<u>BFF3121 Key Concepts</u>

Topic 1: The Investment Background

- *Required rate of return* **=** *real risk free rate + inflation premium + risk premium*
- Risk profiles and return preferences **differ** in accordance with ***age, wealth*** **and** ***income***
- Investor types:
    - Individual investors (life stage matters, risk & return profiles differ, & tax management is important)
    - Institutional investors (maintain relatively constant profile overtime, legal & regulatory constraints are pertinent)

Individual Investor Life Cycle

- An investor's investment strategy changes as he progresses through the stages of the investor life cycle.
- An individual's strategy will always incorporate *life insurance* as protection for family members, and a *cash reserve* equal to about six months' worth of living expenses to meet unforeseen circumstances
- **Figure 1.1**

1. **Accumulation phase** – *<u>High risk</u>* tolerance is assumed in pursuit of <u>above-average returns</u>
    - Early years of career with relatively <u>low net worth</u> and potential <u>outstanding student debt</u>
    - *<u>Long-term investment horizon</u>* means the reinvestment of above-average returns will be subject to the benefit of compounding over a long period of time
    - **Short-term goals**: satisfy *<u>immediate</u>* needs such as a down-payment on a house or car
    - **Long-term goals**: plan for *<u>children's needs</u>* and retirement
2. **Consolidation phase** – *<u>moderate to high ris</u>*k tolerance is assumed in line with the *<u>long-term horizon</u>*
    - Past mid-point of career with income likely exceeding living expenses, and so excess can be invested
    - As the *<u>main goal is retirement planning,</u>* investment horizon is still long-term and above-average returns are still preferred **without excess risk** putting the current nest egg in jeopardy
    - **Short-term goals*:*** *meeting children's needs and holidays*
    - **Long-term goals**: *retirement planning*
3. **Spending and Gifting phase** – *<u>Low risk</u>* tolerance is assumed to preserve capital.
    - Starts at retirement when earning years have concluded.
    - Capital preservation is the focus with returns only required to keep pace with inflation to protect against a decline in real value of savings.
    - **Short-term goals**: lifestyle needs and gifts to family members or charities
    - **Long-term goals:** estate planning

PORTFOLIO MANAGEMENT PROCESS

1. Formulate investment policy statement
2. Examine current and project financial, political, economic, and social conditions
3. Construct the portfolio
4. Monitor and modify investor needs, environmental conditions, and portfolio construction → portfolios are not intended to stay fixed: whilst rebalancing creates costs, it is more costly to hold unfavourable positions.