Security analysis and portfolio management

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Master in Business Administration – Semester3 MF0010– Security Analysis and Portfolio Management - 4Credits (Book ID: B1208) Assignment Set- 1 (60 Marks) Q. 1 Frame the investment process for a person of your age group. Ans:- It is rare to find investors investing their entire savings in a single security. Instead, they tend to invest in a group of securities. Such a group of securities is called a portfolio. Most financial expertsstressthat in order to minimize risk; an investor should hold a well-balanced investment portfolio.

The investment process describes how an investor must go about making. Decisions with regard to what securities to invest in while constructing a portfolio, how extensive the investment should be, and when the investment should be made. This is a procedure involving the following five steps: • Set investment policy • Perform security analysis • Construct a portfolio • Revise the portfolio • Evaluate the performance of portfolio 1. Setting Investment Policy : This initial step determines the investor’s objectives and the amount of his investable wealth.

Since there is a positive relationship between risk and return, the investment objectives should be stated in terms of both risk and return. This step concludes with the asset allocation decision: identification of the potential categories of financial assets for consideration in the portfolio that the investor is going to construct. Asset allocation involves dividing an investment portfolio among different asset categories, such as stocks, bonds and cash. The asset allocation that works best for an investor at any given point in his life depends largely on his time horizon and his ability to tolerate risk.

Time Horizon – The time horizon is the expected number of months, years, or decades that an investor will be investing hismoneyto achieve a particular financial goal. An investor with a longer time horizon may feel more comfortable with a riskier or more volatile investment because he can ride out the slow economic cycles and the inevitable ups and downs of the markets. By contrast, an investor who is saving for his teen-aged daughter's collegeeducationwould be less likely to take a large risk because he has a shorter time horizon.

Risk Tolerance - Risk tolerance is an investor's ability and willingness to lose some or all of his original investment in exchange for greater potential returns. An aggressive investor, or one with a high-risk tolerance, is more likely to risk losing money in order to get better results. A conservative investor, or one with a low-risk tolerance, tends to favour investments that will preserve his or her original investment. The conservative investors keep a " bird in the hand," while aggressive investors seek " two in the bush. " While setting the investment policy, the investor also selects the portfolio management style (active vs. assive management). Active Management is the process of managing investment portfolios by attempting to time the market and/or select „ undervalued? stocks to buy and „ overvalued? stocks to sell, based upon research, investigation and analysis. Passive Management is the process of managing investment portfolios by trying to match the performance of an index (such as a stock market index) or asset class of securities as closely as possible, by holding all or a representative sample of the securities in the index or asset class.

This portfolio management style does not use market timing or stock selection strategies. 2. Performing Security Analysis : This step is the security selection decision: Within each asset type, identified in the asset allocation decision, how does an investor select which securities to purchase. Security analysis involves examining a number of individual securities within the broad categories of financial assets identified in the previous step. One purpose of this exercise is to identify those securities that currently appear to be mispriced.

Security analysis is done either using Fundamental or Technical analysis (both have been discussed in subsequent units). Fundamental analysis is a method used to evaluate the worth of a security by studying the financial data of the issuer. It scrutinizes the issuer's income and expenses, assets and liabilities, management, and position in its industry. In other words, it focuses on the „ basics? of the business. Technical analysis is a method used to evaluate the worth of a security by studying market statistics. Unlike fundamental analysis, technical analysis disregards an issuer's financial statements.

Instead, it relies upon market trends to ascertain investor sentiment to predict how a security will perform. 3. Portfolio Construction : This step identifies those specific assets in which to invest, as well as determining the proportion of the investor’s wealth to put into each one. Here selectivity, timing and diversification issues are addressed. Selectivity refers to security analysis and focuses on price movements of individual securities. Timing involves forecasting of price movement of stocks relative to price movements of fixed income securities (such as bonds).

Diversification aims at constructing a portfolio in such a way that the investor's risk is minimized. The following table summarizes how the portfolio is constructed for an active and a passive investor. [pic] 4. Portfolio Revision : This step is the repetition of the three previous steps, as objectives might change and previously held portfolio might not be the optimal one. 5. Portfolio performance evaluation : This step involves determining periodically how the portfolio has performed over some time period (returns earned vs. risks incurred). Q. From the website of BSE India, explain how the BSE Sensex is calculated. Ans:- SENSEX is calculated using the " Free-float Market Capitalization" methodology, wherein, the level of index at any point of time reflects the free-float market value of 30 component stocks relative to a base period. The market capitalization of a company is determined by multiplying the price of its stock by the number of shares issued by the company. This market capitalization is further multiplied by the free-float factor to determine the free-float market capitalization.

The base period of SENSEX is 1978-79 and the base value is 100 index points. This is often indicated by the notation 1978-79= 100. The calculation of SENSEX involves dividing the free-float market capitalization of 30 companies in the Index by a number called the Index Divisor. The Divisor is the only link to the original base period value of the SENSEX. It keeps the Index comparable over time and is the adjustment point for all Index adjustments arising out of corporate actions, replacement of scrips etc.

During market hours, prices of the index scrips, at which latest trades are executed, are used by the trading system to calculate SENSEX on a continuous basis. Dollex-30 BSE also calculates a dollar-linked version of SENSEX and historical values of this index are available since its inception. (For more details click 'Dollex series of BSE indices') SENSEX - Scrip Selection Criteria 1. Equities of companies listed on Bombay Stock Exchange Ltd. (excluding companies classified in Z group, listed mutual funds, scrips suspended on the last day of the month prior to review date, scrips objected by the

Surveillance department of the Exchange and those that are traded under permitted category) shall be considered eligible 2. Listing History: The scrip should have a listing history of at least three months at BSE. An exception may be granted to one month, if the average free-float market capitalization of a newly listed company ranks in the top 10 of all companies listed at BSE. In the event that a company is listed on account of a merger / demerger / amalgamation, a minimum listing history is not required. 3.

The scrip should have been traded on each and every trading day in the last three months at BSE. Exceptions can be made for extreme reasons like scrip suspension etc. 4. Companies that have reported revenue in the latest four quarters from its core activity are considered eligible. 5. From the list of constituents selected through Steps 1-4, the top 75 companies based on free-float market capitalisation (avg. 3 months) are selected as well as any additional companies that are in the top 75 based on full market capitalization (avg. months). 6. The filtered list of constituents selected through Step 5 (which can be greater than 75 companies) is then ranked on absolute turnover (avg. 3 months). 7. Any company in the filtered, sorted list created in Step 6 that has Cumulative Turnover of > 98%, are excluded, so long as the remaining list has more than 30 scrips 8. The filtered list calculated in Step 7 is then sorted by free float market capitalization. Any company having a weight within this filtered constituent list of