Portfolio theory

Portfolio theory forms the basis of portfolio management. Portfolio management deals with the selection of securities, and there continuous shifting in the portfolio to optimise return in order to suit the objective of an investor. This, however, requires financial expertise in selecting the right mix of securities in changing market condition to get the best out of the stock market. In India as well as in number of Western countries, Portfolio Management Service has assumed the role of a specialised service and a number of professional investment bankers/Fund managers compete aggressively to provide the best options to high net worth clients, who have little time to manage their own investment. The idea is getting on with the growth of the capital market and increasing number of people want to earn profits by investing their hard-earned saving in a planned manner.

Portfolio theory guides investors about the method of selecting and combining securities that will provide the highest expected rate of return for any given degree of risk or that will expose the investor to the lowest degree of risk for a given expected rate of return. Portfolio theory can be discussed under the following heads.

1. Traditional approach

Traditional approach to portfolio management concerns itself with the investor, definition of portfolio objectives, investment strategy, diversification and selection of individual investment as detailed below:

(i) Investor's study includes an insight into his - (a) age, health, responsibilities, other assets portfolio needs: (b) need for income, capital maintenance liquidity (c) attitude towards risk; and (d) taxation status;

(ii) Portfolio objectives are defined with reference to maximizing the investors wealth which is subjected to risk. The higher the level of risk borne more the expected returns.

(iii) Investment strategy covers examining a number of aspects including:

- balancing fix interest securities against equity shares;
- balancing high dividend payout companies against high earning growth companies as requested by investor ;
- Finding the income of the growth portfolio;
- balancing Income Tax payable against capital gain tax; balancing transaction cost against capital gain from Rapid switching; and

- Retaining some liquidity to seize upon bargains.

(iv) Diversification reduces volatility of Returns and and does it create equity diversification is sought. Balancing of equities against fixed interest bearing securities is also sought.

(v) Selection of individual investments is made on the basis of the following principles:

- Methods of selecting sound Investments by calculating the true or intrinsic value of a share and comparing that value with the current market value (that is by along the fundamental analysis) or trying to predict future share prices from past price movements (i.e. following the technical analysis);

- Expert advice is sought besides study of published accounts to predict intrinsic value;

- Inside information is sought and relied upon to move to diversify growth companies, switch quickly to winners than loser companies;

- Newspaper tipster about good track record of companies are followed closely;

- Companies with good asset backing dividend growth good morning record high quality management with appropriate dividend paying policies and leverage policies Stressed out constantly for making selection of portfolio Holdings.

In India, most of the share and stock brokers follow the above Traditional approach for selecting a Portfolio for their clients