An appropriate policy statement should satisfactorily answer the following questions:

1. Is the policy carefully designed to meet the specific needs and objectives of this particular investor? (Cookie-cutter or one-size-fits-all policy statements are generally inappropriate.)
2. Is the policy written so clearly and explicitly that a competent stranger could use it to manage the portfolio in conformance with the client's needs? In case of a manager transition, could the new manager use this policy statement to handle your portfolio in accordance with your needs?
3. Would the client have been able to remain committed to the policies during the capital market experiences of the past 60 to 70 years? That is, does the client fully understand investment risks and the need for a disciplined approach to the investment process?
4. Would the portfolio manager have been able to maintain the policies specified over the same period? (Discipline is a two-way street; we do not want the portfolio manager to change strategies because of a disappointing market.)
5. Would the policy, if implemented, have achieved the client's objectives? (Bottom line: Would the policy have worked to meet the client's needs?)

2.4 Input to the Policy Statement

Before an investor and advisor can construct a policy statement, they need to have an open and frank exchange of information, ideas, fears, and goals. Specifically, the client and advisor need to discuss the client's investment objectives and constraints. To illustrate this framework, we discuss the investment objectives and constraints that may confront "typical" 25-year-old and 65-year-old investors.

2.4.1 Investment Objectives

The investor's **objectives** are his or her investment goals expressed in terms of both risk and returns. The relationship between risk and returns requires that goals not be expressed only in terms of returns. Expressing goals only in terms of returns can lead to inappropriate investment practices by the portfolio manager, such as the use of high-risk investment strategies or account "churning," which involves moving quickly in and out of investments in an attempt to buy low and sell high.

For example, a person may have a stated return goal such as "double my investment in five years." Before such a statement becomes part of the policy statement, the client must become fully informed of investment risks associated with such a goal, including the possibility of loss. *A careful analysis of the client's risk tolerance should precede any discussion of return objectives.* It makes little sense for a person who is risk averse to have his/her funds invested in high-risk assets. Investment firms survey clients to gauge their risk tolerance. Sometimes investment magazines or books contain tests that individuals can take to help them evaluate their risk tolerance (see Exhibit 2.4). Subsequently, an advisor will use the results of this evaluation to categorize a client's risk tolerance and suggest an initial asset allocation such as those contained in Exhibit 2.5.

Risk tolerance is more than a function of an individual's psychological makeup; it is affected by other factors, including a person's current insurance coverage and cash reserves. Risk tolerance is also affected by an individual's family situation (for example, marital status and the number and ages of children) and by his or her age. We know that older persons generally have a shorter time frame within which to make up any losses; they also have (a euphemism for downtrends or crashes) that younger people have not experienced or whose effect they do not fully appreciate. Risk tolerance is also influenced by one's current net worth and income expectations. All else being equal, individuals with higher incomes have a greater propensity to undertake risk because their incomes can help cover any shortfall. Likewise, individuals with larger portfolios can afford to place some assets in risky investments while the remaining assets provide a cushion against losses.

A person's return objective may be stated in terms of an absolute or a relative percentage return, but it may also be stated in terms of a general goal, such as capital preservation, current income, capital appreciation, or total return.

Capital preservation means that investors want to minimize their risk of loss, usually in real terms: They seek to maintain the purchasing power of their investment. In other words, the return needs to be no less than the rate of inflation. Generally, this is a strategy for strongly risk-averse investors or for funds needed in the short run, such as for next year's tuition payment or a down payment on a house.

Capital appreciation is an appropriate objective when the investors want the portfolio to grow in real terms over time to meet some future need. Under this strategy, growth mainly occurs through capital gains. This is an aggressive strategy for investors willing to take on risk to meet their objective. Generally, longer-term investors seeking to build a retirement or college education fund may have this goal.

When **current income** is the return objective, the investors want the portfolio to concentrate on generating income rather than capital gains. This strategy sometimes suits investors who want to supplement their earnings with income generated by their portfolio to meet their living expenses. Retirees may favor this objective for part of their portfolio to help generate spendable funds.

The objective for the **total return** strategy is similar to that of capital appreciation; namely, the investors want the portfolio to grow over time to meet a future need. Whereas the capital appreciation strategy seeks to do this primarily through capital gains, the total return strategy seeks to increase portfolio value by both capital gains and reinvesting current income. Because the total return strategy has both income and capital gains components, its risk exposure lies between that of the current income and capital appreciation strategies.

Investment Objective: 25-Year-Old What is an appropriate investment objective for our typical 25-year-old investor? Assume he holds a steady job, is a valued employee, has adequate insurance coverage, and has enough money in the bank to provide a cash reserve. Let's also assume that his current long-term, high-priority investment goal is to build a retirement fund. Depending on his risk preferences, he can select a strategy carrying moderate to high amounts of risk because the income stream from his job will probably grow over time. Further, given his young age and income growth potential, a low-risk strategy, such as capital preservation or current income, is inappropriate for his retirement fund goal; a total return or capital appreciation objective would be most appropriate. Here's a possible objective statement:

> *Invest funds in a variety of moderate- to higher-risk investments. The average risk of the equity portfolio should exceed that of a broad stock market index, such as the NYSE stock index. Foreign and domestic equity exposure should range from 80 percent to 95 percent of the total portfolio. Remaining funds should be invested in short- and intermediate-term notes and bonds.*

Investment Objective: 65-Year-Old Assume our typical 65-year-old investor likewise has adequate insurance coverage and a cash reserve. Let's also assume she is retiring this year. This individual will want less risk exposure than the 25-year-old investor because her earning power from employment will soon be ending; she will not be able to recover any investment losses by saving more out of her paycheck. Depending on her income from social security and a pension plan, she may need some current income from her retirement portfolio to meet living expenses. Given that she can be expected to live an average of another 20 years, she will need protection against inflation. A risk-averse investor will choose a combination of current income and capital preservation strategy; a more risk-tolerant investor will choose a combination of current income and total return in an attempt to have principal growth outpace inflation. Here's an example of such an objective statement: 65-Year old Policy Statement

Invest in stock and bond investments to meet income needs (from bond income and stock dividends) and to provide for real growth (from equities). Fixed-income securities should comprise 55–65 percent of the total portfolio; of this, 5–15 percent should be invested in short-term securities for extra liquidity and safety. The remaining 35–45 percent of the portfolio should be invested in high-quality stocks whose risk is similar to the S&P 500 index.

More detailed analyses for our 25-year-old and our 65-year-old would make more specific assumptions about the risk tolerance of each, as well as clearly enumerate their investment goals, return objectives, the funds they have to invest at the present, the funds they expect to invest over time, and the benchmark portfolio that will be used to evaluate performance.

2.4.2 Investment Constraints

In addition to the investment objective that sets limits on risk and return, certain other constraints also affect the investment plan. Investment constraints include liquidity needs, an investment time horizon, tax factors, legal and regulatory constraints, and unique needs and preferences.

Liquidity Needs An asset is **liquid** if it can be quickly converted to cash at a price close to fair market value. Generally, assets are more liquid if many traders are interested in a fairly standardized product. Treasury bills are a highly liquid security, and real estate and venture capital are not.

Investors may have liquidity needs that the investment plan must consider. For example, although an investor may have a primary long-term goal, several near-term goals may require available funds. Wealthy individuals with sizable tax obligations need adequate liquidity to pay their taxes without upsetting their investment plan. Some retirement plans may need funds for shorter-term purposes, such as buying a car or a house or making college tuition payments.

Our typical 25-year-old investor probably has little need for liquidity as he focuses on his long-term retirement fund goal. This constraint may change, however, should he face a period of unemployment or should near-term goals, such as honeymoon expenses or a house down payment, enter the picture. Should any changes occur, the investor needs to revise his policy statement and financial plans accordingly.

Our soon-to-be-retired 65-year-old investor has a greater need for liquidity. Although she may receive regular checks from her pension plan and social security, it is not likely that they will equal her working paycheck. She will want some of her portfolio in liquid securities to meet unexpected expenses, bills, or special needs such as trips or cruises.

Time Horizon Time horizon as an investment constraint briefly entered our earlier discussion of near-term and long-term high-priority goals. A close (but not perfect) relationship exists between an investor's time horizon, liquidity needs, and ability to handle risk. Investors with long investment horizons generally require less liquidity and can tolerate greater portfolio risk: less