CHARTERED INSTITUTE FOR SECURITIES & INVESTMENT

CHARTERED WEALTH MANAGER QUALIFICATION

UNIT 2
PORTFOLIO CONSTRUCTION THEORY

Effective for examination from June 2014

UNIT SUMMARY

The objective of the examination is to enable candidates to think critically and communicate clearly in the context of:

- the theory of investment as applied to the management of funds for private clients;

- the structuring of a portfolio of financial assets to suit the needs of a private client;

- the tax planning measures to be considered when structuring a portfolio of financial assets to suit the needs of a private client.

NB The learning in this syllabus builds on the content of the previous unit in the qualification, Financial Markets, and candidates will be assessed on aspects of that unit in the Portfolio Construction Theory exam.

ASSESSMENT STRUCTURE

This is a 3-hour examination of 100 marks comprising three sections:

SECTION A worth 20 marks
- candidates answer ***ALL*** parts of the multiple choice questions in this section.

SECTION B worth 40 marks
– candidates answer ***ALL*** parts of the short answer questions in this section.

SECTION C worth 40 marks
– candidates answer ***TWO*** questions from **THREE**, worth **20 marks** each.

SYLLABUS STRUCTURE

The syllabus is divided into ***learning outcomes***. These are broken down into a series of ***assessment criteria***.

CANDIDATE UPDATE

Candidates are reminded to check the ‘Candidate Update’ area of the Institute’s website (www.cisi.org/masters) on a regular basis for updates that could affect their examination as a result of industry change.

PORTFOLIO CONSTRUCTION THEORY SYLLABUS

LEARNING OUTCOME 01 - Be able to explain the fundamentals of investment theory

1.1 Explain the fundamentals of investment theory:

- setting investment objectives
- implementing investment objectives
- reviewing investment objectives
- conceptualisations of risk within an investment context
- investment return
- risk free rate of return and the risk premium
- diversification
- pound cost averaging
- calculation of foreign currency return
- calculation of domestic return from foreign currency return

1.2 Apply the concept of risk diversification to:

- assessment of a client's financial circumstances: age, wealth, stage of life, cycle, time horizon, need for liquidity, tax position and ethical preferences
- assessment of a client's risk profile
- evaluation of the client's appetite for risk
- construction of a suitable client portfolio

1.3 Appraise interpretations of risk from alternative perspectives

- Characteristics of investment risk
- Investment professional’s perspective
- Client and or customer perspective
- explain decomposition of risk
- explain explicit link between volatility, Beta and Value at Risk (VaR)
- risk profiling of clients

1.4 Explain risk premium

- its nature an usage
- the Taylor rule
- historic long-run averages

LEARNING OUTCOME 02 - Be able to compare and contrast the properties and performance of the principal asset classes held directly by clients and via intermediated investments

2.1 Evaluate cash as a component of a portfolio

- explain expected contribution of cash within a portfolio and according to the separate forms that cash may take:
    - money market instruments
    - Correlation
    - diversification
    - risk premium
    - divisibility

2.2 Evaluate bonds as a component of a portfolio:

- sovereign bonds (gilts)
- corporate bonds
- explain expected contribution of bonds within a portfolio and according to the separate forms that bonds may take

2.3 Evaluate equities as a component of a portfolio:

- explain expected contribution of equities within a portfolio and according to the separate forms that equities may take

2.4 Evaluate commodities as a component of a portfolio:

- explain expected contribution of commodities within a portfolio and according to the separate forms that commodities may take

2.5 Evaluate property as a component of a portfolio:

- explain expected contribution of property within a portfolio and according to the separate forms that property may take

2.6 Evaluate an appropriate risk free asset for investors according to their time horizons and investment strategy.

LEARNING OUTCOME 03 - Be able to evaluate collective investments for use in a portfolio

3.1 Explain the characteristics of collective investment vehicles and their application in an investment portfolio:

- key features of Unit Trusts, OEICs, unit-linked funds, hedge funds and offshore funds
- classifications and rules
- performance/risk/reward profiles
- NAV calculation

3.2 Explain the characteristics of investment trusts and their application in an investment portfolio, including:

- key features and types of trusts
- buying and selling
- NAV calculation
- performance evaluation and risk/reward profiles

3.3 Evaluate concepts of risk, cash holdings, diversification and correlation for collective investments

3.4 Evaluate collective investment vehicles as building blocks to gain asset class exposures and construct the portfolio.

3.5 Explain physical and synthetic ETFs and describe their pros and cons

3.6 Describe impact on portfolio decisions of the tax treatment of non-distributing funds, including hedge funds

LEARNING OUTCOME 04 - Be able to implement long term and tactical asset allocation strategies

4.1 Assess and select asset allocation strategies:
- definition and key properties

4.2 Discuss principles of asset allocation

4.3 Evaluate the role of asset allocation within a portfolio.

4.4 Explain long-term strategic asset allocation

4.5 Discuss and calculate by use of narrative and numeric illustration:
- Static asset allocation
- Dynamic asset allocation / constant proportion portfolio insurance (CPPI)
- asset-liability model
- risk budgeting

4.6 Assess and select tactical asset allocation strategies:
- definition, key properties and deployment
- spread measures used in tactical asset allocation via narrative illustration
- implications of risk appetite
- liquidity, time horizon, liabilities and religious and ethical preferences as constraints upon potential asset allocation
- utilising indirect investments

4.7 Apply indirect investment products in a client's portfolio:

- selecting appropriate funds
- assessing suitability for the client
- analysing charges and taxation
- reviewing performance and management of funds

LEARNING OUTCOME 05 - Be able to evaluate Modern Portfolio Theory and the Capital Asset Pricing Model

5.1 Evaluate the uses of Modern Portfolio Theory:
- the principle of diversification
- the numeric application of portfolio theory
- the impact of correlation upon portfolio risk
- the interaction of indifference curves, the efficient frontier, and the capital market line via graphic illustration/narrative illustration
- the market portfolio

5.2 Evaluate the Capital Asset Pricing Model:
- using numeric illustration and narrative illustration
- the use and application of betas via numeric illustration, graphic illustration and narrative illustration
- assessment of the degree of diversification through R2 via numeric and narrative illustration
- the limitations of CAPM and the efficient frontier

5.3 Be able to discuss and appraise the explicit link between volatility, Beta and VaR
- discuss introduction of risk free asset, zero beta asset, or other safe asset.
- evaluate and critically appraise CAPM versus multi-factor CAPM – Fama and French and Carhart, vs multi factor models

LEARNING OUTCOME 06 - Be able to examine the concepts of behavioural finance and how it is used in the industry

6.1 Define and evaluate the concepts of behavioural finance:
- key properties
- heuristics that help investment decisions
- prospect theory
- cognitive illustrations
- types of trader in the market: information traders, noise traders

6.2 Discuss evidence on efficient market anomalies.
- describe and discuss the relevance of behavioural finance around the client, wealth manager relationship.
- explain and appraise investment design techniques that incorporate behavioural finance for an improvement in long-term investment outcomes.

LEARNING OUTCOME 07 - Be able to appraise different views of market efficiency and their impact on investment style

7.1 Explain market efficiency:
- definition and key features
- random walk
- informational efficiency
- theory and evidence on the three classic forms of market efficiency

7.2 Determine a strategy of active equity selection:
- investment styles: value, growth and growth at a reasonable rate
- investment philosophy: fundamental analysis, technical analysis and quantitative analysis

7.3 Determine a strategy of passive equity selection:
- indexation
- duplication
- stratified sampling
- factor matching
- co-mingling
- tracking error
- subjectivity with indexation

7.4 Apply a strategy of active bond selection:
- duration switching
- riding the yield curve
- bond switching

7.5 Apply a strategy of passive bond selection:
- duration matching (immunisation)
- cash flow matching
- horizon matching (combination)

LEARNING OUTCOME 09 - Explain the role of fund management

8.1 Explain the key properties of the fund manager's role:
- investment considerations
- types of client and differences in their time horizon, risk and liquidity
- factors considered by sponsors when selecting a fund manager

8.2 Evaluate the different approaches to fund management:
- investment strategy and style: active/passive and top down/bottom up
- global and specialised fund management expertise

- quantitative and qualitative based
- investment research and investment decisions
- responsible investment

8.3 Explain the regulatory and best practice framework influencing a fund manager's decisions:
- **Stewardship Code** and Code on Corporate Governance, **voting shares**
- Myners' Principles

LEARNING OUTCOME 09 Be able to explore and explain the implications of responsible and ethical investment and its impact on a private client's portfolio

9.1 Explain the nature of ethical investment:
- key features
- taking an ethical approach to investment design
- providers of ethical funds
- sources of information

9.2 Explain the nature of responsible investment
- key features
- taking a responsible approach to investment design
- providers of responsible investment funds
- sources of information

9.3 Analyse investment performance:
- risks and returns
- benchmarks
- indices

LEARNING OUTCOME 10 - Be able to apply a range of techniques to measure portfolio performance

10.1 Apply benchmarking techniques:
- peer group benchmark
- customised benchmark
- benchmark index

10.2 Calculate total, absolute and relative returns and include:
- raw investment returns: holding period return
- annualising returns of less than one year and more than one year
- relative investment returns

10.3 Calculate time-weighted and money-weighted returns
- via numeric illustration and narrative illustration
- explain why time weighted returns are considered superior

10.4 Evaluate performance attribution:
- asset allocation
- stock selection
- currency

10.5 Evaluate investment performance using Risk and Return:
- total risk
- Jensen measure
- relative duration (bonds)
- Sharpe ratio
- M2 Measure
- Treynor measure
- Appraisal ratio

- Information ratio

10.6 Be able to:
- apply, and explain the advantages and disadvantages of, the various forms of total portfolio risk measurement such as VaR, CVaR

10.7 Examine the application of portfolio theory and diversification in the context of:
- Expected return
- Risk
- Asset allocation and correlation coefficient
- Efficient frontier and portfolio selection
- Capital market line and risk-free investment

10.8 Perform a decomposition of risk based on the Capital Asset Pricing Model theory and explain assumptions, limitations and adjustments

10.9 Explain measures of portfolio performance:
- Holding period
- Time-weighted and money weighted return

10.10 Appraise portfolio performance through benchmarking, attribution / decomposition and taking account of international and foreign currency issues

10.11 Evaluate the following fund appraisal measures:
- Alpha
- Beta
- Sortino ratios
- Total expense ratio

LEARNING OUTCOME 11 - Be able to assess the impact of Stamp duty land tax (SDLT) /Stamp duty reserve tax (SDRT) on the investment decision-making process

11.1 Analyse impact for a domestic, UK investor. This will include:
- income
- capital gains
- inheritance tax

11.2 Determine the nature of chargeable securities:
- their scope
- liability
- rates
- relief and exemptions
- accountable persons
- planning

11.3 Assess the application of stamp duty on unit trusts

11.4 Explain and evaluate VAT in the investment process, portfolio construction and fund management

LEARNING OUTCOME 12 - Be able to determine the tax treatment of On-Shore and Offshore funds

12.1 Explain the taxation of unit trusts and unauthorised unit trusts:
- ISAs
- Qualified Investor Schemes (QIS)

12.2 Explain the taxation of OEICs and Investment Companies with Variable Capital (ICVCs)

12.3 Explain the taxation of offshore funds:
- distributor and non-distributor status
- uses of offshore funds
- planning

12.4 Understand government promoted funds and Special reliefs

LEARNING OUTCOME 13 - Be able to determine the scope of international taxation and tax planning strategies

13.1 Explain UK domiciled, overseas domiciled / non-domiciled.

13.2 Evaluate portfolio considerations when implementing a portfolio for Non-Doms claiming the remittance basis, including the use of UK situs assets and considerations regarding collective investments.

13.3 Explain overseas aspects of income tax, capital gains tax and inheritance tax:
allowances and reliefs (basic calculations)

READING LIST

Periodicals and Newspapers
1. Financial Times
2. FT Weekend
3. Risk Magazine
4. Journal of Derivatives
5. Journal of the Futures Market
6. Investors' Chronicle
7. Securities & Investment Review
8. Investment Week
9. Professional Investor (the quarterly journal of the CFA)
10. Money Management
11. What Investment?
12. Investment Adviser
13. Professional Adviser
14. Money Observer
15. Bloomberg Money

Books

1. Mastering Credit Derivatives; Andrew Kasapi; FT/Prentice Hall
2. Options, Futures and other Derivatives; John C. Hull; Prentice Hall

3. Investments: AND S&P; Bodie Z, Kane A, Marcus AJ; McGraw Hill Higher Education; 7th edn 2007
4. An Investor's Guide to Analysing Companies and Valuing Shares; Cahill M; FT Prentice Hall
5. The Intelligent Guide to Stockmarket Investment; Keasey, K; Hudson, R; Little, K; Wiley 1998
6. Investment Management; Lofthouse S; J Wiley 2001
7. An Introduction to Stock Exchange Investment; Rutterford, J; Davison M; 3rd Edn; 2007
8. A Guide to Stockpicking; O'Connor G; Random House 1996
9. Tolley's Tax Guide; Homer A & Burrows, R; Butterworths Law;
10. Allied Dunbar Expatriate Tax Investment Handbook; Well A (ed); Eastway, N; Gamtlett P; FT Prentice Hall; 7th Edn 2000
11. Financial Times Guide to Personal Tax; FT Prentice Hall
12. Zurich Tax Handbook; Foreman, A & Mowles, G; Allied Dunbar

Websites:

1. www.bankofengland.co.uk
2. www.dmo.gov.uk
3. www.euronext.com
4. www.fca.gov.uk
5. www.ft.com
6. www.ftse.com
7. www.londonstockexchange.com
8. www.nationalsavings.co.uk
9. www.trustnet.com
10. www.hm-treasury.gov.uk

