Unit11. Investing and Portfolio Management in an Efficient Market Context

Reading: Posted on WebCT

Financial Planning in an Efficient Market Context

- Because investments are made in efficient financial markets, it is difficult for an investor to outperform the market consistently.
- However this does not mean that financial assets should be acquired randomly.
- Instead, the investor should develop a financial plan in which financial goals are defined and priorities determined.

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The Process of Financial Planning

- 1. The specification of investment goals
- 2. An analysis of the individual's environment and financial resources
- 3. The establishment of financial plans

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Step 1. The Specification of Financial Goals

- Individuals may have many goals, such as
  - funds for emergencies
  - funds for future purchases
  - funds for retirement
  - funds for heirs/charity
  - funds for speculation/enjoyment of management of wealth

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Financial Life Cycle

- In addition to these specific goals, many individuals have general financial objectives that are related to their age, income, and wealth.
- Typically individuals go through phases called "financial life cycle".
- Financial life cycle has three stages:
  - Period of accumulation
  - Period of preservation
  - Period of depletion

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Period of Accumulation

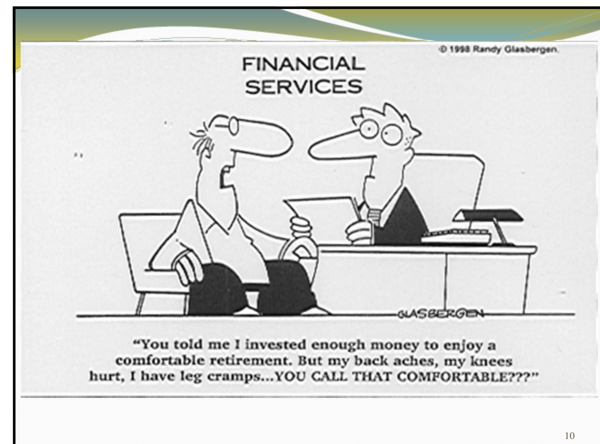
- Income often is less than expenditures so debt often increases during this period of time.
- Yet individuals with debt often start the process of accumulating assets, especially by participating in tax-deferred retirement plans.
- Restructuring and retiring debt are important during this stage. If not for tax-deferral, paying off debt on credit cards is financially better than investing in stocks and bonds.

Period of Preservation

- Income typically > expenditures
- Individuals reduce debt by paying off their mortgages, and continue to accumulate assets.
- Because individuals need substantial amount of money for retirement, they still need to take moderate or prudent risk to earn a sufficient return to finance their retirement.

Period of Depletion

- After retirement most individuals will no longer have salary or wage income
- Pension and Social Security income only replace a portion of pre-retirement income.
- Many individuals draw down their assets to meet expenditures.
- Risk and return should be reduced as safety of principal becomes increasing important.
- However because of long life expectancy, portfolio continues to need some growth to meet long-term expenditures.



Step 2. Analysis of Environment and Resources

- Environment includes factors such as
  - Age
  - Health
  - Employment
- Financial resources is described in two statements:
  - A balance sheet
  - A cash budget

Balance Sheet

- A balance sheet enumerates with is owned and owed.
- Textbook page 881 presents an example of a balance sheet.
- A typical balance sheet has information on
  - Assets: financial assets, non-financial assets, retirement assets.
  - Liabilities: short-term, long-term
  - Net worth = Total assets – Total liabilities

Cash Budget

- Cash budget is a financial statement enumerating cash receipts and cash disbursements.
- Textbook page 883 presents an example of an individual's cash budget for one year.
- There are two main sections to a cash budget:
  - Cash receipts: income from all sources
  - Cash disbursement: expenditures in various categories.
- A cash budget is useful as it highlights the variety of possible sources and uses of funds.
  - If receipts > disbursements, the excess can be invested to meet future financial needs.
  - Individuals may perceive ways to increase receipts or decrease disbursement and thus generate funds for investment.

Pro Forma Financial Statements

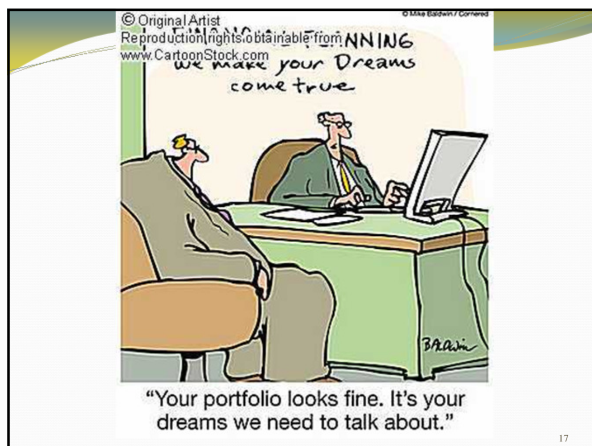
- For the purpose of financial planning, it is desirable to construct one's current financial position as well as to project what the position will be at some time in the future.
- This projected financial statement is called a pro forma financial statement.

Step 3. The Establishment of Financial Plans

- Setting priorities to financial goals – those that are most important should be fulfilled first. Then the next most important goal should be addressed.
- Financial plans should be
  - monitored and
  - altered as conditions/goals change.

An Example of Setting Priorities

- An individual may determine the following goals and their priority:
  - 1. Funds to meet financial emergences
  - 2. Funds to finance a child's education
  - 3. Funds to finance retirement
- Planning:
  - 1. Emergencies: Liquid assets are most appropriate. Stocks are not appropriate. Typically recommendation is 3-6 months of salary income.
  - 2. Child's education: Depending on the child's age, this is likely an intermediate-term investment. Several tax tools can be used for this purpose.
  - 3. Retirement: Depending on the investor's age, this is likely to be long term. Again, tax tools can be used for this purpose. One can do a retirement needs assessment.



Importance of asset allocation and diversification

- Executing a financial plan essentially is asset allocation, for the funds are distributed among various types of investments.
- Determining the allocation requires time and knowledge. Some individuals will seek help from a financial planner, such as a CFP – Certified Financial Planner.
- The financial planner should assess the client's risk tolerance level, and design plans accordingly.

Efficient Markets and Investment Strategies

- There are numerous assets in the markets.
- There are many possible strategies an individual investor can use. Some examples are
  - Small cap only
  - Large cap only
  - Follow insider trading numbers
  - Low P/E ratio
  - Anomalies
- However these particular styles typically involves more risk.
- Constructing a portfolio based on various investment styles or methods of security selection reduces overall risk.
- A well-diversified portfolio eventually becomes more like an index portfolio whose return should mirror the market.

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Why do Some People Appear to Beat the Market?

- A risky profile means the variation of return is large. Some investors may get lucky and hit the high end of the return distribution, while others may not.
- In a sense taking a lot of risk is a bit like gambling – you may hit the jackpot, or you may lose all your money.
- Given the distribution of investment return, some investors must lose, while some must win. So, at any given time, somebody will outperform the market for the time being.

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Key to the Efficient Market Context

- For most investors, it is hard to out-perform the market consistently
- More return requires more risk-taking.
- Efficient markets argue for using
  - Index funds.
  - Exchange-traded funds (ETFs)

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End Note on Investment

- Investment knowledge can aid the process of financial planning and investment management.
- However the information cannot produce superior investment results in a consistent manner.
- For most investors a strategy emphasizing buying diversified securities and holding them until money is needed makes sense because it reduces commission costs and tax obligations.

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