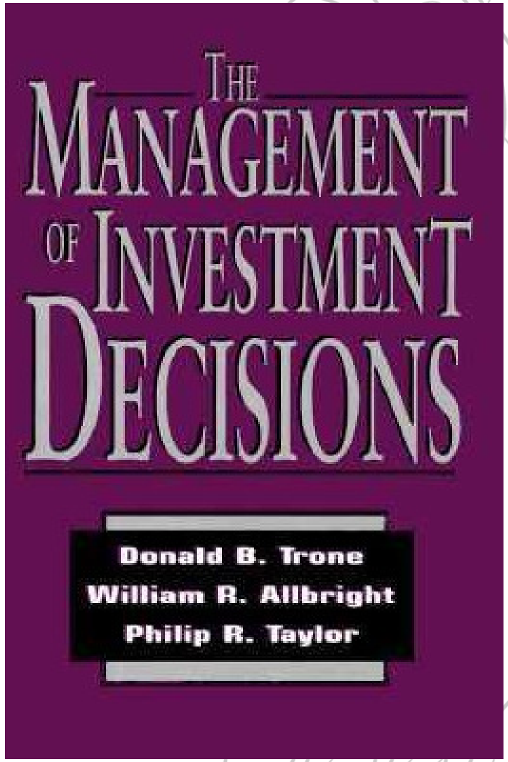
The Management of Investment Decisions

Trone, Allbright and Taylor © 1996

Much has been written about investing, but very little about the process for making investment decisions

While written for trustees and professionals looking after endowment funds, pension plans and wealthy families, this publication offers insights on how to manage your own money or your "DIY" self-managed super fund

"Successful and sophisticated investors have learned over the last 20 years to concentrate their energy on managing their investment decisions, rather than trying to choose winning stocks or top-performing money managers. They have earned superior investment returns as a result of developing a prudent investment process and strategy and then sticking to it"



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Professional investment management process

Analyse

- Assess cash flow needs and investment time horizon

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Optimize

- Choose overall asset allocation based on risk tolerance, asset class universe, time horizon and expected return
- Design most risk efficient portfolio from asset class and fund style building blocks (eg. value, growth, small, core .. equity)

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Formalise

- Document Investment Policy Statement
- Assemble Investment Committee

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Implement

- Select fund managers and investments
- Transition funds

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Monitor

- Monitor performance versus benchmarks
- Rebalance portfolio to return to design allocations

Important hierarchy of investment decisions[1]

Most important, first decisions

What is the length of time that funds can be committed? *(this includes cash funding requirements when applicable, risk tolerance and gets at overall equity:bond mix; the shorter the time horizon or more risk averse you are the less appropriate are equity-like assets)*

What assets will be considered for investing? *(this is about whether the investment universe extends beyond just stocks and bonds into offshore assets, direct property, private equity and other illiquid investments)*

How much of the portfolio will be invested in each class? (*this is the important question of asset allocation and the proportions selected should be selected to achieve the required return for the least portfolio volatility or risk)*

For some situations, insert step "Which entity structures to use? and what assets should they hold? (eg. super, trusts, co., individuals)

Within each specific asset class, what strategies or styles will be used? *(eg. stocks: growth, value, large, small; bond: short term, long term, high yield, global)*

Which managers will be selected to manage each specific strategy? *(for some active direct share investors an allocation might be to "you" however this may not work over time nor work for all asset classes, eg. International Equities)*

Least important, later decisions

(Optional) Which stock to buy/sell and when?

Many start here

1 From US Investment Management Council. *Italics per Professional Wealth*

Investment Policy Statement contents

1. Purpose of this document (how will be used and not sit in the drawer)
2. Background on investor needs (eg. age, situation)
3. Objectives (eg. return targeted, funding requirements)
4. Guidelines and investment policy (what invest in and not, asset allocation …)
5. Selection of money managers (principles and process)
6. Control procedures (monitoring, benchmarking, duties & responsibilities)

> **"The investment policy will produce its greatest benefit during periods of adverse market performance. Committee members will be less tempted to alter an otherwise sound program by irrational fears - the investment policy will act as a stabilizer"**

Legal obligations on trustees and advisors - from US Uniform Code of Fiduciary Conduct[1]

Fiduciaries [eg. trustees, investment committee, advisors] must …

- **Prepare written investment policies[2] and document the process used to derive investment decisions**
- **Diversify portfolio assets with regards to the specific risk/return objectives of the beneficiaries**
- **Use "prudent experts" (professional money managers) to make investment decisions**
- **Control and account for all investment funds and expenses**
- **Monitor activities of all money managers and service providers**
- **Avoid conflicts of interest**

While these principles apply to those charged with managing large funds, such as an Employee Retirement 401k Plans, they should spark questions for you like …

- **Have I documented and do I follow an Investment Policy or strategy?**
- **Am I overly reliant on one type of asset?**
- **Do I formally review investments and performance including using benchmarks?**
- **Do those I work with have conflicts?**

1 From US Employee Retirement Income Security Act of 1974 and more recently adopted "Restatement Third, Trusts (Prudent Man Rule). This rule "does not call for avoidance of risk but for the prudent management of risk"

2 Australian SMSF funds are required to have a written Investment Policy. Unfortunately this is often under-utilised and poorly prepared

Specific fund issues

Managing a socially responsible portfolio

- **Accept potential to reduce total return from ethical restrictions**
- **Balance foremost requirement for "prudent management" with pressures investing in social projects, companies fitting special criteria or with managers who meet certain demographic profiles**

High Net Worth Families

- **Fundamentals are the same but nuances: i) new money may not be coming in, ii) portfolios are taxable, iii) not encumbered/benefit from regulatory oversight, iv) inter-generational wealth transfer, v) legacy concentrated positions (eg. company stock), vi) philanthropy, vii) tendency to use private equity more**

Endowments and foundations

- **Difficult trade-off between money for now versus later ("spending and accumulation policy") and management of volatility**
- **"Income only" or "total return" (better) policy used to guide funding**

Defined benefit (DB) funds (those that provide pre-determined benefits for age & income)

- **Burdens from actuarial forecasts of member entitlements and matching of investments; issues of under funding also exist; simpler reporting than DC funds**

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