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Introduction to Designing and Managing an Investment Portfolio

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Once you've identified your financial and investment goals and assessed your investing personality, you'll need to create an investment portfolio that fits your needs and understand what's involved in managing that portfolio on an ongoing basis.

Entire books--actually, shelves full of books--have been written about ways to design and manage a portfolio, so this discussion obviously can only serve as a basic introduction to the process. However, it can help you understand the challenges involved and decide just how much assistance you might need, as well as how involved you want to be in managing your portfolio on an ongoing basis.

Designing an investment portfolio

Designing an investment portfolio generally involves figuring out how to integrate all your various financial and investment goals. Generally, this involves some form of asset allocation (the process of deciding how to divide your assets among different types of investments, such as stocks, bonds, cash alternatives, and other investments). It may also include specific tax planning strategies to minimize your tax burden.

Goal-based investing

Some people choose to look at each investment goal separately. Each goal might have its own asset allocation designed specifically for that goal, taking into account such factors as time horizon, risk tolerance, and liquidity needs.

One example of this is what's sometimes known as the "bucket" approach. A retiree might have one "bucket" of assets invested exclusively in short-term investments that will be used to pay living expenses for the next 1-3 years. A second bucket might hold mostly bonds and preferred stock designed to produce income that is used to replenish the short-term bucket. A third bucket might include a growth component designed to help the overall portfolio keep pace with inflation over the long term. And another bucket might be invested to provide for a grandchild's education in five years.

Example(s): *Bob prefers to think of his investments as silos. He has an annuity that will provide him with a lifetime income (subject to the claims-paying ability of the issuer) that is sufficient to cover the cost of food, clothing, and housing. He has a portfolio of individual bonds that collectively pay him enough to eat out and travel occasionally. And he owns a group of stocks that he plans to either sell one day to pay for his grandchildren's education or leave to them after he's gone.*

Such goal-based investing allows you to match specific assets to a specific time horizon, which can be particularly useful for large, long-term goals or if your assets are relatively modest. However, it also can lead to inefficiency and inadvertent overlap between multiple portfolios. In some cases, it also might not be the most effective way to manage your tax liability.

Return-based investing

Others find it beneficial to establish a single asset allocation that takes into account all or most of their combined investment assets and is aimed at achieving an overall average rate of return for the entire portfolio. This can promote tax efficiency (for example, by facilitating strategic harvesting of tax losses across multiple assets or accounts). It also gives you a broader perspective on your overall financial situation and can mean greater flexibility to shift your overall asset allocation if necessary.

Example(s): *When Betty retired, her advisor designed her portfolio to provide an average annual return of 4 percent, which she uses to pay all of her living expenses that aren't covered by Social Security. The portfolio includes a growth component designed to ensure that the portfolio keeps pace with inflation. It also is structured so that in Betty's later years, she will begin to draw down the principal itself.*

Monte Carlo simulations can project a portfolio's performance based on how its asset allocation would have performed in the past. Such a simulation can give you an idea of the range of returns, including best-case and worst-case scenarios, that you might reasonably expect from a given portfolio. (However, remember that past performance is no guarantee of future results and any projections are only as good as the assumptions that go into the computer model that creates them.)

Strategic versus tactical?

One fundamental decision you'll want to consider in your portfolio design is whether you want to pursue a strategic investment strategy or be more tactical. If you prefer a strategic, long-term approach to asset allocation, which takes into account your risk tolerance, time horizon, and historic returns for various asset classes, you'll probably gravitate to more of a buy-and-hold approach (see below). By contrast, a tactical approach tends to be more opportunistic and take advantage of changing market conditions by investing a greater percentage in asset classes that are expected to outperform in the immediate future, or that may reduce risk.

A compromise between the two methods is a so-called core-and-satellite approach. To pursue it, you would establish a core strategic asset allocation that is kept relatively constant and is based on your strategic goals, and practice tactical asset allocation with a smaller percentage of the portfolio. For example, you might shift some of the tactical portion of your portfolio into small-cap stocks if you felt they were poised to do well, and then move out of them if your thesis proves wrong or another type of investment presents a better opportunity later.

Managing an investment portfolio

Designing a portfolio is only the first step. Once your general approach and asset allocation strategy are established, you'll need to select specific investments and decide on the timing of any purchases and sales. In other words, your portfolio will need to be managed on an ongoing basis. This is never an easy task (just ask any professional investor). Some of the factors that can affect portfolio performance include socioeconomic and political conflict, higher or lower interest rates, changes in laws or governmental regulations, and tax legislation, to name only a few of the many things that professionals keep an eye on when managing money.

Here is a brief list of some of the tasks and decisions you'll face:

Selecting specific securities

One of the most challenging tasks of portfolio management is selecting specific securities from the thousands available. Typically you and/or your financial professional would establish screening criteria to develop a list of likely prospects for purchase, then do more detailed research to determine precisely what and when to buy.

One of the choices you'll face is the decision whether to invest directly in individual stocks and bonds, or use a vehicle such as a mutual fund to invest in them. Each has its advantages. Individual securities allow greater flexibility in timing a trade, better management of potential tax liability, lower costs (in some cases), and potentially higher returns if you select a stock that takes off. However, diversification requires a higher minimum investment, and though diversification doesn't ensure a profit or protect against potential loss, you could lose your entire investment if you select the wrong security. Mutual funds offer professional management (particularly actively managed funds) and you can generally achieve greater diversification at a lower cost. However, your fellow investors in a fund can affect your returns, and you have less control over when capital gains are realized. Exchange-traded funds (ETFs) also have become popular investment vehicles in recent years. Like a mutual fund, ETFs invest in multiple securities. However, they are traded throughout the day as a stock is and can have tax advantages.

Many investors use both individual securities and funds to take advantage of what each offers. Before investing in a fund, carefully consider its investment objectives, risks, charges, and expenses, which are contained in the prospectus available from the fund. Read it carefully before investing.

Establishing performance criteria

Benchmarking measures the performance of your investment portfolio against certain models. Although you can use something like the latest 10-year Treasury bond, for instance, as a benchmark for all bonds, the term usually refers to comparisons with standardized indexes. The best-known and most reliable indexes include the Standard & Poor's 500, the NYSE Composite Index, the Nasdaq Composite Index, Dow Jones 30 Industrials, the Wilshire 5000, the Russell 2000, and Nasdaq 100. Benchmarking can help you determine whether the investments in your portfolio are matching comparable investments, exceeding them, or underperforming. However, it's important to be sure you've selected appropriate benchmarks. And although benchmarking has proved highly effective, past performance as reflected by the various indexes does not necessarily predict future performance.

Managing an income stream

If you plan to rely on your portfolio for income, you'll need to determine how much you need and how the portfolio will produce it. For example, will you withdraw a portion of the principal, or withdraw only the income? Do you need to be certain about the precise amount of each payment or withdrawal, or is there room for flexibility? Even if you're not using any income the portfolio produces, you'll need to understand how factors such as changing interest rates can affect the income your investments will produce.

Some of these decisions will be made in designing the portfolio, but you may also have to reexamine them as your circumstances and the financial markets change.

Deciding how actively the portfolio will be managed

Portfolio managers generally fall into one of two camps (or maybe somewhere in between). Active managers believe that the best way to produce above-average investment returns is through careful selection of individual securities and trading them at opportune times to take advantage of ups and downs in the financial markets. Another camp believes that trying to beat the market averages is not worth the cost and risks involved and is extremely difficult even for professionals. They argue that buying and holding investments for an extended period--typically years--is more cost-effective. Buy-and-hold is an example of a passive management investing style, which is often practiced through indexing: designing a portfolio to match a specific index to try to replicate its performance.

If you prefer active management, you should either be prepared to devote the time and research necessary to make wise trades, or have someone with more experience handle it for you by investing in actively managed mutual funds or working with a professional money manager.

Deciding when to sell an investment

Some investors feel comfortable selecting an investment, but less certain about when it makes sense to sell an investment . Aside from factors that are unique to a specific investment or your own circumstances, you might consider selling an investment when:

- The investment has performed poorly, well below your expectations
- The investment has performed well and exceeded your expectations
- You feel another investment might perform even better
- It is beneficial from a tax standpoint

Caution: *A wise investor will understand the importance of properly timing the sale of an investment, as well as any tax consequences.*

The costs of managing a portfolio

The rewards of controlling investment-related expenses are twofold: (1) you pay no more than is necessary, and (2) you pay enough to ensure that your portfolio provides strong returns.

A cost-effective implementation of your investment plan begins with an understanding of the charges associated with managing a portfolio. Some of the most common include:

- Investment professional's and money manager's fees: These fees vary widely, depending on the size of your portfolio and the services rendered. Firms and individuals who are registered with the Securities and Exchange Commission are required to publish a fee schedule. Some states permit performance-based fees. Under these arrangements, the fee is higher if the portfolio performs better than expected (a benchmark is predetermined for this purpose).
- Trading costs: Whenever securities are bought or sold, commissions and execution costs are incurred. The commission fee is generally calculated as a function of the number of shares traded, price per share, and degree of trading difficulty, among other things. The execution cost (also referred to as the spread) is the difference between what you pay for a security (the ask price) and what the dealer pays for the security (the bid price).
- Custodial charges: A custodian serves as the keeper or guardian of the investment and actually holds the securities. This custodian (typically a brokerage firm or trust company) is the intermediary between you and the investment professional. Generally, an annual fee is charged for each account held by the custodian.

Tip: *Any management costs and expenses should be adequately disclosed. An above-the-line expense (e.g., administrative expenses) appears on your invoice as a separate line item. Below-the-line expenses (e.g., trading costs) are netted out of the performance of the portfolio.*

Monitoring your portfolio

Even if you pursue a buy-and-hold approach to managing your portfolio, buy and hold doesn't mean buy and forget. Your portfolio's performance will still need to be monitored so that it can be adjusted to changes in your circumstances and/or the financial markets, or simply to ensure that you're getting the performance you expect from it. From time to time, you may need to either rebalance or redesign a portfolio.

Rebalancing simply involves restoring your original asset allocation by shifting your funds among investment categories to regain the ratios you decided on when the portfolio was first designed. For example, if one asset class has done well and now represents more of your portfolio than you originally intended, you might sell some and use the proceeds to invest in another asset class that is now underrepresented.

Tip: *Many investment advisors recommend using shifts of 5 percent or more as a trigger for rebalancing. Others recommend that it be done every year. Tax time or year-end are natural times to think about rebalancing.*

Caution: *You should consider the transaction costs and/or tax consequences that might result from rebalancing. For example, selling an investment might trigger capital gains tax and/or (in the case of a mutual fund) redemption fees.*

Rebalancing is less drastic than redesigning your portfolio, which may involve setting an entirely new asset allocation and/or replacing your existing investments with fresh ones. You may want to consider redesigning your portfolio when you are faced with major life changes, such as retirement, or if your investment goals have changed.

Do it yourself, get assistance, or turn everything over to a professional?

As even this brief discussion shows, designing and managing a portfolio requires at least some understanding and experience with the financial markets and investment planning, plus the time and dedication needed to supervise all the myriad aspects of properly supervising a portfolio on a day-to-day basis.

If you aren't sure you have the time and/or expertise involved, a financial professional can be involved to the extent you feel is appropriate. That role can be all-encompassing or limited to certain tasks. Either way, the duties can be broken into four major categories:

- Managing all or part of your portfolio: Typically, an investment professional will employ and oversee money managers who evaluate and implement investment options and strategies. You may also employ money managers directly to implement your own investment decisions.
- Reviewing your portfolio's performance: This entails measuring the overall performance of your portfolio, as well as the performance of asset classes and individual investments within the portfolio.
- Reporting to you: Reports on your portfolio should provide you with information about its performance, compliance with your investment policy, your progress toward your financial goals, and the effects on cash flow and taxes.
- Recommending changes to your investment plan as the need arises: In general, there should be guidelines for any changes and any periodic rebalancing.

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