

THE FACTS ABOUT INVESTING:

AN UNBIASED APPROACH TO MANAGING YOUR ASSETS

Dear Investor:

These days, it's not hard to find investment experts. There are self-proclaimed gurus on television every night, interpreting that day's financial news. You can read regular articles about investment trends in leading magazines and newspapers. You can access detailed company and market information on the Internet.

With all this information available, many people might wonder why they need a professional investment consultant. The answer is simple: *perspective* and *experience*. Your investment consultant can help you filter out the noise and guide you toward the sound investment principles that will help you attain your investment objectives.

At the Investment Management Consultants Association (IMCA[®]), we are dedicated to educating investment consultants and, through them, their clients with the knowledge to create, evaluate and manage investment portfolios. This booklet was designed to introduce investors to the timeless principles that define sensible investing and the importance of the investment consultant.

We hope you'll find it informative.

Sincerely,

The Board of Directors Investment Management Consultants Association

Do You Have Too Many ADVISERS...Or Not Enough?

MOST PEOPLE AND ORGANIZATIONS with substantial assets have a team of advisers, including lawyers, accountants, insurance salespeople, stockbrokers and others. Often investors end up delegating portions of their portfolio to several experts, yet not assigning anyone to look after the whole. An investment consultant can help you align all of your investments into a single, cohesive strategy designed to meet your long-term financial objectives.

What can an investment consultant do for you?

- Help you assess your risk tolerance, time horizon and investment goals.
- Set an appropriate target rate of return for your portfolio.
- Assist you in developing a sound investment policy.
- Advise you on an optimal asset allocation.
- Provide expertise on screening and selection of investment managers in all the investment styles and asset classes your investment strategy requires.
- Offer input on ways to implement your investment strategy.
- Monitor investment managers' performance versus benchmarks and peer groups.
- Report detailed results to you.
- Regularly review your portfolio with you.
- Discuss recommended portfolio adjustments given changes in investment objectives, risk preferences, market conditions and time horizon.
- Advise you how to replace managers when material problems occur.
- Coordinate the advice of legal, accounting, trust and insurance experts in your overall portfolio.

Setting Your Investment Policy

YOUR INVESTMENT POLICY STATEMENT is the blueprint for your investment program. To understand its importance, imagine a house that's been built without a blueprint. Only the finest materials were used. The craftspeople who worked on it were highly skilled. Nonetheless, there are serious problems. Maybe not all the rooms have doors. The roof doesn't extend over the whole structure. The foundation is shaky. In short, it's not likely to withstand heavy weather. Similarly if you invest without establishing a clear investment policy, you may have the best money managers, but still fail to achieve your overall goals.

The investment policy statement is written to help you, your consultant, plan beneficiaries and other affected parties understand your investment goals.

Generally, you and your consultant work on it together, drafting and redrafting it until the language is clear.

WHY USE AN INVESTMENT POLICY STATEMENT?

- To keep your goals and objectives up front at all times.
- To communicate clearly to all parties involved.
- To maintain continuity in uncertain environments.
- To take the emotion out of the investment decision.
- To establish the standard by which the decisions and results of managers and fund can be measured in terms of progress toward the client's goals.

Investment policy statements generally cover topics including:

- **Objectives:** What is the portfolio designed to accomplish?
- **Expected returns:** What are the minimum returns required to meet overall goals?
- **Time horizon:** How long do you have to reach your stated objectives?
- **Risk tolerance:** How much fluctuation in asset value over a short period of time can you tolerate?
- **Liquidity needs:** How much cash do you expect to withdraw from the investment portfolio?
- **Regulatory requirements:** What IRS regulations, federal, state or local laws, or agency requirements are you required to fulfill? How will you go about meeting these requirements?

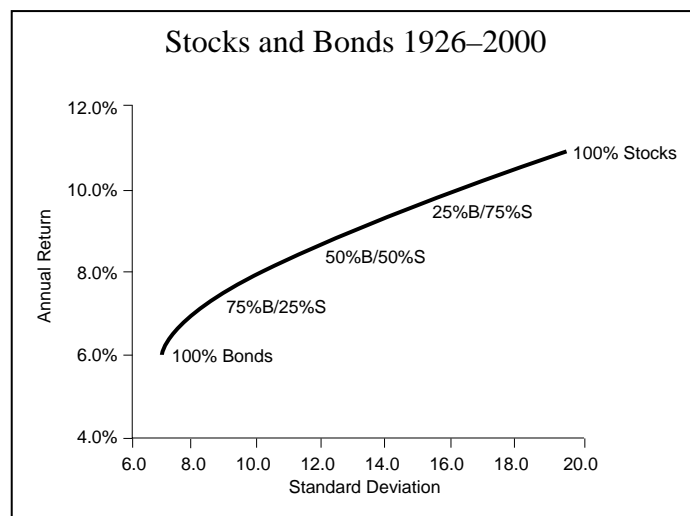
Your Most Important Decision Is Asset Allocation

YOUR INVESTMENT POLICY STATEMENT helps you clarify your overall investment goals and procedures. Now it's time to start translating those principles into an investment program. Your first and most critical step is asset allocation. Experts agree that long-term asset allocation determines a great deal of your investment returns.

What is asset allocation? It's the way you divide your money among stocks, bonds, cash and other assets. Different asset allocation strategies produce different expected returns and risk levels. The objective is to select an asset allocation that will generate the highest possible return given the risk with which you are comfortable.

Economist Harry Markowitz studied asset allocation in his Nobel prize-winning research in 1954. He found that for every given level of risk, there was a unique combination of assets that produced the highest possible returns. For example, if an investor could tolerate higher risk, he might achieve higher returns by investing in a larger percentage of stocks. If another investor preferred moderate risk, she would invest in a larger percentage of bonds for a lower annualized return.

When Markowitz plotted out each optimal portfolio on a graph, the result was a curved line called an "efficient frontier." At any point along the efficient frontier, investors could achieve the highest possible return for a given level of risk. Markowitz defined risk as volatility, that is, how much your portfolio's value moves up and down over short periods.



Investors can use this asset allocation theory today to determine the best mix of stocks, bonds, cash and other assets for their own portfolios.

Developing A Manager Selection Analysis

YOUR ASSET ALLOCATION STRATEGY outlines the way your funds will be invested in three broad categories: stocks, bonds and cash. Next you will need to determine how you will allocate funds within these three categories. This detailed view of your investment strategy can be articulated through a document called a manager selection analysis. Here are some issues to consider when developing a manager selection strategy:

STYLE DIVERSIFICATION

We've already talked about how asset allocation can enhance returns for a given risk level. You can achieve further diversification benefits by spreading your risks among investment styles within a specific asset class. We call this style diversification.

There are a number of investment styles you may wish to consider for your portfolio. For example, it may make sense to diversify your stock investments among growth and value styles. Growth stock managers seek to invest in stocks whose earnings, revenues and stock prices have the potential for strong expansion. Value stock managers seek to invest in stocks that are attractively priced compared to their assets, earnings potentials or dividend yields. You may also wish to invest in a broad range of companies by size. Some stock managers specialize in small capitalization stocks, that is, stocks whose market value is less than \$1 billion, while others emphasize mid-capitalization (\$500 million to \$4 billion) or large-capitalization (\$4 billion and up) stocks. Bond investment styles you may wish to consider include a variety of long-term, intermediate and short-term strategies or funds that emphasize specific sectors of the bond market like governments, corporates, mortgages, high yield, emerging market or international bonds. You may wish to further diversify by including alternative investments in your portfolio such as real estate, hedge funds and commodities.

Some advisers recommend a mix of active and passive strategies. In active strategies you rely on your portfolio manager to select securities that he or she believes will outperform the benchmark. Passive or indexed strategies seek only to mimic the benchmark's performance, often at a lower cost than active styles.

MULTIPLE MANAGERS

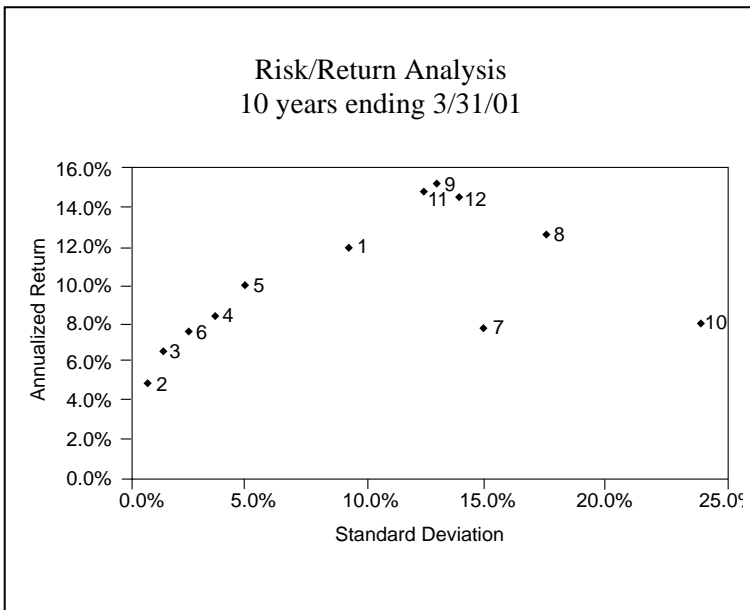
No manager is equally skilled in all asset classes or styles. The easiest way to achieve style diversification is to hire more than one manager, each specializing in a different style.

Different managers use different investment styles. These styles often have low correlation—that is, they react in different ways to the same political, economic or market events. When one style is in favor, another may be out of favor. For example, a growth stock manager will typically do well when a value stock manager does poorly. By investing in both, you can reduce short-term volatility while remaining committed to your long-term goals.

ESTABLISHING GUIDELINES

Once managers have been selected, you may wish to draft a manager selection analysis to outline the appropriate investment manager and style allocation for your portfolio. This document will list the dollar allocation to each manager, along with a brief summary of why this manager was chosen. All manager allocation should be part of the larger context of your overall investment policy statement.

THE RISK AND RETURN OF COMMON INVESTMENT STYLES



Key	Market Indices	Standard Deviation	Annualized Return
1	60% S&P500/40% ML Dom Master	8.83%	12.07%
2	91 Day T-Bills	0.28%	4.93%
3	ML 1-3 Yr. Treasuries	1.64%	6.48%
4	ML Dom Master	3.72%	8.05%
5	ML High Yield Bond	5.00%	10.06%
6	ML Int Treasury Bond	2.90%	7.36%
7	MS EAFE	14.72%	7.81%
8	Russell 1000 Growth	17.64%	12.74%
9	Russell 1000 Value	12.80%	15.24%
10	Russell 2000 Growth	23.55%	8.03%
11	Russell 2000 Value	12.59%	14.81%
12	S&P 500 Index	13.78%	14.43%

Evaluating Money Managers

BY THIS POINT, YOU AND YOUR CONSULTANT have determined exactly the kind of money management expertise you require to meet your goals. In the next step, your consultant will help you identify and select the best investment managers in each category.

MUTUAL FUNDS

Mutual funds provide a good solution for people who are just beginning their wealth-building process. These funds typically allow you to invest in a diversified, professionally managed portfolio of assets with only \$1,000 to \$2,000 initial investment. Mutual funds exist that invest in a variety of asset classes and investment styles, representing the full array of strategies necessary to achieve broad diversification. You can also easily monitor your mutual fund investments through newspaper listings, Internet sites and regular performance reporting. Mutual funds are highly liquid as well; you can usually buy or sell shares quickly, without changing a fund's net asset value.

INSTITUTIONAL MONEY MANAGERS

If you have more than \$100,000 to invest in any single asset class, you may wish to consider separate account investment managers as an alternative to mutual funds. These are independent companies that employ one or more portfolio managers. Typically, separate account investment advisers manage assets for large institutional investors such as corporations, pension plans, foundations and endowments and wealthy individuals.

Among the advantages these money managers offer:

- **Interests aligned with yours.** Separate account management fees are a flat fee based on a percentage of the assets they manage for you. There are no commission fees involved. They make money by growing your assets.
- **Sliding fee schedules.** Most institutional managers charge a lower percentage fee for larger accounts. Mutual funds, by contrast, assess the same expense ratio to all investors, regardless of account size.

HOW CONSULTANTS ADD VALUE

It might seem simple, once you've determined the type of investments you require, to identify the best-performing managers in each category. However, your consultant can bring experience, expertise and perspective to this process, evaluating risk and return characteristics of each investment management style you consider.

Here are some of the ways investment consultants add value in the manager selection process:

- Access to in-depth, up-to-date information about the thousands of registered investment advisers in the United States and abroad.
- Sophisticated performance evaluation tools.
- Insight into investment advisers' organizational structure, process, personnel and other qualitative issues.

- **Strict adherence to investment guidelines.** Separate account managers follow the guidelines in your investment policy statement closely, ensuring minimal change in their investment style over time. Mutual fund managers often have more latitude in how they manage their assets.
- **Responsive to client needs.** Your separate account manager may be able to customize your portfolio to reflect your personal needs and values. For example, if you hold a large portion of your assets in company stock, a separate account manager may be able to eliminate that stock from a diversified portfolio. You may also be able to exclude stocks in industries you object to, such as tobacco, firearms or alcohol.
- **Tax efficiency.** When you invest via a separate account vehicle, you own the stocks in your portfolio directly and you

can control when and whether you sell these stocks to realize capital gains and losses. Your separate account manager may be able to reduce your investment taxes by matching capital gains with losses, by deferring realization of capital gains and through other strategies.

CHOOSING INVESTMENT MANAGERS

Your consultant draws on extensive data and experience in recommending investment managers for your portfolio. Most consultants are in contact with a large number of money managers and make regular onsite visits for due diligence. There are a number of factors he or she will consider in making this decision:

- **The current economic environment.** Some managers can be expected to perform better in specific phases of the business, market or economic cycle. For example, your consultant may be able to recommend managers who have historically reduced risk in difficult market environments.
- **Their investment style and discipline.** How well a specific style fits with others selected for the portfolio.
- **Past performance, as compared to similarly managed portfolios.** Consultants look for both absolute performance and consistency.
- **The volatility and downside risk of each manager's style.**
- **The portfolio manager's tenure.**

Monitoring Performance

INVESTING YOUR PORTFOLIO IS ONLY THE BEGINNING of the consultant's job. Once that is complete, the consultant constantly monitors results to make sure each component of your portfolio—and the portfolio as a whole—is on track to meet your goals.

Your consultant should report performance information to you on a regular basis. You may wish to require your consultant to put in writing that all performance reporting is in compliance with our recently developed IMCA Performance Reporting Standards. These standards ensure that you will receive meaningful, accurate, easy-to-understand information on your investments.

SETTING A BENCHMARK

The first step in measuring performance is to determine an appropriate benchmark. A benchmark is a sampling of the investments similar to those your manager selects for your portfolio. For example, a small cap value manager might be measured against the Russell 2000 Value Index. A core equity manager might more appropriately be compared to the S&P 500 Index.

You may also wish to measure performance against a peer group of similarly managed portfolios. Your consultant can help you identify this peer group and provide return information for it on a regular basis.

Once you have decided upon appropriate benchmarks for each of the components of your portfolio, your consultant can create a blended benchmark representing all of the assets in your portfolio.

MEASURING PERFORMANCE

In the next step, your consultant will measure the change in value of your investments—that is the sum of both income and capital appreciation. This is known as total return. Total return can be measured within the individual investment manager portfolios, as well as for the portfolio as a whole. In both cases, total return should be compared to the total return of the appropriate benchmark.

CONSULTANTS USE A NUMBER OF DIFFERENT TOTAL RETURN CALCULATIONS, INCLUDING:

Dollar-weighted return. This figure measures how much the value of your portfolio has increased or decreased over time. It is most useful for determining how well your portfolio is progressing toward its investment goals. Because dollar-weighted return includes cash flows as well as income and capital appreciation in its calculations, it may not provide an accurate measure of how well the portfolio is performing against its benchmark.

Time-weighted return. This measure minimizes the impact of cash flows to provide a truer measure of performance against a benchmark.

Cumulative annualized returns. Annualized returns represent the average performance per year during a cumulative period. For example, a portfolio that has achieved 80 percent cumulative returns over a five-year period has an annualized five-year cumulative return of 12.5 percent.

Net/gross of fees. Performance can be calculated either before or after fees. Net-of-fee calculations are useful to investors because they show the actual results achieved by the portfolio. Gross-of-fees calculations are more useful in comparing manager performance, since fee schedules can vary significantly from portfolio to portfolio.

Make sure your investment consultant provides you with performance reports that state: “This report has been prepared and presented in compliance with the IMCA Performance Reporting Standards. It meets the mandatory requirements of those standards. IMCA has not been involved with the preparation or review of the report.”

ASSESSING RISK

In addition to performance, consultants monitor risk—that is, the degree to which performance and the total value of your portfolio varies over time. There are a number of risk measurements.

Standard deviation measures the amount by which portfolio returns vary over time. Standard deviation can be broken down into two calculations that measure upside and downside risk.

Beta shows how much of a portfolio’s movements are related to broad market movements. For example, if the S&P 500 goes up by 10 percent and your portfolio goes up by 10 percent as well, then you have a beta of 1. If your portfolio varies by more than its index, beta will be higher than 1; if less, beta will be less than 1.

Risk premium is the amount by which a portfolio's return exceeds that of some risk-free benchmark, like Treasury bills. The idea is that the more risk you take, the higher the returns should be.

Alpha measures the return that can be attributed to individual security selection, rather than broad market movements. It is often used to determine how much value a manager has added through his or her investment decisions.

R-squared tells us how closely a portfolio's return mirrors that of its benchmark. It gives us a way to measure correlation between portfolios and their indices; for example, a portfolio which is exactly the same as its index will have an R-squared of 100.

Risk-adjusted performance ratios. There are three basic tools for measuring risk-adjusted performance. The Sharpe ratio adjusts portfolio returns based on the amount of standard deviation in returns. The Sortino ratio does the same thing, using downside volatility as the risk measure. The Treynor ratio measures return earned per unit of beta, or market risk.

Combining risk and return. Your consultant's ultimate goal is to ensure that your investments provide the best possible return given the risk preferences you have stated. By combining return and risk measurements, your consultant can keep an eye on your portfolio to make sure that it—and all its components—are delivering the risk and return characteristics you expected from them.

Due Diligence

MONITORING PERFORMANCE AND RISK is an important part of your consultant's ongoing role, but it is not the only consideration. Your consultant should ensure quality control in your portfolio by continuously assessing these issues.

ASSET CLASS WEIGHTINGS

Your portfolio's asset allocation changes over time when one asset class performs better than the others. If you allow it to deviate too far from target allocations, you may not achieve the risk and return objectives set out in your investment policy. Your consultant should review asset allocation on a quarterly basis. If your portfolio's asset allocation has shifted significantly, your consultant can advise you on rebalancing strategies.

STYLE DRIFT

Occasionally investment managers drift away from their stated investment discipline. For instance, a small cap stock manager may hold onto stocks that have appreciated, increasing the average market capitalization in the overall portfolio. A growth-oriented manager, whose investment philosophy stresses stocks with above-average earnings potential, may begin purchasing undervalued stocks. These decisions may not have a negative impact on returns immediately; in fact, in many cases managers make these types of decisions to increase returns. However, by abandoning their stated style, they may skew the structure of your portfolio and increase your overall exposure to risk.

Your consultant can monitor the holdings in each component portfolio to make sure that managers remain true to your investment guidelines. When managers change styles, the consultant can argue for a return to the stated discipline or, failing that, can advise reallocating the funds to other managers.

PERFORMANCE ANALYSIS

Consultants provide you with detailed information on how your portfolio has performed—as a whole and in its component parts. They can separate the impact of asset allocation, style allocation and manager skill and adjust the portfolio accordingly.

THE COST OF PROFESSIONAL INVESTMENT ADVICE

Like any other specialist, whether a doctor, dentist, plumber or attorney, your investment consultant charges a fee for services. Even those professionals who say that they provide advice free of charge receive some compensation, often through commissions on the products they sell.

Investment consulting fees can be structured in a number of ways. You should discuss them in detail with your adviser before you begin your investment program.

Among the options available:

Soft dollars: In a soft-dollar arrangement, you pay for investment advice and other services by allowing your investment manager to direct your trading business to a specific broker who in turn pays the consultant a portion of the brokerage commission.

Hard dollars: In a hard-dollar arrangement, you pay for investment advice and services directly, typically on a monthly, quarterly or annual basis.

Asset-based fee: In this structure, your financial adviser receives compensation based on the size of your assets. If your assets grow, he or she will receive a larger payment.

Wrap fee: Under this arrangement, you pay a single fee, usually a percentage of assets, for all investment services, including advice, trading, administration, research and others.

Investing should not be a hobby. You need the best advice you can obtain because investment mistakes are not discovered until it is too late.

What Is an Investment Consultant?

AN INVESTMENT CONSULTANT offers services that are very different and more quantitative than that of a financial planner. Your investment consultant can play a pivotal role in the design, monitoring and management of your portfolio. Licensed investment consultants pursue a customized course of study at leading business schools, covering every aspect of investment management consulting, including:

- Investment Policy
- Asset Allocation
- Risk Management
- Beta Coefficients
- Historical Returns
- Alternate Investment Structures
- Duration and Convexity
- International Financial Markets
- Measuring Return on a Portfolio
- Performance Measurement and Attribution
- Due Diligence and Manager Selection
- Legal and Regulatory Environment
- Ethics

Today, the investment management industry recognizes the CIMA[®] and CIMC[®] certification as the highest standard in consulting expertise. To find a certified investment consultant near you, click here [Certified Investment Adviser Directory](#).

IMCA[®] is the trademark of the Investment Management Consultants Association, Inc., and denotes the highest quality of standards and education for financial professionals.

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