II: THE INVESTMENT PROCESS

2.1 Introduction

An investment portfolio may be managed by the individual portfolio owner or by a chosen professional manager, such as a mutual fund, trust department, or other financial entity. Regardless of which alternative is selected, the investment process, as diagrammed in Figure 2.1, is relatively straightforward. As is seen, this process encompasses the portfolio owner, the portfolio

Figure 2.1: The Investment Process

The Portfolio Owner

Objectives   Risk Tolerance   Tax Status   Investment Horizon

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The Portfolio Manager's Responsibilities

Step 1. Asset Allocation

Stocks   Bonds   Real Assets

Domestic   or   Non-domestic

Step 2. Security Selection

Based on Cash Flows, Comparables, Technical, and Other Information

Which Stocks? Which Bonds? Which Real Assets?

Step 3. Trade Execution

Impact of Commission, Bid/Ask Spread, and Price Pressure

Trade Frequency   Trade Size

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The Manager's Performance

What return did the portfolio manager make?

How much risk did the manager take?

Did the manager underperform or outperform?

manager, and the manager's performance, to each of which we now respectively turn our attention.

2.2 The Portfolio Owner

As shown in Figure 2.1, the portfolio owner's needs and wishes are a direct function of the owner's: (1) objectives, (2) utility function, (3) tax issues, and (4) investment horizon. Some owners are better suited to riskier investments in seeking to achieve their objectives than are others. For certain owners, tax issues may be of paramount importance, and investment horizons obviously differ, depending upon the owners' objectives. Regardless of whether the portfolio is managed by the owner or by a professional manager, the assets comprising the portfolio should be suitable investments. In the preponderance of portfolios, these assets include stocks, bonds, and real assets, or some combination thereof. The charge of the portfolio manager is to appropriately allocate assets into those investment vehicles that are consistent with the needs and wishes of the portfolio owner.

2.3 The Portfolio Manager

Portfolio management may range from passive indexing to a wide variety of active strategies involving security selection, and possibly market timing. The portfolio manager's selection of securities is based on either fundamental or technical analyses that may include cash flow analysis, comparable security analysis, and a wide range of other techniques. The manager may use research from different sources, ranging from the *Wall Street Journal*, to purchased research, to a plethora of other public information. This information's value has been a topic of discussion in the investments arena for decades. Some hold that public information may be useful in outperforming the market overall, while others strongly reject this position. The debate continues apace, as is evident in Chapters IV and V.

Once the security selections have been made, the portfolio manager must execute the buying or selling of the target securities. This execution is of considerable importance because of the direct and indirect costs associated with transactions. These costs include: commissions, the bid-ask spread, and the impact of the transaction on the securities' prices. Obviously, the negative impact of these costs on return performance, as discussed in Chapter VIII, increases with trading frequency and order size. We now turn to the issue of the manager's performance.

2.4 The Manager's Performance

The returns generated by the portfolio manager are of paramount importance to the owner. As is offered in Chapter VI, prior to the mid-1900s the evaluation of return performance was often performed via comparable portfolios. However, with the introduction of modern portfolio theory, there came the formal consideration of risk in the analysis of performance. Over the decades there has been considerable attention paid to various risk-related issues in determining whether or not a manager's performance has been better than would be expected from the market overall or from appropriate sectors thereof. However, there are also numerous other factors within the investment arena that differentially impact the return performance of individual managers and professional managers. These factors include: broker influences, informational resources, commission disparities, economies of scale, and other institutional and market constraints, many of which are addressed in Chapters VI, VII, and VIII. Now that we have briefly reviewed the investments process, an overview of the backdrop for investment management is presented in the next chapter.