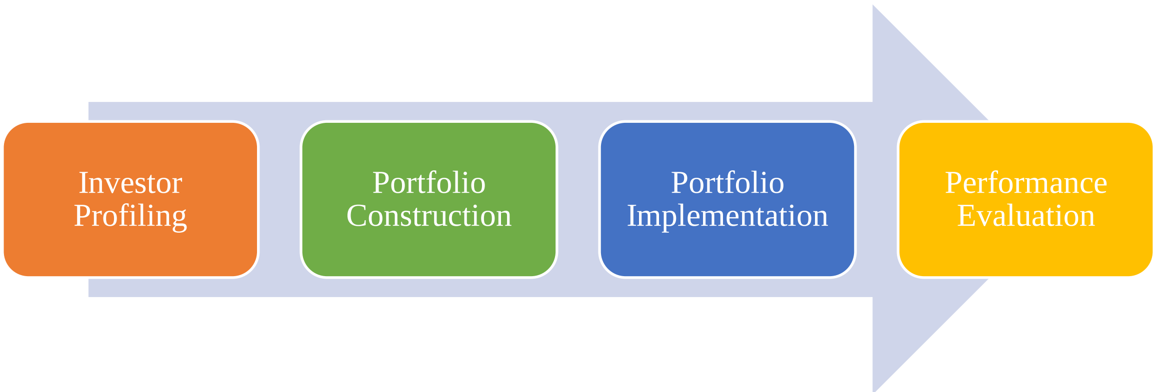
The Investment Process

As we continue our focus on competent investment management, this week's article considers the investment process, that is, the sequence of steps involved in constructing and implementing a portfolio in order to achieve the investor's goals; whether that be wealth maximisation or income generation. Quite often individual securities are purchased without considering the process behind the investment decision.

The investor should understand the investment process as it helps to manage expectations, facilitates better communication with the portfolio manager and even helps the investor in creating his/her own portfolio. The investment process is equally important for the portfolio manager, as it instils discipline and limits the temptation to deviate from the client's investment strategy during periods of market stress or poor performance. Diagram 1. Illustrates the four (4) key steps of the investment process.

Diagram 1: The Investment Process



Step 1: Investor Profiling

Investor or client profiling is the first and most essential step in the investment process. During this stage, the portfolio manager assesses the client's needs, goals, investment horizon, financial situation, risk preference, investment experience, stage in life, tax status and any investment restrictions due to perhaps ethical or moral reasons. For example, some clients, for ethical reasons, may disallow investment in stocks of nuclear power companies. This assessment may be done through the issuance of an investment questionnaire, the answers to which set the reference points for portfolio construction and implementation. The Trinidad and Tobago Securities and Exchange Commission (TTSEC) has a free Risk Profile Test which investors can take prior to consulting with a registered investment adviser or broker-dealer. Visit https://InvestUcateTT.com/investment-tools/ to take the Risk Profile Test. The output of Investor Profiling step, in the investment process, is the client's investment policy statement; which is a set of guidelines that govern the management of the client's assets.

Step 2: Portfolio Construction

Once the client's investment objectives, horizon, restrictions and risk preference are determined the portfolio manager will start constructing an appropriate portfolio for the client. This Portfolio Construction phase of the process includes the determination of the portfolio's asset allocation, that is, the mix of asset classes (bonds, equities and mutual funds) to which the investor's wealth will be apportioned. The asset allocation decision will also consider macroeconomic and capital market conditions.

Step 3: Portfolio Implementation

The Portfolio Implementation stage involves the articulation of an investment strategy or the approach to investment analysis and asset selections. Investment strategies can be active, semi-active or passive. With an active investment strategy, the portfolio manager frequently purchases and sells securities within the portfolio in an attempt to outperform a specific benchmark. A benchmark is a collection of securities that are meant to represent a segment of the market and serves as a basis for comparing the performance of a portfolio relative to the market segment. The All T&T Index, which provides the value of shares of companies listed on the Trinidad and Tobago Stock Exchange, can serve as a benchmark for assessing the performance of a local stock portfolio. A semi-active investment strategy applies the tenets of active investment but with some tight controls, specifically around the portfolio's risk. A passive investment strategy is based on the premise that you cannot outperform the market hence securities similar to those that constitute the benchmark of the market are purchased for the portfolio so the investor can expect to earn, on average, the return on the benchmark.

Given the asset allocation and investment strategy decisions, the portfolio manager will then determine the securities to be purchased for the client's portfolio. At this juncture, the stocks that comprise the equity component of the client's portfolio would be selected in addition to the bonds for the fixed income component.

Step 4: Performance Evaluation

The final step in the investment process, and often the one most revered, is the evaluation of the performance of the investment portfolio. At this stage, the investor will determine whether his/her objectives are being achieved.

Any changes to the client's investment objective, risk preference, income and liquidity needs or changes in life such as marriage or the birth of a child, would require an updating of the client's investment policy statement and a revision to the client's investment portfolio. Investors are encouraged to advise their portfolio managers of any changes to their circumstances or investment objectives.

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