Investment Constraints when Setting a Return Requirement for All Institutional Investors

1. Liquidity requirement
2. Time horizon
3. Tax Concerns
4. Legal and regulatory
5. Unique circumstances
6. Corporate risk management

Source: *Managing Investment Portfolios* Chp 3 Pages 70-78; 88-90; 96-98; 107-109; 116-118; 124

Investment Policy

1. Investment objectives - Risk and return requirements
2. Investment constraints
   a. Liquidity requirements
   b. Time horizon
   c. Legal, regulatory, and tax
3. Scope
4. Authority from the Board of Directors or Trustees
5. Investment committee
6. Appendices with
   a. Investment advisors and asset classes
   b. Portfolio segments
   c. Concentration limits, overall and by asset segment
   d. Detailed portfolio strategies, by asset segment

Source: V-C138-09 *Managing Your Advisor* Page 21

Preferred Stock

Similarities to common stock:

1. Pays dividends
2. Dividend expense not tax deductible
3. Failure to make dividend payment does not force default

Similarities to debt:

1. Fixed interest payments
2. Senior security
3. Typically no voting rights

Types of preferred stock:

1. Cumulative or noncumulative
2. Fixed- or adjustable-rate
3. Auction or Remarketed

Source; HFIS, Chapter 1

Default and Recovery Rates

1. Issuer Default Rate $= \dfrac{\text{Number of Defaulting Issuers}}{\text{Total Number of Issuers at Beg. of Year}}$

2. Cumulative Annual \$ Default Rate

$$= \frac{\text{Cumulative \$Value of Defaulted Bonds}}{\text{Cumulative \$Value of Issuance}}$$

3. Average Annual \$ Default Rate

$$= \frac{\text{Cumulative \$Value of Defaulted Bonds}}{\text{Cumulative \$Value of Issuance} \times \text{Wtd Avg Yrs Outstanding}}$$

4. Recovery Rate $= \dfrac{\text{Trading Price at the Time of Default}}{\text{Par Value}}$

Source: HFIS, Chapter 13

Agency versus Nonagency CMO

	Agency CMOs	Nonagency CMOs
Credit Support	Agency guarantee, underlying mortgages, primary mortgage insurance	Credit enhancement, underlying mortgages, PMI
Actual delay days	Variable: 0,14,24	Variable: 0, 24
BIS risk weighting	0% for GNMA, 20% other	AAA-rated, 20%
Collateral types	Agency pass-throughs, conforming Alt-A loans	Jumbo or other nonconforming pass-throughs, re-performing loans, Alt-A loans
Prepayment model	Standard agency prepayment model	Specialized model based on collateral
Subject to interest shortfall	No, compensating interest paid by GSEs	On some deals

Source: HFIS, Chapter 24

Equity Allocation that Minimizes Surplus Risk

$$\alpha = \frac{\left(1-\beta\frac{L_t}{A_t}\right)\left(\sigma_B^2-\rho\sigma_B\sigma_E\right)}{\sigma_E^2+\sigma_B^2-2\rho\sigma_B\sigma_E}$$

Source: MIM, Chapter 10