Introduction

In India, Portfolio Management is still in its infancy. Barring a few Indian banks, and foreign banks and UTI, no other agency had professional Portfolio management until 1987. After the success of Mutual Funds in Mutual Funds, since 1987, Professional Portfolio Management, backed by competent research staff became the order of the day. After the success of Mutual Funds in Portfolio Management, a number of brokers and Investment Consultants some of whom are also professionally qualified have become Portfolio Managers. They have managed the funds of clients on both discretionary and non-discretionary basis. It was found that many of them, including Mutual Funds have guaranteed a minimum return or capital appreciation and adopted all kinds of incentives which are now prohibited by SEBI. They resorted to speculative over trading and insider trading, discounts, etc., to achieve their targeted returns to the clients, which are also prohibited by SEBI. The recent CBI probe into the operations of many market dealers has revealed the unscrupulous practices by banks, dealers and brokers in their Portfolio Operations. The SEBI has then imposed stricter rules, which included their registration, a code of conduct and minimum infrastructure, experience and expertise etc. It is no longer possible for any unemployed youth, or retired person or self-styled consultant to engage in Portfolio Management without the SEBI’s licence. The guidelines of SEBI are in the direction of making Portfolio Management a responsible professional service to be rendered by experts in the field.

Basically Portfolio Management involves

a. A proper investment decision-making of what to buy and sell;

b. Proper money management in terms of investment in a basket of assets so as to satisfy the asset preferences of investors;

c. Reduce the risk and increase returns.

Investment Strategy

In India, there are a large number of savers, barring the population who are below the poverty line. In a poor country like this, it is surprising that its saving rate is as high as 27% of GDP per annum and investment at 28% of GDP. But the return in the form of output growth is 3% low as 5 to 7% per annum. One may ask why is it that high levels of investment could not generate, comparable rates of growth of output? The answer is poor investment strategy, involving high capital output ratios, low productivity of capital and high rates of obsolescence of capital. What is true of the nation at that Macro level is also true at Micro level of individuals and institutions. The use of capital in India is wasteful and inefficient, dispute the fact that India is labour rich and capital poor. Thus the Portfolio Managers in India lack the expertise and experience, which will enable them to have proper strategy for investment management.

Secondly, the average Indian Household saves around 60% in financial form and 40% in physical form. Of those in financial form, nearly 42% is held in cash and bank deposits, as per the latest RBI data and they have negative real returns or return less than the inflation rates. Besides, a proportion of 35% of financial savings is held in form of Insurance, P.F., Pension Funds etc., while another 12% is in government instruments and Certificates like Post Office Deposits, N.S. Certificates, Provident Provident Funds, National Saving Scheme etc. The real returns on Insurance, P.F., etc., are low and many times lower than the average inflation rates. With the removal of many tax concessions for investments in P.O. Savings instruments, Certificates, etc., they also become less attractive to small and medium investors. The only investments, satisfying all their objectives are capital market instruments. These objectives are income, capital appreciation, safety, marketability, Liquidity and hedge against inflation, and investment by average household in shares and debentures is only around 5% of the total financial savings.

Objectives of Investors: The return on equity investments in the capital market particularly if proper investment strategy is adopted would satisfy the above objectives and the real returns would be higher than any other saving instruments. It is in this context, the art and science of investment and of Portfolio Management became the sine-qua-non of success.

All investments involve risk taking. However, some risk free investments are available like bank deposits or P.O. Deposits whose returns are called risk free returns of about 5-12%. So the returns on more risky investments are higher than that, having risk premium. Risk is variability of return and uncertainty of payment of interest and repayment of principal. Risk is measured by standard deviation of the returns over the mean for a given period. Risk varies directly with return. The higher the risk taken, the higher is the return, under normal market conditions.

Although Indian markets are imperfect and are developing, “all the basic principles and theory of portfolio management would apply and these are recapitulated below.

Risk and Beta

Risk is of two components - systematic market related risk and unsystematic risk or company specific risk. The former cannot be eliminated but managed with the help of Beta (b), which is explained as follows:

\[
\beta = \frac{\% \text{ age change of Scrip return}}{\% \text{ age change of Market return}}
\]

If \( \beta = 1 \), the risk of the company is the same as that of the market and if \( \beta > 1 \), the company’s risk is more than the market risk. If \( \beta < 1 \), the reverse is the position. “

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Specific Risk: If risk is company specific risk it can be reduced by diversification into different industries and companies of different types and nature and whose covariance’s are different and whose performances are disparate.

Types of Risk

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<tr>
<th>Unsystematic Risk</th>
<th>Systematic Risk</th>
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<td>Company related risks due to higher costs, mismanagement, defective sales or inventory strategy, solvency, fall in demand and company specific recession, labour problems etc.</td>
<td>Market related risk due to demand problems, interest rates, inflation, raw materials, import and export policy, Tax policy etc., Business Risk, Market Risk, Financial Risk, Interest Rate Risk, Inflation Risk etc.</td>
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Modern Portfolio Theory (MPT): This postulates that public generally are risk averse. In a perfect market, information is free and quickly absorbed by the market. Given the return, risk can be reduced by diversification of investment into a number of Scrips. Each Scrip has its own risk profile. The risks of any two Scrips are different from the risk of a group of two companies together. Thus, if the risk of Reliance (b) is say 1.90 and that of Dr. Beck is 0.70, the total of these two units is 1.30 as the average. But the actual 'b' may be less at say 1.00, reason being that the covariance of these two may be zero or negative (less than 1).

CAPM & SML: (Capital Asset Pricing Model and Security Market Line)

CAPM postulates that in a perfect market, where shares are correctly priced, every security will give a return commensurate with its risk. “b” is a measure of the risk. The market risk is different from the risks of individual Scrips comprising the market. CML relates to the total risk of the market. But SML refers to the risk, which is undiversifiable market related risk. Total risk is measured by the standard deviation, while the undiversifiable risk is measured by Beta (13). CML, is Capital Market Line and SML is Security Market Line.

Risk premium of portfolio is the excess of the expected portfolio return over the risk free return. Similar is the definition in respect of risk premium of the market, namely, expected Market Return minus Risk Free Return. CML passes through the risk free rate, which represents the true time value of money or the reward for waiting by savers.

In portfolio management and investment decision-making, time element and time value of money are very relevant. Savings are automatic or induced. If induced, it requires a return enough to induce them to part with liquidity. Thus, savings and liquidity will be parted by the investors if only their time preference is satisfied by proper return.

Why time preference? Why savers prefer today’s return to tomorrows return?

“A bird in hand is worth two in me bush”, as the adage goes.

1. More money is to be received after a year, if he has to lend to the user of funds today. He forgives consumption which has to be compensated.
2. Money lent today can produce something more than before and hence present money is more valuable than money tomorrow. This premium is needed for waiting.
3. Money is losing in value due to rise in prices. Hence, money lenders lose and borrowers gain in times of inflation. Premium given is to compensate the lenders against loss due to fall in value of money.

Compounding

Future Value Factor (FVF) is \((1 + r)^n\) is the rate of interest required and \(n\) is the period of years of waiting.

\[ Fn = P (1 + r)^n, \]

Future Value = Present Value x (Future Value Factor)

So the return required by savers is related to the waiting period, loss of consumption at present, or liquidity and risk of loss of money or variance of returns.

Discounting

If the future flow of money is known as \(C_t, C_{t+1}, C_{t+n}\) etc. What is the present value of them and how much is he prepared to pay for them. If he deposits today Rs. 100 he gets Rs. 110 at the end of 1 year and Rs. 121 at the end of 2 years, the interest rate is 10%. This process of finding the present value for future money flows is called discounting. Present value of future amounts is:

\[ P = \frac{1}{(1+r)^n} \]

The multiplier \(\left(\frac{1}{(1+r)^n}\right)\) is called PVF or Present Value Factor.

We should know the amounts of cash flows, (Fn) number of years (n) are the required rate of return (r).

Perpetuity

When we receive a fixed sum of money every year up to infinity, it is called perpetuity. Suppose we want to receive Rs. 100 every year for infinity and interest rate is 10%, we have to deposit Rs. 1,000 and the equation is PV = where PV is present value of perpetuity, fixed periodic cash flow and r is rate of interests.

Annuity

Annuity is a constant cash flow for a finite time period of say 5 years (n). Examples of annuity are found in the case of lease rentals, loan repayments, Recurring deposits, etc. More detailed discussion is given on time element in a separate chapter.

Application to Portfolio Management

Portfolio Management involves time element and time horizon. The present value of future returns / cash flows by discounting is useful for share valuation and bond valuation.

The investment strategy in portfolio construction should have a time horizon, say 3 to 5 years, to produce the desired results of say 20-30% return per annum.

Besides Portfolio Management should also take into account tax benefits and investment incentives. As the returns are taken by investors net of tax payments, and there is always an element of inflation, returns net of taxation and inflation are more relevant to tax paying investors. These are called net real rates of returns, which should be more than other returns. The should encompass risk free return plus a reasonable risk premium, depending upon the risk taken, on the instruments/assets invested. (Tax factors are discussed in another Chapter).

Portfolio Construction, Revision and Evaluation

Portfolio Manager has to use all the tools of research like fundamental analysis and technical analysis in addition to Risk-
Return analysis to decide on the investment, buying and selling etc. After the design of the Portfolio Strategy, the construction and allocation of funds will lead to the building up of the portfolio. Thereafter the portfolio thus built requires a constant review and revision with the result that operations on it are a continuous process. This is also called Monitoring. Finally, once in a quarter or half year, the portfolio performance is evaluated, for its success by comparing die actual achievements with the targets fixed. This throws light on the efficiency of the investment strategy of Portfolio Manager and helps the revision of portfolio.

**MPT and Dominance Concept**

The Modern Portfolio Theory (MPT) is based on assumptions of free “ and perfect information flow and the notion of dominance. This means that if the market is able to absorb the information, fully and efficiently, price reflects the risks involved given the same return, the investor can choose the scrips with the lowest possible risk. This is possible by diversification into a number of companies of say 10 to 15, which have diverse characteristics of risk. Thus, when any two Scrips behave differently to given changes in the economy and industry and when the co-efficient of correlation between them is less than 1, such scrips can be joined in a portfolio so as to reduce the combined risk of the portfolio.

The notion of dominance tells us that no investor should invest in one company alone and if there are two or more companies with the same risk, then he has to choose the one with higher return and if both have the same return he has to choose the one with lower risk. The investor can reduce the risk by distributing his funds in a diverse variety of companies with varying risks and returns which do not have much auto correlation. Thus, the investor has not only to make proper investment decision of what to buy and when to buy, but has a proper investment strategy through diversification and choice of a proper ‘B’ for the scrips selected so that the total risk of portfolio is the lowest possible.

**Diversification Process**

The process of diversification has various phases involving investment into various classes of assets like equity, preference shares, CD’s, NCD’s, P.S.U. Bonds and Shares, Money market instruments like commercial paper, inter-corporate investments, deposits etc. Within each class of assets, there is further possibility of diversification into various industries, different companies etc. The proportion of funds invested into various classes of assets, instruments, industries and companies etc. would depend upon the objectives of investor, under portfolio management and his asset preferences, income and asset requirements. The subject is further elaborated in another chapter.

A portfolio with the objective of regular income would invest a proportion of funds in bonds, debentures and Fixed Deposits. For such investments, duration of the life of the bond/ debenture, quality of the asset as judged by the credit rating and the expected yield are the relevant variables. Bond market is not well developed in India but debentures, partly or fully convertible into equity are in good demand both from individuals and Mutual Funds. The Portfolio Manager has to use his analytical power and discretion to choose the right debentures with the required duration, yield and quality. The duration and immunisation of expected inflows of funds to the required quantum of funds have to be well planned by the Portfolio Manager. Research and high degree of analytical power in investment management and bond portfolio management are necessary.

The bond investments are thus equally challenging as equity investments and more so in respect of money market instruments. All these facts bring out clearly the needed analytical powers and expertise of Portfolio Manager. Bond market is discussed in a separate chapter elaborately.

**SEBI Guidelines for Portfolio Managers**

It will thus be seen that Portfolio Management is an art and requires high degree of expertise. The merchant banker has been authorised to do Portfolio Management Services, if they belong to Categories I and II as licensed by the SEBI. This classification of merchant bankers was dropped in 1996 and only the category I merchant bankers is allowed to operate in India. Others who want to provide such services should have a minimum net worth of Rs. 50 lakhs and expertise, as laid down or changed from time-to-time by the SEBI and would have to register with the SEBI. The SEBI have set out the guidelines in this regard, in which the relations of the client vis-a-vis the Portfolio Manager and the respective rights and duties of both have been set out. The code of conduct for Portfolio Managers has been laid down by the SEBI. The job of Portfolio Manager in managing the client’s funds, either on discretionary or non-discretionary basis has thus become challenging and difficult due to the multitude of obligations laid on his shoulders by the SEBI, in respect of their operations, accounts, audit etc. It is thus clear that Portfolio Management has become, a complex and respon-sible job which requires an in-depth training and expertise. It is in this context that the regulations of SEBI on Portfolio Management become necessary so that the minimum qualifications and experience are also ensured for those who are registered with SEBI. Nobody can do Portfolio Management without SEBI registration and licence.

The SEBI has given permission to Merchant Bankers to do Portfolio Manage-ment. As per the guidelines of September, 1991 a separate category of Portfolio Managers is also licensed by SEBI for which guidelines were given in January 1993. A code of conduct was also laid down for this category, as is the case with all categories of capital market players and intermediates.

**Portfolio Management Service**

As per the SEBI norms, it refers to professional services rendered for manage-ment of Portfolio of others, namely, clients or customers with the help of experts in Investmen-t Advisory Services. The latter involves the advice regarding the worthwhileness of any particular investment or advice of what to .buy and sell. investment management on the other hand involves continuing relationship with client to manage invest-ments with or without discretion for the client as per his requirements.

**Who can be a Portfolio Manager?**

Only those who arc registered and pay the required licence fee are eligible to operate as Portfolio Managers. An applica1It for this
purpose should have necessary infrastructure with professionally qualified persons and with a minimum of two persons with experience in this business and a minimum networth of Rs. 50 lakhs. The Certificate once granted is valid for three years. Fees payable for registration are Rs. 2.5 lakhs every year for two years and Rs. 1 lakh for the third year. From the fourth year onwards, renewal fees per annum are Rs. 75,000. These are subject to change by the SEBI.

The SEBI has imposed a number of obligations and a code of conduct on them. The Portfolio Manager should have a high standard of integrity, honesty and should not have been convicted of any economic offence or moral turpitude. He should not resort to rigging up of prices, insider trading or creating false markets, etc. Their books of accounts, are subject to inspection and audit by SEBI. The observance of the code of conduct and guidelines given by the SEBI are subject to inspection and penalties for violation are imposed. The Manager has to submit periodical returns and documents as may be required by the SEBI from time-to-time.

Method of Operation

The Professional Portfolio Manager can be approached by any individual or organisation with a minimum amount of investible funds of Rs. 1 lakh or Rs. 2 lakhs. If the Manager is willing to accept him as his client, a contract is entered into for management of his funds either on discretionary basis or non-discretionary basis, specifying the objectives, risk to be tolerated, composition of assets / securities in the Portfolio and their relative proportion, fees payable and time period of management, as per the preference of the client etc. The client’s data base is collected, namely, his available income and assets, his needs, his risk preferences, his choice for income or growth or both and host of personal details of the client so as to enable the Manager to design a Proper Investment Strategy for him.

SEBI Norms

SEBI has prohibited the Portfolio Manager to assume any risk on behalf of the client. Portfolio Manager cannot also assure any fixed return to the client. The investments made or advised by him are subject to risk which the client has to bear. The investment consultancy and management has to be charged at rates which are fixed at the beginning and transparent as per the contract. No sharing of profits or discounts or cash incentives to client are permitted.

The Portfolio Manager is prohibited to do lending, badla financing and bills discounting as per SEBI norms. He cannot put the clients’ funds in any investment, not permitted by the contract, entered into with the client. Normally investments are to be made in both capital market and money market instruments.

Client’s money has to be kept in a separate account with the public sector bank and cannot be mixed up with his own funds or investments. All the deals done for a client’s account are to be entered in his name and Contract Notes, Bills etc. are all passed in his name. A separate ledger account is maintained for all purchases/ sales on client’s behalf, which should be done at the market price. Final settlement and termination of contract is as per the contract and for the time period agreed upon. Notice of termination of contract is also as per the contract. During the period of contract, Portfolio Manager is only acting on a contractual basis and on a fiduciary basis. No contract for less than a year is permitted by the SEBI.

Notes