LEVEL 1: PORTFOLIO MANAGEMENT

Reading 51 (4th out of 8): IPS

Difficulty: **easy**

Benchmark Study Time: **2h**

2022

INTENTIONALLY EMPTY

THIS E-BOOK:

- is a selective summary of the corresponding Reading in your CFA® Program Curriculum,
- provides place for your own notes,
- helps you structure your study and revision time!

How to use this e-book to maximize your knowledge retention:

1. **Print** the e-book in duplex and bind it to keep **all** important info for this Reading **in one place.**
2. **Read** this e-book, best twice, to grasp the idea of what this Reading is about.
3. **Study** the Reading from your curriculum. **Here add** your notes, examples, formulas, definitions, etc.
4. **Review** the Reading using this e-book, e.g. write your summary of key concepts or revise the formulas at the end of this e-book (if applicable).
5. **Done?** Go to your study plan and change the Reading's status to **green**: (it will make your Chance-to-Pass-Score™ grow ☺).
6. **Come back** to this e-book from time to time to **regularly review for knowledge retention!**

NOTE: While studying or reviewing this Reading, you can use the tables at the end of this e-book and mark your study/review sessions to hold yourself accountable.

IPS – objectives and construction

The investment policy statement (IPS) is a written document containing both objectives and constraints that apply to a particular investor. This document allows the portfolio manager to control and account for portfolio management results. The IPS includes information crucial for the creation and management of the client's portfolio, such as the investor's objectives (e.g. income expectations), time horizon, liquidity needs, amount of capital, etc. Investment success is impossible without developing a clear plan that will set goals with respect to the risk taken and the expected return. The client and the portfolio manager should develop the IPS together.

IPS and risk taking

The client's portfolio should be compatible with the risk that he or she may take. Explain to the client the mechanisms governing financial markets, especially the **risk-return relationship**. Risk rather than return should be the primary consideration.

Main components of IPS

1. Introduction – describes the investor's situation.
2. Statement of Purpose – defines the purpose of the IPS.
3. Statement of Duties and Responsibilities – details the duties and responsibilities of both the client and the investment manager.
4. Procedures – describe how to develop or change the IPS, with a particular emphasis on emergencies.
5. Investment Objectives – explain the client's investment objectives.
6. Investment Constraints – present constraints that need to be considered when formulating objectives and constructing and monitoring the portfolio.
7. Investment Guidelines – explain how the investment plan should be executed (includes information about things such as asset classes or leverage).
8. Evaluation and Review – discuss the investment performance together with the reasons and guidelines for the future to allow more efficient portfolio management.
9. Appendices – usually consist of two parts: the first part determines strategic asset allocation, whereas the second part describes the rebalancing policy.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

Risk objectives – division

There are two types of risk objectives:

- absolute risk objectives,
- relative risk objectives.

An objective defined by **absolute risk** concerns the likelihood of losing a portion of the total investment or shows the amount of the loss.

Examples:

- Within 12 months, the portfolio will not lose more than USD 10,000.
- Within 12 months, the portfolio will lose no more than 3% of its value.
- Within the 12-month period, the portfolio will not lose its value.
- With a probability less than 3%, the loss within 12 months will not be greater than 10%.
- The loss will be greater than 5% with a probability of less than 5% within 12 months.

Relative risk is about referring to values other than the sum of investment. Often the reference point is a market index, e.g. stock or bond index.

Examples:

- Within 12 months, the portfolio will not lose more than S&P500.
- Within 12 months, the portfolio will not lose more than LIBOR plus 2 percentage points.
- With a probability of 10%, within 12 months the portfolio will not lose more than 5% compared to the CAC 40 index.

Taking risk – willingness vs ability

Willingness to take risk is a subjective factor. It depends on an investor's perception of an investment and a possible rate of return. A portfolio manager often examines the willingness to take risk using a short questionnaire prepared for the client.

Ability to take risk is determined by the situation of the investor, his or her investment horizon, wealth and liabilities, expenses, investment objectives, i.e. his or her financial situation. The manager gathers information about the client's situation in order to properly adjust the level of risk that the investor may accept.

When a conflict between the client's willingness and ability to take risk occurs, **objective factors**, i.e. the client's **ability to take risk**, should be given precedence.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

Return objectives – division

There are two types of return objectives:

- absolute return objectives,
- relative return objectives.

When considering **absolute return objectives**, we refer to nominal or real values.

Examples:

- The value of the portfolio will increase by USD 20,000 within a year.
- Within 12 months, the value of the portfolio will increase by 4%.

Relative return objectives refer to benchmarks, e.g. an index, interest rate, etc.

Examples:

- The rate of return each year will be ahead of LIBOR by 2 percentage points.
- The rate of return within 12 months will be higher than the FTSE 100 index by 5%.
- The rate of return within a year will not be less than the return on the MSCI World Index.

Other investment constraints

Among factors classified as investment constraints, there are:

- liquidity,
- time horizon,
- tax concerns,
- legal and regulatory factors,
- any unique circumstances.

Liquidity

Liquidity is associated with the ability to convert an investment into cash. High liquidity means that this conversion can be done relatively easily and at a low cost. Low liquidity is often related to a higher expected rate of return and it means that the investor accepts the fact that when he or she needs money they may not be able to obtain it easily.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

Time horizon

Time horizon is related to the length of the client's potential investment. The longer the investment horizon, the more risk can be taken by the investor and the less liquid investments can be accepted. The shorter the horizon, the greater the required liquidity and the lower the risk that the investor can bear.

Tax concerns

Tax concerns must be considered individually for each client. Financial status, tax thresholds, and current tax liabilities should be taken into account. Different countries have different tax laws (e.g. some assets may be exempt from taxes depending on the country).

Legal and regulatory factors

Legal and regulatory factors affect all investors or a particular group of investors in a given country or region (e.g. in most countries, pension funds have legally imposed limits on the size of investment in a given asset class).

Unique circumstances

Unique circumstances are related to the client's individual characteristics and they refer to aspects such as religion, ethics, morality, etc. (e.g. unwillingness to invest in sectors such as pornography or alcohol).

Strategic asset allocation (SAA)

Strategic asset allocation:

- is designed to determine the share of long-term assets in the portfolio,
- is created based on clearly defined investment objectives and restrictions or limitations that an investor has to face.

Asset classes:

- cash,
- equities,
- bonds,
- real estate,
- commodities,
- hedge funds,
- private equity.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

Tactical asset allocation (TAA)

Approaches to investing:

- active investing,
- passive investing.

Tactical asset allocation:

- is used in active investment management,
- allows for some deviation from the established structure of the portfolio (SAA) to increase the weight of assets with favorable short-term perspectives,
- is aimed to increase portfolio performance.

Security selection

In the security selection step, specific assets are selected.

Rebalancing

Portfolio rebalancing is designed to restore a portfolio structure compatible with the SAA. The structure may vary if the prices of financial instruments change. Portfolio rebalancing should be planned and exercised regularly in accordance with the guidelines contained in the IPS.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

Summarizing key concepts:

☐ IPS – objectives and construction

My summary:

☐ Main components of IPS

My summary:

☐ Risk objectives: absolute risk objectives, relative risk objectives

My summary:

☐ Taking risk – willingness vs ability

My summary:

☐ Return objectives: absolute return objectives, relative return objectives

My summary:

☐ Other investment constraints: liquidity, time horizon, tax concerns, legal and regulatory factors, any unique circumstances

My summary:

☐ Strategic asset allocation (SAA)

My summary:

☐ Tactical asset allocation (TAA)

My summary:

Keeping myself accountable:

TABLE 1 | STUDY

When you sit down to study, you may want to **try the Pomodoro Technique** to handle your study sessions: study for 25 minutes, then take a 5-minute break. Repeat this 25+5 study-break sequence all throughout your daily study session.

✔ Tick off as you proceed.

POMODORO TIMETABLE: study-break sequences (25′ + 5′)													
date		date		date		date		date		date		date	
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TABLE 2 | REVIEW

Never ever neglect revision! Though it's not the most popular thing among CFA candidates, regular revision is what makes the difference. If you want to pass your exam, **schedule & do your review sessions.**

REVIEW TIMETABLE: When did I review this Reading?													
date		date		date		date		date		date		date	
date		date		date		date		date		date		date	