Describe the portfolio approach to investing.

LOS 48.a

A diversified portfolio produces reduced risk for a given level of expected return, compared to investing in an individual security. Modern portfolio theory concludes that investors that do not take a portfolio perspective bear risk that is not rewarded with greater expected return.

Describe the steps in the portfolio management process.

The three steps in the portfolio management process are:

1. **Planning:** Determine client needs and circumstances, including the client's return objectives, risk tolerance, constraints, and preferences. Create, and then periodically review and update, an investment policy statement (IPS) that spells out these needs and circumstances.
2. **Execution:** Construct the client portfolio by determining suitable allocations to various asset classes based on the IPS and on expectations about macroeconomic variables such as inflation, interest rates, and GDP growth (top-down analysis). Identify attractively priced securities within an asset class for client portfolios based on valuation estimates from security analysts (bottom-up analysis).
3. **Feedback:** Monitor and rebalance the portfolio to adjust asset class allocations and securities holdings in response to market performance. Measure and report performance relative to the performance benchmark specified in the IPS.

Describe types of investors and distinctive characteristics and needs of each.

Types of investment management clients and their characteristics:

Investor Type	**Risk Tolerance**	**Investment Horizon**	**Liquidity Needs**	**Income Needs**
Individuals	Depends on individual	Depends on individual	Depends on individual	Depends on individual
Banks	Low	Short	High	Pay interest
Endowments	High	Long	Low	Spending level
Insurance	Low	Long—life Short—P&C	High	Low
Mutual funds	Depends on fund	Depends on fund	High	Depends on fund
Defined benefit pension	High	Long	Low	Depends on age

Describe defined contribution and defined benefit pension plans.

In a defined contribution plan, the employer contributes a certain sum each period to the employee's retirement account. The employer makes no promise regarding the future value of the plan assets; thus, the employee assumes all of the investment risk.

In a defined benefit plan, the employer promises to make periodic payments to the employee after retirement. Because the employee's future benefit is defined, the employer assumes the investment risk.

Describe aspects of the asset management industry.

The asset management industry comprises buy-side firms that manage investments for clients. Asset management firms include both independent managers and divisions of larger financial services companies and may be full-service or specialist firms offering investments in traditional or alternative asset classes.

Active management attempts to outperform a chosen benchmark through manager skill. Passive management attempts to replicate the performance of a chosen benchmark index. Most assets under management are actively managed, but the market share for passive management has been increasing.

Describe mutual funds and compare them with other pooled investment products.

LOS 48.f (Part 1)

Mutual funds combine funds from many investors into a single portfolio that is invested in a specified class of securities or to match a specific index. Many varieties exist, including money market funds, bond funds, stock funds, and balanced (hybrid) funds. Open-ended shares can be bought or sold at the net asset value. Closed-ended funds have a fixed number of shares that trade at a price determined by the market.

Exchange-traded funds are similar to mutual funds, but investors can buy and sell ETF shares in the same way as shares of stock. Management fees are generally low, though trading ETFs results in brokerage costs.

Separately managed accounts are portfolios managed for individual investors who have substantial assets. In return for an annual fee based on assets, the investor receives personalized investment advice.

(Continued on next card.)

Describe mutual funds and compare them with other pooled investment products.

(Continued from previous card.)

Hedge funds are available only to accredited investors and are exempt from most reporting requirements. Many different hedge fund strategies exist. A typical annual fee structure is 20% of excess performance plus 2% of assets under management.

Buyout funds involve taking a company private by buying all available shares, usually funded by issuing debt. The company is then restructured to increase cash flow. Investors typically exit the investment within three to five years.

Venture capital funds are similar to buyout funds, except that the companies purchased are in the start-up phase. Venture capital funds, like buyout funds, also provide advice and expertise to the start-ups.