



Chapter 13

Managing Your Own Portfolio



Portfolio Investments

- Selection based on
 - expected returns
 - risks
 - tax considerations
- Compare actual performance to expected performance



Investment Policy Statements

- See table on page 178, Investment Policy Statements, Volume III, Investments



HPR Values vs. Investor Goals

- An investment is a candidate for sale if it-
 - fails to perform up to expectations and no real change in performance is expected
 - It has met the original investment objective
 - Superior alternative investment opportunities are available



Portfolio Performance

- Assess portfolio *performance over the short-and the long-term*
- A portfolio can be either passively or actively *managed*
- A *passive portfolio* can be constructed by carefully selecting securities that are held over a given time period



Benchmarks

- *Portfolio performance must be compared to a benchmark, over the same time period*
- For Sharpe's and Treynor's measures the same measure should be applied to the benchmark portfolio.
- If the calculation for the portfolio yields higher value than for the benchmark, the portfolio had the better risk-adjusted return



Sharpe

- *measures the risk premium per unit of total risk*

total portfolio return - risk free rate
portfolio standard deviation



Treynor

- *measures the risk premium per unit of non-diversifiable risk*

Total portfolio return – risk-free rate

Portfolio beta



Jensen

- uses the portfolio's beta and CAPM to calculate its *excess return*, which may be positive, zero, or negative
- Alpha = (portfolio return-risk-free rate) - [portfolio beta x (market return-risk-free rate)]



Jensen's Formula

- The formula could be written as:
 - Jensen's alpha = portfolio return - required rate of return
 - A positive alpha indicates a superior investment
 - A negative alpha indicates an inferior investment
 - The result can be compared to another (managed) portfolio to assess which portfolio had the better risk-adjusted performance



Review

- Review problems 126, 127 and 129 in Volume III, Investments



Analyze the Portfolio

- Regularly scheduled *reviews* and *rebalancing* in portfolios are necessary
- Deal with problem investments quickly
- Changing portfolio objectives should usually be done over a long period of time
 - Some changes may be necessitated by life events



Timing Decision

- The *timing decision* is designed to help investors "buy low and sell high."
- Four formula plans are generally followed by investors. The plans are:
 - Dollar-cost averaging
 - Constant-dollar plan
 - Constant-ratio plan
 - Variable-ratio plan



Dollar-Cost Averaging

- Invests a fixed dollar amount in securities at fixed intervals
 - The plan requires investor discipline
 - As prices go up, fewer securities are purchased, and as prices go down, more securities are purchased



Dollar-Cost Averaging

- Relatively passive, though it does not prevent an investor from selling securities that have appreciated/depreciated in value or from adding securities to the plan
- The main benefit of this formula plan is its lack of market timing. The investor is not put in a position to try to time the market



Review

- Review problem 269 in Volume III, Investments



Constant-Dollar Plan (1 of 3)

- Calls for timing investment transactions
 - Establishes target dollar amount for a speculative portion of the portfolio
 - Establish trigger points at which funds are transferred to or from a conservative portion as needed to maintain the target dollar amount



Constant-Dollar Plan (2 of 3)

- speculative portion
 - invested in aggressive growth stocks, or high beta mutual funds
- conservative portion
 - blue chip stocks, an index fund, or securities with high current income
- The dollar investment in the speculative portion is fixed



Constant Ratio Plan

- plan for timing investment transactions
 - a desired fixed ratio of the speculative portion to the conservative portion of the portfolio is established
 - when the actual ratio differs by a pre-determined amount from the desired ratio, transactions are made to rebalance the portfolio to achieve the desired ratio



Constant Ratio Plan

- key decision is the appropriate ratio
- similar to the constant-dollar plan, but allows for some increase in the speculative portion as the size of the portfolio rises



Variable Ratio Plan

- A more aggressive strategy
 - calls for timing investment transactions
 - the ratio of a speculative portion to the total portfolio varies depending on the movement in value of the speculative securities
 - when the ratio rises or falls by a pre-determined amount, the amount committed to the speculative portion of the portfolio is reduced or increased, respectively



Variable Ratio Plan (continued)

- Expectations of upward movement in the market call for a higher proportion of speculative investments
- Expectations of downward movement call for a lower proportion of speculative investments



Formula Plans

- Regardless of the plan chosen, regular monitoring is crucial
- No investment program should ever be allowed to be considered passive in the sense that it needs no supervision.
 - Even the best of securities can fall on hard times.



Special Security Orders

- limit order specifies the investor's minimum selling price or maximum purchase price
 - Using a limit order assures the investor of a price
 - Risk is that the transaction may not be executed because the limit price is not reached



Special Security Orders (3 of 3)

- special limit order that requests a broker to sell if a stock trades at a certain price or lower
 - This can be used to limit downside risk
 - Whipsawing, a temporary drop in price followed by a strong upward rebound, is the principal risk in using this type of an order



Efficient Portfolio

- An *efficient portfolio* should have a portion of its funds in low-risk, highly liquid investments
 - These act as a buffer to protect against total loss
 - Funds are then available if favorable investment opportunities appear
 - Money market accounts at financial institutions and money market mutual funds are the two primary vehicles used for these highly liquid investments



Selling Investments

- Timing is important
- The tax consequences must be considered in order to maximize after-tax returns
- Only a total of \$3,000 in net capital losses can be taken in one year



Selling Investments (continued)

- Investments should be sold when they have changed such that they no longer serve their originally intended purpose
 - The risk-return parameters may have changed
 - The investment may have met its return objective