Chapter 16: Investors and Their Needs

Introduction

Types and Characteristics of Investors

1. Individual Investors
    a. Introduction: the term individual investor is used to describe any individual. However, there are specific characteristics that are used to classify individual investors; most prominent is by net worth and investable assets, the second by level of knowledge. There is not a ubiquitous classification system, but investors with higher net worth and degrees of knowledge typically receive more personalised investment services and advice.
    b. Retail Investors: make up the largest proportion of individual investors. They typically trade for themselves or with the assistance of an investment professional, usually for their own accounts and in small quantities of securities. Many of the services they receive are provided online.
    c. High-Net Worth Investors: typically receive more personalized investment services and advice and face issues relating to taxes and estates.
    d. Ultra-High-Net-Worth Investors and Family Offices: individuals and families that are of ultra-high-net-worth may have family offices that manage their investment, tax, estate, and real estate.
2. Institutional Investors
    a. Introduction: institutional investors are organizations that hold and manage portfolios of assets for themselves or others. Institutional investors vary by organization type and purpose, and these differences are reflected in the purpose, strategy, and needs of their investments. Some institutions have internal asset management, some have external management, and some have a combination. It typically requires being a larger institution to have internal management, as the cost is high.
    b. Pension Plans
        i. Pension Plans: hold investment portfolios for the benefit of future and current retired members, who are called beneficiaries. The institutions that sponsor pension plans are known as pension/plan sponsors. Money from institutional and employee contributions are used as funds.
        ii. Defined Benefits Plans: promise a defined annual amount to the beneficiaries upon retirement. The exact amount is dependent upon salary prior to retirement, years of service, position, etc… These funds have long time horizons, which shorten with decreases in additional beneficiaries. The sponsoring institution bears the risk of investment failing, which would result in their being required to make additional contributions to the fund.
        iii. Defined Contribution Pension Plans: are plans in which the beneficiaries and institutions contribute to an individual's account, which is then invested. There are a variety of options for investing within the fund, which typically comprise several mutual funds approved by the investment management group of the institution. In these plans, the beneficiaries bear the risk of the investments failing.

c. Endowment Funds and Foundations
    i. Endowment Funds: long-term funds of non-profit institutions. These institutions use endowment funds to provide some services to their clients (patients, students, etc…)
    ii. Foundations: grant-making institutions funded by gifts and by the investment income that they produce. These institutions also often own endowment funds.
    iii. Endowments and foundations often have philanthropic purposes, and the contributions they receive can be tax deductible, and the investment returns they receive can be tax exempt.
    iv. Endowment funds are usually intended to exist in perpetuity, thus they are regarded as long-term investors. They usually have a required amount of assets they must contribute to their mission annually. This requires a balance of long-term and short-term investment and financial goals.
    v. Endowments and foundations have different structures of funding in terms of when and how they can raise money, and these differences result in different strategies and needs for investing. Many have their own investment management teams.

d. Government and Sovereign Wealth Funds
    i. Sovereign wealth funds are funds used by governments to invest money over the long-term. They usually invest in long-term securities and assets, as well as purchasing companies. Governments also have their own investment managers.

e. Non-Financial Companies
    i. Companies that do not provide financial goods and services still require financial management. Unused capital can be invested in short, medium, and long term investment strategies in order to increase capital and fund future investments in research, acquisitions, ventures, etc… This can be done by internal or external investment managers. Companies often invest directly in the shares and bonds of their affiliates. These are called 'strategic investments.'

f. Investment Companies
    i. Investment companies include mutual funds, hedge funds, and private equity funds. These companies exist to hold investments on behalf of their shareholders, partners, or unitholders. These are all types of pooled investment vehicles.

g. Insurance Companies
    i. Insurance companies invest the assets that they have on float in portfolios of assets that allow them to appreciate capital while still having enough liquidity to pay claims when necessary.
    ii. The two main types of insurance companies are liability and casualty insurers and life insurers. By nature these two types have different relevant time horizons, liability/casualty being shorter-term, and life insurance being longer-term.
    iii. Insurance companies employ strategies that use asset/liability matching, which a strategy aimed at reducing risk by matching the return and risk rates of assets and liabilities.

Factors That Affect Investors' Needs

1. Required Return: is determined by an investor's financial goals, which usually have numerical and chronological dimensions. It is important that these goals are possible to reach given an investor's current financial status, especially in regards to ability to acquire returns and handle the associated risks. It is also important that these goals be adjusted for inflation.
2. Risk Tolerance: risk tolerance is a function of both willingness and ability to take risk. Willingness to take risk does not only refer to personality, it also includes investing experience and knowledge. Ability to take risk is determined by an investor's assets, liabilities, liquidity requirements, and time horizon. Some institutional investors may have organizational or legal requirements mandating the level of risk they are allowed to assume. Generally, when two levels of risk are determined, the lower level of risk is to be assumed.
3. Time Horizon: time horizon is determined by an investor's current and future financial needs. Required degree of liquidity is especially important. Generally, longer time horizons allow for greater degrees of risk to be taken, as conditions can be adapted to better over the long term.
4. Liquidity: requirements are determined by financial needs. Investors may need liquidity at a predetermined point in the future for a specific purpose, a specific stream of income, or the ability to pay unexpected costs.
5. Regulatory Issues: some types of investors, particularly institutional investors such as insurance companies, are regulated in their investing activities.
6. Taxes: taxes vary across both types of and specific investors. Taxes required for capital appreciation and capital gains may differ across investors as well as types of accounts. The features of each individual investor's tax situation must be accounted for in order to maximize investment returns.
7. Unique Circumstances: for investors exist in ways that are not captured by the usual descriptions listed above. These can include religious, social, ethical, or professional features of investors.

Investment Policy Statements

1. Introduction
    a. It is common practice for investment professionals to create Investment Policy Statements for those whose assets they manage. The typical structure of an IPS is as follows:
        i. Objectives:
            1. Return Requirement
            2. Risk Tolerance
        ii. Constraints:
            1. Time Horizon
            2. Liquidity
            3. Regulatory Constraints
            4. Taxes
            5. Unique Characteristics
    b. Institutional investors may also have elements of an IPS that dictates its procedural and governance features, as well as the definition of the investment committee and its structure and authority. Additionally, an IPS can include statements of acceptable investment criteria, allocation, and strategies.

2. Institutional Investors and the Investment Policy Statement
    a. In addition to those listed above, IPS for institutional investors often include details of the portfolio’s relation to the organization’s mission, whether the use of leverage or short positions is allowed, how actively the portfolio is to be traded, how investment decisions are to be made, and what benchmarks will be used to assess the success of the portfolio. This also includes whether the portfolio is to be managed internally or externally. It is common for institutional investors to use multiple asset managers who specialise in asset classes, allowing for diversification of management.