Selection of portfolio

The selection of portfolio depends on the various objectives of the investor. The selection of portfolio under objectives are dealt subsequently.

Objectives and asset mix

If the main objective is getting adequate amount of current income, 60% of the investment is made on debts an 40 % on equities. The proportions of investments on debt and equity differ according to the individual's preferences. Money is invested in short term debt and fixed income securities. Hence the growth of income becomes the secondary objective and stability of principal amount may become the third. Even within the debt portfolio, the funds invested in short term bonds depends on the need for stability of principal amount in comparison with the stability of income. If the appreciation of capital is given third priority, instead of short term debt the investor opts for long term debt. The maturity period may not be a constraint.

Growth of income and asset mix

Here the investor requires a certain percentage of growth in the income received from his investment. The investor's portfolio may consist of 60to 100 percent equities and 0 to 40 percent debt instrument. A debt portion of the portfolio may consist of concession regarding tax exemption. Appreciation of principal amount is given third priority. For example computer software, hardware and non-conventional energy producing company shares producing company shares provide good possibility of growth in dividend.

Capital appreciation and asset mix

Capital appreciation means that the value of the original investment increases over the years, investment in real estate's like land and house may provide a faster rate of capital appreciation but they lack liquidity.

Safety of principal and asset mix

Usually, the risk averse investors are very particular about the stability of principal. According to the life cycle theory, people in the third stage of life also give more importance to the safety of the principal. All the investors have this objective in their mind. No one likes to lose his money invested in different assets. But, the degree may differ. The investor's portfolio may consist more of debt instruments and within the debt portfolio more would be on short term debts.

Risk and return analysis

The traditional approach to portfolio building has some basic assumptions. First, the individual prefers larger to smaller returns from securities. To achieve this goal, the investor has to take more risk. The ability to achieve higher returns is dependent upon his ability to judge risk and his ability to take specific risks. The risks are namely interest rate risk, purchasing power risk, financial risk and market risk. The investor analyses the varying degrees of risk and constructs his portfolio. At first, he establishes the minimum income that he must have to avoid hardship under most adverse economic condition and then he decides risk of loss of income that can be tolerated. The investor makes a series o compromises on risk and non-risk factors like taxation and marketability after he has assessed the major risk categories, which he is trying to minimize.

Diversification

Once the asset mix is determined and the risk and return are analyzed, the final step is the diversification of portfolio. Financial risk can be minimized by commitment to top-quality bonds, but these securities offer poor resistance to inflation. Stocks provide better inflation protection than bonds but are more vulnerable to financial risks. Good quality convertibles may balance the financial risk and purchasing power risk. According to the investor's need for income and risk tolerance level portfolio is diversified. In the bond portfolio, the investor has to strike a balance between the short term and long term bonds. Short term fixed income securities offer more risk to income and long term fixed income securities offer more risk to principal. In stock portfolio, he has to adopt the following steps which are shown as

Selection of industries

Selection of companies in the industry

Determining the size of participation

The investor has to select the industries appropriate to his investment objectives. Each industry corresponds to specific goals of the investor. The sale of some industries like two wheeler and steel tend to move in tandem with the business cycle, the housing industry sales move counter cyclically. If regular income is the criterion then industries, which resist the trade cycle should be selected.

The selection of the company depends upon its growth, yield, expected2 earnings, past earnings, expected price earnings ratio, dividend and the amount spent on research and development. Selecting the best company is widely followed by all the investors but his depends upon the investor's knowledge and perceptions regarding the company.

The final step in this process is to determine the number of shares of each stock to be purchased. This involves determining the number of different stocks that is required to give adequate diversification. Depending upon the size of the portfolio, equal amount is allocated to each stock. The investor has to purchase round lots to avoid transaction costs.