R02 Portfolio Construction and Management

This section will consider the main strategies that can be used to construct the optimal portfolio for a client's needs together with how those needs can be identified. It is one part of the larger advice process which can be summarised as follows:

- Assist clients to decide and prioritise their needs.
- Determine and agree an appropriate investment strategy taking into account liquidity, income, growth, risk and tax
- Identify and record in writing the client's overall investment objectives and acceptance of level of investment risk.
- Act in the client's best interest in accordance with the agreed objectives.
- Exercise professional judgment and care in carrying out the management of the investment portfolio.
- Keep the agreed strategy under review especially if there are changes in taxation or the economic and investment environment.
- Carry out the necessary administration and accounting required to look after the portfolio.

The portfolio will be set up based on the client's **strategic aims** and these can be characterised by being long term, established at outset, rebalanced when necessary, based on client objectives/ATR. From time to time it may be necessary to balance these with **tactical decisions**, that is short term adjustments, taking advantage of opportunities, deviating from strategic in attempt to beat the benchmark.

Identifying a client's needs

This will normally require an adviser to establish:

- Client basic objectives, income, growth or a combination of both.
- Timescale/accessibility
- Target growth or income need
- Benchmark against which performance will be assessed
- Amount of funds available to invest.
- Liabilities
- Other assets or income
- Tax status
- Ethical or cultural considerations.
- Legal and tax constraints
- Attitude to risk/capacity for loss
- Reporting requirements to client

Client’s objectives.

Clients will usually have one four main investment objectives:

- Capital preservation. They want to minimise any losses but retain the value of their assets in real terms and so require to match the rate of inflation
- Capital appreciation. Probably looking to achieve growth through the increase in the value of assets over and above the rate of inflation
- Current income. Priority is to achieve the highest level of income, probably because this is needed to fund day to day expenses
- Total return. Probably long term investors who are looking to increase wealth by a mixture of capital growth and income

Investment objectives could be generic or they could be specific such as the need to provide £10,000 a year for further education in 10 years’ time. Most clients will have a range of objectives for the short medium and long term.

Timescale

Timescale is a constraint because it influences the amount of risk that can be taken which in turn will influence the products that can be considered. Put simply the shorter the time scale the less risk can be taken. Conversely the longer the timescale the amount of risk that can be taken will increase. The principle is that fluctuations in price have the greatest impact in the short term.

It should also be noted that timescale will always get shorter so the client's risk tolerance will change over time. The best example is a pension where the timescale might be 30 years at the outset so the investor can take a high risk strategy. However as retirement approaches a more cautious approach will need to be adopted.

Growth or income target and selected benchmark

Naturally it makes sense to agree with a client what they want to achieve from their investment. This in turn will have to be balanced against the amount of risk they are prepared to take. When performance is reviewed this will be first against the target but also against a benchmark. Performance against target is obviously important but a benchmark needs to be selected as this shows how well the manager has done against its peers.

Amount of funds available to invest, liabilities and other assets or income

This is fairly self-explanatory since someone with £100,000 available to invest has far more options than someone with £10,000. It can also result in some contrary results as to what might be expected. Someone who is 68 might be considered as likely to be able to accept less risk than a 30 year old. However in fact they have an indexed linked pension which is more than enough to meet day to day needs. They also have a mortgage free house with a value of £500,000 and no dependents.

Compare that situation to the 30 year old who is employed on a short term contract, large mortgage and two young children.

Tax status

The general rule is that the recommended strategy or products should not put the client into a more adverse tax situation. Consideration should be given to:

- Income splitting so that any income produced is in the name of the lower rate tax payer.
- Deciding whether liability to CGT is preferable to further income tax.
- Use of tax free investments whilst bearing in mind the saying, “don’t let the tax tale wag the investment dog”

Ethical or cultural considerations

The client may wish to avoid certain sectors such as tobacco or armaments. Religious views may also be a consideration in selecting investments.

Legal and tax constraints

The strategy must take account about what is possible. There is a maximum amount that can be invested in an ISA, a pension and other investments each tax year.

Attitude to risk and capacity for loss

This is of course key to selecting the most appropriate portfolio and the FCA has expressed concern at how well this has been done by some firms. There are a number of risk profiling tools available both provided by life companies and independent providers. They have been criticised as being too prescriptive and whilst they can be part of the process, the adviser still needs to have a conversation with the client to establish and record the amount of risk they are prepared to take.

It is also important to establish how much loss the client could absorb and one criticism of risk profiling tools is that they do not take full account of the client’s capacity for loss. All the previous factors will tend to come into play so we could summarise the main factors in establishing risk as:

- Client objectives
- Past experience
- Capacity for loss
- Time frame
- Other assets
- Possible risk questionnaire
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It’s worth thinking about the consequences of having no plan or strategy. There are probably many people in this situation. They may have some old privatisation/demutualisation issues, they might have bought or inherited some collectives with no real thought as to the overall strategy. The potential problems are likely to be:

- Lack of diversification in both asset and sector.
- Assets may not match investor's risk profile.
- May not match investor's need for income or growth
- No target for performance or bench mark will have been set
- No rebalancing has taken place.
- Securities may not be in tax efficient wrappers

No plan investors can also succumb to what is sometimes as irrational investing:

- Made more unhappy by loss than happy by equivalent gain
- Are averse to cutting losses
- Tendency to believe current trends will continue indefinitely
- Invests on trends and current favourites
- Tends to invest at height of market/doesn't invest when market is low
- Over confident

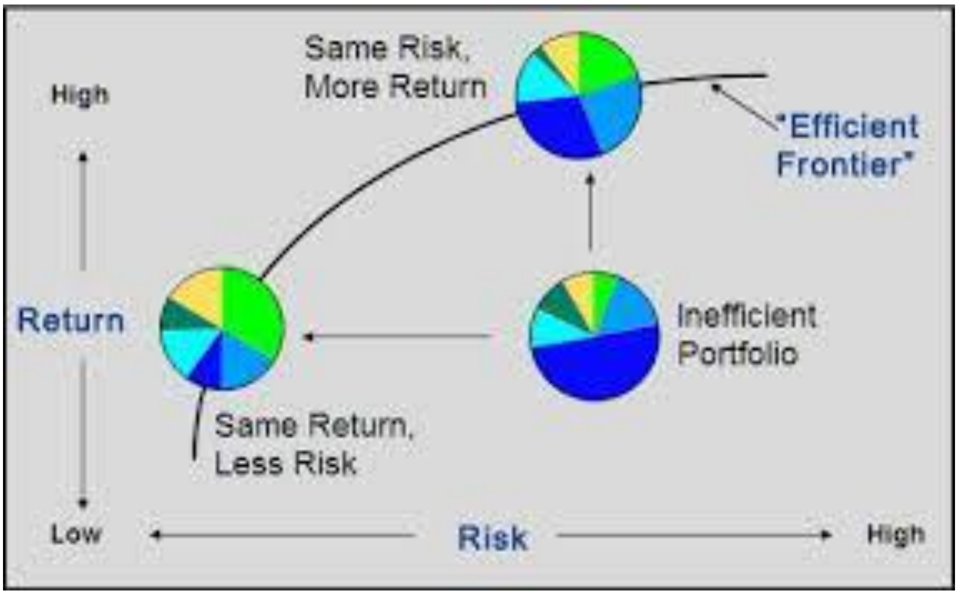
Modern Portfolio Theory

This states that a portfolio should be constructed that gives the maximum possible return for a given level of risk. Alternatively if a client wishes to achieve a certain level of return what is the lowest level of risk to achieve that return?

MPT states that the key to getting the best returns on a portfolio is to focus on the asset allocation rather than on individual security selection.

A key part of MPT is the concept of the **efficient frontier**

In assessing individual assets or portfolios the two key elements are expected return and risk as measured by its standard deviation (SD). As the risk increases we would expect to see the return increase. Shown on a graph it would look like this:



The efficient frontier is the curve that rises as the amount of risk increases. Note that in the early stages as risk (SD) increases, the expected return tends rises rapidly but as risk increases further the subsequent gain in expected return becomes less.

The Modern Portfolio Theory (MPT) behind the efficient frontier uses highly complex mathematical calculations to create the graph but it all centres on the diversification measures of correlation and covariance, as discussed earlier.

The optimal portfolio will be one that lies on the efficient frontier. A portfolio can be considered efficient if it is not possible to obtain a higher expected return without increasing the SD

The key point is that the combined effect of the assets in a portfolio is what matters – not the risks and returns of the individual investments within.
Although this theory uses rigorous and proven mathematics, it does have its drawbacks:

- Models rely on past risk and correlation data and therefore may not predict the optimum portfolio for the future.
- It relies on investors being able to decide on the exact level of risk they are prepared to take.
- An optimised portfolio only takes account of risk / reward. It cannot cater for a client's need for income etc.

Advisory and Discretionary Management

A firm that uses collective investments will usually be run on an **advisory basis**. That is before making any changes they must seek the client's approval. A firm offering to create a portfolio of directly held investments may also work in this way but it might offer a **discretionary service**.

A discretionary manager has the right to purchase, sell or retain investments without giving prior notice or seeking the approval of the client. The terms of what the manager can and cannot do must be set out in the client agreement. Firms using direct investments will then have to decide whether it can manage these themselves or whether it should contract this out to a specialist fund management company.

No matter which method is used there are a number of methodologies that can be used in running a portfolio. These include:

- Buy and Hold v active investing
- Active v passive fund management
- Core and Satellite
- Top down v bottom up
- Fundamental v tactical analysis
- Ethical v non ethical investing
- Contrarian investing
- Value v growth investing
- Momentum investing

Buy and hold is a passive strategy and is characterised by buying and holding shares/funds for long periods. Its main benefits are:

- Low cost/low admin
- Dividend stream should increase return over long term.

On the other hand:

- Few companies survive for long term. There are only 30 companies that have stayed continuously in the FTSE 100 since it was set up in 1984.
- Investors may miss new opportunities as they avoid switching holdings
- Take-overs or mergers may involve holding being absorbed into a very different business
- With funds the manager may be changed and performance may deteriorate.

This can be contrasted with the alternative approach, active investing the holdings or funds are being constantly reviewed which could lead to higher costs but could result in new opportunities being identified. Costs will increase and there is the danger that there is a danger that the manager may be picking up on short term trends

Top down v Bottom up

A top down approach starts by deciding first on the overall asset allocation, then for each of these deciding on the sector and geographical split. Finally individual stocks are selected.

By contrast with Bottom Up the first action is to select individual companies. This approach is used with specialist funds.

Fundamental v Technical

A manager taking a fundamental approach will focus on company analysis studying its key indicators. The aim is to try and assess whether the company presents good value based on the company's trading performance.

A technical approach will focus on the trends in share prices either for the individual company or for the market as a whole. It tends to use charts of past performance to identify future trends. A technical analyst is not too concerned about the performance of individual companies.

Ethical

This can be summarised as "investing for good." There are two approaches, **negative** and **positive screening**.
Negative screening involves identifying companies or sectors that will be avoided. The usual ones are companies involved in tobacco, alcohol armaments and gambling. Other funds may have stricter criteria. The disadvantage of this approach is that the range of companies that can be invested in is lower and some of the excluded ones may be highly profitable.

Positive screening involves identifying companies that meet the fund's ethical criteria and/or attempting to engage with the company to improve their ethical stance.

Contrarian

This involves taking a deliberate decision to go against market trends or popular consensus. It involves buying securities that are out of favour or have low p/e ratios. The danger is that predicted upturn may not come for a considerable time if at all.

Momentum Investing

A momentum strategy involves buying securities that are rising in price in the hope that this will continue. It also involves selling securities that are falling in value and is the opposite of contrarian investing. There is also the danger that investors could fall into the classic trap of buying at the top end of the market just before the fall.

Value v growth

A value investor selects securities that trade for less than their "intrinsic value". They believe that markets overreact to good and bad news resulting in price movements that do not reflect the company's long term potential. Growth stocks tend to have a low p/e ratio and have a history of steady growth in their profits.

Growth investors try to identify securities that offer good growth potential. This is usually defined as a company whose earnings are expected to grow at an above average rate compared to its sector or industry. Tech companies would be classed as a growth stock as their earnings (sales) are increasing rapidly although this may not be reflected in their profits. They ten to have a high p/e ratio.

These two strategies are often said to be opposed to each other but Warren Buffet has said that "growth and value investing are joined at the hip."

Investment choices in a post covid world

Assuming an individual has been able to maintain their regular income, choosing where to invest has probably never been more difficult.

- Deposit accounts are paying on average 0.5% which is less than the rate of inflation. To put that in perspective, £50,000 will produce £250 annually.
- Gilts are trading at yields of less than 1%
- Equities have done well with most major markets performing well. Part of this may be due to individuals moving out of traditionally safer assets in search of yield.

Nevertheless the basic rules of investing still apply.

- Maintain an emergency fund in a cash deposit. For someone of working age this should be at least 3 months net pay and possibly more if their employment status is vulnerable. For retired individuals who have a secured income this might be less. Also included on deposit should be any planned spending in the next five years.
- Pay off any short term high interest debt such as credit cards before starting to invest.
- Use collective investments
- Consider regular savings if you don't have a lump sum.
- Use ISA wrappers to the full and where appropriate transfer existing investments into one.
- Diversify over asset classes and sectors using at least five different funds
- Try to keep charges as low as possible
- Use a platform so you can see everything in one place
- View time as your friend and avoid making constant changes to your investments