Investment Policy

Source: Bodie, Kane and Marcus, Investments, 12 ed., McGraw-Hill, 2021

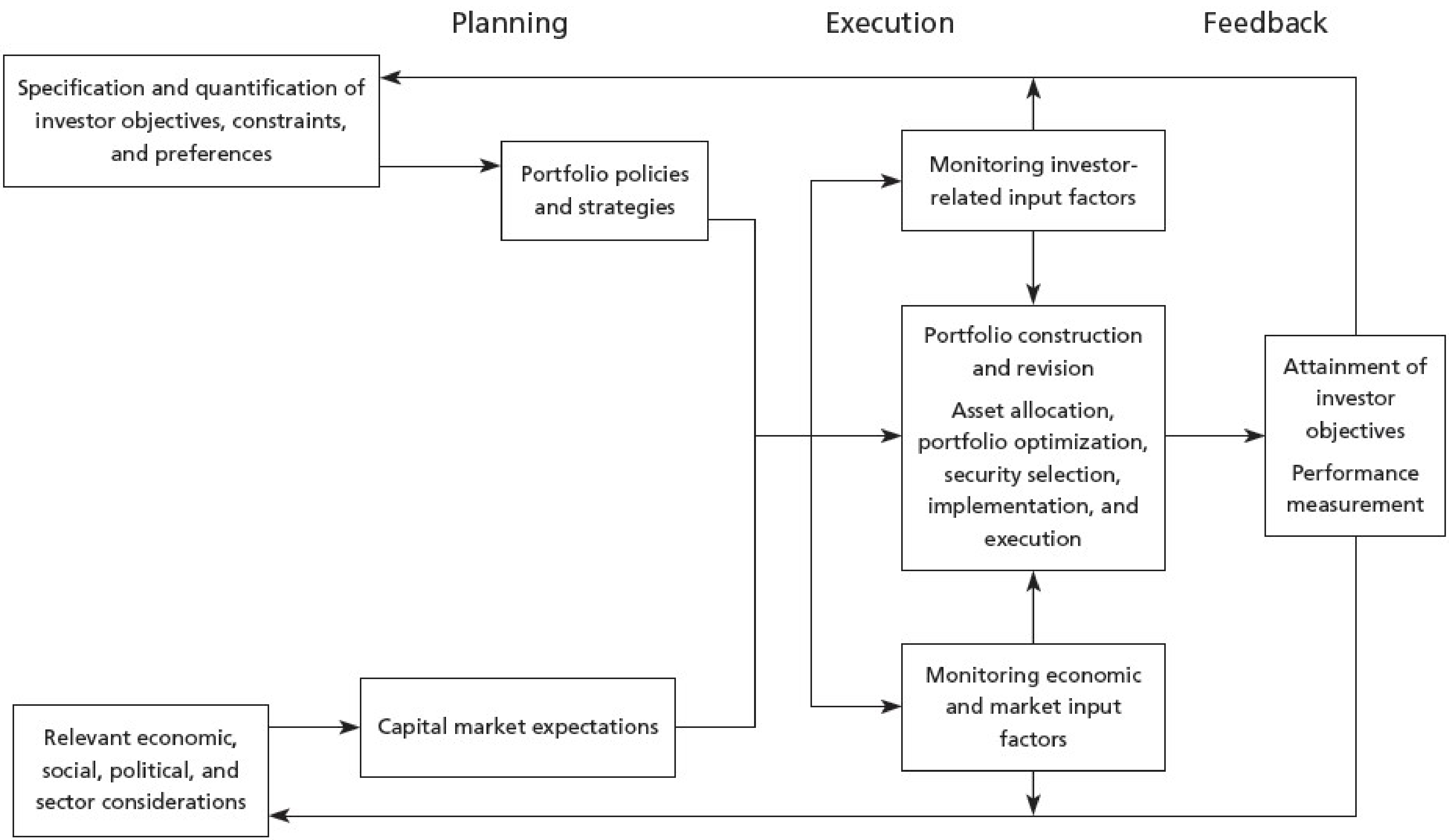
Chapter Overview

- Elements in investment management process
- Objectives of individual and institutional investors
- Major classes of institutional investors
- Investment for the long run

The Investment Management Process

- The elements of the investment process:
  - *Planning*: Establishing inputs necessary for decision making
    - Include data about client as well as the capital market
  - *Execution*: Details of optimal asset allocation and security selection
  - *Feedback*: Process of adapting to changes in expectations and objectives, as well as to changes in portfolio composition that result from changes in market prices

CFA Institute Investment Management Process



Components of the Investment Management Process

- **Table 28.1** Components of the investment management process

I. Planning	
	A. Identifying and specifying the investor's objectives and constraints
	B. Creating the Investment Policy Statement (see Table 28.2)
	C. Forming capital market expectations
	D. Creating the strategic asset allocation (target, minimum, and baseline asset-class weights)
II. **Execution: Portfolio construction and revision**	
	A. Asset allocation (including tactical) and portfolio optimization (combining assets to meet risk and return objectives)
	B. Security selection
	C. Implementation and execution
III. **Feedback**	
	A. Monitoring (investor, economic, and market input factors)
	B. Rebalancing
	C. Performance evaluation

- Source: John L. Maginn, Donald L. Tuttle, Dennis W. McLeavey, and Jerald E. Pinto, "The Portfolio Management Process and the Investment Policy Statement," in *Managing Investment Portfolios: A Dynamic Process,* 3rd ed. (CFA Institute, 2007) and correspondence with Tom Robinson, head of educational content.

Components of the Investment Policy Statement

- **Table 28.2** Components of the investment policy statement

1.	Brief client description
2.	Purpose of establishing policies and guidelines
3.	Duties and investment responsibilities of parties involved
4.	Statement of investment goals, objectives, and constraints (see Table 28.3)
5.	Schedule for review of investment performance and the investment policy statement
6.	Performance measures and benchmarks
7.	Any considerations in developing strategic asset allocation
8.	Investment strategies and investment styles
9.	Guidelines for rebalancing

Determination of Portfolio Policies

Objectives	Constraints	Policies
Return requirements	Liquidity	Asset allocation
Risk tolerance	Horizon	Diversification
	Regulations	Risk positioning
	Taxes	Tax positioning
	Unique needs	Income generation

The Investment Management Process: Objectives

- Objectives
  - Management planning process starts off by analyzing one’s investment clients
    - Consider objectives and constraints that govern their decisions
  - Portfolio objectives center on **risk-return trade-off** between the following:
    - Expected return the investors want (*return requirements*)
    - How much risk they are willing to assume (*risk tolerance*)

Risk Tolerance Questionnaire Example

Question	1 Point	2 Points	3 Points	4 Points
1. I plan on using the money I am investing:	Within 6 months.	Within the next 3 years.	Between 3 and 6 years.	No sooner than 7 years from now.
2. My investments make up this share of assets(excluding home):	More than 75%.	50% or more but less than 75%.	25% or more but less than 50%.	Less than 25%.
3. I expect my future income to:	Decrease.	Remain the same or grow slowly.	Grow faster than the rate of inflation.	Grow quickly.
4. I have emergency savings:	No.	No.	Yes, but less than I'd like to have.	Yes.
5. I would risk this share of my portfolio in exchange for the same probability of doubling my money:	Zero.	10%.	25%.	50%.
6. I have invested in stocks and stock mutual funds:	No.	Yes, but I was uneasy about it.	No, but I look forward to it.	Yes, and I was comfortable with it.
7. My most important investment goal is to:	Preserve my original investment.	Receive some growth and provide income.	Grow faster than inflation but still provide some income.	Grow as fast as possible. Income is not important today.

Matrix of Investor Objectives

- **Table 28.4** Matrix of investor objectives

Type of Investor	Return Requirement	Risk Tolerance
Individual	Life cycle (education, children, retirement)	Life cycle (younger can be more risk tolerant about financial wealth)
Personal trusts	Life cycle	Prudent investor rules
Mutual funds	Variable	Variable
Pension funds (Defined benefit)	Assumed actuarial rate	Depends on proximity of payouts
Endowment funds	Determined by current income needs as well as need for asset growth to maintain real value	Generally conservative
Life insurance companies	Should exceed new money rate by sufficient margin to meet expenses and profit objectives; actuarial rates also important	Conservative
Non–life insurance companies	Match to contingent liabilities	Conservative
Banks	Maintain positive spread over interest rate paid on deposits	Variable

Constraints

- **Liquidity**
  - Ease (speed) with which an asset can be sold and still fetch a fair price
- **Investment horizon**
  - Planned liquidation date of the investment
- Regulations
  - **Prudent investor rule**
- Tax considerations
- Unique needs

Matrix of Constraints

- **Table 28.5** Matrix of constraints

Type of Investor	Liquidity	Horizon	Regulatory	Taxes
Individual	Variable	Life cycle	None	Variable
Personal trusts	Variable	Life cycle	Prudent investor laws	Variable
Mutual funds	Usually low	Short	Little	None*
Pension funds	Young, low; mature, high	Long	ERISA	None
Endowment funds	Low	Long	Little	None
Life insurance companies	Low	Long	Complex	Yes
Non–life insurance companies	High	Short	Little	Yes
Banks	Low	Short	Risk-based capital requirements	Yes

- * The mutual fund itself does not pay taxes, as all investment income is “passed through” to investors. However, it may pay attention to taxes on behalf of its investors.

Sample Policy Statements

- An Investment Policy Statement (IPS) serves as a strategic guide to the planning and implementation of an investment program

1. Scope and purpose
2. Governance
3. Investment, return, and risk objectives
4. Risk management

Asset Allocation

- By far the most important part of policy determination is asset allocation, that is, deciding how much of the portfolio to invest in each major asset category
  - Asset allocation process
    1. Specify asset classes to be included in the portfolio
    2. Specify capital market expectation
    3. Derive the efficient portfolio frontier
    4. Find the optimal asset mix

Managing Portfolios of Individual Investors 1

- Human capital and insurance
- Investment in residence
- Saving for retirement and assumption of risk
- Retirement planning models
- Manage your own portfolio or rely on others?

Managing Portfolios of Individual Investors 2

- Tax Sheltering
  - **Tax-deferral option**
  - **Tax-protected retirement plans**
    - For example, traditional IRAs, Keogh plans, or 401(k) plans
  - **Deferred annuities** are essentially tax-sheltered accounts offered by life insurance companies
    - **Fixed annuities**
    - **Variable annuities**
  - Variable and universal life insurance

Pension Funds 1

- Defined contribution plans
  - Specify the contributions made by and on behalf of employees
  - Investment policy is essentially the same as for a tax-qualified individual retirement account
- Defined benefit plans
  - Specify the retirement *benefits* to which the employee is entitled
  - Pension *plan* versus pension *fund*

Pension Funds 2

- Pension Investment Strategies
  - The tax status of pension funds makes them favor assets with the largest spread between pretax and after-tax rates of return
  - Pension funds make use of **immunization**
  - Investing in equities occurs for both correct and wrong reasons

Investments for the Long Run

- Target investing and the term structure of bonds
  - Investment horizon determines which risk-free rate to choose
- Making simple investment choices
  - Target date retirement funds (TDRFs)
- Inflation risk and long-term investors
  - TIPS are helpful, but not risk-free
  - Market value can fluctuate
  - Reinvestment rate risk