
Portfolio Management

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- ❖ Portfolio is a combination of securities such as stocks, bonds and money market instruments.
 - ❖ The process of blending together the broad asset classes so as to obtain optimum return with minimum risk is called portfolio management.
 - ❖ Diversification of investments helps to spread risk over many assets.
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WHY PORTFOLIOS?

- The simple fact that securities carry differing degrees of expected risk leads most investors to the notion of holding more than one security at a time, in an attempt to spread risks by not putting all their eggs into one basket.
 - Most investors hope that if they hold several assets, even if one goes bad, the others will provide some protection from an extreme loss.
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Diversification

- Efforts to spread and minimize risk take the form of diversification.
 - The more traditional forms of diversification have concentrated upon holding a number of security types(shares, bonds) across industry lines(mining , manufacturing , steel).
 - Most people would agree that a portfolio consisting of two stocks is probably less risk than one holding either stock alone.
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Approaches in Portfolio Construction

- 1. Traditional approach
- 2. Markowitz efficient frontier approach



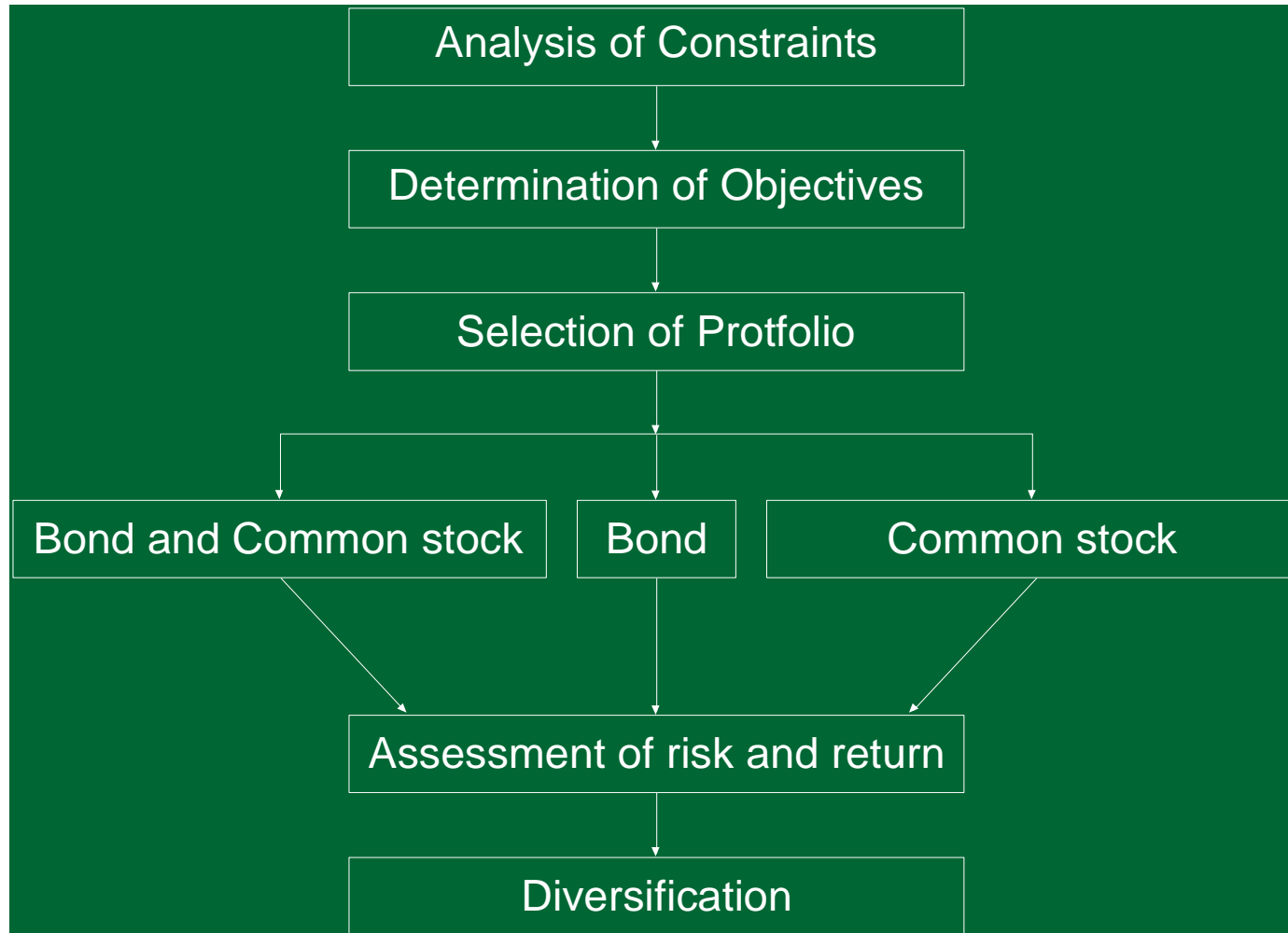
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- ❖ Traditional approach evaluates the entire financial plan of the individual.
 - ❖ In the modern approach, portfolios are constructed to maximise the expected return for a given level of risk.
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Traditional Approach

The traditional approach basically deals with two major decisions:

- Determining the objectives of the portfolio.
 - Selection of securities to be included in the portfolio.
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Steps in Traditional Approach



Analysis of Constraints

- ❖ Income needs
 - Need for current income
 - Need for constant income
 - ❖ Liquidity
 - ❖ Safety of the principal
 - ❖ Time horizon
 - ❖ Tax consideration
 - ❖ Temperament
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Determination of Objectives

The common objectives are stated below:

- Current income
 - Growth in income
 - Capital appreciation
 - Preservation of capital
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Selection of Portfolio

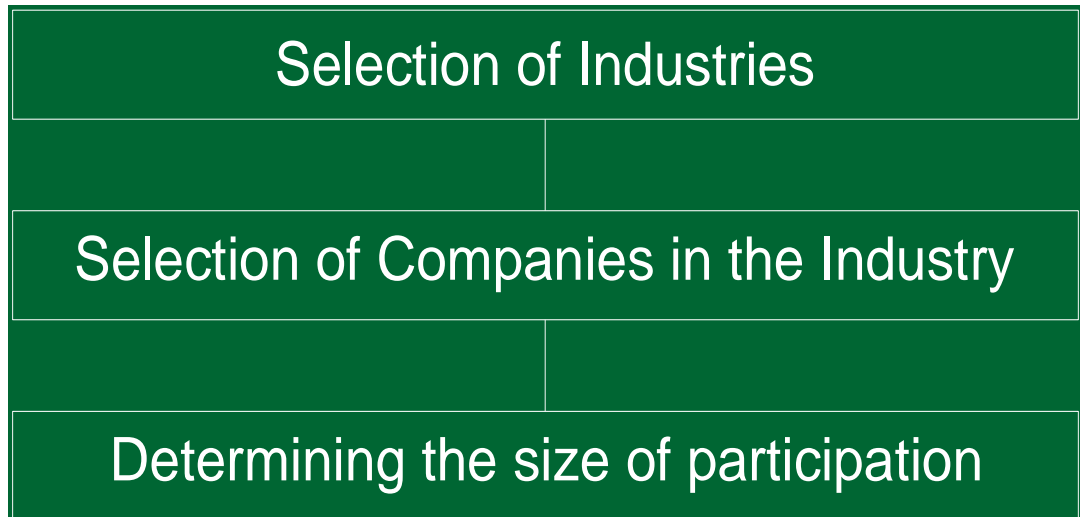
- ❖ Objectives
 - ❖ Growth of income
 - ❖ Capital appreciation
 - ❖ Safety of principal
 - ❖ Risk and return analysis
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Diversification

- ❖ According to the investor's need for income and risk tolerance level portfolio is diversified.
 - ❖ In the bond portfolio, the investor has to strike a balance between the short term and long term bonds.
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Stock Portfolio

Following steps as shown in the figure are adopted



Modern Approach

- ❖ Modern approach gives more attention to the process of selecting the portfolio.
 - ❖ The selection is based on the risk and return analysis.
 - ❖ Return includes the market return and dividend.
 - ❖ Investors are assumed to be indifferent towards the form of return.
 - ❖ The final step is asset allocation process that is to choose the portfolio that meets the requirement of the investor.
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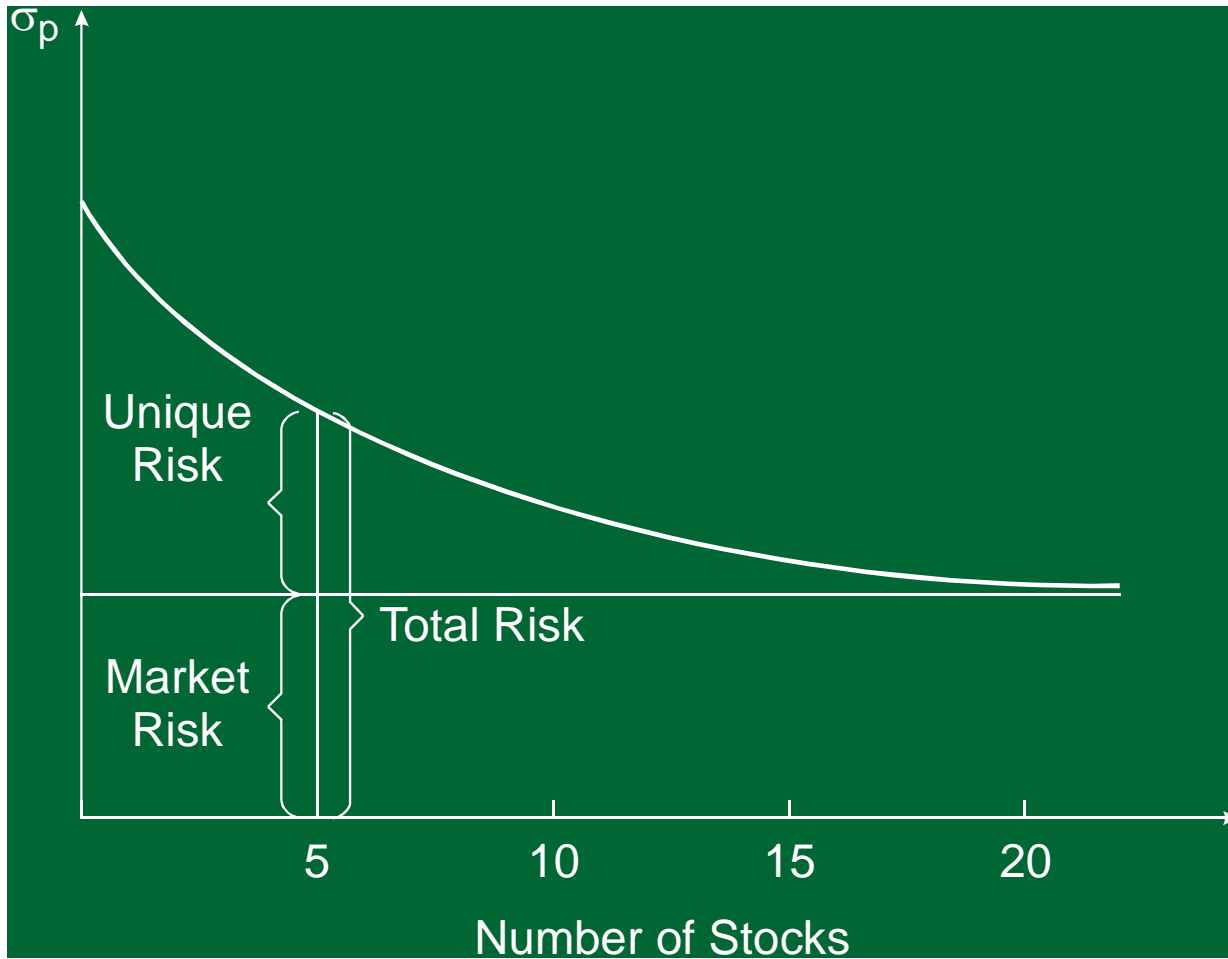
Managing the Portfolio

- ❖ Investor can adopt passive approach or active approach towards the management of the portfolio.
 - ❖ In the passive approach the investor would maintain the percentage allocation of asset classes and keep the security holdings within its place over the established holding period.
 - ❖ In the active approach the investor continuously assess the risk and return of the securities within the asset classes and changes them accordingly.
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Simple Diversification

- ❖ Portfolio risk can be reduced by the simplest kind of diversification.
 - ❖ In the case of common stocks, diversification reduces the unsystematic risk or unique risk.
 - ❖ Analysts says that if 15 stocks are added in a portfolio of the investor , the unsystematic risk can be reduced to zero.
 - ❖ But at the same time if the number exceeds 15, additional risk reduction cannot be gained.
 - ❖ But diversification cannot reduce systematic or undiversifiable risk.
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Diversification and Portfolio Risk



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- The standard deviations of the portfolios are given in y axis and the number of randomly selected portfolio securities in the X axis.
 - The S.D was calculated for each portfolio and plotted.
 - As the portfolio size increases, the total risk line starts declining.
 - It flattens out after a certain point.
 - Beyond that limit, risk cannot be reduced.
 - This indicates that spreading out the assets beyond certain level cannot be expected to reduce the portfolio's total risk below the level of undiversifiable risk.
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