The Portfolio Management Process

Introduction

Portfolio management is the art and science of making decisions about investment mix and policy, matching investments to objectives, and balancing risk against performance. The portfolio management process is a structured and disciplined approach to identifying an investor's objectives and constraints and creating a strategy to meet them. The process includes three main phases: planning, execution, and feedback.

1. Planning Phase

This phase focuses on understanding the investor and setting a strategic foundation for investment decisions.

1.1 Know Your Client (KYC)

KYC is about collecting and analyzing information about the investor's personal and financial situation. The advisor assesses:
- Financial capacity: income, expenses, savings
- Risk tolerance vs risk capacity
- Liquidity needs
- Time horizons (short, medium, long)
- Tax and legal considerations
- Ethical or religious investing preferences

Example: Sarah is a 32-year-old Ugandan entrepreneur who wants to save for her child's education and retire by age 60. Her income is irregular, but she saves diligently and owns rental property.

1.2 Investment Policy Statement (IPS)

An IPS formalizes the investment strategy. It includes:
- Return objectives
- Risk tolerance
- Constraints (liquidity, time horizon, tax, legal, unique needs)
- Strategic asset allocation guidelines
- Monitoring and review processes

Example: Sarah's IPS might target a 10% annual return with moderate risk, allocating 60% to equities, 30% to bonds, and 10% to cash. She prefers avoiding companies involved in gambling or alcohol.

2. Execution Phase

This phase involves putting the IPS into action through security selection and portfolio construction.

2.1 Capital Market Expectations

Forecasting returns, risks, and correlations of different asset classes based on macroeconomic trends, inflation, interest rates, and geopolitical risks.

Example: A BSFIII candidate assumes equity returns of 12%, bond returns of 8%, and T-bill returns of 5% in Uganda. Inflation is expected to average 6% over the next 5 years.

2.2 Asset Allocation

Strategic Asset Allocation: long-term target weights based on the IPS.
Tactical Asset Allocation: short-term deviations to take advantage of market opportunities.

Example: Sarah's strategic allocation might be 60% Ugandan stocks, 30% bonds, 10% cash. But in a rising interest rate environment, the advisor may reduce bond exposure temporarily.

2.3 Security Selection and Portfolio Construction

Security selection involves choosing specific investments within each asset class. Portfolio construction focuses on combining them to optimize return for a given level of risk.

Example: Choosing MTN Uganda and Stanbic Bank shares for the equity portion, long-term T-bonds for fixed income, and a unit trust for liquidity. Diversification is key: the goal is to reduce unsystematic risk.

3. Feedback Phase

This phase ensures the portfolio stays aligned with the IPS and evolving client needs.

3.1 Monitoring and Rebalancing

Monitoring involves regularly checking portfolio performance, risk, and client circumstances.
Rebalancing adjusts asset weights to the original strategic allocation.

Example: If equities grow to 75% of Sarah's portfolio due to a market rally, rebalancing would shift some gains into bonds and cash.

3.2 Performance Measurement and Reporting

Performance should be measured relative to benchmarks and adjusted for risk. Common metrics include:
- Absolute return
- Relative return
- Sharpe ratio (return per unit of risk)
- Time-weighted vs. money-weighted returns

Example: Sarah's portfolio returned 11% vs. a benchmark return of 10%. The Sharpe ratio was 0.9, indicating strong risk-adjusted performance.

Conclusion

The portfolio management process is systematic and client-centered. It guides portfolio managers in aligning investments with client goals while managing risk and adapting to market changes. Understanding this framework is foundational for more advanced portfolio theory and practice.