Chase Webber

A Portfolio's Story

Introduction

The formulation of a portfolio between an investor and an investment manager is a lengthy, but rewarding process. These processes consist of the decision-making, development, and implementation. Once complete, the management process begins – the planning processes are essential and the foundation for the monitoring of the portfolio.

Decision Process

The decision-making process begins with the introduction to the client. When introduced, it is important that the investment manager captures all the information about the investor they can receive – financial goals, constraints, objectives, investing history, and life goals are all examples of quality & useful details. Investing & employment history are important as a client may have many accounts, both taxable and non-taxable accounts, large holdings of a single asset in a self-managed portfolio, employer's stock options, and/or other details/restrictions that could potentially alter the strategies the manager implements into the portfolios. It is important to understand if the investor is an individual or institutional investor, as portfolio construction & other factors will differ between the two. Given they are an individual investor, the most important detail would likely be the clients' age; age allows a manager to get a broad understanding of their risk-tolerance & time horizon on investments before getting into the finer details.

These finer details are extremely important, they allow a manager to come up with a 'road map', or investment plan, specific to the client. The beginning details like age, salary, additional income needs, tax concerns, and others can help a manager determine what strategy would likely reap the most benefits for this investor. These options can range from long-term to short-term plans, income-based portfolios, and others – all based on the beginning details received from the client. Understanding the investor's goals, as a whole, is crucial for the manager. These goals & details allow the manager to form a portfolio specific to their needs and allocate to assets the investor is comfortable with. But, it is crucial that a manager understands both the expected returns & their risk tolerance of the investor – this will allow the manager to come to a general understanding of the client-specific asset allocation for the investor's portfolio(s).

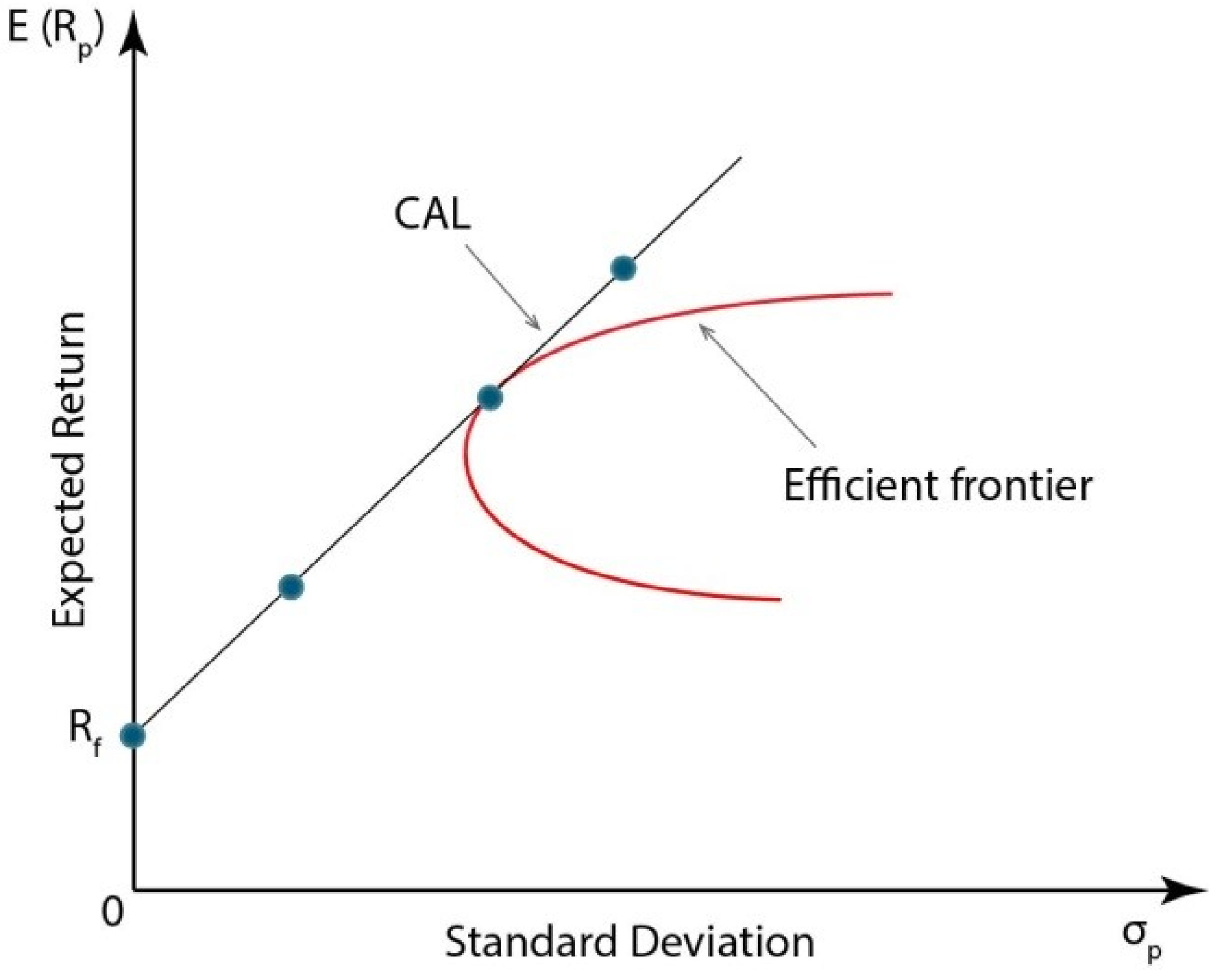
Aside from the investor-specific details, it is important that both parties, the prospect and manager, come to a decision on whether or not working with the other party is a good financial decision. The prospective investor must weigh between signing with a RIA firm, who have a fiduciary duty to their clients, or a broker-dealer/non-RIA firm; they must also decide if they want to have input in all the investment decisions – a discretionary or non-discretionary manager. This all ties into fee structures, restrictions, and other topics – all laid out in the investment policy statement (IPS) which takes place in the development stage.

Development

Once the introduction has been completed and both parties agree on continuing working together, the manager has some work to do in regards to the development of the portfolio. This includes summing the client's net worth, laying out the holdings of their current portfolio(s), drafting the asset allocation based on the client-specific details, selecting potential securities within the allocation, and most importantly, creating the investment policy statement.

The investment policy statement lays out the structure, or plan, of the portfolio as a whole. Also, all of the investor's expectations of the manager should be clearly laid out in the IPS. The IPS will contain a statement of purpose, investment objectives, constraints, tax information, and finally, the legalities and details known as the upshot. The **statement of purpose** includes the reason(s) for the investor retaining the money manager. An example could be new-found wealth or a referral. The **investment objectives** are next, and must be agreed upon between the investor and money manager. The manager must understand the entire goals of the investor, and ensure they are all laid out in this section. This includes questioning, again, the investor's risk tolerance, expected returns, liquidity preferences, and others in order to correctly determine their asset allocation & security selection. Though the IPS is able to be changed, it is important that both the manager and investor agree to everything in the IPS and ensure no important details are left out – this is to protect both the manager and investor if anything was to go wrong. This section should also include the expected returns of the portfolio with a benchmark, commonly the S&P 500; it is important that a manager does not 'definitely' or 'certainly' state anything about returns, they should be estimated, not certain. This section must also include the amount of risk the investor has stated they are willing to take. Once the manager and investor agree to everything within the objectives section, the manager should have all the details they need for the asset-mix between risky and risk-free assets. Moreover, the **constraints** section includes limitations for both the selling and buying of managers; this section is most important for discretionary-trading managers, as they trade without input from the client. For example, a client may restrict selling a stock in their portfolio due to a personal connection to it, or, they may tell their manager to stay away from short-selling stocks because of their risk tolerance. **Tax information** follows, and this is commonly a section provided for the investor's accountant. Finally, the **upshot** wraps up the IPS. Most of the time, each client will receive the same upshot, but fee structure and monitoring style could differ between clients. This section contains guidelines about what will be invested in, explanations on how the investments are chosen, how monitoring will be done, the fee structure, and is ended with the client's signature if they accept everything written in the IPS.

By this time, the asset allocation strategy should be complete and ready to preview for the investor. To simply put it, asset allocation is the difference between risky assets and risk-free assets, and this is different for each investor. Examples of risky assets include securities and ETFs & risk-free assets include cash or treasuries. In order for the manager to determine what the client's asset allocation strategy is, they must fully evaluate their client's risk tolerance. One theoretical method in determining where the investor falls on the CAL. **See Below.**

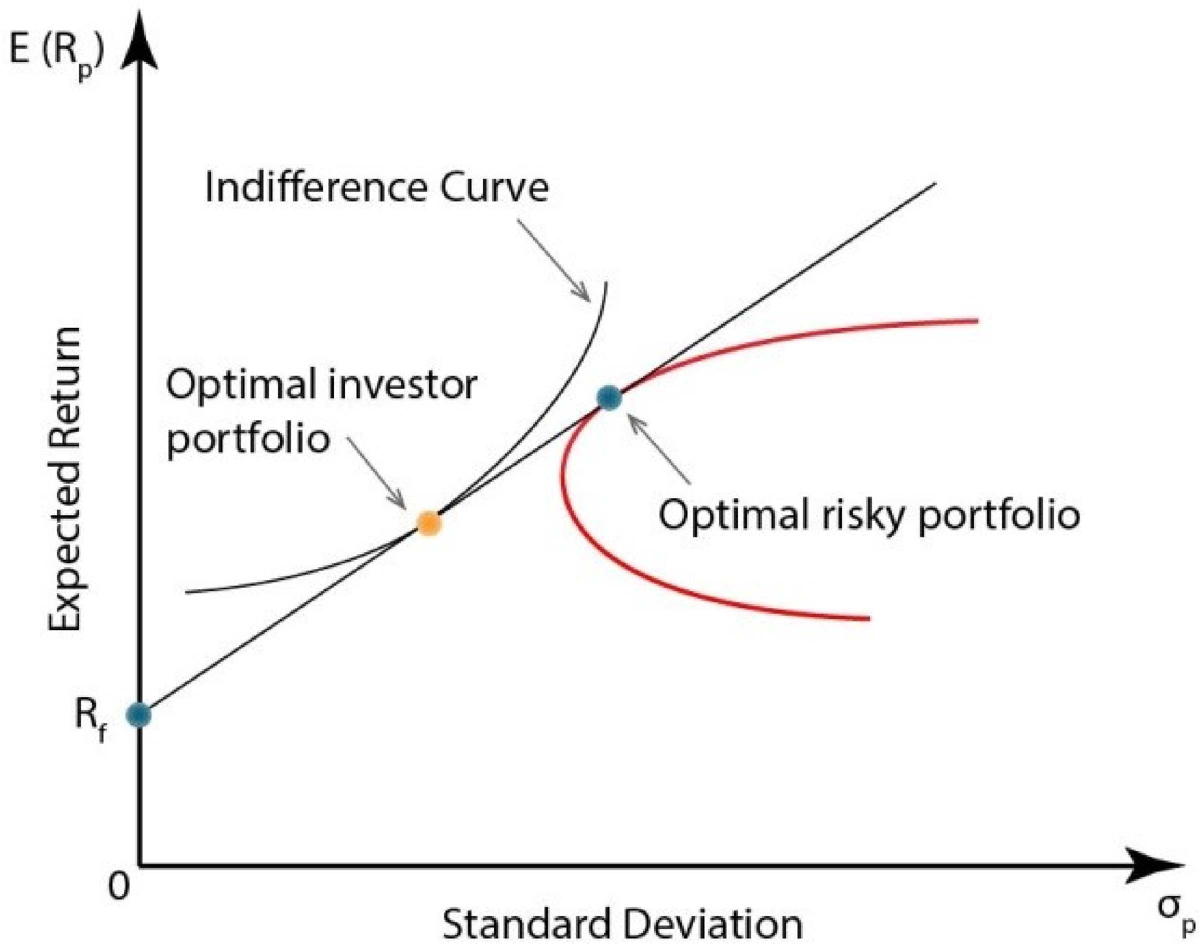


Soleadea.org

The capital allocation line (CAL) is a line that shows all of the combinations between the risky and risk-free assets, with its slope being the sharpe ratio. The sharpe ratio shows how much extra return that is being produced over the risk-free rate when more allocation is given to the risky assets; it is important for managers to maximize this ratio as much as possible to maximize returns. Finally, the metric used to find the client's point on this curve is with the indifference curve – the indifference curve is seen as an investor's utility, or risk aversion; this shows an investor's risk tolerance and the amount of return they want in order to take on the risk, or, the optimal investor portfolio. **See chart on page #6.**

In short, for a manager to correctly allocate the assets between risky and risk-free based on their utility, the manager must find the highest possible indifference curve that touches the CAL. Given all of this information, it is important that a manager uses their own professional opinion in the decision, as there may be macroeconomic variables that indicate the mix should be different than what the CAL shows. For example, macroeconomic variables that could affect the mix include inflation, interest rates, and GDP growth. Most importantly, managers must keep in mind the client's risk aversion and make sure the allocation is in-line with it. Once the manager comes to a final conclusion of what the asset-mix should be, it is important to go over this plan with the client to ensure they understand what the plans for their money are – even for discretionary managers who act without input from the client.

Along with the asset allocation strategy, the manager should have drafted a strategy of the allocation within the risky segment, or their security selection plans. The manager's strategy of allocation within the risky segment is normally the same for each portfolio they oversee; but is not always the case – the portfolios will likely be the same weightings for the majority of clients, but it could also differ from portfolio to portfolio due to restrictions & other client-specific factors. The asset allocation strategy is the process where managers determine the asset-class(es) they will invest in within the risky portfolio. Within the portfolio, the correlation risky assets have with one another should not exceed 0.3 – reducing risk & maximizing returns. In order to determine the allocation within this segment, the manager must find the investor's minimum variance curve (MVC) – a curve showing how much return will be generated per amount of risk taken. The key point on this curve is the efficient frontier, where, theoretically, when intersecting with the CAL, the manager can generate the maximum return for a given level of risk, or, the optimal risky portfolio. This point on the curve provides maximum efficiency, where covariance is low and provides the best-possible returns for the lowest-possible of risk. **See below.**



Soleadea.org

The universal allocation for the manager lies on this point and is their property information that is used to generate clients the best-possible returns for the lowest-possible risk. But, again, it is important that a manager has some input into the final decision as current macroeconomic variables could affect the returns of this strategy – so in real-life situations, portfolios will differ between clients.. This allocation strategy directly feeds into the security selection process of the risky portfolio. Another theoretical methodology to structure a portfolio is the modern portfolio theory, where at a certain level of risk, a manager can maximize returns through diversification. Now that the manager has determined the optimal weightings of asset classes within the risky portfolio, the security selection and implementation process can take place.

Implementation

The beginning portion of the implementation process involves choosing the individual securities that will reside in the portfolio. Based on the efficient frontier, the manager can understand what type of investments are optimal for the client in the risky portfolio; for example, choosing higher volatility stocks or bonds with higher risk of default for the younger clients who are willing to take on more risk for more potential returns.

In regards to the risk-free portfolio, the most attractive, risk-free investments commonly come from money market instruments. These investments are seen as cash equivalent, and the most common are treasury bonds, notes, and bills. These investments are seen as riskless as they are backed by the US government with just about zero risk of default. Security selection within the risky portfolio uses greater technical and theoretical analysis. Moving on to the risky portfolio, there are many different risky-instruments that the manager can choose for the portfolio; examples include: stocks, bonds, ETFs, mutual funds, alternatives (PE, hedge funds, amongst others), and many others. It is important to note that the manager ensures they are investing in securities that fall in line with the client's placement of the efficient frontier and follow the IPS. But, it is important to understand that some investors may have special needs where they may not fall exactly on the intersection point of the efficient frontier and CAL. In regards to choosing the actual securities within the risky portfolio, there are valuation techniques that exist for all different types of risky investments. For ETFs, managers can look at yields and expense ratios & for bonds managers can seek out yields that outweigh the risk of defaulting. Managers could even base their investing decision on the client's tax bracket, where they can choose to invest in tax-exempt bonds like munis. For bonds, the manager can structure a systematic bond ladder where the client is constantly receiving interest and noticing the lowered tax implications as the maturity years of bonds are all different. Continuing on, Monte-Carlo simulations can help estimate the future performance of all of the asset classes, sectors, industries, and individual securities – Monte Carlo simulations help managers better understand the potential for an investment that may be difficult to analyze. In terms of financial planning, a Monte Carlo simulation allows a manager to model the potential growth of principal in a portfolio and help reaffirm a client that they will be able to retire by a certain time, or, it can output a result that recommends the client to cut down their spending habits. But, it is important to note that managers and investors must keep in mind that unforeseen circumstances like Covid can never be taken into account. Also, it is important for them to keep in mind that they must not have any behavioral biases when choosing investments, such as regret avoidance so that they do not miss out on any investments that could be optimal for the client. There are many methods, models, and valuation techniques for a manager to determine the most attractive investments.

In line with the methodology, individual securities have been commonly known to have the clearest and most valuation modeling techniques; examples include a dividend discount model, free cash flow, or comparing to a comparable firm's financial ratios. Modeling uses a bottom-up security analysis – where the first step is to find an undervalued security. After that, the manager must ensure they understand all industry, sector, company, and executive news circulating around that security – and ensure it is a strong holding for the portfolio. But, it is key to remember for this process that some clients may have special needs that cause changes in the portfolio from client-to-client – such as, an individual could be holding a large amount of their employer's stock in an individual portfolio, because of that, the manager should not implement that stock into his strategy. Now that the manager has been able to complete the asset allocation & security selection portion, it is time for the physical implementation.

In regards to the actual implementation of the portfolio, this step is simple compared to the others. A client and manager must agree on a custodian, like Schwab or Fidelity, to host their portfolio. After the custodian is agreed upon, the manager must wait to receive capital from the investor in order to actually invest & integrate their plan. Depending on what has been decided between the manager and investor & is in-line with the manager's strategy, the manager will either invest all at once or dollar cost average into the market, and will have to decide if there is anything worth keeping in the client's previous portfolios. Once the capital has been received & decisions have been made, it is time for the manager to make the trades & buy the securities. Now that implementation has been completed, as well as all of the other planning steps, it is now time for the monitoring of the portfolio.

Monitoring

Now that the portfolio has been implemented, it is the managers time to provide the optimal portfolio and returns for their client. This involves the manager having at least 1 yearly review with their client to ensure that they are up-to-date with their current needs – liquidity preferences may have changed or additional income needs may have increased. The yearly meeting is a good time to review the IPS and decide if any updates/changes need to be made. Along with changes in the IPS, it is key for a manager to respond to any unexpected life changes that occur in the monitoring phase – the manager may have to change the investor's risk tolerance & investment strategy due to the fact that the client just lost their job. Monitoring should be the manager's expertise – keeping the client informed and continuing to come back. In these meetings, it is also important for a manager to go over the performance of the portfolio, so the client understands what has been happening to their money. In this stage, there are many ways for a manager to show how the performance of their portfolios compare to benchmarks or other portfolio types. Managers can use return contribution and attribution methods to explain the returns of the portfolio, compare returns of trading decisions to the total benchmark returns, and most importantly, show where and how they are providing excess return over the benchmark index. A manager can also use a metric called the information ratio, which tracks the active returns of the portfolio, compared to the volatility of the portfolio that generated the returns. This allows an investor to determine if the manager was overconfident or underconfident in regards to returns in the planning processes of the portfolio.

One of the most important portions of the monitoring phase involves rebalancing – on average this is done quarterly to reduce trading fees. Over time, economic conditions change, and because of that, security selection will change. This applies mostly to active investment managers, who are constantly buying and selling securities in order to maximize returns. Passive managers will also rebalance, but not nearly as much as active portfolio managers do iAlong with rebalancing, tax loss harvesting (TLH) is commonly very important to clients in order to minimize tax repercussions. TLH involves selling a security that has taken a loss to cancel out the gains on a different security that has been sold – this offsets or even eliminates the capital gains/income tax you have to pay from selling a security at a gain. Finally, in the monitoring phase, managers should seek to hold and maintain a strong connection with their clients in order to instill trust and faith in the manager.

Conclusion

Every step of the process, decision-process, development, implementation, and monitoring, all play a key role in the formulation of a portfolio. It is key that both the manager and client are transparent in all of their needs throughout this process. A client will approach a manager if they care about their money and want it to grow, and it is important that the manager shares the same ideals about the client's assets.