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PORTFOLIO MANAGEMENT

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Abstract

The paper covers the basics of the Portfolio Management Theory, especially the process of asset allocation for the best risk-adjusted portfolio. This is an inevitable part of portfolio building which results in the subsequent increase in profit to risk ratio.

Keywords: portfolio, risk, profit, model, investment, theory, securities, asset, ratio.

Introductory words

Portfolio Management has been considered one of the main areas of Finance for both academics and practitioners. The Portfolio Management subject studies anything that is related with building a portfolio of assets (stocks, derivatives, or bonds, or even real estate) with the goal of maximizing the expected returns and minimizing the risk. The first model was developed by Harry Markowitz during the fifties and it is called Modern Portfolio Theory or the Mean-Variance Model because it affirms that investors should be concerned by only the mean and the variance of the portfolios [1].

Following this model during sixties some authors presented the first asset pricing model (Sharpe, 1964) named as CAPM and it can be considered as one of the main contributions to modern finance. Although it is a theoretic model it has been used a lot in real financial markets and in companies. According to the fundamental equation of this model, the expected return of any asset will be a function of its systematic risk (which can be measured by the beta).

An investment company is defined as a financial intermediary that collects funds from individual investors and invests those funds in a potential range of assets. There are several types of investment companies: open-end funds, closed-end funds, ETF’s, etc. During the last two decades investment companies (especially those with mutual funds) have experienced a huge growth both in number and in size all over the world. There are different topics that must be analyzed or studied on investment companies, but the most relevant is the evaluation [2]. There will be presented the main performance measures (Sharpe Ratio, Jensen’s alpha, etc.) and analyzed their advantages and disadvantages.

The process of portfolio management may be divided into 3 subcategories, which define how to select a security in order to meet client’s needs, and understand his risk tolerance. So, they are:

1)Understanding the Client values and preferences

The process always starts with the investor. Getting to know the client′s needs, the client′s tax status is fundamental for a portfolio manager.

2) Portfolio Construction

The next part of the process is the actual construction of the portfolio. The first of these is the decision on how to allocate the portfolio across different asset classes defined broadly as equities, fixed income securities and real assets (such as real estate, commodities and other assets). This asset allocation decision can also be framed in terms of investments in domestic assets versus foreign assets, and the factors driving this decision.

The second component is the asset selection decision, where individual assets are picked within each asset class to make up the portfolio. In practical terms, this is the step where the stocks that make up the equity component, the bonds that make up the fixed income component and the real assets that make up the real asset component are selected.

The final component is execution, where the portfolio is actually put together. Here investors must weigh the costs of trading against their perceived needs to trade quickly. While the importance of execution will vary across investment strategies, there are many investors who fail at this stage in the process [2].

3) Evaluate portfolio performance

The final part of the process, and often the most painful one for professional money managers, is performance evaluation. Investing is after all focused on one objective and one objective alone, which is to make the most money you can, given your particular risk preferences. Investors are not forgiving of failure and unwilling to accept even the best of excuses, and loyalty to money managers is not a commonly found trait [4].

To sum up, portfolio management theory is essential for making wise decisions as well as it mitigates the risk and meet the investors needs to the highest extent.

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