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# MEASURING UP

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ISSUE

A refresher course on the investment management process.

## Back to Basics: The Investment Management Process

In this, our “Back to School” issue of *Measuring Up*, Yanni Partners will provide a refresher course on the investment management process, with an emphasis on the Investment Policy Statement. The investment process has three primary steps: planning, execution, and feedback.

The planning phase focuses on identifying the investor’s objectives and constraints and creating the strategic asset allocation. Combined, these intermediate steps form the basis for the Investment Policy Statement, which is the formal document that dictates the investment strategy and goals of a portfolio.

In the execution phase, investment managers construct the portfolio within the confines of the strategic asset allocation and Investment Policy Statement. Once the portfolio has been developed, the feedback step then requires performance evaluation as well as monitoring and rebalancing of the investments. (See *Figure One*).

### Planning Phase

The first step of the process is to identify the investor’s objectives and constraints, which will be formalized in the Investment Policy Statement. Typically, the objectives are expressed in terms of risk and return, which are interdependent.

In other words, the investor’s risk tolerance will largely determine the return objective.

An effective investment strategy must have a means of measuring risk as well as determining the investor’s willingness and ability to incur risk. Risk is typically quantified using statistical measures such as standard deviation of returns; however, this measure is limited because it does not differentiate between upside and downside risk. Effective risk measures isolate downside exposure.<sup>1</sup> Portfolio simulations also help to quantify downside risk.

An investor’s willingness and ability to incur risk will largely determine the ultimate risk profile. The investor’s willingness to take risk is based on personality and behavior and will vary greatly among investors. The ability to take risk is based on liquidity needs, investment time horizon, and the investor’s financial strength. The investor’s overall risk profile is the combination of his/her willingness and ability to incur risk.

<sup>1</sup> Yanni Partners, “Managing Investment Risk: The Path to Achieving Objectives,” March 2002.

Within the context of the risk objective, the portfolio return objective should then be identified. The most common measure of an investment's return is its total return, which is the sum of the asset's price appreciation and any cash flows over a given time period.

The return objective incorporates the investor's required return objective and his/her risk tolerance. The required return of the portfolio is the amount an investor needs to earn, on average. For example,

objectives. The other constraints primarily impact the investor's investable universe and asset allocation.

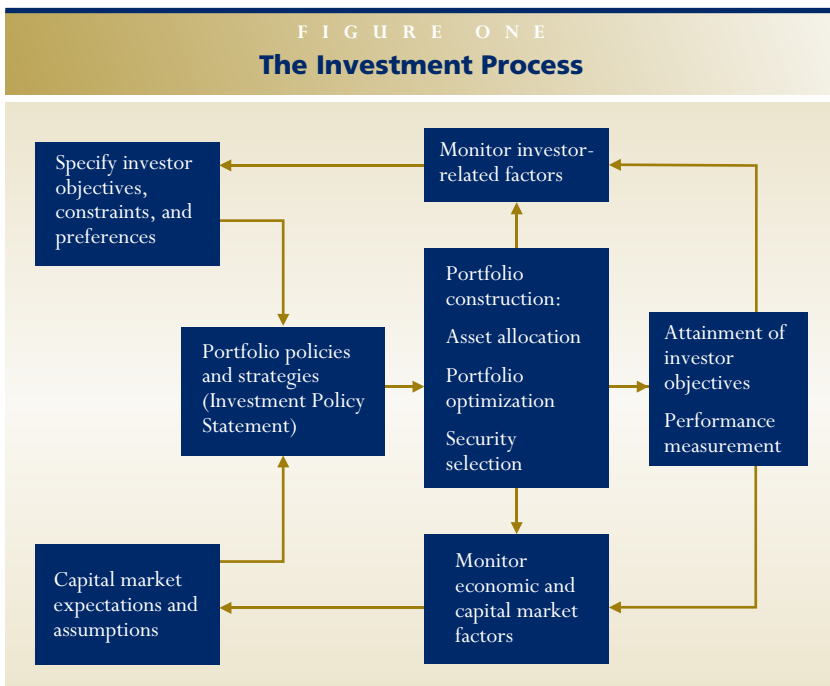
The liquidity constraint can be described as any need for cash in excess of new contributions to the account. An asset is considered liquid if it can be sold quickly and without significant loss in value. Some asset classes, such as real estate or absolute return strategies, can only be converted quickly at a significant cost. Certain portfolios, including operating accounts and pension funds, require liquid assets on hand to make cash distributions; this requirement will limit the allocations to illiquid asset classes. The liquidity constraint therefore has two components: the asset side (the ability to convert the holdings into cash quickly and without great loss of value) and liability side (the spending requirements of the portfolio). Higher spending requirements will require higher liquidity, and therefore lower expected return, due to the lower risk profile.

The time horizon constraint may be described as the time period associated with the investment objective. The time horizon for a portfolio may be short-term (1-10 years), long-term (greater than 10 years), or a combination of the two. With longer time horizons, a greater level of risk is generally warranted as the investor has a greater opportunity to recover any losses.

Taxes and legal or regulatory requirements will also affect the investor's portfolio structure. For taxable investors, tax policy may affect the timing of investment sales and investment choices. Legal or regulatory restrictions, such as the Employee Retirement Income Security Act (ERISA), limit investment options and govern the actions of pension and defined contribution plan administrators.

The final constraint encompasses any other requirements unique to the client that will affect the investment process and portfolio. Socially responsible investing is a common example. Socially responsible investing aims to align a client's investment strategy with the core beliefs of the organization. Typically,

FIGURE ONE  
**The Investment Process**



Source: Managing Investment Portfolios: A Dynamic Process, 3rd Edition

a pension plan sets the required return based on expected cash flows to and from the plan. The return objective should be adequate to meet the client's wealth objectives and spending constraints, while remaining within the stated risk parameters.

Any risk or return decision must be made in the context of portfolio constraints, which will affect the eventual investment strategy. Examples include liquidity requirements, investment time horizon, tax bracket, legal and regulatory issues, and circumstances unique to the investor. The first two constraints directly impact the investor's ability to take risk, and therefore affect both the risk and return

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organizations incorporate social, ethical, moral, and/or religious criteria into the investment process.

The next step of the planning phase is to construct the Investment Policy Statement, using the client's objectives and constraints as a base. The Investment Policy Statement is a written document that states the client's specified return objective and risk tolerance level over a relevant time period, within the framework of any constraints. Putting the Statement in writing serves several purposes: a written document prevents differences of opinion and the resulting conflicts, minimizes the possibility of mismanagement due to vague guidelines, establishes a reasonable basis for measuring portfolio performance, and creates reasonable expectations for the client. Above all, the Statement should support a long-term investment discipline and help insure against unwarranted ad-hoc revisions to the strategy. A typical Statement will detail the investment goals of the portfolio, the appropriate asset allocation, investment strategy guidelines, performance expectations, and the procedures for portfolio reviews.

The investment goals of the portfolio provide a broad overview of the portfolio and help guide the more detailed asset allocation and manager due diligence processes. The target asset allocation of the portfolio is based on the client's risk and return profile, as well as liquidity needs and expected investment time horizon. The Statement should include both a target allocation for each asset class, as well as an allowable allocation range within which the portfolio may lie.

The investment strategy section of the Statement should address allowable investment vehicles, prohibited investments, the specific guidelines for the various asset classes, and the investment manager due diligence process. The appropriate investment vehicle is typically dictated by the size of the mandate, although socially responsible investors may require accounts which can be more easily tailored to meet their unique needs. The Statement

also needs to list any investments considered inappropriate for the portfolio, based on the inherent risk of the security. As the specific guidelines for each asset class may vary greatly, it is important that each provision is detailed in the Statement.

In order to provide clarity and consistency of process, the Statement should also define the due diligence criteria for selecting portfolio managers and investments. Setting specific criteria will help determine whether a manager fits the approved investment program. Investment consultants, such as Yanni Partners, assess the qualities, attributes, and merits of each manager, and determine the role each manager should play in the portfolio.

The Investment Policy Statement must also define performance expectations as well as evaluation criteria for investment managers. Investment managers are commonly compared relative to an appropriate market benchmark and a universe of managers with similar investment strategies. Further, the managers' investment styles and philosophies should be evaluated to ensure that the products remain appropriate. This should be measured and reported quarterly. On an annual basis, the client and consultant should review the Statement itself for any material changes in the Plan's goals or objectives. To facilitate the investment and reporting processes, the Statement must also identify the duties and investment responsibilities of the portfolio's investment committee, consultant, the investment managers, and the custodian.

When properly designed and implemented, the Investment Policy Statement is essentially the business plan of the investment portfolio. It dictates the goals of the portfolio and the strategy to achieve those goals. As such, it needs to have enough detail that a third party would be able to implement the investment strategy, yet not be so detailed that it requires constant updates. It also needs to have enough flexibility that the strategy can be executed in a complex investment environment.

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## Execution And Feedback Steps

Once the Investment Policy Statement is completed, the next step of the process is to implement the strategy. The client portfolio is constructed based on the asset allocation as well as capital market assumptions. Yanni Partners calculates long-term capital market assumptions of risk and return for several asset classes, which help form the basis for client portfolio allocations and return expectations. In addition, Yanni Partners utilizes quantitative portfolio optimization tools to combine assets effectively to achieve clients' risk/return objectives. Portfolio managers then implement the investment strategy based on the strategic asset allocation and constraints outlined in the Statement.

After building the investment portfolio, the client and consultant must frequently monitor and evaluate the investments, making any changes as necessary. The feedback step of the investment process has two components: performance evaluation and monitoring/rebalancing. On a quarterly basis, the fund sponsor and consultant should evaluate the portfolio performance, compared relative to the stated return and risk objectives. To evaluate investment managers, consultants measure returns relative to an appropriate benchmark and determine performance attribution based on portfolio sector weightings relative to the index. Also, consultants evaluate the benchmark to determine if it is still appropriate for the portfolio considered.

On a regular basis, the portfolio asset allocation needs to be monitored and rebalanced to ensure that objectives and constraints are satisfied. One motivation to rebalance the portfolio is due to changes in investment objectives or constraints, stemming from changes in the investor's circumstances. Also, the investor may need to rebalance the portfolio as asset prices change over time. Changes in portfolio structure may also stem from changes in the capital market assumptions, though this is rare, as the assumptions are long-term estimates of risk and return. However, significant changes in markets' valuation levels will give rise to changes in return expectations.

## Conclusion

The keys to a successful investment strategy lie in creating and maintaining an appropriate Investment Policy Statement and adhering to the investment process. These steps will help ensure that the portfolio's risk and return metrics remain consistent with the client's goals and that the strategic asset allocation remains appropriate for the Plan. Since nearly 90% of total portfolio returns stem from the asset allocation decision, determining the proper allocation for each client portfolio is necessary to achieve specific investment goals.<sup>2</sup> A fund sponsor that monitors its asset allocation strategy using a rigorous process will enhance the likelihood that it will meet its investment objectives.

Yanni Partners provides a full range of consulting services vital to the management of various portfolios. Our ultimate goal is to offer a basis for improved investment monitoring and performance.

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<sup>2</sup> Brinson, Gary P., L. Randolph Hood, and Gilbert L. Beebower: "Determinants of Portfolio Performance," *Financial Analysts Journal*, July/August, 1986.

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