NICO Asset Managers
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INVESTOR'S GUIDE

A guide to the financial markets, investments and the economy

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Topic 303: Portfolio Investment constraints

Last week, we looked at shares and their different types. This week, we will look into the constraint's investors face in their portfolio investments.

An investment portfolio is a collection of assets owned by an investor. The portfolio constraints the investor faces can be grouped into five categories which are liquidity, time horizon, taxes, legal and regulatory environment; and unique circumstances.

1. Liquidity

This looks at a portfolio's ability to meet an investor's foreseen and unanticipated need for cash. Liquidity constraints may arise because of a number of reasons and may limit the investor's ability to meet their needs. In addition to this, the liquidity state of a stock market one invests in also determines portfolio liquidity. If an investor needs cash and decides to sell shares in a market that is not liquid, they will find a hard time to transact on their investments when an urgent need arises for cash.

2. Time horizon

The time horizon constraint entails the estimated time one thinks will need cash in an investment portfolio. It therefore plays an important role in setting up return objectives and defining liquidity constraints. In most scenarios, short time horizons for an investment objective require less risky investments than long time horizon objectives.

3. Taxes

Taxes are one of the most universal investment constraints faced by investors. As an investor, you must be aware of the tax implications of your investments. Although there are different categories of taxes, the following are the most common ones; income tax, capital gains tax, wealth transfer tax and property tax.

Types of tax

- Income tax is defined as tax that is earned on an individual's income. The income includes earnings from employment, profits, income from pensions, and investment income such as interest, dividends and rents.
- Capital gains tax is tax that is applicable to the gains realized when an investor sells their capital assets like shares and bonds at a profit.
- Wealth transfer tax is tax levied on the passing of title to property from one owner to another. Examples include inheritance tax paid at the investors death and gift taxes made by the investor during his lifetime.
- Property tax on the other hand is tax that applies to the market value of real property investments. This is assessed annually as a percentage of the reported value.

All tax will affect an investor's portfolio by decreasing the wealth by the amount of tax paid and decreasing the portfolios growth as the money paid out as tax would have been invested further. The investor will therefore need to employ strategies that they will employ to maximise their exposure to the tax. For example, in some countries, investing in bonds directly exempts you from tax. Therefore, an investment strategy would be to invest more in tax free assets to reduce the amount of tax paid in an investment portfolio.

Next week, we will look at legal and regulatory environment; and unique circumstances as portfolio investment constraints investors face.

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