

LM04 · PORTFOLIO MANAGEMENT · CFA LEVEL I

Basics of Portfolio Planning and Construction

The IPS, risk/return objectives, constraints (RR-TTLLU), strategic vs. tactical asset allocation, and ESG integration

What This Reading Covers

How the portfolio manager translates *client needs* into an actionable plan. Starts with the **Investment Policy Statement (IPS)** — which defines objectives and constraints — and proceeds through **strategic asset allocation, tactical asset allocation, security selection, and rebalancing**. Closes with how **ESG** considerations may be integrated.

Learning Outcome Statements

- LOS a** Describe the reasons for a written investment policy statement
- LOS b** Describe the major components of an IPS
- LOS c** Describe risk and return objectives and how they may be developed for a client
- LOS d** Explain willingness vs. ability to take risk
- LOS e** Describe investment constraints: liquidity, time horizon, tax, legal/regulatory, unique
- LOS f** Explain the specification of asset classes
- LOS g** Describe portfolio construction principles and the role of asset allocation
- LOS h** Describe how ESG considerations may be integrated

Exam Tip: Memorise the **RR-TTLLU** framework: *Risk, Return, Time horizon, Taxes, Liquidity, Legal, Unique circumstances*. This is the single most-tested structure in portfolio planning.

LOS A · REASONS FOR A WRITTEN IPS

Why Have a Written Investment Policy Statement?

The IPS is the **starting point of the portfolio-planning process**: a plan for investment success.

Three Core Reasons for a Written IPS

- 1 Helps the investor decide on **realistic investment goals** (manage expectations).
- 2 Creates a **standard to measure performance** against.
- 3 **Guides actions of the portfolio manager** — used to assess the suitability of a particular investment.

Institutional IPS Additions

For institutions, an IPS should also cover **governance arrangements** — appointing & reviewing the portfolio manager, and the degree of manager discretion.

Living Document

The IPS should be **reviewed and updated regularly**, because client circumstances, objectives, and constraints change over time.

The IPS imposes **investment discipline** on the client and the manager and objectively articulates the risks and costs of investing.

LOS B · MAJOR COMPONENTS OF AN IPS

The Eight Major Components of an IPS

#	COMPONENT	CONTENT
1	Introduction / Description of Client	Describes the client's circumstances and situation
2	Statement of Purpose	States why the IPS exists
3	Statement of Duties & Responsibilities	Responsibilities of the client, the custodian, and the investment manager
4	Procedures	Steps to keep the IPS up to date; procedures to respond to contingencies
5	Investment Objectives	Risk and return objectives derived from client communications (heart of the IPS)
6	Investment Constraints	Liquidity, time horizon, taxes, legal/regulatory, unique circumstances (heart of the IPS)
7	Investment Guidelines	How the policy is executed (leverage, derivatives, permitted asset types, exclusions — e.g., no alcohol/gambling/firearms)
8	Evaluation & Review	Feedback on investment results; benchmark and review frequency

Appendices

A. Strategic Asset Allocation (SAA) — sets the policy portfolio / baseline weights.

B. Rebalancing Policy — rules / tolerances; also permitted tactical deviations.

Exam pattern: know that objectives + constraints = *heart of the IPS*; the SAA lives in the appendix but is *driven* by the objectives/constraints.

LOS C · RETURN OBJECTIVES

Return Objectives

Return objectives **must be realistic** given the risk the client is willing and able to bear.

Absolute Return Objective

A specific required rate of return, stated in:

- **Nominal** terms ("at least 6% per year")
- **Real** terms ("3% more than inflation")
- **Pre-fee** or **post-fee**
- **Pre-tax** or **post-tax**

Relative Return Objective

Stated **relative to a benchmark** — e.g.,

"outperform the S&P 500 by 200 bps annualized over 3 years".

Important: Compatibility Check

The account manager must verify that the stated **return objective is compatible with the risk tolerance**.

A client who demands 15% annually but cannot accept a single-year loss has inconsistent objectives.

Exam Tip: Always ask: "Is the return nominal or real? Pre-tax or after-tax? Pre-fee or net of fees?" These specifications materially affect the required portfolio return.

LOS C · RISK OBJECTIVES

Risk Objectives

① Absolute Risk Objectives

Capital preservation — e.g., a maximum loss in any 12-month period.

"Select risk level such that a 95% probability exists the fund will not suffer a loss greater than 4% in any given 12-month period"

Can also be stated in dollar loss terms or as strict limits.

② Relative Risk Objectives

Relate risk to a **benchmark** — typically via **tracking error**.

"No greater than a 5% probability of returns more than 4% below the MSCI World Index over any 12-month period"

Can be strict (absolute floor) or probabilistic.

Institutional Risk Objectives

Risk objectives may be tied to a **future liability** — e.g., a defined-benefit pension plan's risk objective is set so that assets cover promised pension payments (asset/liability management).

Portfolio risk objectives must be **compatible with the client's risk tolerance** — which has two dimensions (next step).

LOS D · WILLINGNESS VS. ABILITY TO TAKE RISK

Risk Tolerance = min(Ability, Willingness)

Risk tolerance is a function of two separate dimensions — and the portfolio manager uses the **lower of the two**.

Ability to Bear Risk (objective, financial)

Depends on **financial circumstances**:

- **Time horizon** (longer = higher ability)
- **Income** (secure/stable income = higher ability)
- **Wealth** relative to liabilities (more assets than liabilities = higher ability)
- **Insurance** against unexpected events
- **Financial responsibilities**

Willingness to Bear Risk (subjective, psychological)

Based on the investor's **attitudes, beliefs, and experience** with investments. Determined through conversation and questionnaires.

Reflects **disposition** and **financial understanding**.

The Four-Way Matrix

	WILLINGNESS: ABOVE AVERAGE	WILLINGNESS: BELOW AVERAGE
Ability: Above average	High risk tolerance — consistent	Conflict — <i>educate</i> the client
Ability: Below average	Conflict — <i>talk the client "down"</i> ; low ability prevails	Low risk tolerance — consistent

Conflict Resolution

Willingness high, ability low → the low ability prevails. Take the *lower* of the two: the client cannot afford to take the risk they *want* to take.

Ability high, willingness low → the advisor may *educate* the investor to correct misconceptions, but should not push a client beyond their willingness.

Exam Tip: In both conflict cases, the portfolio is built to the **lower** of ability vs. willingness. The manager's response differs: "talk them down" (if willingness > ability) vs. "educate" (if ability > willingness).

LOS E · CONSTRAINTS

Investment Constraints — Part I

The five constraints are commonly memorized as **L-T-T-L-U**: Liquidity, Time horizon, Taxes, Legal/regulatory, Unique.

① Liquidity

Redemption / withdrawal requirements. Need to hold investments readily convertible to cash at a price close to fair value.

- Individuals: anticipated withdrawals, emergencies, large upcoming purchases (home, education)
- Institutions: scheduled payouts (pension payments, endowment spending rule, insurance claims)
- High liquidity needs → favour cash, short-term bonds, large-cap liquid equities; avoid private equity, real estate, hedge funds with lockups

② Time Horizon

The shorter the time horizon, the more difficult it is to overcome losses.

- Short-term (s.t.): typically < 3–5 years → lower-risk, stable-value investments
- Long-term (l.t.): > 10–20 years → higher tolerance for volatility; equity-heavy allocations
- Some investors have **multi-stage** horizons (e.g., accumulation + retirement)

Exam Tip: Time horizon and liquidity interact — a short horizon generally raises liquidity needs and lowers risk capacity.

LOS E · CONSTRAINTS

Investment Constraints — Part II

③ Tax Concerns

Registered (tax-sheltered) accounts — not a consideration; gains deferred/exempt (e.g., 401(k), IRA, RRSP).

Non-registered / taxable accounts — income, dividends, and capital gains are often taxed at *different rates*:

- Interest / ordinary income — typically highest rate
- Dividends — often preferential
- Capital gains — often preferential; **only taxed when realised** (deferral benefit of buy-and-hold)

Portfolio implication: locate tax-inefficient assets (bonds, REITs) in tax-sheltered accounts; keep tax-efficient assets (buy-and-hold equities) in taxable accounts.

④ Legal & Regulatory

Constraints imposed by law, regulation, or plan document. Example: **self-investment limits for pension plans** with respect to the plan sponsor (cap on employer stock). Trusts may have statutory prudent-investor rules; foundations may be bound by spending requirements.

⑤ Unique Circumstances

Client-specific:

- **Restricted assets** — can't sell founder's stock
- **Holding requirements** — lock-up provisions
- **Concentration restrictions** — diversification limits
- Ethical / religious screens (ESG, Shariah)
- Privacy, family legacy considerations

KNOWLEDGE CHECK — QUIZ 1

IPS, Objectives & Constraints

Q1. Which of the following is *not* a primary reason for a written IPS?

Q2. A client has a *high* ability to bear risk but a *low* willingness. The advisor should:

Q3. A return objective stated as "*inflation + 3% per year, net of fees*" is best described as:

Q4. Which component of an IPS describes how the portfolio will be rebalanced?

Q5. A client nearing retirement has scheduled large withdrawals over the next 24 months. The *most affected* constraint is:

LOS F · SPECIFICATION OF ASSET CLASSES

Specifying Asset Classes

An **asset class** is a category of assets with **similar characteristics and risk/return relationships**.

ASSET CLASS	SUB-CLASSES
Cash	Commercial paper, T-Bills
Equities	Large-cap / small-cap, domestic / international
Fixed-Income	Government / corporate, investment-grade / non-investment-grade
Real Estate	Residential / commercial, domestic / foreign
Alternative Investments	Hedge funds, PE, VC, commodities, infrastructure

Specification Criteria

1. **Mutually exclusive & exhaustive** — no overlap, nothing left out.
2. **Similar returns & σ within each class** — high within-class correlation.
3. **Low correlation across classes** — for diversification benefit.

Diversification Across Classes

Because across-class correlations are relatively low (vs. high within-class), **allocating across asset classes** is where most of the diversification benefit comes from.

Exam Tip: When asked "why specify asset classes this way?" — the answer cites *high within, low across* correlations, making asset-class selection a more-powerful lever than individual security selection.

LOS G · STRATEGIC ASSET ALLOCATION

Strategic Asset Allocation (SAA)

Definition

The % **allocated to each asset class** chosen to achieve the client's objectives — the **baseline / policy portfolio**.

Two Inputs to the SAA

- 1 **IPS:** objectives (risk / return) and constraints
- 2 **Capital Market Expectations (CME):** forecasts of return, volatility, and correlation for each asset class

The manager **constructs an efficient frontier** using the CME and identifies the portfolio on the frontier that best meets the IPS risk/return requirements — this is the SAA.

Why SAA Matters So Much

Allocation across asset classes tends to be the primary driver of returns — because it sets exposure to the *systematic risk factors* that drive each class. Being in the *right asset class at the right time* dominates security selection effects.

Exam Point

"Correlations of returns within an asset class should be relatively **high**; correlations between asset classes should be relatively **low**." If correlations are similar within and across, the classes are not well specified.

LOS G · PORTFOLIO CONSTRUCTION

From SAA to an Actual Portfolio: Four Steps

- 1 **Risk Budgeting** — divide the desired level of portfolio risk (per the IPS) across the different asset classes (the SAA).
- 2 **Tactical Asset Allocation (TAA)** — intentional *short-term* deviations from the SAA to exploit perceived opportunities.
- 3 **Security Selection** — choosing specific securities within an asset class (deviations from index weights).
- 4 **Portfolio Rebalancing** — correct drift from the SAA due to income and price changes.

Passive Approach

Hold the SAA weights; use index funds / ETFs; minimal TAA or stock picking.

Active Approach

Uses TAA and/or security selection to seek alpha vs. the benchmark.

Core-Satellite

A hybrid: a **passive "core"** (tracks SAA / broad index) surrounded by **active "satellites"** seeking alpha in specific segments. Balances cost efficiency with active-return potential.

Exam Tip: TAA = short-term, tactical; SAA = long-term, strategic. Security selection is *separate* from TAA — security selection is within-class, TAA is across-class.

WORKED EXAMPLE • SAA, TAA & SECURITY SELECTION

Putting the Pieces Together

EXAMPLE

Classifying Manager Actions

GIVEN / SCENARIO

A portfolio's IPS specifies a Strategic Asset Allocation of 60% equities / 35% fixed income / 5% cash. The manager currently holds 65% equities / 30% fixed income / 5% cash (expecting equities to outperform over the next 6 months) and, within equities, overweights Technology vs. the benchmark S&P 500 weights.

CLASSIFICATION

- **SAA:** the 60/35/5 policy mix — long-term, in the IPS Appendix.
- **TAA:** the temporary +5% overweight to equities / -5% to fixed income — a short-term deviation from the SAA.
- **Security Selection:** the Technology overweight within the equity sleeve — choosing securities/sectors that deviate from the benchmark's weights.
- **Rebalancing:** if price moves then pushed the actual weights further from the SAA than tolerance allows, the manager would trade back toward 60/35/5 (or toward the TAA tilt, depending on policy).

TAKEAWAY

Active return can come from **both** asset-allocation tilts (TAA) *and* security selection. Rebalancing is a control process, not an active return source.

KNOWLEDGE CHECK — QUIZ 2

Asset Classes & Asset Allocation

Q6. Well-specified asset classes should have:

Q7. A manager overweights equities to 65% from the SAA weight of 60% based on a 6-month market outlook. This is best described as:

Q8. Which step is *least* likely to be a primary driver of a portfolio's return over the long run?

Q9. The primary input to the SAA — besides the IPS — is:

Q10. A "core-satellite" portfolio construction approach *most likely*:

LOS H · ESG CONSIDERATIONS

Integrating ESG into Portfolio Planning & Construction

ESG factors may enter at **asset-allocation** and **security-selection** stages. Appropriate ESG data may not always be available.

Approaches to ESG Investing

APPROACH	WHAT IT DOES
Negative screening	Exclude companies or industries based on ESG factors (e.g., no tobacco, no weapons, no fossil fuels)
Positive screening / Best-in-class	Identify and invest in companies with <i>positive</i> ESG practices; tilt toward leaders within each sector
ESG integration	Consider ESG factors throughout the asset-allocation and security-selection process alongside traditional financial factors
Thematic investing	Sectors or companies with specific ESG-related themes (e.g., renewable energy, water, gender diversity)
Impact investing	Investments providing a return <i>and</i> promoting positive ESG practices (measurable social/environmental impact)
Engagement / active ownership	Use share voting and access to management to promote ESG goals

Implementation Issues

- If the universe is constrained by negative screening, a broad market index is **not an appropriate benchmark**. Specialised ESG indices are available.
- Positive-screening / best-in-class → **customised benchmarks** are required.
- Thematic investing → requires finding **thematic PMs** who specialise.
- For **active ownership**, clarify whether clients vote their own shares or direct the manager to vote according to specific ESG factors.

Performance Impact

Imposing ESG-based constraints **likely affects portfolio performance** — in either direction:

- **May decrease returns** — limits the investable universe; ESG analysis has costs.

- **May increase returns** — good-governance firms may outperform; avoiding ESG-risk companies may reduce left-tail losses.

Exam Tip: The CFA curriculum does *not* claim ESG either helps or hurts returns — know the mechanism in **both directions** and that appropriate benchmarks may need to be customised.

KNOWLEDGE CHECK — QUIZ 3

Construction, ESG & Integration

Q11. A fund that excludes tobacco, firearms, and fossil-fuel companies from its investment universe is *best* described as applying:

Q12. Comparing an ESG-screened portfolio to a broad market index is *most likely*:

Q13. Imposing ESG constraints on a portfolio:

Q14. Which of the following would be classified as the client's *unique circumstance*?

Q15. In an IPS, the **heart** of the document is best described as:

MODULE COMPLETE

Your Scorecard

0 / 15

LM04 Key Takeaways

The IPS

- 1 **Three reasons:** realistic goals, performance standard, manager guidance.
- 2 **Eight components:** intro, purpose, duties, procedures, objectives, constraints, guidelines, review + appendices (SAA, rebalancing).
- 3 **Heart of the IPS** = objectives + constraints.

Objectives & Risk Tolerance

- 4 **Risk objectives:** absolute (e.g., max loss) or relative (tracking error).
- 5 **Return objectives:** absolute or relative; real/nominal; pre/post fee; pre/post tax.
- 6 **Risk tolerance** = min(ability, willingness). Willingness > ability → talk down; ability > willingness → educate.

Constraints (LTTLU)

- 7 **Liquidity, Time horizon, Taxes, Legal/regulatory, Unique circumstances.**

Construction

- 8 **Asset classes:** high correlation within, low across.
- 9 **SAA** = IPS × CME on the efficient frontier; primary return driver.

- 10 **TAA** = short-term deviations; **security selection** = within-class picks; **rebalancing** = drift control.

ESG

- 11 Approaches: negative, positive/best-in-class, integration, thematic, impact, engagement.
- 12 Implementation: customised benchmarks often required; return impact is *not* one-directional.

Last-Minute Exam Checklist

IPS components: Intro, Purpose, Duties, Procedures, Objectives, Constraints, Guidelines, Evaluation + Appendices

Risk tolerance: min(ability, willingness)

Constraints: L-T-T-L-U

SAA = IPS + CME → efficient frontier

TAA = short-term; **security selection** = within-class

ESG approaches: negative, positive, integration, thematic, impact, engagement

ESG benchmarks: often customised; return impact is two-sided