Common errors in portfolio management flashcard

ASSIGN BUSTER

Under normal circumstances the investors appear to be committing some errors in managing their investment portfolio.

Some of the common errors are listed below: • With nebulous ideas about the risks and returns associated with different securities the investors take investment decisions to make a return of 25 to 30 percent year which may make expose them to greater risks. • The investors quite often do not formulate clear policies concerning their investment decisions with respect to their risk exposition.• The normal tendency of the investors is to make a simple extrapolation of the past trends without incorporating the changes that might affect the future expectation. • The investors make their decisions, based on partial evidences, hearsay which are not reliable and tips given by brokers or friends. They do not take various investment risks seriously and follow others due to lack of confidence on their own judgment. • The investors often buy and sell the stocks at the same time when they decide to alter the portfolio.

• Investors quite often buy stocks which are apparently cheap and they feel comfortable in buying shares of cheaper value as compared to higher value stocks. • Another common error the investors make is to buy shares of companies of which they are familiar with (Railfoundation). Asset Allocation In any stock market, it will so happen, that different asset classes perform at different times. Hence it may not be possible to switch the portfolio to the best of the asset class by timing the market. The exact way to derive the best of every asset is to make a proper asset allocation.

The asset allocation has to be done keeping in view the financials goals of the investor coupled with a long term investment perspective. The term ‘ asset allocation’ refers to the process of distribution by the investor of his investments among various classes of investment vehicles. The asset allocation need not be limited to stocks and bonds alone. It can even incorporate the equity funds being offered by international institutions, gold funds, structured products, and even real estate products (Rajeev Deep Bajaj, 1998). Thus the importance of the asset allocation decision in improving the overall portfolio return can not be undermined.

The investment manager has to consider the risk preferences, cash needs, and tax status of the individual investor before making his decisions on the asset allocation. He has to decide on the asset mix that maximizes the after tax returns subject to the risk and cash flow constraints. In fact this is the essence of passive approach to asset allocation, in which the characteristics of the investor is the predominant factor in deciding the right asset mix for the portfolio. Market Timing There is one important and active component of asset allocation that guides the portfolio managers to deviate from the passive strategy of mixing the assets for any portfolio.

This is the ‘ market timing’. To the extent the investment managers believe that they can time the market implying that they can very well anticipate which markets are likely to go up beyond expectations and which markets will perform less than anticipated, they will decide to alter the passive mix of the assets in the portfolio according to their predictions about the timing of the market. Thus when an investment manager is of the view that the stock market is overvalued and is heading for a correction, while the real estate

market is predictably under valued, he may decide to reduce the exposure to the stock market and divert the funds at disposal to the real estate market. Despite their protestations about their indulgence in the market timing, most of the portfolio managers undertake some kind of market timing.

It is being said by the professional market strategists that asset allocation is an important decision. The reason behind such a statement is that tremendous results are earned only by perfect and successful market timers. However it has to be understood successful selection is much more advisable than successful market timings as the experience goes, it is always difficult to derive the differential advantage using market timing rather than making a successful stock selection. Asset Selection Decision The ability to time market well will greatly relieve the job of selecting the individual investments.

However in reality the market timing can not always be relied upon. This necessitates the carrying out of the function of selecting the particular assets within the each asset class wisely to earn excess returns. Just as in the case of asset allocation asset selection can also take an active or a passive route. Under passive asset selection, the selector follows the practice of picking up the investments randomly within each asset class. He may also follow a strategy of diversifying full across investments within each class.

In the latter case the strategy is known as ‘ indexing’ and the market value of each asset determines its proportion within each class. When the investor combines the passive asset selection with passive asset allocation, the

tendency is to earn a return that commensurate with the kind of risk taken and not to aggressively trade in the different assets involved. While this strategy can be regarded as particularly exciting as it always makes some return or ego gratifying, it also involves less transaction cost and is less costly in terms of the time of the investor and often in respect of taxes too.“ Active asset allocation involves picking individual assets within each asset class that are likely to outperform the rest of that asset class, i. e. , buying undervalued assets and selling overvalued assets”.

In the same way the investor uses the market timing, he adopts a very different approach to find those assets which are having mis-values. The investor uses both technical analysis and fundamental analysis for arriving at the selection of the assets. Under technical analysis the investor uses charts and indicators which present analysis of price and volume of the assets to make his asset selection. While using the fundamental analysis he relies on publicly available information to find these assets.

However there are evidences to suggest that both the analysis yield results. Even though different investment managers use different strategies they do not seem to earn same amount of excess returns finally. This may be due to the fact that these investors do not adopt these strategies in a discipline manner. Evidences also suggest that picking up the assets based on the private information is the sure way to earn excess returns and is considered as the superior method for asset selection. However the private information nowadays is being equated to insider trading and is subjected to the laws governing the insider trading.

However using the fine distinction between private information and inside information, the investors and portfolio managers continue to go after gathering information which will give them the differential advantage over other players in the market.