# The Investment Process©

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A great deal of research shows that mutual funds outperform the accounts of investors who are investing in those mutual funds.[1] This is due to the timing of investors' decisions. Investors are human and subject to emotional decisions, often investing in a fund after a period of great performance or exiting a fund after a period of poor performance. Human decision-making is subject to a number of behavioral biases which can impact actual realized investment performance. One way of minimizing the impact of these types of factors on investment returns is to have a disciplined investment process.

A disciplined process is strategic and can minimize the tendency to make emotional decisions. A disciplined process is also based on principles of investing that have been known to work and consider where the greatest sources of investment return and risk come from. For example, research also shows that the greatest variability in investor returns comes from the asset allocation decision. The classic study of Brinson, Hood and Beebower showed that over 90% of the variability or returns came from the strategic asset allocation decision, investment selection accounted for about 4% and tactical asset allocation about 2%.[2] Subsequent studies refined this work. Xiong, Ibbotson, Idzorek and Chen[3] showed that market movement had the greatest impact on returns, followed by strategic asset allocation and active management in close proximity. It is clear from all of the studies that the most important factor in investing is simply to be invested. We could debate nuances of which of the other decisions (strategic asset allocation, tactical asset allocation, investment selection) are the most important. However, they are all important and contribute to an investor's ultimate investment performance. Fortunately, a disciplined investment process ensures that all of these important decisions are included and implemented in a strategic manner.

There are eight basic steps in the investment process as depicted in Figure 1[4]. The process begins with gaining an understanding of the client's (investor's) needs, wants, preferences and constraints. Next, the manager or advisor needs to assess what is happening in the economy and investments markets and what might happen in the future. Note that this step could just as logically occur before client assessment and often does as investment advisors are assessing the economy and markets for the benefit of all of their clients. I prefer this order, however, to remind readers that the

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[1] For example, Amy C. Arnott, "Why Fund Returns are Lower Than You Might Think," Morningstar.com, August 30, 2021.
[2] Gary Brinson, Randolph Hood and Gilbert Beebower,"Determinants of Portfolio Performance," Financial Analysts Journal, July-August 1986.
[3] James Xiong, Roger Ibbotson, Thomas Idzorek and Peng Chen, "The Equal Importance of Asset Allocation and Asset Management, Financial Analysts Journal 2010.
[4] Adapted and improved from Tools and Techniques of Investment Planning, 3rd Edition, Leimberg, Doyle, Robinson & Johnson, 2013.

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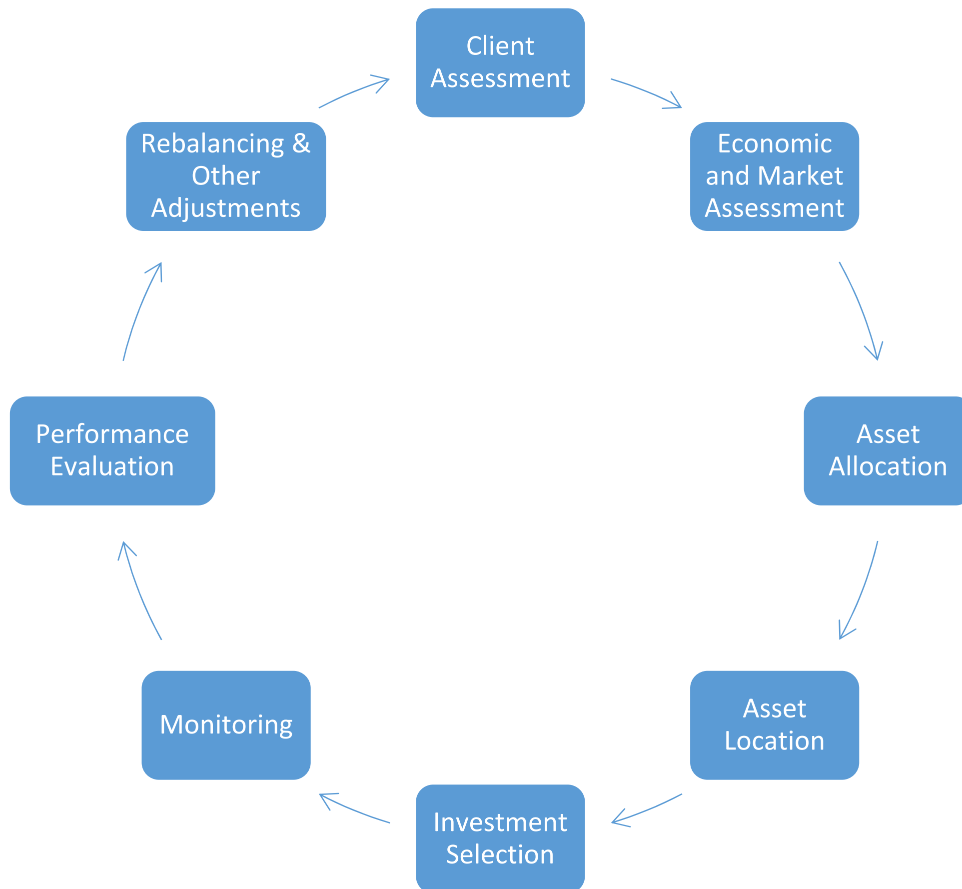
client always comes first. Additionally, the advisor should assess the economy and the markets with respect to the client's situation. The next step asset allocation – how much of a portfolio should be invested in different types (and or sub-types) of investments. Some advisors may split this step into two steps – Strategic Asset Allocation and Tactical Asset Allocation. Strategic asset allocation is long term in nature – typically a target for one or more years. Some advisors may consider an optional step of tactical asset allocation - short term adjustments to the longer-term strategic allocation.

**Figure 1 The Investment Process**




A step commonly excluded from the investment process is asset location. Investors often have different types of investment accounts, for example retirement accounts which are tax deferred and taxable investment accounts for which taxes are paid annually. An important consideration today is which asset types should be in which type of account to maximize long-term after-tax investment returns. Once we know how much of an investor's portfolio will be invested in each asset type and account type, we need to decide on which securities, funds or managers to invest in. Once the plan is implemented with the asset allocation in place and underlying investments selected, we need to continuously monitor and evaluate the underlying investments to make sure they are meeting our objectives. If they are not meeting objectives, changes are to be

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made.  Different types of investments will perform differently and result in the actual asset allocation straying from the target asset allocation.  Periodically, the portfolio is rebalanced to bring it back in line with the target.  This stage might also include other adjustments to maximize after-tax performance on a periodic basis such as tax loss harvesting.  The process is continuous with periodic re-assessment of the client, economy and markets followed by reconsideration of the target asset allocation, etc.

Client Assessment

Know your client!  Each investor is unique, with their own preferences, constraints, tolerance for risk, investment time horizon, family status and tax situation. A full understanding of all these dimensions must be assessed before determining what investments are suitable for a particular investor. A full understanding of the client's situation will lead to creation of an investment portfolio that is most likely to help them achieved their goals.  Important factors to understand are:

- Client family situation.  You should gain and understanding of the client's family and how that might impact their investment plan (beneficiaries, those that might need financial support, potential inheritance)
- Client financial situation.  Are they employed with a steady source of income? Does their current income support their current level of spending and the ability to accumulate more funds to meet life goals?  What retirement plans are available to them and how much is contributed by their employer/company? What do their assets and liabilities look like?
- Goals. What are the client's major life goals that will require funding from the investment portfolio such as new or second home purchase, retirement, education for family members, travel.
- Time Horizon.  What it the time horizon(s) for the investment portfolio considering various goals.  Typically a longer time horizon means a client can take on more risk and has a longer time to accumulate funds to meet goals.
- Risk.  How much risk can the client tolerate?  How much risk are they able to withstand?  This gets to one ability to take on risk and their personal tolerance for risk which may not be the same thing. A client may be financially able to take on risk, but may not be willing to tolerate the variability which can occur.  This is typically measured using some sort of risk tolerance questionnaire.
- Tax situation.   Tax is a cost that reduces the spendable return from the portfolio. It is important to understand the clients current and potential future tax situation (e.g., tax rates for different types of income).
- Constraints.  Often a client may have constraints on the types of investments that can be used.  They may prefer not to invest in particular types of companies or different types of securities.

All of this data needs to be assessed to determine an appropriate investment portfolio. Major factors should be codified in a formal Investment Policy Statement which will be finalized once the asset allocation and asset location steps are completed.

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## Economic and Market Assessment

The current economic situation and capital markets (where stocks, bonds and other investments are traded) must also be considered. The assessment of the investor and the assessment of the economy and capital markets are combined to determine an appropriate strategic asset allocation for the investor.  An assessment of the economy includes understanding the current stage of the economic cycle (expansion, peak, contraction, trough) both domestically and globally as well as understanding prospects for inflation and interest rates both nationally and globally.  You must then gain an understanding of how the economy is likely to impact capital markets where investment assets are bought and sold.  Lastly, all of this knowledge leads to estimating expected rates of returns and risk of different types of investments.  For example, inflation and interest rate expectations are key factors in determining bond yields on bonds of varying maturities.  This in turn leads to estimates of equity returns, often based on typical or expected risk premia to bond rates.  Unique risks, liquidity, supply and demand also play a role in determining expected returns and risk for different types of investments.

## Asset Allocation

The strategic asset allocation is the proportion of different classes of investments that are most appropriate for the investor given current market conditions for the foreseeable future – usually about five years. I divide investment types into four broad classes:

- Cash reserves – very liquid investments with very little possibility of losing principal. This includes cash in savings accounts, certificates of deposit and money market funds.
- Traditional Equities – these are commonly known as stocks – more specifically common stocks. You are effectively buying a portion of a business when you buy a stock. Your return comes from a potential distribution of future profits from the business and potential appreciation in value. You might invest directly in stocks by buying shares in individual companies or indirectly by buying shares in a pooled investment vehicle, like a mutual fund, exchange traded fund (ETF), partnership or trust.  Within traditional equities there are sub asset classes such as large capitalization, medium capitalization and small capitalization stocks. They can also be subdivided by geography (domestic, international developed markets and international emerging markets) and investment style (growth stocks, value stocks or blended stocks).
- Traditional Fixed Income Securities – these are commonly known as bonds. You are effectively loaning money to a borrower which might be a government entity or company. Your return is expected to come from payments of interest and the return of your principal loan amount in the future. As with traditional equities you can purchase bonds or make a loan directly or do so through a pooled investment vehicle.  Fixed income securities can also be divided into sub asset classes such as government bonds, corporate bonds, short term bonds, long term bonds, inflation protected bonds and high-yield (riskier bonds).

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- Non-Traditional or Alternative Investments – this category includes a variety of investments that some simply call alternative such as real estate or commodities, however I include a greater variety of investments here. I include any investment that behaves differently than traditional equity and traditional fixed income securities. As with traditional investments listed above these may be implemented directly or indirectly using pooled vehicle. Non-Traditional Investments include, but are not limited to:

    - Preferred stock – an ownership interest in a company that is different that common stocks. Typically, preferred stock pays a stated dividend that has preference over common stock dividends (meaning it is paid first before any dividends are paid to common stocks). On the other hand, it typically has a more limited upside potential. Think of preferred stock as a hybrid security – it behaves a little bit like a stock and a little bit like a bond. Preferred stock investments are often lumped together with common stock under traditional equity investments above.
    - Convertible bonds – a bond that has an option to be converted into stock (or something else) at some future date. You receive a promised interest payment and the promise to a return of your principal in the future, but you also have the potential for upside in the value of the stock should you exercise your option. Convertible bonds behave a little like a bond and a little like a stock. Convertible bonds are often lumped together with traditional bonds investments above.
    - Real assets – in contrast to buying and ownership interest in an operating company (stock) or make a loan (bond) and investment in real assets is a purchase of some underlying asset such as real estate, infrastructure equipment or commodities (such as precious metals, oil or agricultural products). Your expected return comes from appreciation in the value of the asset and in many cases rental income.
    - Derivatives – these are securities that derive their value from other securities. An example would be stock options or warrants which are rights to buy stock for some specific time horizon at some specific price.
    - Alternative strategies include a variety of investment strategies that are designed to behave differently than traditional stocks and bonds. For example, one alternative strategy is covered call writing where you purchase stocks but sell someone else to the right to buy that stock in the future at some specified price – collecting a premium like insurance or rent on the stock. There are a variety of other alternative strategies such as protective put or collar investments, long/short funds and arbitrage funds.

Generally, investors should have some investments in each of the four broad categories. Diversification is key – it important not to invest in assets that all move together. This reduces the risk of the entire portfolio. Investors should also generally diversify using different sub asset classes within each major asset class. Diversity must

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also be considered on a geographic basis. Todays' capital markets are global and investments that are globally diversified have a higher return relative to risk than purely domestic investments. This includes some exposure to global developed, as well as, developing markets. You should carefully consider the risk and liquidity of all investments with a bias towards markets that are developed and liquid.

The first step is to determine how much of an investors' investable assets should be held in cash reserves. For most individuals this should initially be about six months of spending so that funds are available for any period of disability or disruption in the capital markets. Additionally, if the investor is already drawing money from investment accounts for spending needs, then an additional 18 months of cash reserves should be held (a total of two years of planned spending).

The remaining investable assets should be split between the remaining three investment classes through a strategic asset allocation - a planned proportion of each class that matches the client assessment and capital market assessment. This strategic asset allocation is usually expected to be held for about five years but should be re-examined sooner if client circumstances or capital market expectations change dramatically.

Typically, traditional equities should comprise from 40% to 90% of an investor's "investment" portfolio (total investable assets less cash reserve). Equities have historically had the highest long-term return of all asset classes but have also had the highest volatility. The proportion to put into equities depends on the investor's tolerance for risk (lower tolerance means lower proportion in equities), time horizon (longer time before investments would need to be sold means higher proportion in equity and expected future behavior of stocks relative to the other asset classes (returns, volatility and correlation with other asset classes – how similarly they are expected to behave).

Traditional fixed income should comprise from 5% to 40% of an investor's "investment" portfolio (total investable assets less cash reserve). The proportion depends on the same factors considered for equities but with differing relationships for risk tolerance and time horizon. Lower tolerance for risk means a higher proportion in bonds while a longer time horizon means a lower proportion in bonds.

Non-traditional investments should comprise the remainder of the "investment" portfolio – somewhere between 5% and 20% when defined broadly. This allocation should be based on relative expected returns, volatility and correlation among these three broad asset classes. Liquidity is also key for many non-traditional investments.

In summary, a typical strategic asset allocation would involve investments in the following proportions:

- Cash Reserve – dollar amount needed for potential spending for 6 to 24 months.
- Investment Portfolio (percentage of remaining investable assets less cash reserve)

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|---|---|
| • Traditional Equities | 40% to 90% |
| • Traditional Fixed Income | 5% to 40% |
| • Non-Traditional Investments (defined broadly) | 5% to 20% |

While this strategic asset allocation would be planned to be held for the long term, it may be necessary to tactically shift the portfolio in the interim. A tactical shift would be appropriate if capital market expectations have changed and short-term market expectations are different that the expectations used in the strategic asset allocation – for example, if short term expectations for stock returns have declined you may want to lower the proportion invested in stocks slightly.

Asset Location

Once we have determined how much of the overall portfolio should be invested in each asset class and sub-asset class, we need to determine which accounts should hold which assets (assuming there are multiple available accounts). Different types of accounts have differing tax treatments. A typical regular investment account is taxed annually, whereas retirement accounts are either tax deferred or tax exempt. An employer retirement plan or traditional IRA is tax deferred until funds are withdrawn. Roth type accounts are both tax deferred and withdrawals are not taxed in most cases. Investment income in a regular account is taxed at either ordinary income tax rates (interest, dividends, and short-term gains) of capital gains (long term gains) tax rates which are lower. Distributions from traditional retirement accounts and IRAs are taxed as ordinary income even if they were generated by capital gains. As a result, if multiples types of accounts are available you may not want to have the same allocation across accounts. Instead, you should determine each investment optimal location to maximize the after-tax return. Here are some general guidelines:

- Low total return assets should generally be in taxable accounts whereas high total return assets should generally be in tax deferred or tax-exempt accounts.
- Assets generating mainly ordinary income should generally be in tax deferred or tax-exempt accounts.
- Assets generating mainly long-term capital gains should generally be in taxable accounts depending upon the expected holding period (the longer the planned holding period the longer the tax deferral and more likely it should be in a taxable account.

Some accounts such as trusts may render these guidelines null and void as the trust instrument must be adhered to. These general guidelines can also conflict and asset location can be an art. For example, at the time this article was written long term bonds have very low expected returns but are taxed currently as ordinary income in taxable accounts. The first guideline would suggest a taxable account is fine while the second would lean towards a deferred account. In these circumstances you should also consider liquidity needs and place in taxable accounts more assets that have lower volatility that could be sold when liquidity needs present themselves. The size of an allocation to a particular asset class can also prevent placement in the optimal account

type.  Client needs or preferences may also be to have a more uniform return and risk profile across accounts (for example when the accounts are in different family member names, are designed to fund specific goals or have different beneficiaries). When it is not optimal to place assets is the preferred account type you can engage in tax lost harvesting or other strategies to manage tax costs.

At this stage, an investment policy statement should be created for the client for their review which sets out the characteristics, goals, objectives, and limitations on how the account will be managed. It should also include the strategic asset allocation and any desired tactical adjustment or asset location parameters.  This is the governing document as to how each account will be managed.

Investment Selection

As noted above, all of the asset classes that we should consider for investment can be accessed directly by purchasing individual securities or through pooled investment vehicles such as mutual funds, ETFs, partnerships and trusts. The types of securities used will vary by client and the size of the investment portfolio. Generally, pooled investment vehicles offer greater diversification opportunities and are appropriate for most investors. The portfolios of securities (for example, stocks) within these vehicles is overseen by a portfolio manager(s). In some cases this involves a simple index portfolio designed to invest in all the securities in an index or may involve a more complex strategy such as purchasing securities the manager things are priced at an attractive value relative to the underlying fundamentals of the investments (value stocks for example). In selecting a manager there are three main things to look at:

- Performance: Evaluate the past performance of the manager and whether that performance can be expected to continue. Performance includes returns, risk and the return relative to the risk of the managers fund compared to an appropriate benchmark. Expenses and taxes both detract from the long-term accumulation of wealth so it is important to look at and examine these elements of performance as well.
- People: Evaluate the individuals managing the fund as well as management of the firm that employees them. Consider their education, experience, past performance (including at other funds) and adherence to ethical codes of conduct.
- Process: Evaluate their investment process and whether it makes sense relative to the asset class they are managing.

If individual securities are to be purchased within asset classes a great deal of analysis (fundamental and technical) and monitoring are required.

Monitoring

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The overall portfolio and individual investments should be continuously monitored to ensure that they continue to meet the desired characteristics and are consistent with the client's Investment Policy Statement.

### Performance Evaluation

On a periodic basis, typically quarterly or annually, it is important to evaluate the performance of the clients' account(s) relative to relevant benchmarks. This should include an examination of how each investment is contributing to that overall performance. If investments are not meeting expectations, replacements should be considered.

### Rebalancing and Other Adjustments

Based on the performance evaluation you should make any necessary adjustments to individual investments. Additionally, you should look at the overall allocation to different asset classes based on current valuations versus the targeted allocation. On a periodic basis you should consider rebalancing accounts to ensure you are meeting the desired strategic and tactical asset allocation. Individual assets will appreciate (or depreciate) at different rates and the actual asset allocation will stray from the strategic asset allocation as time passes. You should ensure that you consider the tax effects of any rebalancing on taxable accounts. This can be done by making needed changes in non-taxable accounts or by tax loss harvesting.

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