

# The 5-Step Investment Process

## **1. Personal Investor Profile, PIP**

Answers the question “Who am I?” First know thyself!

Personal data: Age, Marital status, Children, Home ownership, etc.

Time Horizon: Short-term or long-term goals, Planned retirement date, Legacy, etc.

Risk tolerance: Eat well or sleep well? Questionnaires on most financial websites.

Tax status: Federal and state tax brackets, Alternative minimum tax.

## **2. Investment Policy Statement, IPS**

Answers all the “What? Where? When? Why? and How?” questions

Written agreement on the details of how the portfolio will be managed

General philosophy and objectives

Passive strategy: Which asset classes, Asset allocation policy, When to rebalance or ... Active strategy: Which securities, Rules for when to buy, when to sell

Prohibitions, if any; e.g. no buying on margin, no short sales, etc.

## **3. Design the portfolio**

For passive investors: Pick the specific index funds for the asset classes and the allocation defined in your IPS above.

For active investors: Pick the specific stocks and bonds which match the parameters defined in your IPS above.

## **4. Implement the portfolio**

Go online or call your broker

Purchase all the securities selected in the portfolio designed in Step 3 above.

## **5. Review as appropriate**

For passive investors: Review annually and rebalance back to the asset allocation defined in your IPS above

For active investors: Follow the trading rules defined in your IPS above.

**Note:** Your PIP and IPS can be very simple documents, perhaps half a page each. However they should be written down. When the market crashes (not if!) refer back to your written documents instead of panicking. Don't even think of skipping Steps 1 and 2 above and jumping straight into Steps 3, 4 and 5.

You can do all this yourself, but you may prefer to seek professional help. If so, the portfolio manager you hire should spend at least an hour interviewing you before working with you to write an appropriate PIP and IPS.

## **Asset Classes**

### **Fixed income:**

Cash and cash equivalents, money market funds, short-term CDs, T-bills, etc.

Very low return, but also low risk: no negative years

Bonds, Bond funds, etc.

Higher return, but down in 2 years out of past 20.

### **Equities:**

Stocks and stock mutual funds, ETFs, Commodities, Real estate and REITs, etc.

Higher long-term returns than bonds, but down in 4 or 5 years out of past 20.

## Modern Portfolio Theory, MPT

Developed by Harry Markowitz in 1952, also Bill Sharpe et al over the following decades.  
Recognizes that the lack of correlation between certain assets is a powerful advantage  
Building a portfolio of uncorrelated assets minimizes the risk for a given return,  
or maximizes the return for a given risk.

## The Brinson Study

Survey of 82 major pensions in 1986, updated in 1991  
Asset allocation decisions account for >91% of variance in portfolio performance  
Stock picking accounts for <5%, and market timing for <2%.

## Asset Class Correlations: April 2009 thru September 2017 (PortfolioVisualizer.com)

	<u>BND</u>	<u>VTI</u>	<u>VEU</u>	<u>VNQ</u>	<u>DBC</u>	
Vanguard Total Bond Market	BND	-	-0.31	-0.25	-0.11	-0.15
Vanguard Total Stock Market	VTI	-0.31	-	0.90	0.75	0.51
Vanguard All-World Ex US	VEU	-0.25	0.90	-	0.69	0.59
Vanguard REIT	VNQ	-0.11	0.75	0.69	-	0.38
Powershares Commodity Index	DBC	-0.15	0.51	0.59	0.38	-

## Simple Portfolios: Data from the past 20 year period from 1997 thru 2016.

	<u>VBMFX</u>	<u>VTSMX</u>	<u>Portfolio 1</u>	<u>Portfolio 2</u>	<u>Portfolio 3</u>
Average Return	5.1%	9.5%	5.6%	8.2%	8.7%
Standard Deviation	3.5%	18.6%	3.1%	12.7%	12.4%
Sharpe Ratio	0.81	0.39	1.07	0.47	0.52
Best year	11.4% 2000	31.4% 2003	11.7% 1997	24.5% 1997	26.3% 2003
Worst year	-2.3% 2013	-37.0% 2008	0.3% 2015	-24.4% 2008	-24.9% 2008
# Down years	2	4	0	4	5

where **VBMFX** is the Vanguard Total Bond Index Fund, similar to **BND** ETF

**VTSMX** is the Vanguard Total Stock Market Index Fund, similar to **VTI** ETF

Portfolio 1 is 90% **VBMFX** + 10% **VTSMX**

Portfolio 2 is 30% **VBMFX** + 70% **VTSMX**

Portfolio 3 is 30% **VBMFX** + 30% **VFINX** (S&P 500) + 30% **VEXMX** (MidCap) + 10% **VGSIX** (REIT)

## Vanguard Lazy Portfolios

Rick Ferri, Bill Schulteis, Scott Burns, William Bernstein: Portfolios with 2 to 9 index funds

## Matt Hougan's really cheap 6-asset portfolio

	<u>Expense Ratio</u>
15% <b>SCHZ</b> Schwab Aggregate Bond	0.06%
40% <b>SCHB</b> Schwab U.S. Broad Equity	0.04%
30% <b>SCHF</b> Schwab International Equity	0.08%
5% <b>SCHE</b> Schwab Emerging Markets Equity	0.14%
5% <b>SCHH</b> Schwab U.S. REIT	0.07%
5% <b>DJCI</b> UBS Commodity ETN	0.50%

## Next month, November 8<sup>th</sup>, 2017

Efficient Market Hypothesis

Capital Asset Pricing Model

Passive versus active investment strategies

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