



The Investment Process

A PROFESSIONAL APPROACH

The investment process can be a sub set of a holistic financial plan or it can be a separate and specific module. In either process, the steps that need to be taken are the same. It is very important to take the time to develop an investment philosophy because it will help you determine your goals, identify your current situation and measure the “GAP” in between. This is sometimes referred to as a “GAP” analysis. Further, it will help you make decisions with regard to which securities to invest in, how much to invest in each type of security, and when to invest.

The **five-step procedure** for making these decisions—the basis of the investment process.

- 1 Create Investment Policy**
- 2 Analyze Securities**
- 3 Construct a Portfolio**
- 4 Revise the Portfolio**
- 5 Evaluate the Performance of the Portfolio**

Please remember, this process is a man-made science and the order of the process and the methods of the process may be influenced by the consultant's own idiosyncrasies.

1. Create Investment Policy

The initial step, creating an investment policy, involves determining the investor's objectives and the amount of his or her investable wealth that is available to be earmarked for a particular goal. Since there is a positive relationship between risk and return, investment objectives should also be stated in terms of both risk and return. Modern portfolio theory is a good tool to help aid in the matching of risk and return relationships. In doing so, there are two allocation decisions that can be used: Strategic and Tactical. Strategic decisions take into account the investor's investment horizon, risk profile, required returns/cash flow needs, available assets, tax brackets, inflation rates and the average returns of different assets classes. Tactical decisions are made by investors who believe that one asset class will perform better than another. For example, stocks will out-perform bonds, or international equities will out-perform domestic equities.

Together, strategic and tactical decisions will result in a mix (weighting) of asset classes that are believed to maximize returns for the investor's acceptable level of risk. These asset classes are also sector-weighted against an index that will be used to measure the portfolio's performance. Often, the portfolio takes a sector bet and over-weights in a particular sector or sectors.

The next step is to make a selection decision. Again there are two types: Passive and Active. Passive decisions look at the average returns for a market class or class index, such as the S&P 500 or an S&P index mutual fund. Other managed mutual funds are considered passive when an investor has determined which fund to select, and the investor and the advisor do not make further selection decisions. The selection decisions would only be made by the mutual fund's manager. Investors who think they know something special make active decisions, such as taking advantage of an opportunity to purchase an under-priced security. Picking individual securities, short selling, and using options are other examples of active selection decisions. Here the investor and the advisor are actively making the selection decisions.

To review, the investment policy identifies an investor's objectives, considers risk tolerances, which then forms the portfolio's asset allocation. The allocation is broken into two parts: asset classes and asset mixes (weightings). The investment strategy is to either time the market or accept the policy. Here the investor can select under-priced securities, or choose passive exposures. We will see this first step emerge again in step three.

2. Security Analysis

The second step of the investment process, performing security analysis, involves examining a number of individual securities (or groups of securities) within the broad categories of financial assets previously identified in step one. Here investors are trying to identify securities that currently appear to be mis-priced. To do this, there are many methods, however, most of these methods fall into one of two classifications: technical analysis and fundamental analysis. Technical analysis involves the study of stock market prices in an attempt to predict future price movements for the common stock of a particular firm. Initially, past prices are examined in order to identify recurring trends or patterns in price movements. Then more recent stock prices are analyzed in order to identify emerging trends or patterns that are similar to past ones. This matching of emerging trends or patterns with past ones is done in the belief that these trends or patterns repeat themselves.

Fundamental analysis begins with the assertion that the true (or intrinsic) value of any financial asset is equal to the present value of all cash flows that the owner of the asset expects to receive. The fundamental stock analyst will attempt to forecast the timing and size of these cash flows, and then will convert them to their equivalent present value by using an appropriate discount factor and dividend discount model. What this means is that the analyst must attempt to forecast the stream of dividends that a particular stock will provide in the future, which is equivalent to forecasting the firm's earnings per share and payout ratios. Once the true value of the stock has been determined, it is compared to the current market price of the stock in order to see if the stock is fairly priced or not. Stocks that have a true value less than their current market price are known as overvalued or overpriced stocks, while those that have a true value greater than their current market price are known as undervalued or under-priced stocks. If a stock is overpriced, investors must determine if they are willing to pay the higher price, or wait for the stock to fall closer to its true value. This of course, may never happen. In summary, securities can be evaluated both by analyzing the performance of a particular company's stock and/or by analyzing the financial statements of a particular company.

Let's take a closer look at how an investor may conduct step two. We will start by reviewing asset allocation. The objective of the investment manager is to 1) optimize the allocation between asset classes, i.e. equity vs. debt vs. cash, and 2) is to optimize the allocation within an asset class. Example: equities are broken down into sub-categories such as large cap stock, small cap stock, mid cap stock, etc. Fixed income (debt) can be broken down into sub-categories such as government bonds, mortgage-backed bonds, corporate bonds, and further into varying durations, i.e., short term, intermediate term and long term. Realize that when optimizing the allocation between asset classes, the number of asset classes under consideration is small, but when optimizing the allocation within an asset class, such as equities, the number of assets under consideration can be large. These asset classes are also sector-weighted against an index that will be used to measure the portfolio's performance. Often, the portfolio takes a sector bet and over-weights in a particular sector or sectors.

ALLOCATION GOAL EXAMPLE

ALLOCATION WITHIN ASSET CLASSES					
STOCKS (EQUITIES) 60%		BONDS (FIXED/DEBT) 25%		CASH 15%	
Large Cap Growth	10%	Mortgage-Backed	25%		
Small Cap Growth	10%	U.S Govt.	25%		
Mid Cap Growth	10%	Corporate	25%		
International	10%	Municipal	25%		
Mid Cap Value	30%	Total	100%		
Total	100%				

Now we are ready to examine a number of individual securities or groups of securities within the broad categories of financial assets identified. To do this there are many methods. For equities, the two most common methods are Fundamental Analysis and Technical Analysis. For debt instruments, the most common methods are Active Management and Passive Management. Securities analysis is a very complex area and we cannot cover all of the methods used, nor can we fully examine the areas that will be covered. We will mainly focus on equities and fundamental analysis. Individual stocks will be discussed first, followed by pooled securities (mutual funds).

HOW TO ANALYZE STOCKS

Fundamental Analysis can come in many forms, but the common denominator is to search for mis-priced securities by comparing the intrinsic or true value of a company with the current price of the company's stock. If the intrinsic value was below the current stock price, the stock would appear overpriced. Why would one pay more for something than its true value? If the intrinsic value were above the current stock price, the stock would appear undervalued. Why wouldn't you buy something that was worth more than the price you would have to pay? Of course, investors often do the opposite of what seems logical, but the philosophy behind fundamental analysis is to find the undervalued security.

So the real question is, "How does one determine the value of a security?" To answer this question, fundamental analysis uses some very sophisticated methods like discounted cash flow analysis, projected cash flow analysis, discount rates, capital asset pricing models (CAPM), dividend yield and growth models, arbitrage pricing theories, etc. These methods are more commonly used by investment professionals and institutions. Investors are more likely to use methods like price/earnings ratios, price/book ratios, and price/sales ratios. The price/book ratio is most useful for old-economy companies with a huge asset base, whereas price/sales is a good measure for firms with few or no earnings. These methods will be discussed further later.

The problem with true fundamental analysis is that it is very complicated and requires years of experience and education. With this in mind, we will look at a simpler fundamental approach.

The best place to start examining what a company really looks like is with their annual report. This will contain all the answers to the following questions: What business or businesses is the company in? What do they really do? Is the company growing and if so, how fast? Is the company making money? Is the company financially sound? Is the company's current stock price undervalued or over-priced?

Now let's look at each question individually and see how to answer it.

WHAT BUSINESS OR BUSINESSES IS THE COMPANY IN? AND WHAT DO THEY REALLY DO?

In today's environment, companies no longer just operate in one line of business. They merge, acquire and form strategic alliances almost continuously. This makes it hard for the investor to follow the various products offered by the company and to evaluate the competitive nature of potential rivals. One example is General Electric. At one time, people probably associated GE with home appliances like stoves and dishwashers. But today, GE acts more like a mutual fund due to its broad segment of business activities. Its current business segments include Financing, Industrial Products, Aircraft Engines, and Power Systems. In 2016, GE Capital represents 9% of GE's revenues, and the appliances and lighting segment represents 7.3% of revenue. Another example is in the pharmaceutical industry. Some of the well-known companies derive nearly 100% of their revenues from the sale of pharmaceuticals while others derive only 50% of their revenues from pharmaceuticals with the balance from other non-related businesses. This in itself is neither good nor bad, but if an investor wanted to own a pharmaceutical company, they would want to know what they were buying. To better understand what business a company is in, refer to the letter to shareholders in the company's annual report.

IS THE COMPANY GROWING, AND IF SO, HOW FAST?

Most people buy equities for the growth potential that they possess and in hopes that the company's stock will grow equal to or faster than the company. A company can manipulate its growth outlook in many different ways -- cost cutting, divestitures or acquisitions are just a few. However, in the long run, stock prices are driven by earnings growth and revenues have to increase if earnings are going to be maintained and/or increased. A good measure of a company's growth outlook can be found in their sales numbers. Increasing sales are a good initial indicator that a company is on the right track. When looking at sales growth rates, be aware that for very large companies, it is more difficult to continue growth at the rates of the past. This is due to the law of large numbers. It is much easier to grow from one million dollars in sales to two million in sales than it is to grow from 1 billion to two billion.

Remember, sales numbers are a good initial indicator and the underlying objective is that earnings growth signifies that a company is making more than enough to offset its costs. It is not unusual in today's dot-com world to have young companies display strong growth potential but generate little or no earnings. So remember, large sales numbers do not always mean large earnings.

These figures can be found on the company's income statement in both the annual report and quarterly reports.

IS THE COMPANY MAKING MONEY?

As we began to see in the last question, just because a company has growth, does not mean it is profitable. A simple formula for profits is: Revenue minus Expense equals Profit. Examining the profitability of a company means looking at how efficiently a company is using its resources. One common measure used to examine profitability is return on assets (ROA). This is net income divided by total assets and shows how well a company has translated a dollar of its asset base into a dollar of earnings. For example, a company with a return on assets of 15% has translated each dollar of its asset base into \$0.15 of earnings. Another commonly used measure is return on equity (ROE). This is net income divided by shareholder's equity and shows the extent to which a dollar of shareholders' equity has translated into earnings.

Using ratios to examine companies can be especially helpful when looking at more than one company. Ratios level the playing field and help the investor examine the companies even if they are of different sizes. The two measures of profitability mentioned, ROA and ROE, will show you which company is most efficiently using its resources to generate net income. Even if both companies have the same net income figures, their ROA and ROE may be different. You will find the information necessary to calculate ROA and ROE on the income statement and the balance sheet.

IS THE COMPANY FINANCIALLY SOUND?

The cash flow statement and the balance sheet are where an investor should look to examine the financial stability of a company. Here we can look at two common concerns analysts have on how a company stands financially -- cash flow and debt. Cash flow is different than earnings. A company can have earnings but due to accounting practices, may not have cash flows that match its earnings. The investor needs to understand when and how a company recognizes revenues and expenses. The statement of cash flows, which can be found in the annual report, will help the investor see just how much cash came in and where it came from. Once an investor has determined the where and when, he or she can then look to see what the company did with it. Some companies, who are in a growth mode, may invest their free cash in capital spending by opening new stores. Other companies may pay off debt, buy other firms, build up cash reserves, buy back their stock, or pay dividends. What a company does with their cash will depend on where they are in their business life cycle. All of these activities can be found in the statement of cash flows.

Next, an investor needs to look at how a company uses debt. Debt is not necessarily bad, as long as the interest payments that support the debt can be made and are amortized on a controlled basis. Most companies use debt to help them expand, and it gives companies the flexibility they need to balance their capital raised through equity offerings. As in life, everything in moderation, and the same goes with debt. If a company has a debt ratio that is high, they may be spending too much of their cash on servicing the debt and not enough on growing the company. There is no right or wrong level of debt that should be carried by a company because levels of debt vary according to different industries. However, investors can compare the level of debt among similar companies within a given industry. To do this, the investor can divide assets by equity to derive the company's financial leverage. This information can be found on the balance sheet.

IS THE COMPANY'S CURRENT STOCK PRICE UNDERVALUED OR OVERPRICED?

This question is probably the most common question among investors. We all want to buy low and sell high; unfortunately, many investors hurt their returns by trying to time the market. It needs to be noted that most investors spend their time trying to get the lowest price and focus their analysis efforts on evaluating stock prices. Remember, there is financial statement analysis, which we focused on in the prior questions, and there is security performance analysis. A company may have a good grade from the financial statement analysis point of view, but have a price that is too high to be attractive. As mentioned earlier, determining the true value of a security using advanced fundamental models can be complicated, so investors may want to use other tools. The price earnings ratio is probably the most popular tool, but investors also use price/book and price/sales multiples. The price/book ratio is most useful for old economy companies with a huge asset base, whereas price/sales is a good measure for firms with few or no earnings. The benefit of the P/E ratio is that it tells the investor if the company is a value company or growth company. The benefit of the P/B ratio is that it tells investors approximately how much they are paying for a company's assets based on historical, rather than current, valuations. The P/S ratio is a valuation measure that indicates how much an investor is paying for a revenue stream. Whichever ratio you use, compare it with the ratios of other companies in its industry and to the ratio of the market at large.

OTHER QUESTIONS

HOW DOES THE COMPANY'S CURRENT P/E COMPARE TO THE HISTORICAL AVERAGE P/E?

An investor may want to compare a company's current price earnings ratio with the price earnings ratio over some time period. If the current P/E is lower than the average, the stock may look more attractive than if the current P/E were higher than the average.

WILL THE STOCK DOUBLE EVERY FIVE YEARS?

At a 15% net rate of return, an investor's money would double every five years. Investors may want to look to see if the stock has been doubling every five years and then look to see if its projected growth rate is at or above 15%.

IS THE EARNING PER SHARE (EPS) DOUBLING EVERY FIVE YEARS?

As in the last question, a doubling every five years equates to a 15% return. Investors can look to see if the EPS of a company is also doubling every five years. It becomes a system of checks and balances.

HOW TO ANALYZE MUTUAL FUNDS

Analyzing mutual funds is very similar to evaluating an individual security and yet at the same time very different.

Before examining some helpful selection tools, let's define what a mutual fund is. There are several types of mutual funds. Closed end, open end, diversified, non-diversified, etc. Here we will be focusing on open end investment companies. A mutual fund is an organization that offers investors a chance to pool their assets with other investors and to have that portfolio of assets professionally managed. The assets are invested in accordance with pre-defined goals. Because the company pools the investments of hundreds or thousands of individual investors and institutions, a mutual fund provides benefits that an individual, working alone, might not be able to receive. For example, the most common benefits are: 1) Professional Management 2) Diversification 3) Convenience. These benefits can be found in all types of open end mutual funds. So, no matter what the investment guidelines call for in the way of market capitalization and sector concentration, you can find a mutual fund to fit the bill.

HOW HAS THE FUND PERFORMED?

By itself, the question, “How has the fund performed?” does not really mean much because we do not know what it is being compared to. Therefore, we need to further define our measuring stick and consider the question in regard to factors such as the fund’s peer group, the risk adjusted rate of return, and the fund’s appropriate benchmark.

The historical risk adjusted performance of the fund needs to be compared to that of other funds with similar (in its peer group) investment objectives. It would not be helpful to compare a fund designed for income with a fund designed for growth. Further, just because a fund is labeled a domestic growth fund does not mean this is what the investor is really buying. The reason for this is what is called style drift or style slippage. The manager, over time, may have purchased securities outside the fund’s core objective in hopes of increasing performance. All in all that might not sound so bad, but remember that if your asset allocation model calls for 25% large cap growth, and that is what is needed to reduce the risk in your portfolio, then 25% large cap growth is what you want. If you purchased a growth fund to fill this need, you do not want your large cap growth exposure to be reduced because the manager decided to buy some small cap growth companies in hopes of increasing returns. Here this would have increased your portfolio’s small cap growth exposure, decreased your large cap exposure, and you would have a portfolio totally different from that of your investment guidelines. In summary, be sure you are comparing apples to apples.

Another way to analyze how a fund has performed in comparison to its peers is to look at its percentile ranking. To do this, look at the entire fund universe for a given category, i.e., large cap growth funds, and compare where the fund under review falls. When looking at the percentile rank, remember what we learned above. A fund can appear to be the top performer in its class by simply being mislabeled.

Next, let’s look at the risk-adjusted return. Merely reflecting on historical performance may not reveal the degree of risk that was taken by the fund to achieve the returns that are shown. For example, most people would say that if fund “A” returned 10% per year for the past five years that it did better than fund “B” that returned 8% over the past five years. That is sometimes the case, however not in all cases due to the risk taken by the fund in order to perform at the higher level. If these two funds had identical investment objectives and their returns are comparable, but one has taken on greater risk in order to achieve those returns, then the funds did not perform equally. So, “How risky has the fund been?”

Let’s look at some risk measurement tools:

STANDARD DEVIATION
BETA
R2
ALPHA
SHARPE RATIO
TREYNOR RATIO
JENSEN RATIO

STANDARD DEVIATION

DEFINITION *A measure of the dispersion of possible outcomes around the expected outcome of a random variable.*

In English, what this means is how far up or down a return will vary from its average return. For example, if the average return for a fund is 10%, and it has a standard deviation of 3, the expected range of return will be from 7% to 13%. This range has a 68.26% probability of happening. This number is the mathematical number given to measure deviation by -1 or $+1$ deviation point. In our example, $-1 = 3\%$ less than the average return and $+1 = 3\%$ more than the average return. It is important to remember that the fund's performance is not guaranteed to stay within this range and returns could be negative or extremely higher. The reason for this is that the range of returns has a 68.26% probability of occurring not at 100%. When looking at similar funds, the fund with the lower standard deviation should be less volatile.

BETA

DEFINITION *A relative measure of the sensitivity of an assets return to changes in the return on the market.*

Beta is often referred to as systematic risk, which is non-diversifiable risk. The market is considered to have a beta of 1. Let's look at two questions that can be answered by beta.

"What is the relative price volatility of this fund compared to the market's price volatility?"

For example, a portfolio with a beta of 1.2 is 20% more volatile than the market, or if the market moves up, say 10%, then this fund might be expected to move up about 12%.

"What is the relative variation in return of this fund compared to the market's variation in return?"

Again using a beta of 1.2, if the market is currently yielding an overall return of 10%, but was expected to yield only 5%, then this fund might be expected to yield an incremental 6% above what it was otherwise expected to earn based on its own unique characteristics.

R2 (COEFFICIENT OF DETERMINATION)

This measures the correlation between an asset's return and those of the broader market index. An index fund, for example, would have an R2 of 100, meaning that 100% of the fund's movement can be explained. A fund with an R2 of 50 would indicate that only 50% of the fund's movement could be explained. Another way to think about it is that the higher the R2, the more confidence an investor can have in the beta.

ALPHA

Alpha is the difference between a security's expected return and its equilibrium expected return. Alpha is not associated with overall market movements and is referred to as unsystematic risk, which is diversifiable risk. Let's look at an example of how this measurement works.

If a fund has an annual average return of 10%, and the index that it is measured against has an annual average return of 7%, the alpha would be 3%. If the fund's return were 5%, the alpha would be -2% . It is easy to see that an investor would want to choose funds with a positive alpha.

SHARPE RATIO

It measures the risk-adjusted rate of return as compared to the market's historical returns. The higher the Sharpe ratio, the better the fund's expected risk-adjusted rate of return. The Sharpe ratio is calculated by dividing the fund's standard deviation into the difference between the average rate of

return and the risk-free rate of return. For example, a fund with an annual average return of 14% and a standard deviation of 2 would have a Sharpe ratio of .30 when the risk free rate of return was 8%. $(.14-.08)/.20$. What this means is that for every point of standard deviation, the fund should return .30.

TREYNOR RATIO

It measures the risk-adjusted rate of return as compared to the market's historical returns but measured by the market's risk premium. The formula for the Treynor ratio is the same as the Sharpe ratio with the denominator replaced with beta instead of standard deviation. Here again, the investor would prefer a fund with a high ratio.

JENSEN RATIO

This measures the risk-adjusted rate of return by looking at the alpha. The excess return of a fund is equivalent to the market's excess return times the fund's beta. If the market alpha is always zero, then investors are looking for funds' alphas that are significantly greater than zero.

SUMMARY OF RISK MEASUREMENT TOOLS

MEASUREMENT TOOL	DESIRED RESULT
Standard deviation	Low
Beta	Low
R ²	High
Alpha	Positive
Sharpe Ratio	High
Treynor Ratio	High
Jensen Ratio	High

Finally, in answering the question “How has the fund performed?” an investor needs to isolate a fund to a particular index or benchmark. Again, we want to be sure we are evaluating a fund on a level playing field. When comparing a fund to its appropriate index, an investor can use the tools previously discussed to help them make the comparison. The goal is to outperform the index while at the same time taking less risk than the index. If this were not the goal, the investor would be compelled to simply purchase index based products. The following will be an example of a tool that can be used to measure return accountability.

SECTION

	ACTIVE	PASSIVE
TACTICAL ALLOCATION (TIMING)	4 Tactical Allocation and Active Selection	2 Tactical Allocation and Passive Selection
STRATEGIC ALLOCATION	3 Strategic Allocation and Active Selection	1 Strategic Allocation and Passive Selection

ACTIVE RETURNS DUE TO:	
Tactical Allocation	2-1
Active Selection	3-1
Other	4-3-2+1
TOTAL ACTIVE	4-1

COMPUTATIONAL REQUIREMENTS FOR RETURN ACCOUNTABILITY

	ACTIVE	PASSIVE
TACTICAL ALLOCATION (TIMING)	4 $\sum_i (W_{ai} \times R_{ai})$	2 $\sum_i (W_{ai} \times R_{pi})$
STRATEGIC ALLOCATION	3 $\sum_i (W_{ai} \times R_{ai})$	1 $\sum_i (W_{pi} \times R_{pi})$

W_{pi} = policy (passive) weight for asset class "i"
 W_{ai} = actual weight for asset class "i"
 R_{pi} = passive return for asset class "i"
 R_{ai} = active return for asset class "i"

Now let's skip ahead a few steps and look at what the results would really tell you.

ACTIVE RETURN COMPONENTS

Active asset allocation only (2-1)	-.26
Selection only (3-1)	+.26
Other (4-3-2+1)	-.07
Total Active Return (4-1)	-.08

Here, the mutual fund and its management represent active management. Passive would be represented by the appropriate index that the mutual fund was being benched-marked against. The question would be "Should you invest in the mutual fund or the index fund?"

In the above example, the active management was underperforming the passive investment by .08. If the active return were positive, the mutual fund manager would be outperforming the index.

WHAT DOES THE FUND OWN?

An investor can get a feel for a mutual fund by examining which securities the manager is holding, how many securities are in the fund, and the mix of companies within it. All of these factors can have an effect on your returns. Also, do not rely on the fund's name to tell you what is really in the portfolio or, as previously mentioned, do not rely on the name of the fund to tell you what type it is. Remember style drift. Evaluating the holdings of a fund will be helpful.

WHAT IS THE MANAGEMENT STRUCTURE?

A mutual fund may be managed by one individual person, a team, or even by committee. In any case, the fund is only as good as the people behind it. Knowing how the buy, sell and hold decisions are made is useful information. Also, it is important to know if the returns of the fund are from the current management structure. Managers often change.

All mutual funds charge fees because there is no way to run a business for free. The way they charge fees can definitely affect returns and the investor needs to understand the fee structure of the fund they select. All funds charge an ongoing management fee. There is a myth that no-loads do not charge an ongoing fee, but this simply is not true. This is the fee that is charged for the day-to-day management of the professional investment advice. The management fees will greatly vary so be sure to fairly compare fees to similar funds. For example, the management fees on a bond fund should not be compared to the fees of a growth fund because it is less expensive to manage a bond portfolio compared to a growth portfolio. So, compare the fees to the same class of mutual fund: bond funds to bond funds and stock funds to stock funds. Some funds have a sales charge associated with them for the additional advice an investor receives from an investment professional at the local level, such as a stockbroker. This person is the one who can help the investor develop the investment guidelines and measure the risk tolerance of the investor as well as assist with the entire investment process. The choice between a load fund or a no-load fund is not always as simple as it may appear. An investor may wish to choose a load fund over a no-load for the same reasons he might choose any one fund over another. For example: The investor may find that the fund's investment objective, style, risk level, quality of management, and returns are better-suited to his needs than those of similar no-load funds in the marketplace. Of course, all things being equal, a fund with higher expenses will have to return more than a lower expensed fund to yield the same result.

Analyzing securities is a very complex and in-depth topic. Investment professionals spend years trying to master their skills of identifying mispriced securities and measuring company performance. The preceding has been an entry to the topic and investors are encouraged to continue developing their interests and skills in securities' analysis.

3. Construct a Portfolio

The third step of the investment process is to construct a portfolio by putting steps one and two together. This involves identifying those specific assets in which to invest, as well as determining the proportions of the investor's wealth to put in each one. Selectivity, timing and diversification are the issues that the investor needs to address in this construction process. Selectivity refers to security analysis and thus focuses on the securities that appear to be attractive. Timing, or implementation strategies, focuses on how and when to invest in the selected securities. Many investors like to invest all of their wealth at once, while other investors prefer to average their wealth into the selected securities over a period of time. Diversification involves constructing the investor's portfolio in a manner such that risk is minimized, subject to certain restrictions. Remember, many of the decisions that are required to construct a portfolio are ascertained in the development of the investment policy and security analysis.

4. Revise the Portfolio

The fourth step of the investment process, portfolio revision, is simply the repeating of the prior steps. As time goes on, investors may change their investment objective, which in turn requires the portfolio to be updated. The portfolio also may be overweighted in a particular asset class due to that asset class growing faster than others in the portfolio. This is often referred to as rebalancing the portfolio and can be done monthly, quarterly, semi-annually, annually or at any other time interval an investor chooses. In any case, a new portfolio should be formed by selling certain securities that are currently held, and purchasing others that are not currently held. Another motivation for revising a portfolio is that over time the prices of securities change, meaning that some securities that initially were not

attractive may become attractive and others that were attractive at one time may no longer be so. In making any changes to a portfolio, investors need to consider several factors that may affect their final decision. Two of the most important factor are taxes and transaction expenses.

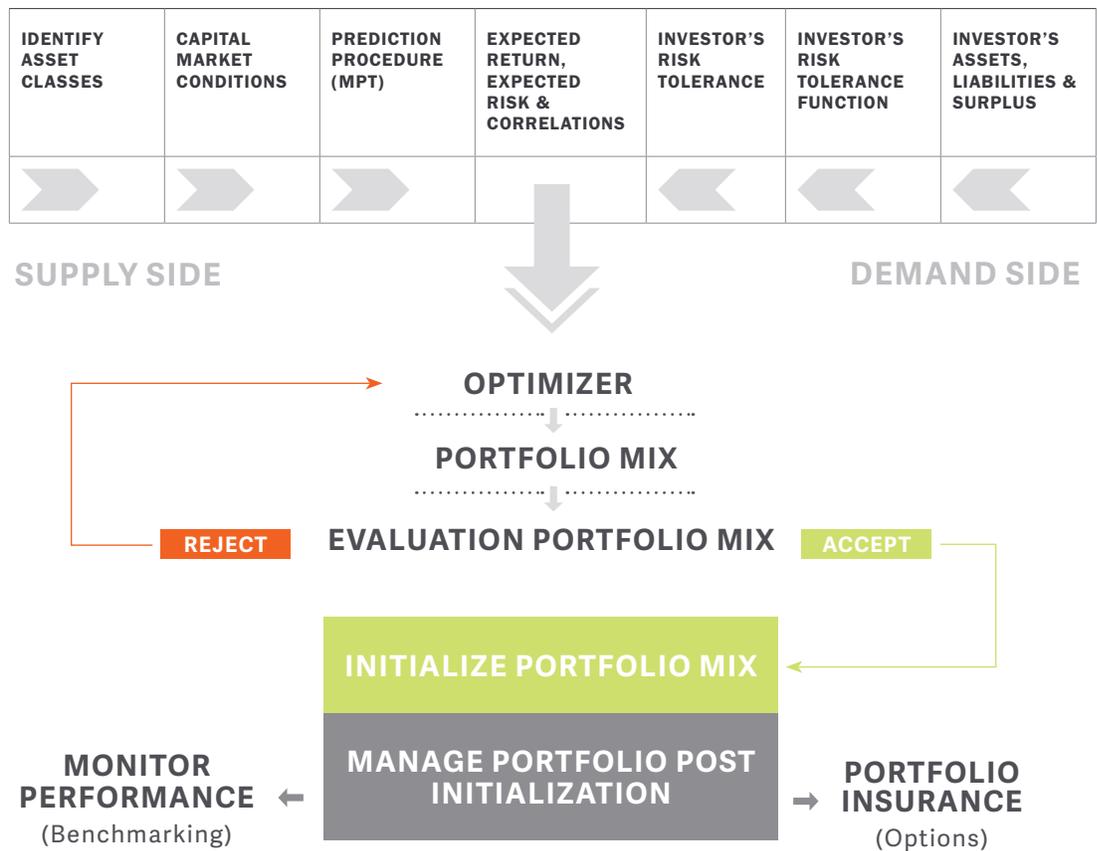
5. Evaluate the performance of the portfolio

The fifth step of the investment process is to evaluate the portfolio's performance over a given time period. The period chosen should be long enough so that the investment policy has had a chance to prove or not prove itself, and short enough so adjustments to the portfolio can be made before the portfolio's performance falls out of line with the investment policy. Quarterly and annual portfolio reviews are two of the most common time periods used. The portfolio evaluation should consider performance in terms of not only the return earned, but also the risk experienced by the investor. For this reason, it is important to measure the portfolio with a relevant standard or benchmark. For example, growth portfolios are often benchmarked against the S&P 500. One benchmark is not better or worse than another. The goal is to find a benchmark that is closely related to the goals of the investor and then measure the portfolio against that mark. One investor may have multiple investment goals and/or accounts and therefore may use more than one benchmark.

The following are charts showing the investment process from a two-stage portfolio management view. **Stage I Asset Allocation, Stage II Asset Selection.**

Stage I: Asset Allocation

Objective: Allocate total investable funds among asset classes consistent with the risk tolerance and return requirements of the investor.



Stage II: Asset Selection

Objective: Within each asset class, select and monitor specific investments to achieve identified objective.

