

Portfolio management

Finance



Portfolio management Portfolio construction The process of portfolio construction is normally designed to make sure that the allocations to managers and investment strategies are consistent with the risk and return goals of the portfolio. Thus portfolio construction is basically a personalized, disciplined procedure. In portfolio construction, the individual risk and return features of the fundamental investments should be considered alongside one's unique requirements, goals as well as risk considerations.

Consequently, this paper seeks to dissect the portfolio construction process, offering insights on effective practices (Lussier, 2013).

Generally, it is believed that the beginning of portfolio construction started in 1952 after the Portfolio Selection hypothesis of Harry Markowitz was published. This is the theory that introduced Modern Portfolio Theory to the world and offered a framework intended to maximize returns at a certain volatility level, described as the standard deviation of returns. Currently, an amalgamation of various theories forms the foundation for the process of investment consulting. It is this process of investment consulting that formalizes investing and develops a blue print for constructing one's portfolio. Thus, the investor's Financial Advisor must develop a blueprint for the investor on the basis of his/her needs and objectives, investment parameters as well as long-term asset allocation approach (McMillan & Pinto, 2011).

After the strategic asset allocation has been developed, then, portfolio construction can start. As an aspect of the process of portfolio construction, investment options should be assessed not in seclusion but as complements to one another and as important elements of a bigger whole. When constructed suitably, the entire portfolio must minimize single-manager risk

<https://assignbuster.com/portfolio-management/>

while at the same time looking to make the most of portfolio-wide returns, which is facilitated by combining managers that display low historical correlation in addition to exhibiting different behaviors in various market environments. There are four vital steps in portfolio construction which include determination of objectives and goals, asset allocation, searching and selection of a manager and performance monitoring. The first step is determination of investment parameters and involves cash flow requirements, risk tolerance of the investor, performance objectives, investment restrictions and time horizon. The second step is definition of investment strategy and consists of formulation of policy statement, risk optimization/reward trade-off and lastly determining asset allocation. The third step consists of implementation of investment strategy which basically includes construction of the portfolio, investment framework evaluation (consisting of individually managed accounts, exchange-traded funds and mutual funds) and finally selection of the manager. The fourth step is performance measurement and comprises of establishment of performance benchmarks and evaluation of absolute and relative returns (Guerard, 2013).

The final step in this process consists of provision of a continuous review and adjustment which basically seeks to have an ongoing review of strategies and objectives, changing client circumstances as well as financial market conditions. Additionally the portfolio manager ought to be knowledgeable about the current economic conditions and attempt to predict the future on such basis. This comprises of using statistical models by making use of variables at times known as indicators. The manager can make use of some of the most popular economic indicators such as interest and inflation rates, <https://assignbuster.com/portfolio-management/>

retail sales, unemployment rates and GDP decline/growth. Whereas economic forecasting is exactly not a science, nevertheless, it remains an essential decision-making instrument for portfolio managers as well as businesses together with governments as they develop financial strategy and policy (Reilly & Brown, 2012). The last step in portfolio construction is selection of individual securities which typically is selection of particular securities in an asset category. On the basis of risk considerations, the portfolio manager determines the security allocation strategy and should then populate every asset class with particular individual securities together with mutual funds to gratify the allocation. For instance when researching on a stock to establish if it is a suitable investment the following approach should be used; first and foremost the investor must look at the fundamentals which basically is making use of company-specific accounting and financial data to establish if the company is robust by employing analysis of financial statements as well as accounting ratios.

Secondly s/he must study the price history of the stock by researching on how stock has been performing in the recent past and make use of fundamental technical analysis. Thirdly the investor must look at the price target by working with selected valuation methods and making comparisons to peer companies to approximate a stock price target spanning over the next 12-24 months. In addition, the manager must make use of catalysts by determining an opinion of a stock on the basis of publicly available data, news and information. Lastly, the portfolio manager should engage in a comparison process whereby s/he compares stock with 2 or 3 other stocks within the same industry (Laopodis, 2013). Finally, an investor should be guided through the market cycles by choosing a good Private Wealth Advisor <https://assignbuster.com/portfolio-management/>

or Financial Advisor, who will recommend strategic changes, as required, in addition to assisting the investor strike through a continuing balance between return and risk. Thus risk is seldom understood fully and the portfolio construction is at times overlooked. Nevertheless, just the way surgery cannot be performed without a qualified surgeon, portfolio construction should be done with a Financial Advisor at hand (Fabozzi & Markowitz, 2011).

References

- Fabozzi, F, & Markowitz, H. (2011). Equity Valuation and Portfolio Management. New York: John Wiley & Sons, Inc.
- Reilly, F & Brown, K. (2012). Investment Analysis and Portfolio Management. New York: Cengage Brain.
- Guerard, J. (2013). Introduction to Financial Forecasting in Investment Analysis. New York: Springer.
- Laopodis, N. (2013). Understanding Investments: Theories and Strategies. New York: Routledge.
- Lussier, J. (2013). Successful Investing Is a Process: Structuring Efficient Portfolios. New York: John Wiley & Sons, Inc.
- McMillan, M. & Pinto, J. (2011). Investments: Principles of Portfolio and Equity Analysis. New York: John Wiley & Sons, Inc.