CHAPTER 2

THE ASSET ALLOCATION DECISION

I. Individual Investor Life Cycle

A. The Preliminaries
1. Insurance
    a. Life Insurance – provides lump-sum benefit to the heirs upon death of the insured person. Could provide cash value also depending on the type of plan
    b. Health insurance – helps pay medical bills
    c. Disability insurance – provides continuing income should the insured become unable to work
    d. Automobile and home/rental insurance – provides protection against accidents and damage to cars or residences
2. Cash Reserve
    a. Includes cash equivalents such as money market mutual funds
    b. Experts recommend an amount equal to six months' living expenses

B. Life Cycle Investment Strategies
1. Accumulation Phase – early to middle years of working career
2. Consolidation Phase – past midpoint of careers. Earnings exceed expenses
3. Spending/Gifting Phase – begins after retirement

C. Life Cycle Investment Goals
1. Near-term, high-priority goals – shorter-term financial objectives that individuals set to fund purchases that are personally important to them
2. Long-term, high-priority goals – include some form of financial independence, such as the ability to retire at a certain age
3. Lower-priority goals – these are not critical

II. The Portfolio Management Process (Exhibit 2.3)
1. Formulate a policy statement after determining the investor's short-term and long-term needs as well as risk tolerance
2. Study current financial and economic conditions and forecast future trends
3. Construct the portfolio
4. Evaluate portfolio's performance, continuously monitor investor's needs and market conditions and update policy statement as needed

III. The Need for a Policy Statement

The Policy Statement is a roadmap that guides the investment process. It

A. Helps investors understand their own needs, objectives, and investment constraints
B. Sets standards for evaluating portfolio performance
B. Reduces the possibility of inappropriate behaviour on the part of the portfolio manager

IV. Input to the Policy Statement

A. Investment Objectives- investment goals expressed in terms of both risk and returns
   1. A careful analysis of the client's risk tolerance should precede any discussion of return objectives (see Exhibit 2.4)
   2. Return objective may be stated in terms of an absolute or relative percentage return. It may be also be stated in terms of general goals such as:
      a. Capital preservation – minimize risk of loss
      b. Capital appreciation – growth of the portfolio in real terms to meet future need
      c. Current income – focus is on generating income rather than capital gains
      d. Total return – increase portfolio value by capital gains and by reinvesting current income
   3. Examples
      a. Investment Objective: Twenty-five-year-old – Given the young age and income growth potential, a capital appreciation strategy would be most appropriate
      b. Investment Objective: Sixty-five-year-old – Given the fact that employment will be ceasing soon, a current income and capital preservation or total return strategy would be most appropriate

B. Investment Constraints
   1. Liquidity Needs – vary between investors depending on age, employment, tax obligations, etc.
   2. Time Horizon – influences liquidity needs and risk tolerance
   3. Tax Concerns
      a. Capital gains or losses – taxed differently from income
      b. Unrealized capital gain – reflect price appreciation of currently held assets that have not yet been sold
      c. Realized capital gain – when the asset has been sold at a profit
      d. Trade-off between taxes and diversification – tax consequences of selling company stock for diversification purposes
      e. Marginal tax rate – tax rate on each additional dollar of income
      f. Average tax rate – total tax payment divided by total income
      g. After-tax return = Pre-tax return (1 – Marginal tax rate)
      h. RSP (Retirement Savings Plan)
         - Contributions qualify as a tax deduction if certain income limits are met
         - tax on returns is deferred until the funds are withdrawn from the account
   4. Legal and Regulatory Factors- must be considered
   5. Unique Needs and Preferences – could influence investment choice

C. Constructing the Policy Statement – a policy statement helps determine an investor's objectives and constraints

D. Some Common Mistakes
   1. Having too much money invested in the employer's stock
   2. Trading stocks too often

3. Selling stocks too soon

V. The Importance of Asset Allocation

A. Real Investment Returns after Taxes and Costs – taxes and inflation can significantly lower returns

B. Returns and Risks of Different Asset Classes – small company stocks have generated the highest returns historically, but the volatility of the returns have been the greatest too

C. Asset Allocation Summary – a major portion of a portfolio's returns is explained by asset allocation

VI. Asset Allocation and Cultural Differences – asset allocations differ across countries

APPENDIX

Objectives and Constraints of Institutional Investors

I. Mutual Funds – pool investors funds and invest them in financial assets as per their investment objectives

II. Pension Funds – receive contributions from the firms, their employees, or both and invest those funds
   A. Defined Benefit – promise to pay retirees a specific income stream after retirement
   B. Defined Contribution – do not promise a set of benefits. Employees' retirement income is not an obligation of the firm

III. Endowment Funds – represent contributions made to charitable or educational institutions

IV. Insurance Companies
   1. Life Insurance Companies
   2. Nonlife Insurance Companies

V. Banks – a bank's success is primarily based on its ability to generate returns in excess of its cost of funds

VI. Institutional Investor Summary

CHAPTER 3

SELECTING INVESTMENTS IN A GLOBAL MARKET

I. The Case for Global Investments

A. Reasons for the expansion of investment opportunities
   1. Growth and development of foreign financial markets
   2. Advances in telecommunications technology
   3. Mergers of firms and security exchanges

B. The Case for Global Investment Portfolios
   1. Ignoring foreign markets can substantially reduce the investment choices for investors
   2. The rates of return on foreign securities often have substantially exceeded those for Canadian only securities
   3. The low correlation between the Canadian stock market and many foreign markets can help to substantially reduce portfolio risk

C. Relative Size of the Global Financial Markets (Exhibit 3.1)
   1. The size has grown from $2.3 trillion from 1969 to over $103 trillion in 2006
   2. The share of the U.S. in world capital markets has dropped from about 65 percent of the total prior to 1970 to about 44 percent in 2006
   3. The growing importance of foreign securities in world capital markets is likely to continue

D. Rates of Return on Various Securities
   1. Global Bond Market Returns (Exhibits 3.2 and 3.3)
   2. Global Equity-Market Returns (Exhibit 3.4)

E. Risk of Combined Country Investments
   1. Correlation Coefficient - a relative measure of the relationship between two series over time. A value of +1.00 (perfect positive correlation) means the rates of return for the two investments move exactly together. A value of -1.00 (perfect negative correlation) means that the rates of return for the two investments move exactly opposite to each other. A value of 0 indicates that the movement in the rate of return on one investment has no bearing or influence on the movement in the rate of return for the other investment
   2. Global Bond Portfolio Risk (Exhibits 3.5 and 3.6)
      - Macroeconomic factors such as international trade patterns, economic growth, fiscal policies, and monetary policies cause the correlation of bond returns between Canada and foreign countries to differ
      - The correlation of returns between a single pair of countries changes over time because the factors influencing the correlation change over time
   3. Global Equity Portfolio Risk (Exhibits 3.7 and 3.8)
      - Adding foreign securities to a Canadian portfolio reduces risk by more than what a domestic diversification strategy can achieve
   4. Summary on Global Investing – the relative size of the market for foreign bonds and

stocks has grown in size and importance, becoming too big to ignore

II. Global Investment Choices

A. Fixed Income Investments - contractually mandated payment schedules
   1. Savings Accounts – usually no minimum balance or required term
      - Money Market Certificates - instruments that require minimum deposits for specified terms, and pay higher rates of interest than savings accounts. Penalty imposed for early withdrawal
   2. Capital Market Instruments - fixed income instruments that trade in the secondary market
      a. Government securities
         - Include bills, notes, and bonds
         - Backed by the issuing Federal, Provincial, Territorial or Municipal government
      b. Government Agency Securities
         - Are not direct obligations of the government
         - Sold by various agencies and Crown corporations of the government to support specific programs
      c. Corporate Bonds
         - Indenture
         - Call provisions
         - Sinking fund
   3. Preferred Stock
      a. Hybrid security with some features of both bonds and stocks

B. International Bond Investing - Investors should be aware that there is a substantial fixed income market outside Canada that offers additional opportunity for diversification.
   1. Eurobond
      a. An international bond denominated in a currency not native to the country where it is issued
   2. Maple Bonds
      a. Canadian dollar denominated bond, issued by foreign corporations or governments, and sold in Canada
   3. International Domestic Bonds
      a. Sold by an issuer within its own country in that country's currency

C. Equity Instruments
   1. Common stock
      a. represents ownership of a firm
   2. Common Stock Classifications
      a. Industrials
      b. Utilities
      c. Transportation
      d. Financial institutions
   3. Buying Foreign Equities

a. Direct purchase or sale of foreign shares
b. Purchase or sale of international or global mutual funds or exchange-traded funds (ETFs)
c. Purchase or sale of American Depository Receipts (ADRs)
   - Certificates of ownership issued by a U.S. bank that represents indirect ownership of a certain number of shares of a specific foreign firm on deposit in a U.S. bank in the firm's home country

D. Special Equity Instruments: Options – the right to buy or sell common stock of a company at a specified price within a certain period of time
   1. Warrants
   2. Puts and Calls

E. Futures Contracts
   1. Commodity Futures
   2. Financial Futures

F. Investment Companies
   1. Money Market Funds
   2. Bond Funds
   3. Common Stock Funds
   4. Balanced Funds
   5. Index Funds
   6. Exchange-Traded Funds (ETFs)

G. Real Estate
   1. Real Estate Investment Trusts (REITS) – Investment funds that invest in various real estate properties
      a. Construction and development trusts – Lend money required by builders during the initial construction of a building
      b. Mortgage trusts – Provide long-term financing for properties
      c. Equity trusts – Own various income-producing properties
   2. Direct Real Estate Investment
      a. Raw Land
      b. Land Development
      c. Rental Properties

H. Low Liquidity Investments
   1. Antiques
   2. Art
   3. Coins and Stamps
   4. Diamonds

III. World Portfolio Performance
   1. Performance of stocks and bonds examined for period 1993 – March 2009
   2. Annual rates of return, standard deviation of returns, and systematic risk (beta)

computed

3. Study shows the systematic risk measure (beta) does a better job of explaining the returns during the period than the total risk measure (Exhibits 3.9 and 3.10)
    a. correlations between asset returns (Exhibit 3.11)

Appendix 3 – A Review of Bond Categories and Terminology

a. Senior Secured Bonds
    - Mortgage Bonds
    - Collateral Trust Bonds
    - Equipment Trust Certificates
b. Debentures
    - Unsecured bond
c. Subordinated Bonds
    - Claims subordinate to senior secured bondholders and debenture holders
d. Income Bonds
    - Interest payment contingent upon earning sufficient income by stipulated dates
e. Convertible Bonds
    - Offers the upside potential of common stock and the downside protection of a bond
f. Zero Coupon Bonds
    - Offered at a deep discount from the face value. No interest payment during the life of the bond