Lecture 1 Summary (1)

LO. Describe the portfolio approach to investing.

The portfolio approach means evaluating individual investments by their contribution to the risk and return of an investor's portfolio.

Diversification helps investors reduce risk without compromising their expected rate of return. A simple measure of diversification risk is the diversification ratio. The lower the ratio, the better the diversification.

$$\text{Diversification ratio} = \frac{\text{Risk of equally weighted portfolio of n securities}}{\text{Risk of single security selected at random}}$$

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Lecture 1 Summary (2)

LO. Describe the steps in the portfolio management process.

The three steps in the portfolio management process are:

1. Planning	• Understanding the client's needs. • Preparing an Investment policy statement.
2. Execution	• Asset allocation. • Security analysis. • Portfolio construction.
3. Feedback	• Portfolio monitoring and rebalancing. • Performance measurement and reporting.

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Lecture 1 Summary (3)

LO. Describe types of investors and distinctive characteristics and needs of each.

The investment needs of each client type are given in the following table:

	Investment Horizon	**Risk Tolerance**	**Income Needs**	**Liquidity Needs**
Individual Investors	Depends on individual goals	Depends on the ability and willingness to take risk	Depends on rationale behind investment	Depends on individual
Banks	Short	Low	Pay interest on deposits	High, to meet the daily withdrawals
DB pension plans	Long, depends on the employee profile	High for longer investment horizon	High for mature funds (payouts are closer), low for growing funds	Low
Endowments and foundations	Long	High	Meeting spending obligations	Low

Lecture 1 Summary (4)

	Investment Horizon	Risk Tolerance	Income Needs	Liquidity Needs
Insurance Companies (P&C)	Short	Low	Low	High
Insurance Companies (Life)	Long	Low (because of high liquidity needs)	Low	High
Mutual Funds	Varies by fund	Varies by fund	Varies by fund	High, to meet redemptions

LO. Describe defined contribution and defined benefit pension plans.

Defined Contribution Plan: Company contributes an agreed-upon amount to the plan. The agreed-upon amount is recognized as a pension expense on the income statement and the contributed amount is treated as an operating cash outflow.

Defined Benefit Plan: A company makes promises of future benefits to be paid to the employees.