

Basics of Portfolio Planning and Construction

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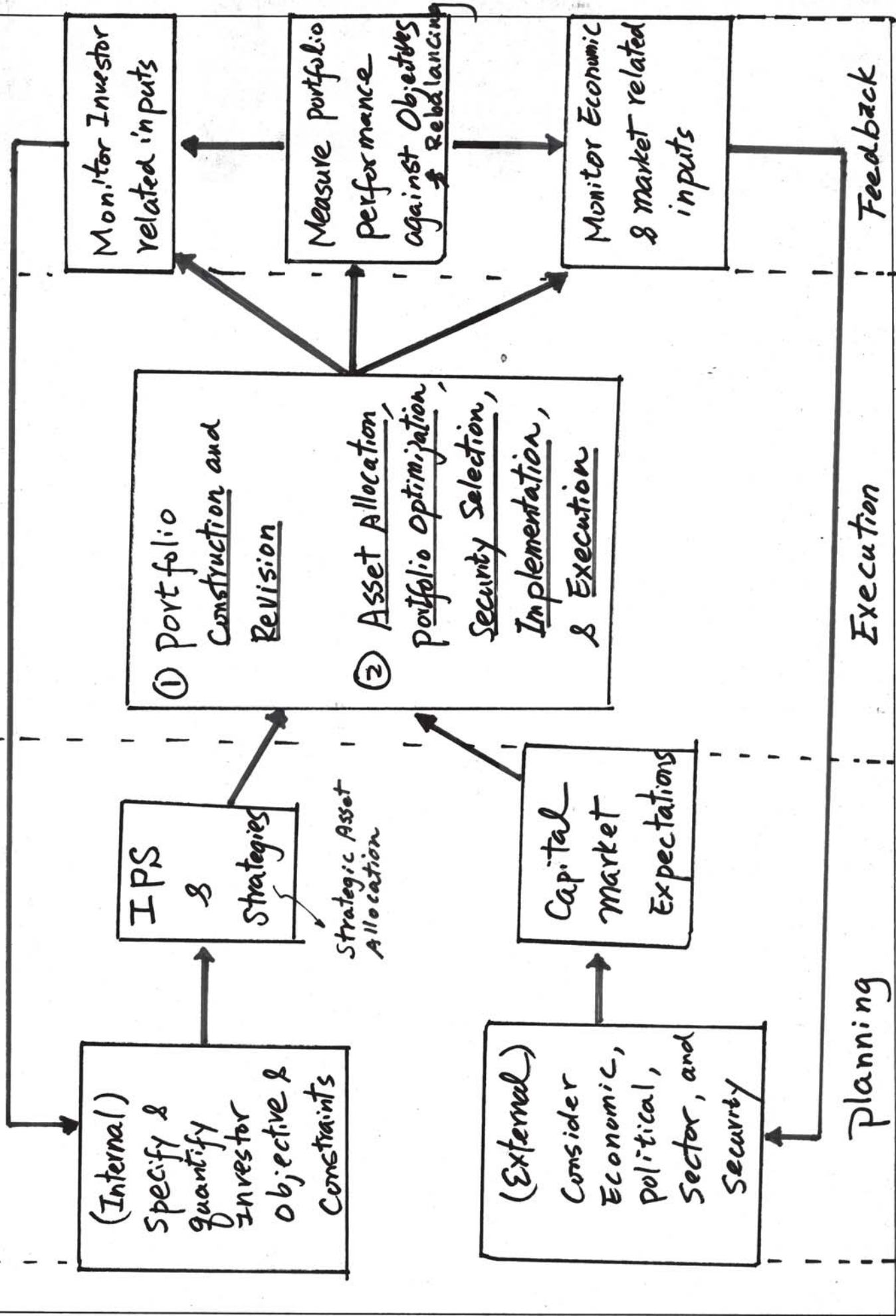
Why Investment Policy Statement (IPS) is so important?

- ① Provide a written Strategic Plan.
- ② Determine Suitability for investors.
- ③ Establish Strategic Asset Allocation.
- ④ Specify manager's role and responsibility

What is duty of Portfolio managers?

- ① Construct a portfolio to meet the needs of investor according to IPS.
 - ② Monitor, Rebalance and review the "portfolio allocation" as well as the IPS to continuously meet Client's needs.
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- (a) market/economy conditions will change
 - (b) Client's circumstance could change
 - (c) Development of New investment instruments and markets
 - (d) Changing in tax law.

The Portfolio Management Process



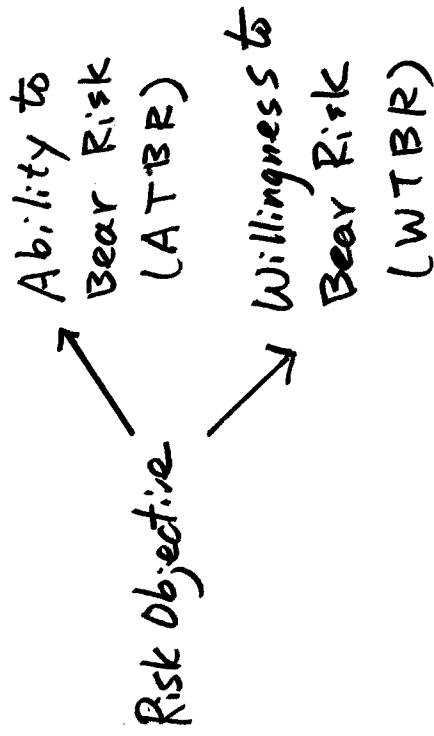
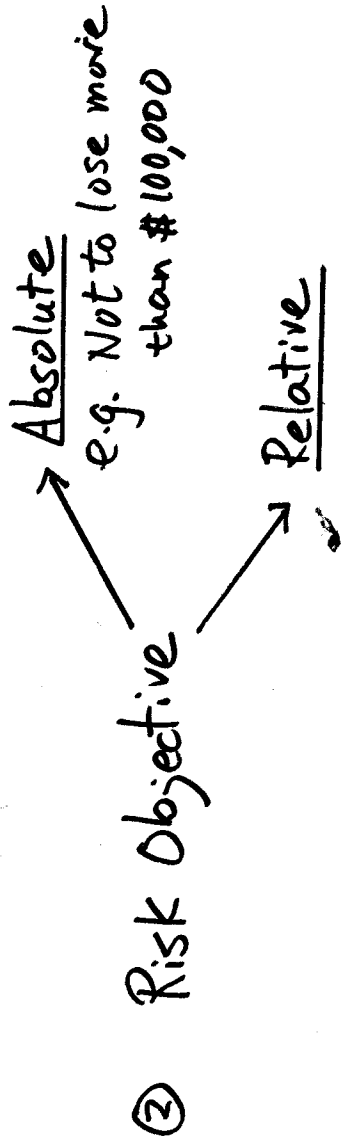
Portfolio Planning and Construction

The IPS: Introduction → Statement of Purpose → Duties & Responsibility
→ procedures → Investment Objective → Investment Constraints
→ Investment Guidelines → Evaluation & Review

Objective: ① Return Objective: What is the required return before tax to meet the Needs and inflation

$$BTRR = \frac{ATRR}{(1 - \text{Tax Rate})} + \text{inflation rate}$$

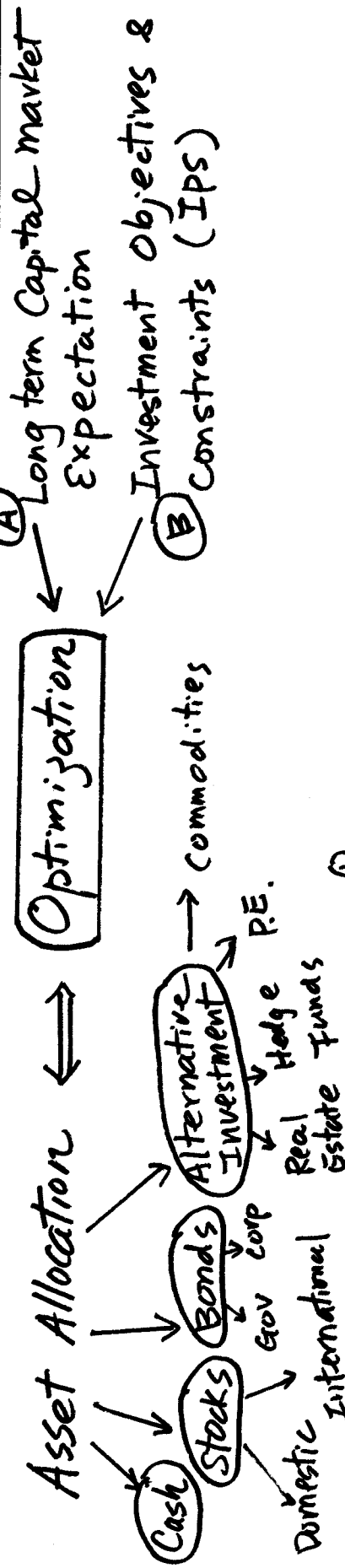
* inflation adjustment → to maintain the real value of investment.



ATBR \leftrightarrow Investment Horizons, wealth, Insurance, Job Security
WTBR \leftrightarrow Attitudes & beliefs, Risk Aversion & Risk Tolerance

Investment Constraints: T, T, L, L, L, L

- ① Time Horizon \rightarrow affect ATBR; usually multi-stages
- ② Tax Situation \rightarrow Low Cost base stocks; Capital Gain Tax
- ③ Liquidity \rightarrow Debt, Living expenses, Mortgage expenses, Child Support & Education, Keep 5-6 months in Cash Living Exp.
- ④ Legal & Regulatory \rightarrow Insiders of a firm Board member.
- ⑤ Unique Circumstance \rightarrow own large amount of family stocks
Special bequest (e.g. donation)
Concentrated holding in stock
No alcohol & tobacco stock



- Allocation must meet
- ① Required Return from IPS
 - ② Safety Cash Reserve
 - ③ Diversification of Risk
 - ④ Hedging inflation risk (maintaining Real value)
 - ⑤ minimize Longevity risk (the risk that one will outlive one's asset)

Goal 1

Goal 2

Allocation to the efficient frontier "CML" that maximize investor's Expected Utility $EU = \bar{R}_p - A\sigma_p^2$; A = Degree of Risk Aversion