UNIVERSITY OF CALGARY
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Investments & Portfolio Management

Investment Policy

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The Bottom-Up Approach to investing

The bottom up approach consists in investing in undervalued securities ('jewels in the rough').

- Intuitively, it makes sense that 'good deals' exist in financial markets (like good deals are found in markets for goods). One has simply to find and invest in such 'good deals' to 'beat the market' (i.e. getting better returns than what the market typically delivers).
- Such approach is still practiced today and can be referred to as 'stock picking'. A more sophisticated version is 'value investing' (see https://en.wikipedia.org/wiki/Value_investing).
- Until recently, stock brokers were making quite a lot of money from trading commissions, so there was an incentive to get retail investors (individuals) to trade in and out of stocks by promoting the latest 'flavor of the week', adding to popular belief in 'stock piking'.
- But this is not taking into consideration modern portfolio theory and market efficiency.
    - Risk tolerance and diversification matter (as well as admin/transaction costs);
    - Asset mix (e.g. 60% equity / 40% bonds) matters more than the choice of security;
    - Exceedingly difficult to beat the market since securities are typically fairly priced.

A Modern Investment Approach

A modern investment approach is first and foremost investor-centric and process driven.

- It is logical to customize an investment portfolio to fit the characteristics of the investor.
  - The Markovitz risk-return framework implies that the risk tolerance of the investor is a key factor in determining which target risk/return is optimal for a given investor.
  - The investment horizon, the liquidity requirements, etc. should match the investor goals and circumstances (which vary a lot between categories of investors).
- It is generally acknowledged that designing and following a well-structured process increases the likelihood of delivering the sought-after outcomes in an efficient manner.

The characteristics of the investors are usually split in three categories.

- The objectives (can be referred to as goals or financial needs, e.g. target return)
- The preferences (e.g. risk tolerance)
- The circumstances (can be referred to as constraints, e.g. taxes)

A modern investment management process (per the CFA Institute)

Planning (outcome: an investment policy statement or 'IPS')

- Identification of investor's objectives, preferences, and circumstances.
- Development of the investment policy statement
- Forming long-term capital market expectations
- Development of the strategic asset allocation (min/max asset class weights)

Implementation (outcome: an actual portfolio according to the IPS)

- Asset allocation and portfolio optimization
- Security analysis
- Portfolio construction / execution

Feedback (outcome: looping planning and implementation to fine-tune the portfolio)

- Monitoring of inputs and portfolio rebalancing
- Performance measurement and reporting

A modern investment management process (per the CFA Institute)

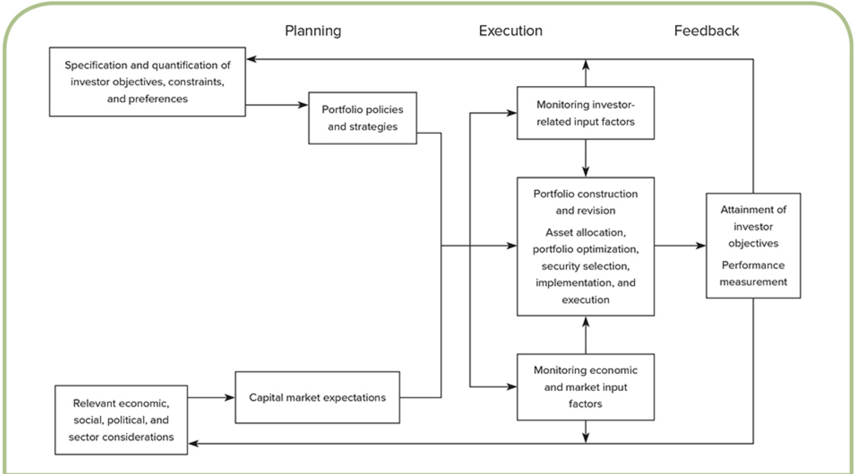

Figure 28.1 CFA Institute investment management process

A typology of investors

Individual investors

- Wealth management and retirement (e.g. defined contribution pension plan or RRSP)

Defined benefit pension plans (aka ‘DB’, as sponsored by various employers)

- Plans which provide employees a predefined benefit on retirement (e.g. https://www.otpp.com/)

Investment companies / mutual funds / exchange traded funds (‘ETF’)

- Commingled investment pools owned by investors

Endowments and foundations

- Funds of nonprofit institutions that help them provide designated services

Sovereign wealth funds

- State-owned investment funds (e.g. https://en.wikipedia.org/wiki/Government_Pension_Fund_of_Norway)

Insurance companies

- Financial intermediaries specialized in providing life and property insurance policies

Banks

- Financial intermediaries that provide various services notably accept deposits and lend money

A typology of investors' needs, preferences, and circumstances

	Return requirements	Risk tolerance	Time horizon
Individual investors	Life cycle but varies by individual	Life cycle but varies by individual	Life cycle but varies by individual
Defined benefit pension plans	Assumed actuarial rate	Typically quite high	Long
Investment companies (e.g. mutual funds, ETFs)	Varies by fund	Varies by fund	Varies by fund
Endowments and foundations	Spending commitments and maintain real value	Typically high	Long
Sovereign wealth funds	Varies by fund	Varies by fund	Long
Life Insurance companies	Actuarial rate	Typically quite low	Long
Non-life Insurance companies	Typically low	Typically quite low	Short
Banks	To pay interest on deposits and expenses + return for shareholders	Quite low	Short

Source: adapted from CFA Institute reading (2019)

A typology of investors' needs and preferences and circumstances

	Liquidity needs	Taxes	Regulations
Individual investors	Varies by individual	Varies by individual	Low
Defined benefit pension plans	Varies by maturity of the plan	Typically tax-exempt	High (pension statutes)
Investment companies (e.g. mutual funds, ETFs)	High to meet redemptions	Flow-through	High (security regulator)
Endowments and foundations	Typically low	Typically tax-exempt	Low
Sovereign wealth funds	Varies by fund	Typically tax-exempt	Low
Life Insurance companies	Typically low	Taxed	Complex
Non-life Insurance companies	High to meet claims	Taxed	Medium
Banks	High to meet repayment of deposits	Taxed	High (bank regulator)

Source: adapted from CFA Institute reading (2019)

Key components of an Investment Policy Statement

Introduction describing the investor

Purpose of the investment policy statement

Duties and investment responsibilities of the parties involved

Investment objectives and constraints

Investment guidelines

- How to execute, incl. permissible use of leverage and derivatives, asset exclusion if any

Evaluation and review

- Performance measures and benchmarks

Appendices

- Strategic asset allocation
- Rebalancing policy