Investment strategy and portfolio management

Business, Management

For organisations operating in unpredictable and competitive markets, it becomes a challenge for fund managers to create an optimal investment portfolio for their companies and their clients. Fund managers are presented with various prospects in emerging markets, equities, real estate, corporate bonds, government bonds, hedge funds, financial derivatives, and other alternative investments options. With such a diverse investment market, it becomes increasingly complicated for fund managers and other investors to shape, manage and monitor investment portfolios. This report presents a discussion on the future strategic asset allocations which Kaplan should employ in making its investments in order to ensure high levels of profitability in the company.

Harry M. Markowitz, a University of Chicago economist, developed the portfolio theory in 1927 (Markowitz 1952). Portfolio theory is an investment technique that enables investors to make suitable estimates of both the anticipated risks and returns, as evaluated statistically, for their investment portfolios. Harry identified how investors can combine different investment assets into an efficiently diversified portfolio. He argued that combining investment assets with different price movements – negatively correlated assets; would reduce the expected risk of a portfolio and improve the expected rate of return of from the portfolio. He described how to best design a diversified portfolio and confirmed that such a portfolio was expected to perform well.

Analysis of the Current Issues in the Investment Environment

The recent disruptions in financial and money markets have triggered fear and anxiety among many investors. Globally, share markets have been

falling sharply, considerably affecting portfolios and confidence of investors internationally. Therefore, before we settle on any investment strategy there are a number of factors we will need to consider and evaluate critically, before designing our optimal investment strategy.

The other current issue in the economic environment is the issue of investors losing confidence in assets investments and fund investments, opting to withdraw their investment for fear of making more losses in future. Investors lose confidence in the market consequently resulting in a credit crunch.

Alternatives for Credible Strategic Asset Allocation

Here we attempt to deal with the turmoil in the market and how to work through with these stringent conditions to ensure we avert our losses and ensure we get positive results. Companies have not ceased to do well simply because the markets are down. All that is needed is the right approach to reassure investors of growth and reasonable investment decisions to ensure the business does not plunge into huge losses as a result of the current turmoil in international financial markets. Basically, asset allocation is a structured and efficient method of diversification.

The most sensible way to get through a difficult period without incurring huge losses is to stay well diversified. In our case, we can implement a number of strategies to help us manage our investment portfolios. One credible alternative is to stay diversified; for a well diversified portfolio with negatively correlated assets can adequately withstand turbulent economic times, since not all assets or markets are affected in the same magnitude by economic crises (Mark Grinblatt 1995). Maintaining a diverse range of

investments implies that bad returns from one or a few assets will in fact have a mild effect on the portfolio.

At times, some good investments emerge during turbulent economic times, thus, presenting an opportunity to uncover profitable prospects. Due to the panic by most investors, they tend to dispose of investment assets, which if given time would recover and earn them better returns. However, as a result of asymmetry of investment information in the market by investors, periods of economic crises present some worthy investment opportunities that some other investors can take advantage of such as reduced share prices and other undervalued investment assets, which after the economy recovers might give good returns (Ablan 2008). Also, during an economic recession, if a business is well regulated, it can come through and might end up with fewer competitors. Nonetheless, persuasive prospects are likely to emerge but the risks associated with such investments will need to be closely managed.

Portfolio Management - Asset Allocation

Asset allocation is a portfolio management technique that is concerned with balancing between income-oriented and growth investments in a portfolio. This apportioning enables the investor to capitalize on the risk/reward trade off between the various assets in the portfolio and gain from both profits and growth. There are four basic steps to asset allocation; selecting which asset categories to include in the portfolio (stocks, bonds, real estate, money market, financial derivatives or precious metals), choosing the most suitable proportion to allot to each asset class, identify a suitable variety within the set target and then finally diversifying within each asset category.

Due to the losses which are expected to be incurred By Kaplan Capital Company from the current asset allocations of the company (Refer Table 1-appendix). It is proposed that the company should adopt a different plan of asset allocation (refer table 2 appendix). If Kaplan Capital Company continued to hold its current portfolio assets it is expected to get losses of £1. 831 million (refer table 1 – appendix). This will reduce the profitability of the company and also reduce the funds available to refund the contributors.

It is therefore proposed that Kaplan Capital Company adopts an international portfolio asset allocation in order to increase the diversification of its investments against systematic risks in the local market and make more gains by investing in the best performing assets in the international market. The proposed international portfolio asset allocation is expected to earn the company a profit of £3. 25 million (refer table 2- appendix). This will be achieved by investing in Equities in the NYSE, Eurobonds, Germany Mutual funds, UK corporate bills and cash and short-term instruments in the UK market. It is therefore proposed that Kaplan should dispose its current portfolio assets and adopt the proposed strategic investment plan.

Certainly, the suitable asset mix for different investors depends on various factors such as financial goals, risk tolerance and time horizon. Financial goals of the company will determine how the company will apportion various investment assets in a portfolio. In the case of Kaplan Capital, it expects a considerable cash outflow from June 2012, by the initial contributors. In line with its financial goals, the company had allocated a large proportion of its portfolio to equities and bonds, which are deemed to give good returns in the long-term.

The company’s risk acceptance is a very important factor in selecting an investment asset allocation. Risk tolerance is the degree of financial risk that the company accepts and is willing to bear - the loss resulting from a particular investment asset (Genevieve Brown 2001). The company should stipulate its level of risk tolerance, which should be reviewed occasionally; as risk allowance may change after some time.

Undoubtedly, the time horizon for each of the client’s or companies financial goals will influence the asset allocation mix. For instance, in the case of Kaplan Capital Fund, a client with a high risk tolerance would opt to allocation a larger proportion of the portfolio to stocks than that of the funds being allocated for the university funds of the member’s 14-year-old child.

Portfolio Management - Strategic Versus Tactical Asset Allocation

Designing a suitable asset combination is an active process that plays a fundamental role in influencing a business’s overall portfolio risk and return. Intrinsically, a portfolio's asset mix should reveal the company’s goals at any instant. There are two main asset allocation strategies.

Strategic asset allocation involves determining target portions and then regularly rebalancing the portfolio in line with those objectives as investment profits skew the original initial asset allotment proportions (Hendry 2011). The model is similar to a " buy and hold" tactic, instead of an active trading strategy. Naturally, the strategic asset allocation objectives may change in due course as the company’s targets and demands change and as the time scope for major events, for instance a client’s retirement and school or university college funding, gets shorter.

Tactical asset allocation on the other hand is asset allocation techniques that provides for a choice of proportions in each asset class. These are the minimum and maximum suitable proportions that allow the company to capitalize on market conditions within these limits (Genevieve Brown 2001). Under this strategy, some form of market timing is possible, since the fund's manager can allocate a higher percentage of the range to stocks when they are expected to perform better and lower the proportion when the economic expectation is bleak. Generally, a strategic asset allotment is associated with a passive investment approach, while tactical asset distribution is associated with an active investment technique.

Using ‘ Active’ Investment Approach versus ‘ Passive’ Investment Approach in the Different Asset Classes

A passive portfolio strategy is an investment approach that requires minimal anticipation input, and alternatively relies upon diversification of the portfolio to correspond the performance of some market indicator. A passive approach presumes that the market will include all available information in the price charged for investment assets. Whereas an active portfolio strategy is an investment model that applies available information in the market and prediction methods to establish a better performance than an asset collection that is only diversified broadly (Eckett 2008). However, the company should balance between the active and passive investment approaches and apply a balanced investment strategy for portfolio management.

In the case of Kaplan Capital, it is expected that funds withdrawn will exceed fund inflows by 6% per annum on average for the next five years. To avert

these forecasted losses, the company could consider using an active investment approach to raise the needed funds from the equities and cash and short-term instruments asset classes. In that, these two classes of assets would be the best to use to realise funds on the short term, within three months, before the first contributors start withdrawing their funds.

In my opinion, I would suggest the management to disposal of the UK equities and purchase better performing stocks at the New York Stock Exchange. Buying securities for each asset class and selling them when they reach their price targets (Colin John Nicholson 2009). According to statistics, investing in the US stock market would generate better returns, factoring in that most of the stocks are undervalued and therefore, there is a great chance to maximise on returns, within the five years and more so before June 2012.

Kaplan Capital should invest in Eurobonds, Germany mutual funds, UK corporate bills, and retain 5% holding in the cash and short-term instruments, since Euro bonds are the best performing bonds in the world. With the international financial markets recovering from the effects of the 2010/2011 recession, it is forecasted that interest rates will improve and hence a boost in expected earnings from bonds. For the case of the bonds, Kaplan Capital should use the passive investment approach.

Conclusion

Kaplan Capital should implement a balanced investment strategy for its portfolio management. This style primarily aims at maintaining a balance between investment risk and revenues. A balanced investment approach

aggregates the pros of aggressive and defensive investing tactics. Aggressive investment style entails making investments in high risk high return investments, with the exclusive aim of maximising profits from ventures. Conversely, a defensive investment technique aims at preserving capital and ensuring some minimal return from investments.

In balanced investment system, the company can balance between risk and return by diversifying asset investments in both high risk high return and low risk low return investments. A balanced investment generally adopts a portfolio capital apportioning rule that defines how much to invest in shares and bonds and the amount to invest in treasury bills, short-term financial instruments and funds. Normally one part of the portfolio is managed actively, while the other part is allowed to grow without intervention. Balanced investment strategy can be slightly aggressive or slightly defensive with respect to investments made.

This balanced investment strategy will enable the company to diversify its portfolio effectively and hedge against high total portfolio value unpredictability. In this case, Kaplan needs to avert its forecasted losses within the next five years. This strategy is suitable for companies looking for medium-term (3 to 5 years) returns, like Kaplan Capital which needs to avert its losses for the subsequent five years.