PART I

# LEARNING OBJECTIVES, SUMMARY OVERVIEW, AND PROBLEMS

# CHAPTER 1

# BASICS OF PORTFOLIO PLANNING AND CONSTRUCTION

## LEARNING OUTCOMES

*The candidate should be able to:*

- describe the reasons for a written investment policy statement (IPS);
- describe the major components of an IPS;
- describe risk and return objectives and how they may be developed for a client;
- distinguish between the willingness and the ability (capacity) to take risk in analyzing an investor's financial risk tolerance;
- describe the investment constraints of liquidity, time horizon, tax concerns, legal and regulatory factors, and unique circumstances and their implications for the choice of portfolio assets;
- explain the specification of asset classes in relation to asset allocation;
- describe the principles of portfolio construction and the role of asset allocation in relation to the IPS;
- describe how environmental, social, and governance (ESG) considerations may be integrated into portfolio planning and construction.

## SUMMARY

In this chapter, we have discussed construction of a client's investment policy statement, including discussion of risk and return objectives and the various constraints that will apply to the portfolio. We have also discussed the portfolio construction process, with emphasis on the strategic asset allocation decisions that must be made.

- The IPS is the starting point of the portfolio management process. Without a full understanding of the client's situation and requirements, it is unlikely that successful results will be achieved.
- The IPS can take a variety of forms. A typical format will include the client's investment objectives and also list the constraints that apply to the client's portfolio.
- The client's objectives are specified in terms of risk tolerance and return requirements.
- The constraints section covers factors that need to be considered when constructing a portfolio for the client that meets the objectives. The typical constraint categories are liquidity requirements, time horizon, regulatory requirements, tax status, and unique needs.
- Clients may have personal objections to certain products or practices, which could lead to the exclusion of certain companies, countries, or types of securities from the investable universe as well as the client's benchmark. Such considerations are often referred to as ESG (environmental, social, governance).
- ESG considerations can be integrated into an investment policy by exclusionary screening, best-in-class selection, active ownership, thematic and impact investing, and ESG integration in security analysis.
- Risk objectives are specifications for portfolio risk that reflect the risk tolerance of the client. Quantitative risk objectives can be absolute or relative or a combination of the two.
- The client's overall risk tolerance is a function of the client's ability to accept risk and their "risk attitude," which can be considered the client's willingness to take risk.
- The client's return objectives can be stated on an absolute or a relative basis. As an example of an absolute objective, the client may want to achieve a particular percentage rate of return. Alternatively, the return objective can be stated on a relative basis, for example, relative to a benchmark return.
- The liquidity section of the IPS should state what the client's requirements are to draw cash from the portfolio.
- The time horizon section of the IPS should state the time horizon over which the investor is investing. This horizon may be the period during which the portfolio is accumulating before any assets need to be withdrawn.
- Tax status varies among investors and a client's tax status should be stated in the IPS.
- The IPS should state any legal or regulatory restrictions that constrain the investment of the portfolio.
- The unique circumstances section of the IPS should cover any other aspect of a client's circumstances that is likely to have a material impact on the composition of the portfolio. Certain ESG implementation approaches, such as negative (exclusionary) screening, best-in-class, thematic investing, impact investing, and ESG integration may be discussed in this section.
- Asset classes are the building blocks of an asset allocation. An asset class is a category of assets that have similar characteristics, attributes, and risk/return relationships. Traditionally, investors have distinguished cash, equities, bonds, and real estate as the major asset classes.
- A strategic asset allocation results from combining the constraints and objectives articulated in the IPS and capital market expectations regarding the asset classes.
- As time goes on, a client's asset allocation will drift from the target allocation, and the amount of allowable drift as well as a rebalancing policy should be formalized.

- In addition to taking systematic risk, an investment committee may choose to take tactical asset allocation risk or security selection risk. The amount of return attributable to these decisions can be measured.
- ESG considerations may be integrated into the portfolio planning and construction process. Such considerations can be difficult given that ESG data is often not required to be disclosed by companies. ESG implementation approaches require a set of instructions for investment managers with regards to the selection of securities, the exercise of shareholder rights, and the selection of investment strategies.

## PRACTICE PROBLEMS

1. Which of the following is *least important* as a reason for a written investment policy statement (IPS)?
   A. The IPS may be required by regulation.
   B. Having a written IPS is part of best practice for a portfolio manager.
   C. Having a written IPS ensures the client's risk and return objectives can be achieved.
2. Which of the following *best* describes the underlying rationale for a written investment policy statement (IPS)?
   A. A written IPS communicates a plan for trying to achieve investment success.
   B. A written IPS provides investment managers with a ready defense against client lawsuits.
   C. A written IPS allows investment managers to instruct clients about the proper use and purpose of investments.
3. A written investment policy statement (IPS) is *most likely* to succeed if:
   A. it is created by a software program to assure consistent quality.
   B. it is a collaborative effort of the client and the portfolio manager.
   C. it reflects the investment philosophy of the portfolio manager.
4. The section of the investment policy statement (IPS) that provides information about how policy may be executed, including restrictions and exclusions, is *best* described as the:
   A. *Investment Objectives*.
   B. *Investment Guidelines*.
   C. *Statement of Duties and Responsibilities*.
5. Which of the following is *least likely* to be placed in the appendices to an investment policy statement (IPS)?
   A. *Rebalancing Policy*
   B. *Strategic Asset Allocation*
   C. *Statement of Duties and Responsibilities*
6. Which of the following typical topics in an investment policy statement (IPS) is *most closely* linked to the client's "distinctive needs"?
   A. *Procedures*
   B. *Investment Guidelines*
   C. *Statement of Duties and Responsibilities*

7. An investment policy statement that includes a return objective of outperforming the FTSE 100 by 120 basis points is *best* characterized as having a(n):
   A. relative return objective.
   B. absolute return objective.
   C. arbitrage-based return objective.

8. Risk assessment questionnaires for investment management clients are *most* useful in measuring:
   A. value at risk.
   B. ability to take risk.
   C. willingness to take risk.

9. Which of the following is *best* characterized as a relative risk objective?
   A. Value at risk for the fund will not exceed US$3 million.
   B. The fund will not underperform the DAX by more than 250 basis points.
   C. The fund will not lose more than €2.5 million in the coming 12-month period.

10. In preparing an investment policy statement, which of the following is *most difficult* to quantify?
    A. Time horizon
    B. Ability to accept risk
    C. Willingness to accept risk

11. After interviewing a client in order to prepare a written investment policy statement (IPS), you have established the following:
    - The client has earnings that vary dramatically between £30,000 and £70,000 (pre-tax) depending on weather patterns in Britain.
    - In three of the previous five years, the after-tax income of the client has been less than £20,000.
    - The client's mother is dependent on her son (the client) for approximately £9,000 per year support.
    - The client's own subsistence needs are approximately £12,000 per year.
    - The client has more than 10 years' experience trading investments including commodity futures, stock options, and selling stock short.
    - The client's responses to a standard risk assessment questionnaire suggest he has above average risk tolerance.

    The client is *best* described as having a:
    A. low ability to take risk, but a high willingness to take risk.
    B. high ability to take risk, but a low willingness to take risk.
    C. high ability to take risk and a high willingness to take risk.

12. After interviewing a client in order to prepare a written investment policy statement (IPS), you have established the following:
    - The client has earnings that have exceeded €120,000 (pre-tax) each year for the past five years.
    - She has no dependents.
    - The client's subsistence needs are approximately €45,000 per year.
    - The client states that she feels uncomfortable with her lack of understanding of securities markets.

- All of the client's current savings are invested in short-term securities guaranteed by an agency of her national government.
- The client's responses to a standard risk assessment questionnaire suggest she has low risk tolerance.

The client is *best* described as having a:
A. low ability to take risk, but a high willingness to take risk.
B. high ability to take risk, but a low willingness to take risk.
C. high ability to take risk and a high willingness to take risk.

13. A client who is a 34-year-old widow with two healthy young children (aged 5 and 7) has asked you to help her form an investment policy statement. She has been employed as an administrative assistant in a bureau of her national government for the previous 12 years. She has two primary financial goals—her retirement and providing for the college education of her children. This client's time horizon is *best* described as being:
A. long term.
B. short term.
C. medium term.

14. The timing of payouts for property and casualty insurers is unpredictable ("lumpy") in comparison with the timing of payouts for life insurance companies. Therefore, in general, property and casualty insurers have:
A. lower liquidity needs than life insurance companies.
B. greater liquidity needs than life insurance companies.
C. a higher return objective than life insurance companies.

15. A client who is a director of a publicly listed corporation is required by law to refrain from trading that company's stock at certain points of the year when disclosure of financial results are pending. In preparing a written investment policy statement (IPS) for this client, this restriction on trading:
A. is irrelevant to the IPS.
B. should be included in the IPS.
C. makes it illegal for the portfolio manager to work with this client.

16. Consider the pairwise correlations of monthly returns of the following asset classes:

| | **Brazilian Equities** | **East Asian Equities** | **European Equities** | **US Equities** |
|---|---|---|---|---|
| Brazilian equities | 1.00 | 0.70 | 0.85 | 0.76 |
| East Asian equities | 0.70 | 1.00 | 0.91 | 0.88 |
| European equities | 0.85 | 0.91 | 1.00 | 0.90 |
| US equities | 0.76 | 0.88 | 0.90 | 1.00 |

Based solely on the information in the above table, which equity asset class is *most sharply* distinguished from US equities?
A. Brazilian equities.
B. European equities.
C. East Asian equities.

17. Returns on asset classes are *best* described as being a function of:
    A. the failure of arbitrage.
    B. exposure to the idiosyncratic risks of those asset classes.
    C. exposure to sets of systematic factors relevant to those asset classes.

18. In defining asset classes as part of the strategic asset allocation decision, pairwise correlations within asset classes should generally be:
    A. equal to correlations among asset classes.
    B. lower than correlations among asset classes.
    C. higher than correlations among asset classes.

19. Tactical asset allocation is *best* described as:
    A. attempts to exploit arbitrage possibilities among asset classes.
    B. the decision to deliberately deviate from the policy portfolio.
    C. selecting asset classes with the desired exposures to sources of systematic risk in an investment portfolio.