NPTEL Course

Course Title: Security Analysis and Portfolio Management
Course Coordinator: Dr. Jitendra Mahakud

Module-1
Session-1
Introduction to Investment Management

1.1 What is Investment Management?

Investment is employing money in different instruments or assets in the present, with the expectation of a positive rate of return in the future. In other words investment is the sacrifice in the present in the expectation of a future gain. The future returns are expected to compensate the time the investors hold the asset, expected rate of inflation and uncertainty of the future. The emphasis has been given mostly on the financial assets and it is also extended to physical and real assets. Investment management is the process of administering the employment of money in financial and other instruments in the present, with the expectation of a positive rate of return in the future.

1.2 How the Investments are Done?

Income level of the investor is the most important factor, which affects their investmnets decision. In the process when the current income exceeds the current consumption the remaining amount of savings are generally invested in the market. When the current consumption exceeds the current income also the investors can participate in the investmnet process through borrowings from the banks and other financial institutions. In this case they have to pay back the borrowing amount as well as the interest charged on this borrowed amount.

1.3 Types of Investors

Types of investors in the market are classified on the basis of the individuals' objective, investmnet horizon period and risk appetite or risk tolerance limit. Individuals who are just using the market to make money quickly for a short period of time are called a traders. Their risk level has been high and they invest with their own money as well as borrowed money. The market participants who like to stay in the morket for a longer period of time, take moderate risk and usually invest with their own money are called as investors. Other type of investors are referred as gamblers, who invest in a very short period of time and take the highest risk among all the investors.

1.4 Investment Constraints

Major constraints of investment include liquidity, time horizon, tax concerns, legal and regulatory concerns and unique circumstances.

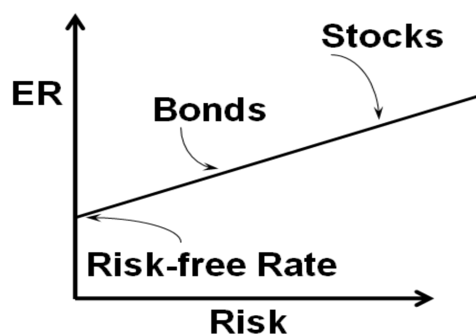
Liquidity refers to the need for cash in excess of any savings or new contributions available at a specific point in the future. A Liquidity needs may be planned (child's college funding in 10 years) or unplanned (a medical emergency) but both require ready ability to convert investments into cash. Some assets, such as real estate, may take considerable time to sell. Others, such as certificates of deposit, may impose early withdrawal penalties. **Time horizon** typically refers to the time at which an investment objective must be met. Some objectives such as saving for a house may have a short time horizon, while retirement or endowment planning can have long horizons. Investors must often plan for several time horizons at once. The time horizon influences the ability to accept risk and could modify asset allocation strategy. Investors with little tolerance for temporary return fluctuations may need a different plan than would be suggested by time horizon alone, and multiple time horizons can further constrain allocation decisions. **Tax concerns** include differences between the tax rates for different types of investment return (interest versus capital gains or dividends), estate taxes, differences between current income and retirement income tax rates, and the potential for tax legislation to change. **Legal and regulatory factors** may include limits on the allocation to specific assets, the ability to access certain funds and even prohibitions on certain investments. **Unique circumstances** may include social concerns and specific family needs. These include a desire for socially responsible investments, health needs, dependent needs, and the investors experience with certain types of investments. Apart from these the macroeconomic environment has been also an important factor to be considered for the investment.

1.5 Investmnet Decision Process

Investment process involves analyzing the basic nature of investmnet decisions and organizing the activities in the decision process. In investments it is critical to distinguish between an expected return i.e. the anticipated return for some future period and a realized return i.e. the actual return over some past period. Investors must always consider the risk involved in investing. Risk is defined as the chance that the actual return on an investmnet will be different from its expected return. In the fianncial market most

of the investors are risk averse. A risk averse investor is one who will not assume risk simply for its own sake and will not incur any given level of risk unless there is an expectation of adequate compensation for having done so. In competitive financial markets, the largest risks have the largest payoffs. In financial markets, investors are constantly on the lookout for either the same risk for a larger return, or the same return for lower risk. Investors manage risk at a cost - lower expected returns (ER).

Figure 1 the expected return-risk Trade-off available to investors



Expected risk return trade-off between different financial assets has been shown in the Figure 1. The risk free rate of return is defined as the return on risk less asset often proxied by the rate of return on treasury bills. From the figure it can be seen that bonds are less risky than stocks and therefore, the expected return on bond is also lower than the expected return on stock. Investors can choose from a wide range of securities in their attempt to maximize the expected return from these opportunities. They face constraints; however, the most important factor has been the risk they face. Traditionally, investors have analyzed and managed securities using a broad two-step process: security analysis and portfolio management. Security analysis is the first part of the investment decision process involving the valuation and analysis of individual securities. Portfolio management is the second step in the investment decision process involving the management of a group of assets (i.e. a portfolio as a unit. The different steps of portfolio management process are as follows:

- Objectives and constraints of the investors
- Choice of the assets mix
- Formulation of investment strategy
- Selection of securities
- Execution of the portfolio
- Portfolio revision
- Portfolio performance evaluation

The factors which affect the portfolio management process are as follows:

- Uncertainty in the ex-post or realized returns

- Availability of investment opportunities
- Types of investors
- Market efficiency

In the investment management process the common errors which take place are as follows:

- Inadequate idea about risk and return
- Biased formulation of investment policy
- Extrapolation of the past data
- Love for cheap stocks
- Over or under diversification of assets
- Wrong attitude towards losses and profits

The major qualities of successful investments are: (i) Creative dynamic thinking, (ii) patience, (iii) flexibility and (iv) decisiveness.

Additional Readings:

- Alexander, Gordon, J., Sharpe, William, F. and Bailey, Jeffery, V., "Fundamentals of Investment, 3rd Edition, Pearson Education.
- Bodie, Z., Kane, A, Marcus,A.J., and Mohanty, P. " Investments", 6th Edition, Tata McGraw-Hill.
- Fisher D.E. and Jordan R.J., "Security Analysis and Portfolio Management", 4th Edition., Prentice-Hall.
- Jones, Charles, P., "Investment Analysis and Management", 9th Edition, John Wiley and Sons.
- Prasanna, C., "Investment Analysis and Portfolio Management", 3rd Edition, Tata McGraw-Hill.
- Reilly, Frank. and Brown, Keith, "Investment Analysis & Portfolio Management", 7th Edition, Thomson Soth-Western.

Additional Questions with Answers

Session- Introduction to Investment Management

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1. Explain the meaning of investment? What are the qualities and constraint of successful investment?

Ans: It is the current commitment / holding of money or other resources in the expectation of reaping further benefits and that will compensate the investor for: The time the investors hold the fund, Expected rate of inflation, Uncertainty of the future.

- Qualities for Successful Investment: Contrary thinking, Patience, Composure, Flexibility, Decisiveness.

- Major Investment Constraints are: Time, Age, Risk Tolerance, Tax Liability, Income fluctuations, Economic Conditions.

2. What are the Investment Decision Processes?

Ans. Investment Decision Processes:

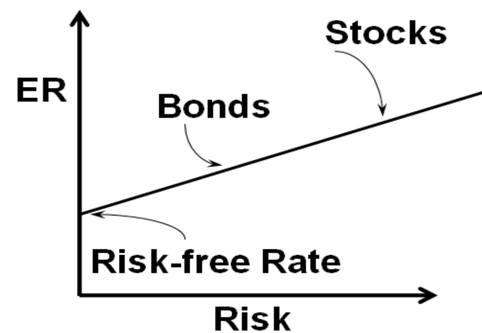
- Knowledge About Fundamentals of Investment: Expected Return and Realized Return
- Risk Return Tradeoff

The Investment Decision Process: Two-step process

- Security analysis and valuation: Necessary to understand security characteristics
- Portfolio management
    - Selected securities viewed as a single unit
    - Efficient financial markets
    - Measurement of portfolio performance

3. What do you mean by Trade-off between Expected Return and Risk?

Ans. In competitive financial markets, the largest risks have the largest payoffs. In financial markets, investors are constantly on the lookout for either the same risk for a larger return, or the same return for lower risk. Investors manage risk at a cost - lower expected returns (ER).



4. Discuss portfolio management process and factors affecting portfolio performance?

Ans. Portfolio Management Process:

- Objectives and Constraint
- Choice of the asset mix
- Formulation of Strategy
- Selection of Securities
- Portfolio Execution
- Portfolio Revision
- Performance Evaluation

Factors Affecting the Portfolio Management Process:

- Uncertainty in ex post returns
- Quick adjustments
- Investment opportunities
- Types of Investors

5. What are the different approaches towards investment decision in relation to better trade of between risk and return?

Ans. Approaches to Investment Decision Making:

- Fundamental: Analysis of Macroeconomic, company specific and industry specific factors for decision making.
- Psychological: Each investor is having own preference point of risk-return trade-off. Risk aversion in general may be true but given the individual investor's behavioral judgment the choice of portfolio will be different.
- Academic: Valuation technique suggested by finance theories.
- Specialized: Technical analysis.

Qualities for Successful Investment:

- Contrary thinking: Investment choice without any heard behaviour. Investor try to time the market in opposite to the common trend across the market.
- Patience: Difference between investing and trading. In long run investment horizon risk must be rewarded with higher premium.
- Composure: Capable to distinguish between noise and information
- Flexibility: Proper balance of low risk and high risk investment avenues
- Decisiveness: Sound judgment based on the economic and fundamental factors.

Common Errors in Investment Management decision process;

- Inadequate idea about return and risk
- Biased formulation of investment policy
- Naive extrapolation of the past
- Simultaneous switching
- Love for cheap stocks
- Over diversification or Under diversification
- Wrong attitude towards losses and profits
- Tendency to speculate