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Security Analysis & Portfolio Management

Miscellaneous - 3

Q: How is Markowitz model better than any other model?

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Ans:

Markowitz model is better than any other model because of the following reasons:

1. Optimal Portfolio: Before Markowitz's proposal, the predominating models were based on the idea of the existence of an optimal portfolio obtained through the maximization of portfolio returns, more often composed of only a single asset. Markowitz argued that this idea was mistaken, since one single asset involved a high level of exposure to variability and he proved mathematically that investors should diversify their portfolios so as to reduce their risks, since a set of portfolios existed that combined higher gains with particular levels of risk, forming an efficient frontier.

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2. Contribution of asset to total variance of the portfolio: The most important aspect of Markowitz's work was to show that it is not the asset risk that is intrinsically important to the investor, but rather the contribution that the asset makes to the total variance of the portfolio, based on its covariance with all other assets therein included.

3. Combining unrelated or negatively correlated assets: The objective, of diversification proposed by Markowitz, is to combine assets that move in opposite directions, so that a drop in the price of a portfolio asset can be compensated by the rise in the price of another asset within the same portfolio.

4. Efficient Diversification: The Markowitz Model makes a systematic and rational attempt to establish a relationship between risk and return. It helps in determining the efficient portfolio, by way of efficient diversification. Benefits can be derived from efficient diversification. A small amount of diversification can result in substantial reduction in risk.

5. Focus on correct variable: The focus of the investors' decision is based on correct variables such as expected return, expected risk, and the relationship of one security return to other.

6. Focus on riskiness of assets: Markowitz forced others to consider that some measure of risk, and not just the expected rate of return, should be considered when dealing with investment decisions.

Q: Explain briefly the following: *(www.prepnext.com)*

1. Stock Selection
2. Market Timing
3. Convertible Debentures
4. Convertible Preference Shares
5. Bull and Bear
6. Limitations of Factor Models

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Ans:

1. **Stock selection:**

   Stock selection is a technique for investing when specifically dealing with stocks (equity markets). The stock investment or position can be "long" (bought) (to benefit from a stock price increase) or "short" (sold) (to benefit from a decrease in a stock's price), depending on the investor or financial professional's expectation of how the stock price is going to move. A stock selection is when a fund manager concludes that a particular stock will make a good investment and, therefore, should be added to his or her portfolio.

   Overall performance of the fund can be examined in terms of superior or inferior stock selection and the normal return associated with a given level of risk. Stock selection can be a very difficult process because there is never a foolproof way to determine what a stock's price will do in the future. However, by examining numerous factors, an investor may be able to get a better sense of future stock prices than by relying on guesswork.

2. **Market Timing:**

   Market timing is the strategy of making buy or sell decisions of financial assets (often stocks) by attempting to predict future market price movements. It implies assessing correctly the direction of the market, either bull or bear and positioning the portfolio accordingly.

   If investors want to maximise their returns, they must not only purchase the right security but must also know the right time to purchase and sell. To generate superior performance better than the market average, markets have to be timed correctly.

   Portfolio manager can achieve superior performance by picking up high beta stocks and decreasing the cash position during a market upswing. When the forecast is of declining market, the managers should move out of equities and increase the cash

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percentage of the portfolio or decrease the beta of the equity portion of the portfolio. The market timer seeks to sell at the "top" and buy at the "bottom." As it is extremely difficult to predict the future direction of the stock market, it is very difficult to perfectly time the market.

3. **Convertible Debentures:**

Convertible debentures are the debentures that give an option to the debentureholders to convert the debentures into equity shares after the expiry of a specified period.

Convertible debentures give an investor the privilege of being a secured creditor of the company and to change his status to that of a shareholder. The convertible debentures are of two types:

(1) Fully Convertible Debentures or FCDs which are converted into equity shares after the expiry of a certain period specified at the time of issue of such debentures. The rate of interest on these debentures is usually lower than non-convertible debentures.

(2) Partly Convertible Debentures or PCDs in which a part of the debenture is converted into equity shares and the balance is non-convertible. The non-convertible part of the PCD is redeemed after the expiry of the specified period. A company may offer PCDs with a buy-back facility also, in which the non-convertible portion can be sold by its holders to the company within a specified period at a pre-determined price.

4. **Convertible Preference Shares:**

The holders of convertible preference shares have the right to convert their shares into equity shares within a fixed period of time. On exercising the option of conversion at that date, the shares are to be surrendered by the shareholders and, in exchange, equity shares are allotted at pre-determined rate.

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5. **Bull and Bear:**

   Bull: Bull is the person who buys shares in the expectation of a rise in price with the intention of selling the shares at a higher price at a future date.

   Bear: Bear is the person who sells shares in the expectation of a fall in price with the intention of buying the shares at a lower price at a future date.

6. Limitations of factor models:

1. Factor exposure may not be stable over time.
2. Factor exposure payoffs (returns) are assumed to be linear. This may not be the case in reality.
3. Although factor analysis captures an asset's exposure to a set of commonly known risk factors, there often remains a significant proportion of its risk that cannot be explained by these common factors.

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