Certified Portfolio Manager

Sample Material

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1. INTRODUCTION TO PORTFOLIO MANAGEMENT

A portfolio is a collection of financial assets consisting of investment tools such as stocks, bonds, gold, foreign exchange, asset-backed securities, real estate certificates and bank deposits which are held by a person or group. Although a portfolio consists of various assets, it is considered a single entity with measurable qualities because of the relationship between the assets involved.

Portfolio management service (PMS) is a type of professional service offered by portfolio managers to their client to help them in managing their money in less time. Portfolio managers manage the stocks, bonds, and mutual funds of clients considering their personal investment goals and risk preferences. In addition to money, the portfolio managers manage the portfolio of stocks, bonds, and mutual funds.

A Portfolio Management Service varies from a mutual fund. What's common is that in both PMS and mutual funds, the actual investment decisions and stock selection are made by a fund manager. PMS offers personalized service and customized portfolio solutions and hence the cost structure is relatively higher. Mutual funds come under the purview of the Securities and Exchange Board of India (SEBI) and performance indicators are available in the public domain.

Once a portfolio has been made, the investor has many options to monitor its performance. There are innumerable sites which provide support for maintaining and tracking a one's portfolio. One can just as easily refer to the associated fund manager to find out an accurate picture. Otherwise, an account statement is readily sent after every interval to the shareholders to keep them properly updated.

1.1 History of Portfolio Management

Portfolio management is an attempt to maintaining one's investments efficiently. In the early 1900s analysts used financial statements to find the value of the securities. The Railroad Securities of the USA was the first securities to be analyzed. As the time passed, analysis of securities grew in practice in the investment field by using published data. The data however did not have a standard form of being published. Analysts backed the use of different ratios for this purpose. John Moody supported the use of financial ratios to know the worth of an investment. This was detailed in his book The Art of wall Street Investing. This type of analysis came to be known as "common-size analysis."

The other major method adopted was 'Technical Analysis' which is still gaining in popularity today. This method involved the study of stock price movement with the help of price charts. The

advocates of technical analysis believed that stock price movement is systematic and a definite pattern could be identified to help forecast future movement. The identification of the trends and patterns in the price movements provided insight on the direction of the stock or market movement in the foreseeable future. To add to the rules of technical analysis, the Wave Principle was introduced. The analyst, Elliot wave, concluded that the market movement was orderly and followed a pattern of waves while moving up and while moving down. This helped identify reversals or continuations on trends.

According to J.C. Francis the development of investment management has had three different phases.

- ✓ **Phase I:** The Speculative Phase. Investment was widely followed by the masses but only the rich. The process was speculative in nature. Investment management was more an art than a science and needed skills. Price manipulation was resorted to by the investors and this resulted in the stock exchange crash in the year 1929. After this, the highly speculative ventures of investors were declared illegal in the US by the Securities Act of 1934.
- ✓ **Phase II:** Professionalism. After coming up of the Securities Act, the investment industry began to lay emphasis on ethics, establishing standard practices and generating a good public image. Gradually, the market became a safe place to invest and the individuals from different income groups started investing and they analyzed securities before investing. During this time, Benjamin Graham and David L. Dood published the well known research book Security Analysis in 1934. There research work was considered first work in the field of security analysis and acted as the base for further study.
- ✓ **Phase III:** The scientific phase. The foundation of modern portfolio theory was laid by Markowitz with his work on portfolio management. He tried to quantify the risk and showed how the risk can be minimized through proper diversification of investment which required the creation of the portfolio. Technical tools were also provided for the analysis and selection of optimal portfolio. The work of Markowitz was extended by the William Sharpe, John Linter and Jan Mossin through the development of the Capital Asset Pricing Model (CAPM).

In India, after economic liberalization and globalization, many private players in the investment and banking industry came through. A large number of mutual funds have come up in the market since 1987. With the advent of computers the whole process of portfolio management has become quite easy. The computer can absorb large volumes of data, perform the computations accurately and quickly give out the results in any desired form. Moreover simulation, artificial intelligence etc

provides means of testing alternative solutions. The economic reform made the Indian industry efficient, with market transparency, better infrastructure and customer services. The markets became dominated by large institutional investors with diversified portfolios.

Presently, phases II and III are currently advancing simultaneously with investment in various financial instruments becoming safer, with proper knowledge to each and every investor. Development of the quantitative techniques and professional portfolio management, backed by research is now adopted by mutual funds, investment consultants, individual investors and big brokers. The Securities Exchange Board of India (SEBI) is a regulatory body in INDIA. It ensures that the stock market is free from fraud.

1.2 Necessity of Investment Policy

Portfolios are built to suit the return expectations and the risk appetite of the investor. A combination of assets or securities is formulated which meets the level of return the investor is willing to accept. To do this, management of the portfolio is necessary as meeting both the returns expectation and risk-taking ability is tough. Portfolio Management is used to select a portfolio of new product development projects to achieve goals for the investor. They are to,

- ✓ Maximize the profitability or value of the portfolio.
- ✓ Provide balance.
- ✓ Support the strategy of the enterprise.

Every portfolio manager must follow an investment policy. An investment policy is a statement that helps a manager in running an investor's portfolio in accordance with investment goals, constraints and objectives. This is needed to keep discipline intact so that at the end of the investment horizon, the returns on portfolio matches the investor's expectations. Keeping a standard investment policy also helps track the performance of different portfolio managers. There are certain client situations that an investment policy considers.

- ✓ Repercussions of the client hitting adverse financial situations.
- ✓ The client's reaction to such a situation.
- ✓ The awareness of the client about investments and markets.
- ✓ Any legal restrictions affecting the investor's investment.

The policy statement should include a benchmark portfolio, or a standard of comparison. It should be made sure that the risk of the benchmark and the assets included in it commensurate with the investor's risk preference and investment needs. For example, an investor preferring low-risk investment strategy should have a policy statement and should compare the investment

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manager's performance against a low-risk benchmark portfolio. Existence of a policy statement acts as a safe guard against any unethical practices adopted by the investment manager.

1.2.1 Composition of a Policy Statement

An investment policy should maintain relevant inputs with two main factors- investment objectives and investment constraints – of an investor. The investment objectives specify the needs of the investor as well as the level of risk he or she is willing to take in order to have the desired returns. Risk tolerance depends on a person's psychology and other factors such as insurance coverage, age, marital status, number of children and cash reserves to name a few.

The amount of return is expressed in terms of percentages as well as in subjective terms like capital preservation, capital appreciation, current income, and total returns. With capital preservation, the investor wants to minimize the loss and seeks the return which is at least equal to the prevailing rate of inflation and not any less. Those interested in capital appreciation take a more aggressive investment strategy and want the portfolio to grow in real terms. If the investor's aim is current income, he/she focuses on generating income rather than capital gains. Finally, in the case of total returns, the investor aims to earn a return through capital gains along side of reinvesting the current income. Investment objectives cannot be the same for all levels of investors. They are specific to the individual investor depending upon the level of the risk tolerance, returns to be generated, age, time horizon and other associated factors.

1.3 SEBI Regulations

In order to protect the interest of the investors and the overall economy, the Securities Exchange Board of India has put down regulation to prevent manipulation and maintain a standard in the profession. Portfolio managers must first and foremost be registered and obtain a certificate to show that the individual has the relevant expertise to manage and advise on his or her client's investments. At the time of registration, the manager must show capital adequacy i.e. a minimum net worth of Rs. 2 crore. Before taking up an assignment, the portfolio manager needs to enter into an agreement in writing with such client clearly defining the relationship, and setting out their mutual rights, liabilities and obligations relating to management of funds or portfolio of securities containing the details as specified in Schedule IV. The portfolio manager needs to furnish a report to the client on a periodical basis, as agreed in the contract, but not exceeding a period of six months and as and when required by the client. This report may be provided on the website with restricted access to each client. The client has the right to obtain details of his or her portfolio from the portfolio managers.

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SEBI Portfolio Manager Regulations have not prescribed any scale of fee to be charged by the portfolio manager to its clients. However, the regulations provide that the portfolio manager shall charge a fee as per the agreement with the client for rendering portfolio management services. The fee so charged may be a fixed amount or a return based fee or a combination of both. The portfolio manager shall take specific prior permission from the client for charging such fees for each activity for which service is rendered by the portfolio manager directly or indirectly (where such service is outsourced).

1.4 Risks in Investment

In investment terminology, 'risk' refers to the variability of the expected returns. It is an attempt to quantify the probability of the actual return being different than the expected return. The variability of the return or the risk can be segregated into many components.

- ✓ **Business Risk:** This risk is the variability of returns introduced by the nature of business entity invested in. A change in the price of raw materials and finished goods, supply and demand for raw and finished materials, wage rates, fuel costs, economic lives of assets, tax laws, and changes in operating costs are some of the components pertaining to a business that have a direct impact on profitability or the ability to repay a business debt. Because of this the company's share prices also get affected.
- ✓ **Financial Risk:** This is the variability of the returns from investments made in the company that is brought about by the financing mix used by the company. If only equity is used, its financial risk will be relatively less, as there will be no obligatory repayments to be made. A company using debt however will bear a bigger risk as there will be mandatory repayments of principal and interest. These factors lead to variable profits and share prices.
- ✓ **Liquidity Risk:** This is the uncertainty of the ability of an investor to exit from an investment when desired. Exiting an investment usually involves the secondary market where securities are traded. When assessing liquidity, one must take into consideration to points- time taken for liquidation and price realization. A security is illiquid when the investor either has to sell at a lower rate than expected or has to wait a long duration before disposing it or both.

1.5 Portfolio Management Process

The focus of portfolio management is to match the characteristics of the assets with the needs of the investors on a regular and on-going basis. In brief, the portfolio management process involves.

- ✓ Identifying the investor's objectives, preferences and constraints to develop an investment policy.

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- ✓ Strategizing by determining the best combinations of financial and real assets available in the market and implementing the strategies.
- ✓ Studying the market conditions, relative asset values, and the client's circumstances.
- ✓ Doing the appropriate changes to the portfolio to reflect alterations in one or more pertinent variables.

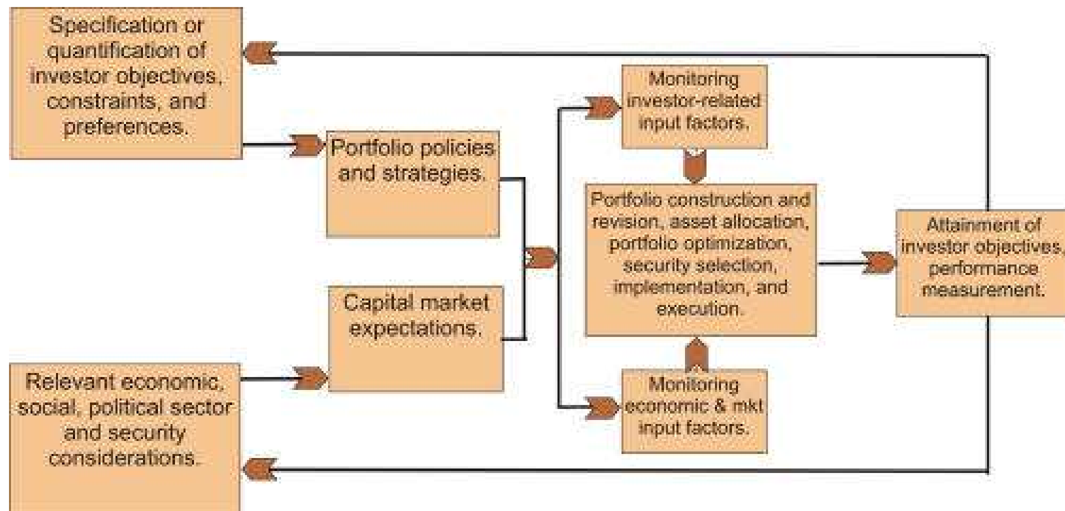

Fig: Process of Portfolio Management_

1.6 Parties Involved in Portfolio Management

A portfolio manager is the person responsible for investing a fund's assets, implementing its investment strategy and supervising the daily portfolio trading. Other parties involved in the process of portfolio management are.

- ✓ **Marketers:** People who bring the revenue for the company running the PMS by acquiring clients.
- ✓ **Fund managers:** The people who direct investment into the proper avenues.
- ✓ **Compliance staff:** Ones there to ensure accord with legislative and regulatory constraints.
- ✓ **Internal auditors:** Professionals to examine internal systems and controls.
- ✓ **Financial controllers:** Those for accounting for the institutions' own money and costs.
- ✓ **Computer experts and "back office" employees:** They are there to track and record transactions and fund valuations for up to thousands of clients per institution.