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HOW TO SET UP AND MANAGE AN INVESTMENT PORTFOLIO

A portfolio is not simply a bunch of stocks and bonds you have bought randomly without any thought of how each security relates to each other.

The construction of a portfolio is instrumental in the returns you will receive and the volatility of these returns. Before you set up a portfolio, it is important to determine its overall objective as well as any investment constraints that you may have.

Many financial organizations provide you with an Investment Policy Statement that clearly outlines the role of the adviser or investment manager and the investment objectives and investment constraints for you, the investor. The statement also identifies the types of investments and the amount of exposure of each security and each sector as a percentage of the overall portfolio. Defining the level of risk assumed is identified in this statement. This applies to all types of securities invested in.

For those of you whose monies are managed by a financial adviser, it is important to keep in mind what statements you are signing. For the most part, large financial organizations want to protect themselves from being sued. This is why you need to sign so many documents that minimize any liability for the financial institution. Secondly, they make you sign a risk tolerance statement for each account you have. You will notice that this only applies to each account and not your total consolidated investments. Once again, the securities commissions only monitor compliance for each account in terms of determining any liability in a lawsuit.

Personally, I think it is critical to know the amount of risk you are taking on your total consolidated investments regardless of how many accounts you have. As I indicated previously, financial institutions are more concerned about their own liability than their clients'.

My advice for every investor, both the Do It Yourself and the ones with an adviser, is to add up all of your investments from every account you have and to create a consolidated asset mix. For US and foreign currency investments, I would take the Canadian dollar equivalent of each security in determining the consolidated list of assets and asset mix. For any equity and fixed income investments in mutual funds and ETF's, it is important to review the asset mix, equity and fixed income sector weights and levels of risk assumed. Analyzing both equity sector and fixed income weights is essential in this exercise.

Once you know your precise consolidated asset mix, you can relate that information to the amount of risk you are comfortable taking on. Combining this information with your overall portfolio goals and objectives, income needs and time horizon can make it much easier for you to assess if you are on the right track.

Consolidated Asset Mix

Once you have calculated your total consolidated holdings, create the following categories:

Cash

Fixed Income- Investment Grade

Fixed Income – High Yield

Preferreds

Common Equity – Total

Canadian equity

US Equity

European Equity

Emerging Markets

Total

Calculate the level of expected income from each security and asset class

Determine the appropriate asset mix for you given both your individual needs, risk tolerance, income requirement and time horizon.

Establish a personalized minimum maximum percentage range of every asset category based on your specific circumstances.

Try to balance these personal needs with the security market outlook.

Manage your asset mix tactically – ie. If your risk tolerance is low and the stock market outlook is very uncertain, maintain a low level of equity exposure based on the equity ranges established earlier.

If the equity market outlook starts to look more favourable, you can increase your equity weight towards the higher part of the range. This exercise is an attempt to balance the current market outlook with your unique specific needs.

Fixed Income Investments

Many investors do not worry as much about the risk they are taking with their fixed income investments. This is not wise.

Owning a fixed income mutual fund or ETF does not automatically reduce your overall risk through diversification. It is important to dissect all the investments of each fund or ETF held to determine the following factors:

Investment Grade of fixed income holdings – percentage in investment grade and high yield

Average term and duration of your fixed income investments

Yield to Maturity is much more important than simply looking at average yield.

For corporate bonds, it is important to see what the percentage weight is for each individual corporate issuer.

Equity Sector Weights

There are eleven equity sub sectors in both the TSX Composite and the S&P 500 index. Every month I collect the weights of each group for each country. From these numbers I am currently using a benchmark weight of 55% US and 45% Canadian. Occasionally I change these percentages depending on the outlook for each country's equity market and domestic currency.

After I calculate these benchmark weights, I make an additional assessment of where I think the most and least equity exposure to each group should be going forward based on the outlook for economic growth. I change these weights every month based on the outlook. However, my changes to each sector relative to the benchmark weights, ie whether I am overweight, market weight or underweight, change much less frequently. Being at market weight means my recommended weight is the same as the benchmark 55% US 45% Canada weights I calculated previously.

Exposure of Individual stocks and equity sectors

In order to minimize your portfolio risk, it is important to diversify both your individual stock exposure and equity sector weights. Having a maximum equity weight of 5% in any one stock as a percentage of your total equity holdings is a good strategy to minimize your risk.

I have seen many investors owning a bunch of mutual funds and three Canadian banks thinking that the addition of the banks lowered their level of risk. As most diversified mutual funds and ETF's already own bank stocks, adding three new positions in banks actually increases their level of portfolio risk by having too much exposure to the financial sector.

I have also come across some investors with a massive holding in one stock. Assuming the stock has gone up considerably, the weight of both that stock and that sector is greatly exaggerated in the portfolio, adding an unnecessary portfolio risk. We all recall when Nortel represented 32% of the TSX Composite and also remember what eventually happened.

Correlation of investment returns of one company relative to the overall market

Before you decide to add BCE to your portfolio when you already have Telus and Rogers, it is important to determine a stock's correlation with the market.

A stocks' correlation coefficient can range from -1 to +1. If a stock has a correlation coefficient of -1, it means that if the market goes up by 20%, the stock will go down by the same percentage.

If a stock has a +1 correlation with the overall market, the stock will fall by the same percentage of the market in a downturn.

The objective for investors is to own stocks with negative correlations to the market to reduce your level of portfolio risk. In addition, you can clearly visualize how your portfolio will react simply by adding one new stock to it. There is a website that lists individual stock's correlation with the market. The website address is portfoliovisualizer.com.

Conclusion

Both setting up initially and actively managing an investment portfolio requires a lot of work and discipline.

Adding up all your investments from all of your accounts creates a consolidated look at your asset mix and risk levels assumed. This should be done at least quarterly if not more to ensure you remain on the right track to achieve your long- term objectives.

This also involves a detailed analysis of your mutual funds and ETF's as many funds have very different asset mixes and equity and fixed income exposure than is readily apparent upon an initial glance.

Once you do this exercise routinely, you will feel much more comfortable taking on a more active role in your investment decisions.

Some of you prefer not to do this work yourselves, preferring to get someone else to carry out this work. This is exactly why I have established my **Portfolio Review Service** that is set up specifically to provide you with this information.

If any of you are interested, please click on the Portfolio Review heading on my website for more information plus a sample report.

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