UNIT V

Subject Name	Subject Code	Semester	Prepared by
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Portfolio – Meaning

Portfolio management is the art of selecting the right investment tools in the right proportion to generate optimum returns with a balance of risk from the investment made. In other words, a portfolio is a group of assets. The portfolio gives an opportunity to diversify risk.

The portfolio is a collection of investment instruments like shares, mutual funds, bonds, FDs and other cash equivalents, etc. Portfolio management is the art of selecting the right investment tools in the right proportion to generate optimum returns with a balance of risk from the investment made.

In other words, a portfolio is a group of assets. The portfolio gives an opportunity to diversify risk. Diversification of risk does not mean that there will be an elimination of risk. With every asset, there is an attachment of two types of risk; diversifiable/unique/unexplained/unsystematic risk and undiversifiable/ market risk / explained /systematic risk. Even an optimum portfolio cannot eliminate market risk, but can only reduce or eliminate the diversifiable risk. As soon as risk reduces, the variability of return reduces.

Best portfolio management practice runs on the principle of minimum risk and maximum return within a given time frame. A portfolio is built based on investor's income, investment budget and risk appetite keeping the expected rate of return in mind.

Objectives

When the portfolio manager builds a portfolio, he should keep the following objectives in mind based on an individual's expectation. The choice of one or more of these depends on the investor's personal preference.

1.Capital Growth

2.Security of Principal Amount Invested

3.Liquidity

4.Marketability of Securities Invested in

5.Diversification of Risk

6.Consistent Returns

7.Tax Planning

Investors hire portfolio managers and avail professional services for the management of portfolio by as paying a pre-decided fee for these services.

Principles – Diversification

The Dominance Principle

States that among all investments with a given return, the one with the least risk is desirable; or given the same level of risk, the one with the highest return is most desirable.

Diversification

Normal Diversification

This occurs when the investor combines more than one asset in a portfolio

Superfluous or Naive Diversification

Occurs when the investor diversifies in more than 20-30 assets. Diversification for diversification's sake.

a. Results in difficulty in managing such a large portfolio

b. Increased costs

Search and transaction

Markowitz Diversification

This type of diversification considers the correlation between individual securities. It is the combination of assets in a portfolio that are less then perfectly positively correlated.

Although there are no securities with perfectly negative correlation, almost all assets are less than perfectly correlated. Therefore, it is possible to reduce total risk through diversification. If we consider many assets at various weights, it is possible to generate the efficient frontier.

Portfolio Construction

Portfolio construction is a process of selecting securities optimally by taking minimum risk to achieve maximum returns. The portfolio consists of various securities such as bonds, stocks, and money market instruments.

The main objective for portfolio construction is to build a suite of investments, from a range of asset classes, that balances the needs for cash, protection from market downturns and consistency in returns with your long-term growth objectives.

Steps in construction of Portfolio

Once a portfolio is in place, it's important to monitor the investment and ideally reassess goals annually, making changes as needed.

Step 1: Assess the Current Situation.

Step 2: Establish Investment Objectives.

Step 3: Determine Asset Allocation.

Step 4: Select Investment Options.

Step 5: Monitor, Measure and Rebalance

Portfolio Revision – Optimum Portfolio.

Portfolio Revision is the process of changing the composition of securities or bonds in the portfolio depending on the performance, expectations & the strategy. If the policy of investor shifts from earnings to capital appreciation the stocks should be revised accordingly.

Need for Portfolio Revision

1.An individual at certain point of time might feel the need to invest more. The need for portfolio revision arises when an individual has some additional money to invest.

2.Change in investment goal also gives rise to revision in portfolio. Depending on the cash flow, an individual can modify his financial goal, eventually giving rise to changes in the portfolio i.e. portfolio revision.

3.Financial market is subject to risks and uncertainty. An individual might sell off some of his assets owing to fluctuations in the financial market.

Portfolio Revision Strategies

There are two types of Portfolio Revision Strategies.

Active Revision Strategy

Active Revision Strategy involves frequent changes in an existing portfolio over a certain period of time for maximum returns and minimum risks.

Active Revision Strategy helps a portfolio manager to sell and purchase securities on a regular basis for portfolio revision.

Passive Revision Strategy

Passive Revision Strategy involves rare changes in portfolio only under certain predetermined rules. These predefined rules are known as formula plans.

According to passive revision strategy a portfolio manager can bring changes in the portfolio as per the formula plans only.

Optimum Portfolio

Optimal portfolio is a term used in portfolio theory to refer to the one portfolio on the Efficient Frontier with the highest return-to-risk combination given the specific investor's tolerance for risk. It's the point where the Efficient Frontier (supply) and the Indifference Curve (demand) meet

The most essential characteristic of an efficient portfolio is the expected return on investment. This represents the amount of risk that an investor wants to accept in exchange for a return on his or her invested money. It is usually expressed in terms relative to the risk-free rate and inflation.

How to create an optimal Portfolio

Optimal portfolio is a term used to refer Efficient Frontier with the highest return-to-risk combination given the specific investor's tolerance for risk.

In this materialistic world, many people have a tendency to invest and to make money out of it. To break out this competition we need to be unique and our work should be exceptionally good. So, what are the things that need to be done in order 'to stand out of the crowd'? The answer is to create an Optimal Portfolio. This can be done by implementing some technical ideologies.

Eggs In One Basket

It's a famous phrase often used in the financial world to describe Diversification.

Diversification is the process of allocating capital in a way that reduces the exposure to any one particular asset or risk. Diversification helps to reduce risk or volatility by investing in variety of assets.

Diversification is an alternative to insurance. It's the idea of managing not through purchasing an insurance policy but through owning a variety of assets. Any level of Diversification will reduce portfolio standard deviation and will mean the Diversified portfolio's risk-adjusted return will be better than the normal weighted average risk-adjusted return. So, it is important to do Diversification. But it's all an assumption.

Capital Asset Pricing Model (CAPM)

CAPM is a model used to determine theoretically a required rate of return of an asset.

The Capital Asset Pricing Model (CAPM) describes the relationship between systematic risk, expected rate of return, and Cost of capital for assets, particularly stocks. In CAPM investors hold a huge diversified portfolio in order to reduce. The CAPM gives investors a simple calculation that they can use to get a rough estimate of the return that they might expect from an investment versus the risk of the outlay of capital.

Efficient Portfolio Frontier

It is the set of optimal portfolios that offer the highest expected return for a defined level of risk or the lowest risk for a given level of expected return.

Returns are dependent on the investment combinations that make up the portfolio. The standard deviation of security is synonymous with risk. The lower variance between portfolio securities results in lower portfolio standard deviation. Optimal portfolios that comprise the efficient frontier tend to have a higher degree of diversification. A key finding of the concept is the benefit of diversification resulting from the curvature of the Efficient Portfolio Frontier. The curvature reveals how diversification improves our portfolio. It also helps to represent the risk and standard deviation based on our investment.

The Contents in this E-Material is taken from the text and reference book as given in the syllabus.