

STUDY SESSION

16

Portfolio Management

Process, Asset Allocation, and Risk Management

The first reading in this study session explains the portfolio management process. The second reading describes multifactor models of asset returns and selected applications of such models. The final reading introduces investment risk measurement and management.

READING ASSIGNMENTS

Reading 47	The Portfolio Management Process and the Investment Policy Statement by John L. Maginn, CFA, Donald L. Tuttle, PhD, CFA, Dennis W. McLeavey, CFA, and Jerald E. Pinto, PhD, CFA
Reading 48	An Introduction to Multifactor Models by Jerald E. Pinto, PhD, CFA, and Eugene L. Podkaminer, CFA
Reading 49	Measuring and Managing Market Risk by Don M. Chance, PhD, CFA, and Michelle McCarthy

LEARNING OUTCOMES

READING 47. THE PORTFOLIO MANAGEMENT PROCESS AND THE INVESTMENT POLICY STATEMENT

The candidate should be able to:

- a** explain the importance of the portfolio perspective;
- b** describe the steps of the portfolio management process and the components of those steps;

- c** explain the role of the investment policy statement in the portfolio management process and describe the elements of an investment policy statement;
- d** explain how capital market expectations and the investment policy statement help influence the strategic asset allocation decision and how an investor's investment time horizon may influence the investor's strategic asset allocation;
- e** define investment objectives and constraints and explain and distinguish among the types of investment objectives and constraints;
- f** contrast the types of investment time horizons, determine the time horizon for a particular investor, and evaluate the effects of this time horizon on portfolio choice;
- g** justify ethical conduct as a requirement for managing investment portfolios.

READING 48. AN INTRODUCTION TO MULTIFACTOR MODELS

The candidate should be able to:

- a** describe arbitrage pricing theory (APT), including its underlying assumptions and its relation to multifactor models;
- b** define arbitrage opportunity and determine whether an arbitrage opportunity exists;
- c** calculate the expected return on an asset given an asset's factor sensitivities and the factor risk premiums;
- d** describe and compare macroeconomic factor models, fundamental factor models, and statistical factor models;
- e** explain sources of active risk and interpret tracking risk and the information ratio;
- f** describe uses of multifactor models and interpret the output of analyses based on multifactor models;
- g** describe the potential benefits for investors in considering multiple risk dimensions when modeling asset returns.

READING 49. MEASURING AND MANAGING MARKET RISK

The candidate should be able to:

- a** explain the use of value at risk (VaR) in measuring portfolio risk;
- b** compare the parametric (variance–covariance), historical simulation, and Monte Carlo simulation methods for estimating VaR;
- c** estimate and interpret VaR under the parametric, historical simulation, and Monte Carlo simulation methods;
- d** describe advantages and limitations of VaR;
- e** describe extensions of VaR;
- f** describe sensitivity risk measures and scenario risk measures and compare these measures to VaR;
- g** demonstrate how equity, fixed-income, and options exposure measures may be used in measuring and managing market risk and volatility risk;
- h** describe the use of sensitivity risk measures and scenario risk measures;
- i** describe advantages and limitations of sensitivity risk measures and scenario risk measures;

- j** describe risk measures used by banks, asset managers, pension funds, and insurers;
- k** explain constraints used in managing market risks, including risk budgeting, position limits, scenario limits, and stop-loss limits;
- l** explain how risk measures may be used in capital allocation decisions.