PORTFOLIO CONSTRCUTION AND SELECTION

Portfolio is combination of securities such s stocks, bonds and money market instruments. The process of blending together the broad asset classes so as to obtain return with minimum risk is called portfolio construction. Diversification of investments helps to spread risk over many assets. A diversification of securities gives the assurance of obtaining the anticipated return on the portfolio. In a diversified portfolio, some securities may not perform as expected, but others may expected the expectation and making the actual return of the portfolio reasonably close to the anticipated one. Keeping a portfolio of single security, my lead to a greater likelihood of the actual return somewhat different from that of the expected return. Hence, it is a common practice to diversify securities in the portfolio.

Approaches in portfolio construction

Commonly there are two approaches in the construction of the portfolio of securities viz, traditional approach and Markowitz efficient frontier approach. In the traditional approach, investor's needs in terms of income and capital appreciation are evaluated and appropriate securities are selected to meet the needs of the investor. In the modern approach, portfolios are constructed to maximize the expected return for a given level of risk. It views portfolio construction in terms of the expected return and the risk associated with obtaining the expected return.

Traditional approach

The traditional approach basically deals with two major decisions. They are:

a) Determining the objectives of the portfolio.
b) Selection of securities to be included in the portfolio.

   Normally this is carried out in four to six steps. Before formulating the objectives, the constructions of the investor should be analyzed. Within the given frame work of constraints, objectives are formulated. Then based on the objectives, securities are selected. After that the risk and return of the securities should be studied. The investor has to assesses the major risk categories that he or she is trying to minimize. Compromise on risk and non-risk factors has to be carried out. Finally relative portfolio weights are assigned to securities like bonds, stocks and debentures and then diversification is carried out.

   Analysis of constraints

   The constraints normally discussed are: income needs, liquidity, time horizon, safety, trx considerations and temperament.

   Income needs

   The income needs depend on the need for income in constnt rupees and current rupees. The need for income in current rupees arises from the investor's need to meet all or part of the living expenses. At the same time inflation may erode the purchasing power the investor may like to offset the effect of the inflation and so, needs income in constant rupees.

Steps in traditional approach

Analysis of constraints
Determination of objectives
Selection of portfolio
Bond and common stock bond common stock
Assessment of risk and return
Diversification

(a) Need for current income

the investor should establish the income which the portfolio should generate, the current income need depends upon the entire current financial plan of the investor. The expenditure required maintaining a certain level of standard of living and all the other income generating sources should be determined. Once this information is arrived at, it is possible to decide how much income must be provided for the portfolio of securities.

(b) Need for constant income

Inflation reduces the purchasing power of the money. Hence, the investor estimates the impact of inflation on his estimated stream of income and rises to build a portfolio which could offset the effect of inflation. Funds should be invested in such securities where income from them might increase at a rate that would offset the effect of inflation. The inflation or purchasing power risk must be recognized but this does not pose a serious constraint on portfolio if growth stocks are selected.

Liquidity

Liquidity need of the investment is highly individualistic of the investor. If the investor prefers to have high liquidity, then funds should be invested in high quality short term debt maturity issues such as money market funds, commercial papers and shares that are widely traded. Keeping the funds in shares that are poorly traded or stocks in closely held business and real estate lack liquidity. The investor should plan his cash drain and the need for net cash inflows during the investment period.

Safety of the principal

Another serious constraint to be considered by the investor is the safety of the principal value at the time of liquidation. Investing in bonds and debentures is safer than investing in stocks. Even among the stocks, the money should be invested in regularly traded companies of longstanding. Investing money in the unregistered finance companies may not provide adequate safety.

Time horizon

Time horizon is the investment planning period of the individuals. This varies from individual to individual. Individual's risk and return preferences are often described in terms of his "life cycle". The stages of the life cycle determine the nature of investment. The first stage is the early career situation. At the career starting point assets are lesser than their liabilities. More goods are purchased on credit. His house might have been built with the help of housing loan scheme. His major asset may be house he owns. His priority towards investment may be in the form of savings for liquidity purposes. He takes his insurance or protecting him from unforeseen events like death and accidents and then he thinks of the investments. The investor is young t this stage and has long horizon of life expectancy with possibilities of growth in income, he can invest in high-risk and growth oriented investments.

The stage of the time horizon is the mid-career individual. At this stage, his assets are larger than his liabilities. Potential pension benefits are available to him. By this time he establishes his investment program. The time horizon before him is not as long as the earlier stage and he wants to protect his capital investment. He may wish to reduce the overall risk exposure of the portfolio but, he may continue to invest in high risk and high return securities.

The final stage is the late career or retirement stage. Here, the time horizon of the investment is very much limited. He needs stable income and once he retires, the size of income he needs from investment also increases. In this stage, most of his loans are repaid by him and his assets far exceed the liabilities. His pension and life insurance programme are completed by him. He shifts his investment to low return and low risk category investments, because safety of the principal is given priority. Mostly he likes to have lower risk with high interest or dividend paying component to be included in his portfolio. Thus the time horizon puts restriction on the investment decisions.

Tax consideration

Investors in the income tax paying group consider the tx concessions they could get from their investments. For all practical purpose, they would like to reduce the taxes. For income tax purpose, interest and dividends are taxed under the head "Income from other sources". The capital appreciation is taxed under the head "capital gains" only when the investor sells the securities and realizes the gain. The tax is then at a concessional rate depending on the period for which the asset has been held before being sold. From the tax point of view, the form in which the income is received i.e. interest, dividend, short term capital gains and long term capital gains are important. If the investor cannot avoid taxes, he can delay taxes. Investing in government bonds and NSC can avoid taxation. This constraint makes the investor to include the items which will reduce the tax.

Temperament

The temperament of the investor himself poses a constraint on framing his investment objectives, some investors are risk lovers or takers who like to take up higher risk even for low return. While some investors are risk averse, who may not be willing to undertake higher level of risk even for higher level of return. The risk neutral investors match the return and the risk. For example, if a stock is highly volatile in nature then the stock may be selling in a range of Rs.100-200 and returns may fluctuate between Rs.00-100 in a year. Investors who are risk averse would find it disturbing and do not have the temperament to invest in this stock. Hence, the temperament of the investor plays an important role in setting the objectives.

Determination of objectives

Portfolios have the common objective of financing present and future expenditure from a large pool of assets. The return that the investor requires and the degree of risk he is willing to take depend upon the constraints. The objectives of portfolio range from income to capital appreciation. The common objectives are stated below

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

  The investor in general would like to achieve all the four objectives, nobody would like to lose his investment. But, it is not possible to achieve all the four objectives simultaneously. If the investor aims at capital appreciation, he should include risky securities where there is an equal likelihood of losing the capital. Thus, there is a conflict among the objectives.