for their personal accounts. Institutional investors are organisations that hold and manage portfolios of assets for themselves or others. The characteristics that define individual investors are usually different from those that define institutional investors.

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## TYPES AND CHARACTERISTICS OF INVESTORS

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# 2

Investors are not a homogeneous group; both individual and institutional investors have distinct characteristics.

### 2.1 Individual Investors

Individual investors are often differentiated based on their resources. Most will have relatively modest amounts to invest. Other, more affluent individuals will have larger amounts. The term “retail investor” can be used to refer to all individual investors, but it is common to use the term to refer to individual investors with modest resources to

invest. Many investment firms make a distinction between their retail clients, more affluent clients with larger amounts, and high- and ultra-high-net-worth investors with the largest amounts of investable assets.

There is no defined standard in the industry to classify individual investors by investable assets; each investment firm designates its own categories and values within those categories. For example, one firm may use four categories (retail, mass affluent, high net worth, and ultra-high net worth), whereas another firm may use six categories (retail, affluent, wealthy, high net worth, very high net worth, and ultra-affluent). Firms that use the same categories may have different cutoff points. For example, one firm may classify retail clients as those with investable assets up to €100,000, and another firm may use a cutoff point of €250,000.

The services offered by investment firms and the investments available will typically vary by the amount of money the client has to invest. Some specialist funds may require minimum sizes of investment (e.g., \$1 million), and some portfolio management services may have minimum fees, making them uneconomical for smaller account sizes.

An investment firm that focuses on retail investors has to service the needs of a large number of relatively small accounts. Often, this means consolidating the retail investors' assets into a smaller number of funds and having automated processes for the administration of client fund holdings.

An investment firm or division within an investment firm focussing on high-net-worth investors may have fewer clients, but higher average account balances, than one that focuses on retail investors. Investor assets may still be invested in funds, but some high-net-worth investors will prefer their own segregated accounts (known as separately managed accounts). Wealthy clients may have higher expectations of client service than retail customers, and usually the services that are provided to them are more personalised.

Individual investors vary in their level of investment knowledge and expertise. Some individual investors have relatively limited investment knowledge and expertise, and others are more knowledgeable, perhaps as a result of their education or work experience. Because individual investors are often thought of as less knowledgeable and less experienced than institutional investors, regulators in many countries try to protect them by putting restrictions on the investments that can be sold to them. For example, in the United States, the Securities and Exchange Commission (SEC), as of 2013, restricts investments in hedge funds to accredited investors. An individual qualifies as an accredited investor if he or she earned income of \$200,000 or more in each of the prior two years and reasonably expects to earn at least \$200,000 in the current year or has (alone or together with a spouse) a net worth (excluding his or her primary residence) greater than \$1 million. This restriction is presumably based on the logic that wealthier investors are expected to have a higher level of investment knowledge or at least be better able to pay for advice and better able to bear risk.

Additional aspects of the personal situations of individual investors—such as age and family obligations—will also differ and affect their investment needs and decision making. The expected holding period (time or investment horizon) for investments, risk tolerance, and other circumstances also affect investors' needs.

The services that the investment industry provides to individual investors differ depending on the investors' wealth and level of investment knowledge and expertise, as well as the regulatory environment. Retail investors tend to receive standardised (less personalised) services, whereas wealthier investors often receive services specially tailored to their needs.

### 2.1.1 Retail Investors

Retail investors are by far the most numerous type of investor. They buy and sell relatively small amounts of securities and assets for their personal accounts. They may select investments themselves or hire advisers to help them make investment decisions. They also may invest indirectly by buying pooled investment products, such as mutual fund shares or insurance contracts.

The investment industry provides mostly standardised services to retail investors because they generate the least revenue per investor for investment firms. Many retail investment services are delivered over the internet or through customer service representatives working at call centres.

#### INVESTOR PROFILE: ZHANG LI



Zhang Li is a retail investor whom we met in The Investment Industry: A Top-Down View chapter. She earns 5,000 Singapore dollars a month and wants to save for a deposit on an apartment in the suburbs of Singapore. She also wants to save to pay for her son's university education in 10 years' time. To accumulate money for the apartment deposit, she can save using short-term, low-risk investments. She can save using longer-term investments, such as mutual funds of shares and bonds, for her son's education.

### 2.1.2 High-Net-Worth Investors

Wealthier investors generally receive more personal attention from investment personnel. Their investment problems often involve tax and estate planning issues that require special attention. They either pay directly for these services on a fee-for-service basis or indirectly through commissions and other transaction costs.

### INVESTOR PROFILE: MIKE SMITH



Mike Smith is a high-net-worth investor whom we met in *The Investment Industry: A Top-Down View* chapter. He recently sold his technology company and has \$10 million to invest. He wants to invest not only to meet his lifestyle needs but also to plan his estate to secure his children's future and leave a large charitable donation after his death. He has expressed an interest in investing globally in real estate.

#### 2.1.3 Ultra-High-Net-Worth Investors and Family Offices

Very wealthy individuals usually employ professionals who help them manage their investments, future estates, and legal affairs. These professionals often work in a **family office**, which is a private company that manages the financial affairs of one or more members of a family or of multiple families. Many family offices serve the heirs of large family fortunes that have been accumulated over generations. In addition to investment services, family offices may provide personal services to the family members, such as bookkeeping, tax planning, managing household employees, making travel arrangements, and planning social events.

Wealthy families often have substantial real estate holdings and large investment portfolios. The investment professionals who work in family offices generally manage these investments using the same methods and systems that institutional investors use. They pay especially close attention to personal and estate tax issues that may significantly affect the family's wealth and its ability to pass wealth on to future generations or charitable institutions.

## 2.2 Institutional Investors

Institutional investors are organisations that hold and manage portfolios of assets for themselves or others. There are many different types of institutional investors with varying investment requirements and constraints. Institutional investors may invest to advance their mission or they may invest for others to meet the others' needs. Institutional investors that invest to advance their missions include pension plans, endowment funds and foundations, trusts, governments and sovereign wealth funds, and non-financial companies. Institutional investors that invest to provide financial services to their clients include investment companies, banks, and insurance companies. These institutional investors may also provide services to the institutional investors that invest to advance their missions.

Some institutional investors manage their investments internally and employ investment professionals whose job it is to select the investments. Other institutional investors outsource the investment of the portfolio to one or more external investment firms. The choice between internal and external management will often be driven by the size of the institutional investor, with larger institutional investors better able to afford the resources required for internal management. Some institutional investors will adopt a mixed model, managing some assets internally in which they have expertise and outsourcing more specialised investments—for example, alternative investments—to

external managers. Those institutional investors that choose to outsource investment management still have complex decisions to make in terms of which managers to appoint. They may use internal expertise to make manager selection decisions, or they may employ a consultant.

### 2.2.1 Pension Plans

**Pension plans** hold investment portfolios—pension funds—for the benefit of future and current retired members, who are called beneficiaries. A company or other entity may set up a pension plan to provide benefits to its employees. The companies and governments that sponsor these plans are called pension sponsors or plan sponsors. Money from employer and/or employee contributions is set aside to provide income to plan members when they retire. The contributions must be invested until the employee retires and receives the retirement benefits.

Pension plans differ by whether they are organised as defined benefit or defined contribution plans.

**2.2.1.1 Defined Benefit Plans** **Defined benefit pension plans** promise a defined annual amount to their retired members. The defined amount typically varies by member based on such factors as years of service and annual compensation while employed. Typically, employees do not have the right to receive benefits until they have worked for the company or government for a period specified by the pension plan. An employee's rights are vested (protected by law or contract) once they have worked for that period.

Defined benefit pension funds, particularly those of government-sponsored plans, are among the largest institutional investors. Pension funds may invest in equity securities, debt securities, and alternative investments because they typically have relatively long time horizons. As employees retire, new employees are added to the plan. If new employees are not being added to the plan, the time horizon of the plan will decrease over time.

In a defined benefit pension plan, the sponsoring employer promises its members (or employees) a defined amount of benefit. For example, it is quite common for the employer to promise an annual pension that is a set proportion of the employee's final pre-retirement salary. The pension may be adjusted for inflation over time. The employer will make contributions to the pension fund to fulfil the promise. Employees may also be asked to contribute.

In a defined benefit plan, the employer bears the risk—in this case, that the investments made by the pension fund fail to perform as expected. If the investments fail to perform as expected, the employer may be required to make additional contributions to the fund. However, it is possible that pension sponsors will be unable to make the necessary contributions and that beneficiaries will not receive the benefits expected. Defined benefit plans are becoming less common around the globe and are being replaced by defined contribution plans.

INVESTOR PROFILE: EURO PENSION FUND



Euro Pension Fund is the fund for a defined benefit pension plan located in Frankfurt, Germany. The plan sponsor remits money to the fund based on estimates of pension benefit obligations compared with pension plan assets. Working members of the plan also pay a portion of their wages to the fund. Each month, the fund pays out money to the retired members of the pension plan. The fund must invest to pay both short-term benefits and benefits that will be payable many years from now. It needs a complex blend of investments in a wide range of assets to achieve its goals. It has an asset management team that devises the fund’s strategy and implements it. Anna Huber is a member of that team.

**2.2.1.2 Defined Contribution Pension Plans** In a **defined contribution pension plan**, the pension sponsor typically contributes an agreed-on amount—the defined contribution—to an account set up for each employee. Employees also generally contribute to their own retirement plan accounts, usually through employee payroll deductions. The contributions are then invested, normally in funds that the employee chooses from a list of eligible funds within the plan. The plan provides enough choices of funds to allow employees to create a broadly diversified portfolio. The sponsor generally limits the choices to a set of mutual funds sponsored by approved investment managers. The pension plan sponsor should also ensure that the fees charged on the funds are reasonable. At retirement, the balance that has accumulated in the account is available for the employee.

In defined contribution plans, the member (or employee) bears the risk that the pension account’s investments fail to perform as expected. This contrasts with defined benefit plans, in which the employer bears the risk. In defined contribution plans, the employer has no obligation to make additional contributions if the investments perform poorly. If the retirement fund is less than expected, the employee may have to make do with less retirement income or, possibly, defer retirement. Because saving enough and choosing the right investments are very important, defined contribution plan sponsors are increasingly providing financial guidance to their beneficiaries or arranging for financial planners to help guide members.

**2.2.1.3 Comparison of Defined Benefit and Defined Contribution Pension Plans**

Defined Benefit Plan	Defined Contribution Plan
Member’s benefit in retirement is defined.	Member’s benefit in retirement is not defined.
Employer’s contributions are not defined.	Employer’s contributions are defined.



Defined Benefit Plan	Defined Contribution Plan
Investments are chosen by a pension fund manager(s).	Investments are chosen by the member.
Risk that investments do not perform as expected is borne by the employer.	Risk that investments do not perform as expected is borne by the member.
Employer may need to make additional contributions.	Member may need to adjust lifestyle or defer retirement.

In the past, most pension plans were defined benefit pension plans. Because these plans promise defined benefits to their beneficiaries, they are expensive obligations for the sponsor (employer) and many sponsors no longer offer them. This change explains why defined contribution pension plans are increasingly replacing defined benefit plans in most countries.

### 2.2.2 Endowment Funds and Foundations

Endowment funds and foundations are also significant institutional investors in many countries. **Endowment funds** are long-term funds of non-profit institutions, such as universities, colleges, schools, museums, theatres, opera companies, hospitals, and clinics. These organisations use their endowment funds to provide some services to their students, patrons, and patients. **Foundations** are grant-making institutions funded by gifts and by the investment income that they produce. Most foundations do not directly provide services. Instead, they fund organisations that provide services in such areas as the arts or charities. Foundations often own endowment funds, which invest the foundation's money.

Endowment funds and foundations typically have a charitable or philanthropic purpose and receive gifts from donors interested in supporting their activities. In many countries, donations to these organisations are tax deductible for the donors. That is, donations reduce the income on which the donors have to pay taxes. Investment income and capital gains that these organisations receive from investing these funds may also be tax-exempt.

Endowment funds are usually intended to exist in perpetuity and, as such, are regarded as very long-term investors. But they are also typically required to spend annually on the charitable or philanthropic purpose for their existence, so money needs to be drawn from their funds. Many endowment funds and foundations establish spending rules; for example, they may set spending goals of a percentage range of their assets. Often, their challenge lies in balancing long-term growth with shorter-term income or cash flow requirements.

Each endowment fund or foundation has its own specific circumstances. Some are able to raise money on an ongoing basis, whereas others are restricted from raising more money. Some endowment funds and foundations are required to spend a fixed portion of the portfolio each year, whereas others have more flexibility to vary spending. These differences have implications for how the institutional investor's assets are invested. An endowment client that is restricted from fundraising has to meet its financial needs from income or the sale of assets, but an endowment client that has no restriction on fundraising may also raise money to meet its financial needs.

Most organisations with endowment funds hire professional investment managers to manage the funds. Some manage portions of their funds internally, in some cases through an investment management company that they own.

### INVESTOR PROFILE: PHILANTHROPY FOUNDATION



Philanthropy Foundation was started in 1950 with a gift of \$1 million. The foundation invested its money, raised no additional money, and now has assets of \$250 million. The foundation supports various charitable causes and is committed to donating \$5 million every year, although it typically makes donations in excess of this amount. Gertrude Ahlbergson is the chief investment officer for Philanthropy Foundation. She has determined that because the foundation is designed to exist forever, it can have some very long-term investments. It can afford to take considerable investment risk because it is only committed to donating a small proportion of its assets to charity every year. It can increase the payments if investment returns are sufficient.

### 2.2.3 Governments and Sovereign Wealth Funds

Governments receive money from collecting taxes or selling bonds. When they do not have to spend this money immediately, they usually invest it. Some governments have accumulated enormous surpluses from selling natural resources that they control or from financing the trade of goods and services. They have created **sovereign wealth funds** to invest these surpluses for the benefit of current and future generations of their citizens.

Sovereign wealth funds typically invest in long-term securities and assets. They also may purchase companies. Sovereign wealth funds either manage their investments in-house or hire investment managers to manage their money.

### INVESTOR PROFILE: CROWN STATE MONEY



Crown State Money is a sovereign wealth fund created 10 years ago by the (fictional) country of Crown State to invest some of the revenues from Crown State's oil fields. Crown State knows that its oil will not last forever, so the fund invests for the long term in order to sustain the country's development and benefit future generations if oil revenues fall. Neil Thornmarsh is employed by Crown State Money to manage the money it allocates to alternative investments.

### 2.2.4 Non-Financial Companies

Analysts often identify companies as either financial companies or non-financial companies. Financial companies include investment companies, banks and other lenders, and insurance companies. These companies provide financial services to their clients. In contrast, non-financial companies produce goods and non-financial services for their customers.

Non-financial companies invest money that they do not presently require to run their businesses. This money may be invested short-term, mid-term, or long-term. The corporate treasurer usually manages the short-term investment assets. These assets typically include cash that the company will need soon to pay salaries and accounts payable and financial vehicles that are safe and liquid, including demand deposits (checking accounts), money market funds, and short-term debt securities issued by governments or other companies.

Long-term investments are usually managed under the direction of the chief financial officer or the chief investment officer, if the company has one. Companies often invest long-term to finance future research, investments, and acquisitions of companies and products. Companies may invest long-term directly, or they may hire investment managers to invest on their behalf.

#### INVESTOR PROFILE: UK TECHNOLOGY



UK Technology develops and sells computer software and hardware. It produces consistently strong revenues year after year. It invests a proportion of these revenues in research and development, but in spite of this regular investing, it has accumulated a significant amount of cash that it has invested in short-term and long-term bonds and equity. It does not want to return the excess cash to its shareholders because it anticipates some major acquisitions in the future. Stanton Whitworth is employed by the investment management company hired to advise UK Technology on its investments.

Many companies invest directly in the shares and bonds of their suppliers and in the shares of potential merger partners to strengthen their relationships with them. Practitioners call these investments “strategic investments.” These types of investments are common in Asian countries, such as Japan and South Korea, and in European countries, such as France, Germany, and Italy.

#### 2.2.5 Investment Companies

**Investment companies** include mutual funds, hedge funds, and private equity funds. These companies exist solely to hold investments on behalf of their shareholders, partners, or unitholders (units refer to shares and bonds for equity and debt securities, respectively). As discussed in the Investment Vehicles chapter, these companies are called **pooled investment vehicles** because investors in these companies pool their money for common management. Investment companies are managed by professional investment managers who work for investment management firms. These management firms often organise and market the investment companies that they manage and thus serve as the investment sponsors.

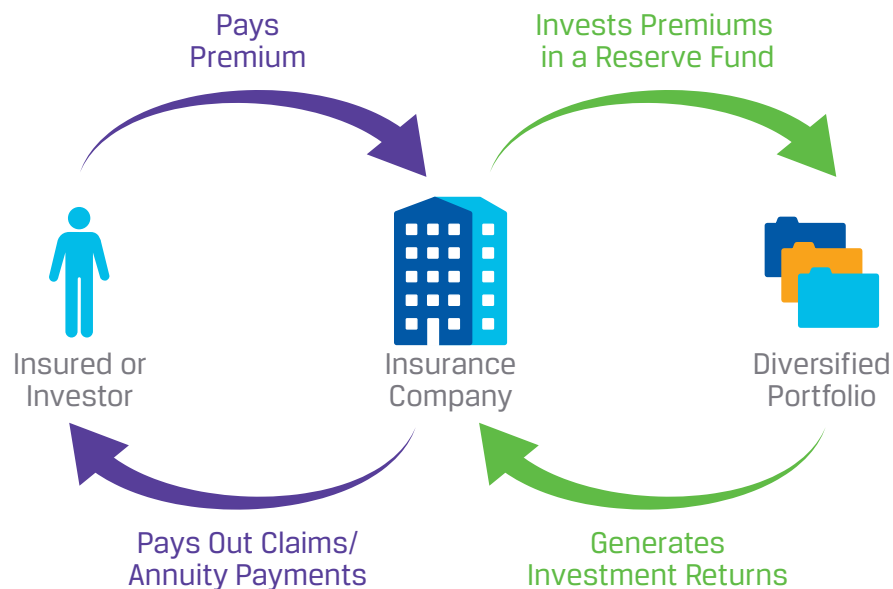
Mutual funds pool the assets of many investors into a single investment vehicle, which is professionally managed and benefits from economies of scale. There are thousands of mutual funds managed by investment management firms. Mutual funds are typically categorised by their investment(s). Investments eligible for inclusion may be

narrowly or broadly defined and based on types of assets, geographic area, and so on. For example, mutual funds may indicate that they invest in Chinese equities identified as having growth potential, global equities, long-term investment-grade European corporate bonds, or commodities. The investment management firm receives a fee for managing the fund. Although a mutual fund can be regarded as an institutional investor, the term “mutual fund” also refers to the investment vehicle, shares of which an individual or institutional investor can hold in a portfolio.

Hedge funds and private equity funds can similarly be considered institutional investors that manage private investment pools and as investment vehicles. They are distinguished by their use of strategies beyond the scope of most traditional mutual funds.

### 2.2.6 Insurance Companies

Insurance companies comprise another important category of institutional investor. Insurance companies collect premiums from the individuals and companies they insure. Premiums are payments that insurance companies require to provide insurance coverage. Some of these premiums are put into reserve funds from which insurance companies pay out claims. The premiums in the reserve funds are invested in highly diversified portfolios of securities and assets that aim to ensure that sufficient funds are always available to satisfy all claims. Regulators often set requirements to restrict the types of investments insurance companies can hold. Insurance companies profit from income that they can earn on the float, which is the amount of money they have available to use after receiving premiums and before paying claims.



There are two main types of insurance companies. One type is property and casualty insurance companies, which protect their policyholders from the financial loss caused by such incidents as accidents and theft. The other type is life insurance companies, which make payments to the policyholder's beneficiaries in the event the policyholder dies while the insurance coverage is in force. There are some insurance companies that provide both types of insurance. Property and casualty insurers have short-term horizons and relatively unpredictable payouts; therefore, they prefer shorter-term investments that are more conservative and liquid. In contrast, life insurers have

longer-term time horizons and more predictable payouts and, therefore, have more latitude to invest in riskier assets. They usually invest their reserve funds, which often are very large, in securities, commodities, real estate, and other real assets.

#### INVESTOR PROFILE: ABC INSURANCE

ABC Insurance is a global **insurance company** that insures thousands of people's lives. It takes the monthly premiums its clients pay for their insurance and invests them in financial markets. It holds a mixture of short-term and long-term investments because some policyholders will die in the short term and some will live for a much longer period.



Zhang Li, the retail investor described in Section 2.1.1, purchased life insurance from ABC Insurance to provide money for her family in the event of her death. Isabel Robilio is the chief investment officer for ABC Insurance.

Insurance companies try to match their investments to their liabilities. For example, if they expect to make fixed annuity payments in the distant future, they may invest in long-term fixed-income securities to match the interest rate risk of their investments to the interest rate risk of their liabilities. This strategy of matching investment assets to liabilities, called asset/liability matching, reduces the risk that the company will fail to pay its claims.

Most large insurance companies manage their investments in-house. They also may contract with investment managers to manage specialised investments in industries, asset classes, or geographical regions where they lack expertise or access.

Investors—individual and institutional—differ in their financial resources, circumstances, objectives, attitudes, financial expertise, and so on. These differences affect what services the client requires and what types of investments are appropriate for the client. Therefore, it is important to capture the information about the client and the client's needs.

# 3

## FACTORS THAT AFFECT INVESTORS' NEEDS

Each investor—individual or institutional—has different investment objectives. Key factors that are common to all investors but that will vary for each investor include the following:

- Required return
- Risk tolerance
- Time horizon

Investors may also have specific needs in relation to liquidity, tax considerations, regulatory requirement, consistency with particular religious or ethical standards, or other unique circumstances. Investors' circumstances and needs change over time, so it is important to re-evaluate their needs at least annually.

### 3.1 Required Return

Investors differ in how much return they need to meet their goals. The rate of return required—before and after tax—can be calculated using some goal for future wealth or portfolio value. For example, based on an investor's age, initial investable assets, expected savings, and tax situation, an adviser may calculate that a 6% rate of return before tax on investments is required for the investor to meet his or her goal of having a €500,000 portfolio value at retirement. If the required rate of return seems unlikely to be achieved, the investor's goals may have to be revised or other factors, such as the level of savings, may have to be adjusted.

An investor may take a total-return perspective, which makes no distinction between income (for example, dividends and interest) and capital gains (that is, increases in market value). The source of return—changes in value or income—does not matter to a total-return-oriented investor. Alternatively, an investor may distinguish between income and capital gains, seeking income for current spending and capital gains for long-term needs.

The return requirement, particularly for a long-term horizon, should be specified in real terms, which means adjusting for the effect of inflation. This adjustment is important because it maintains the focus on what the accumulated portfolio will provide at the end of the time horizon. An increase in value that simply matches inflation does not give a client increased spending power.

The investment manager or adviser has to be comfortable that the investor's desired rate of return is achievable within the related constraints. Most clients would like high returns with low risks, but few investments have this expected profile. The adviser or manager has a role in counselling the client. Typically, higher levels of expected return will require higher levels of risk to be taken. Some investors will choose to invest in highly risky assets because they require high levels of return to meet their goals, but the potential consequences (the downside risks) associated with this strategy need to be understood. Other investors will have already accumulated sufficient

assets that they do not need high returns and can adopt a lower-risk approach with more certainty of meeting their goal. This situation could be the case for a pension plan that has a high funding level, meaning that its assets are sufficient, or nearly sufficient, to meet its liabilities. Other investors that have accumulated significant assets may choose to invest in riskier assets because they are capable of bearing the risk and able to withstand losses.

Investors, particularly individual investors, will usually adjust the proportion they invest in different kinds of assets over time as they age and their circumstances change. Individual investors with defined contribution pension plans can also adjust their investments within the defined contribution plan.

### 3.2 Risk Tolerance

Investors typically have limits on how much risk they are willing and able to take with their investments. As noted earlier, there is a link between risk and return. Typically, the higher the expected return, the higher the risk associated with that return. Equally, the more risk taken, the higher the expected return. The investor's risk tolerance is a function of his or her ability and willingness to take risk.



The ability to take risk depends on the situation of the investor, such as the balance between assets and liabilities, and the time horizon. If investors have far more assets than liabilities, any losses that result from risk taking may not alter their lifestyle. If investors have a long time horizon, they have more scope to adjust their circumstances to cope with losses by saving more or waiting for markets to recover, although recovery and its timing cannot be guaranteed.

Willingness to take risk is also related to the investor's psychology, which may be assessed using questionnaires completed by the investor. Willingness to take risk is often thought of as a more important issue for individual investors, but even those who oversee institutional investments will have risk guidelines within which they must operate and that help define their ability and willingness to take risk.

Some institutional investors, such as insurance companies and other financial intermediaries, may also face regulatory restrictions on how much risk they can take with their portfolios.



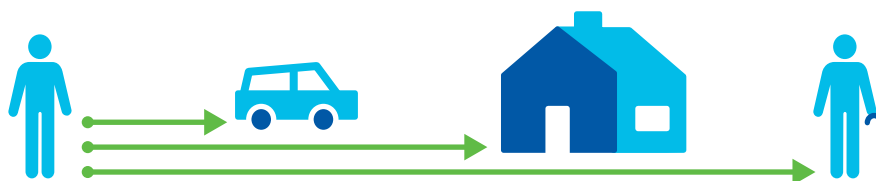
There may be situations in which an investor's willingness to take risk and his or her ability to take risk differ. In such situations, the investment adviser should counsel the investor on risk and determine the appropriate level of risk to take in the portfolio, taking into account both the investor's ability and willingness to take risk. The lesser of the two risk levels should be the risk level assumed.

### 3.3 Time Horizon

The investor and adviser must be clear on the time horizon for the investments. Some investors will need to access money from their portfolios in the short term, whereas others will have a much longer time horizon.

On the institutional side, for example, a property and casualty insurance company that expects to have to meet claims in the next few years will have a short time horizon, whereas a sovereign wealth fund that is investing oil revenues for the benefit of future generations will have a long time horizon, possibly decades.

In the case of individual investors, for example, someone who is planning on buying a new home or paying for college in two or three years will have a short horizon for at least a portion of his or her investments. A 20-year-old saving for retirement will typically have a long horizon, probably more than 40 years.



The investment horizon has important implications for how much risk can be taken with the portfolio and the level of liquidity that may be required. Liquidity is the ease with which the investment can be converted into cash. For example, an illiquid private equity investment with a likely payoff in 10 years would be unsuitable for an investor with a 5-year horizon.

Investors with longer time horizons should be able to take more risk because they have more time to adapt to their circumstances. For example, they can save more to compensate for any losses or returns that are less than expected. History shows that over time, markets go up more often than they go down, so an investor with a longer time horizon has more potential to accumulate positive return performance. Longer-term investors are also better able to wait for markets to recover from a period of poor performance, although recovery cannot be guaranteed.

### 3.4 Liquidity

Investors vary in the extent to which they may need to withdraw money from their portfolios. They may need to make a withdrawal to fund a specific purchase or to generate a regular income stream. These needs have implications for the types of investments chosen. When liquidity is required, the investments will need to be able to be converted to cash relatively quickly and without too much cost (keeping transaction costs and changes in price low) when the cash is needed.



An individual may also require that a portion of the portfolio be liquid to meet unexpected expenses. In addition, the individual may have known future liquidity requirements, such as a planned future expenditure on children's education or retirement income needs.

For an institution, the liquidity constraint typically reflects the institution's liabilities. For example, a pension fund may expect to begin experiencing net cash outflows at a particular point in the future (i.e., when pension payments exceed new contributions to the plan) and will need to sell off some portfolio investments to meet those needs. It needs to hold liquid assets in order to do this.

### 3.5 Regulatory Issues

Some types of investors have regulatory requirements that apply to their portfolios. For example, in some countries and for certain types of institutional investors, there are restrictions on the proportion of the portfolio that can be invested overseas or in risky assets, such as equities. Regulations on the holdings of insurance companies are typically extensive. Exhibit 1 shows some restrictions that apply to institutional pension funds in several countries as of December 2016. In the countries shown, restrictions can exist on the amount of the pension fund that can be invested in an asset class (such as public equity) and/or on the amount that can be invested outside the pension plan's home country.

**Exhibit 1 Investment Regulations Applying to Pension Funds in Selected Countries**

Country	Maximum Public Equity Investments (% of portfolio)	Maximum Foreign Public Equity Investments (% of portfolio)	Other
Brazil	70%	10%	Foreign investment restricted to MERCOSUR countries for equities (other asset classes are more flexible)
Canada	No limit	No limit	Maximum of 10% of market value invested in any one entity or related entities
Egypt	15%	0%	Not allowed to invest in foreign assets
Estonia	75%	No limit	—
Japan	No limit	No limit	—
Switzerland	50%	No limit	Total real estate exposure limited to 30%. These limits may be extended if general principles of prudent management, security, and risk diversification are met.
United States	No limit	No limit	Limits on buying shares or bonds of sponsor

Source: Based on data from [www.oecd.org](http://www.oecd.org).

### 3.6 Taxes

Tax circumstances vary among investors. Some types of investors are taxed on their investment returns, and others are not. For example, in many countries, pension funds are exempt from tax on investment returns. Furthermore, the tax treatment of income and capital gains can vary. It is important to consider an investor's tax situation and the tax consequences of different investments.

Investors should care about the returns they earn after taxes and fees because that is what is available to spend. For example, an investor who is subject to higher tax on dividend income than capital gains will typically desire a portfolio of investments seeking capital growth (i.e., from an increase in value of shares) rather than income (i.e., dividends from shares).

Individuals may also face different tax circumstances for different parts of their wealth. For example, an individual may choose to hold some assets in a pension account if income and capital gains on assets held in a pension account are tax-exempt or tax-deferred. The investor may choose to hold assets expected to generate capital gains in a taxable investment account if capital gains are taxed at a lower rate than income. Where assets are located (held) can significantly affect an investor's after-tax returns and wealth accumulation.

### 3.7 Unique Circumstances

Many investors have particular requirements or constraints not captured by the standard categories discussed so far.

Some investors have social, religious, or ethical preferences that affect how their assets can be invested. For example, investors may choose not to hold investments in companies that engage in activities they believe potentially harm the environment. Other investors may require investments that are consistent with certain religious beliefs. For example, some investors may not invest in conventional debt securities because they do not believe they comply with Islamic law.

Investors may also have specific requirements that stem from the nature of their broader investment portfolio or financial circumstances. For example, an individual who is employed by a company may want to limit investment in that company, which would help the employee reduce single-company exposure and gain broader diversification. Interestingly, many individuals are actually inclined to boost their holdings in their employers' shares on the grounds of loyalty or familiarity, despite the risk that this strategy entails. Such a strategy can have severe consequences if the company fails or its financial position declines. For example, many employees of Enron Corporation, a US energy company, not only lost their jobs but also suffered significant investment losses when Enron went bankrupt.

Institutional investors may also have unique and specific requirements as a result of their objectives and circumstances. For example, a medical foundation may want to avoid investing in tobacco stocks because it believes encouraging tobacco smoking is counter to its objectives of improving health.

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## INVESTMENT POLICY STATEMENTS

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# 4

It is good practice to capture information about the client and the client's needs in an **investment policy statement (IPS)**. An IPS—for both individual and institutional investors—serves as a guide for the investor and investment manager or adviser regarding what is required of and acceptable in the investment portfolio. An IPS also forms the basis for determining what constitutes success in managing the portfolio.

The IPS should capture the investor's objectives and any constraints that will apply to the portfolio. The investor and manager/adviser should agree on the IPS and review it on a regular basis, typically once a year. It should also be reviewed when the client experiences a change in circumstances. Creating and reviewing an IPS is a good opportunity for the investment manager and client to discuss the client's goals.

A common format for an IPS is to split it into sections covering objectives and constraints. Each section has its own subsections. The IPS identifies the investor's circumstances and goals within the types of needs and differences discussed in Section 3. The following format is typical:

- Objectives
  - Return requirement
  - Risk tolerance
- Constraints
  - Time horizon
  - Liquidity
  - Regulatory constraints
  - Taxes
  - Unique circumstances

A typical IPS covers objectives and constraints, but many investors, especially institutional investors, will also include procedural and governance issues in the IPS. The IPS may set out the role of an investment committee, its structure, and its authority. It may also set out the roles of investment managers, the basis on which they will be appointed, and the criteria on which they will be reviewed. An important role of the IPS is to provide information that is useful in determining the types and amounts of assets in which to invest and the way the portfolio will be managed over time. So, the IPS serves as the basis for determining the appropriate portfolio strategies and asset allocations. The following section provides more detail for an institutional investor's IPS.

## 4.1 Institutional Investors and the Investment Policy Statement

Most institutional investors create and adopt a comprehensive IPS. These statements specify many of the following points:

- the general objectives (including return objectives) of the investment program and their relationship to the mission of the institution
- the risk tolerance of the organisation and its capacity for bearing risk
- all economic and operational constraints, such as tax considerations, legal and regulatory circumstances, and any other special circumstances
- the time horizon over which funds are to be invested
- the relative importance of capital preservation and capital growth
- the asset classes in which the institution is allowed to invest
- a target asset allocation that indicates what proportion of the investment funds will be invested in each asset class
- whether leverage (use of debt) or short positions are allowed
- how actively the institution will trade
- how investment decisions will be made
- the benchmarks against which the institution will measure overall investment returns

The board of the institution or its senior leadership formally adopts the investment and payout policies.

The investment leaders decide whether to manage investments in-house or to contract with one or more investment managers. Institutional investors that manage their investments in-house hire a team of investment professionals to manage their investments.

Institutional investors that use outside investment managers may use one manager to manage all investments or multiple managers. Institutional investors often use multiple managers to reduce the risk of substantial loss as a result of poor performance by any one manager. Many institutional investors use different managers for each asset class in which they invest. By hiring managers who specialise in particular asset classes, the institutional investors gain investment expertise and access to investments that a generalist might not have.

## SUMMARY

- The investment industry provides services to individual investors—from those of modest means (retail customers) to the very wealthy with a substantial amount of money to invest. Investment services are also provided to many types of institutional investors, such as pension plans, endowment funds and foundations, governments and sovereign wealth funds, non-financial companies, investment companies, and insurance companies.
- Needs vary among different investor types. Clients have their own objectives related to their circumstances and have different constraints that apply to their portfolios. Key dimensions include
  - return requirement—before and after tax,
  - risk tolerance, and
  - time horizon.
- Investors may also have particular requirements related to liquidity, tax, regulation, and other unique circumstances, including consistency with particular religious or ethical standards.
- It is good practice to capture the needs of an investor in an investment policy statement. The investment policy statement serves as a guide for the investment manager or adviser regarding what is required of and acceptable in the investment portfolio.
- The investment policy statement should capture the investor's objectives and any constraints that will apply to the portfolio. An investment policy statement is typically divided into sections that cover objectives and constraints. Each section has its own subsections.

## CHAPTER REVIEW QUESTIONS

- 1 The investment needs of individual investors are *most likely*:
  - A the same among investors of similar ages and wealth.
  - B similar in many respects to those of institutional investors.
  - C unique to each individual's circumstances and requirements.
- 2 Which of the following types of investors is *most likely* to be identified as an individual investor?
  - A Insurance company
  - B Sovereign wealth fund
  - C Ultra-high-net-worth investor
- 3 Which of the following types of institutional investors is *most likely* to have the shortest investment time horizon?
  - A Life insurer
  - B Endowment fund
  - C Property and casualty insurer
- 4 If investments underperform expectations in a defined benefit pension plan, additional contributions may be required from the:
  - A plan sponsor.
  - B plan beneficiaries.
  - C investment manager.
- 5 If the investment returns of a defined benefit pension plan exceed projections, pension benefits will *most likely*:
  - A decrease.
  - B remain the same.
  - C increase.

- 6** Asset allocation and investment decisions in a defined contribution pension plan are made by the:
- A** plan sponsor.
  - B** plan member.
  - C** investment manager.
- 7** An investor with a long time horizon will *most likely* have a:
- A** higher tolerance for risk.
  - B** reduced investment return expectation.
  - C** lower ability to invest in illiquid investments.
- 8** The return requirement for an investor should be:
- A** specified in nominal terms.
  - B** achievable within the relevant constraints.
  - C** higher for investors with low risk tolerances.
- 9** When an investor's willingness and ability to take risk differ, the investment adviser should counsel the investor to use a risk level based on the:
- A** ability to take risk only.
  - B** willingness to take risk only.
  - C** lesser of the two risk levels.
- 10** An investor's investment policy statement:
- A** ensures that investment plan objectives are met.
  - B** should be reviewed only when the client's circumstances change.
  - C** outlines what is required of and acceptable in the investment portfolio.
- 11** A difference in investment policy statements for institutional investors and individual investors *most likely* relates to the inclusion of:
- A** client constraints.
  - B** investment objectives.
  - C** procedural and governance issues.

**ANSWERS**

- 1 C is correct. Investment needs are directly affected by personal situations, such as age, wealth level, family obligations, and investment horizon, which are generally unique among individual investors. A is incorrect because the investment needs of individual investors tend to vary among individuals based on factors in addition to wealth and age, such as family obligations, investment horizon, and so on. B is incorrect because the characteristics that define individual investors are usually different from those that define institutional investors. Consequently, investor needs are likely to be different for individual investors compared with institutional investors.
- 2 C is correct. High-net-worth and ultra-high-net-worth investors are individual investors with the largest amounts of investable assets. A and B are incorrect because insurance companies and sovereign wealth funds are institutional investors.
- 3 C is correct. Property and casualty insurers have short-term horizons and relatively unpredictable payouts. A is incorrect because life insurers have longer-term time horizons and relatively predictable payouts. B is incorrect because endowments are usually intended to exist in perpetuity and, as such, can be regarded as very long-term investors.
- 4 A is correct. A defined benefit pension plan promises a specified annual benefit to its retired members, typically based on age, years of service with the firm, and average compensation prior to retirement. The employer bears the risk associated with the performance of the pension plan portfolio. If the investments fail to perform as expected, the employer may be required to make additional contributions to the fund based on regulatory requirements. B is incorrect because the plan beneficiaries would not be required to make additional contributions to a defined benefit pension plan as a result of poor performance. C is incorrect because the investment manager is hired to manage the pension plan assets and does not guarantee investment performance results.
- 5 B is correct. The benefits associated with a defined benefit pension plan are established independent of specified investment targets. If the performance of the fund exceeds projections, a pension surplus may be created that improves the funding status of the plan but does not alter the benefit payments made to plan members.
- 6 B is correct. In a defined contribution pension plan, asset allocation and investment decisions are made by the plan member. A is incorrect because the plan sponsor is not responsible for investment decisions within a defined contribution pension plan. C is incorrect because the investment manager is not responsible for the asset allocation decisions within a defined contribution plan.
- 7 A is correct. Investors with longer time horizons can take on more risk because they have more time to adapt to their circumstances. B is incorrect because investors with long time horizons, and consequently a greater ability to take on



risk, are likely to have higher return requirements given their higher level of assumed risk. C is incorrect because investors with long time horizons have a greater ability to invest in illiquid investments.

- 8** B is correct. The investment manager or adviser has to be comfortable that the investor's desired rate of return is achievable within the related constraints. A is incorrect because the return requirement, particularly for a long-term horizon, should be specified in real terms, which means adjusting for the effect of inflation. Adjusting for the effect of inflation is important because it focuses on what the accumulated portfolio will be able to purchase rather than just the nominal monetary value. C is incorrect because for investors with lower risk tolerances, the return requirement will be lower because of the low level of risk in the portfolio.
- 9** C is correct. There may be situations in which an investor's willingness to take risk and his or her ability to take risk are different. In such situations, the investment adviser should counsel the investor about risk and determine the appropriate level of risk to take in the portfolio, taking into account both the investor's ability and willingness to take risk. The lesser of the two risk levels should be the risk level assumed. A and B are incorrect because both the ability and willingness to take risk must be considered.
- 10** C is correct. The investment policy statement serves as a guide for the investor and investment manager regarding what is required and what is acceptable in the investment portfolio. A is incorrect because the investment policy statement outlines the investment plan objectives and serves as a guide to achieving the objectives but it cannot ensure that investment plan objectives will be met. B is incorrect because the investor and manager/adviser should agree on the investment policy statement and review it on a regular basis, typically at least once a year. If the client experiences a change in circumstances, the investment policy statement may be reviewed more frequently.
- 11** C is correct. Procedural and governance issues are constraints specific to many institutional investors. A and B are incorrect because the investment policy statement for both institutional investors and individual investors will include client constraints and investment objectives.