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PORTFOLIO – REVISION STRATEGIES

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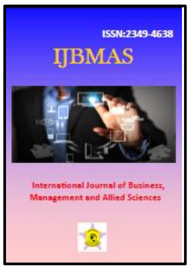

ABSTRACT

The objective of every rational investor is to maximize return and minimize the risk. Diversification is the technique adopted for reducing risk. To apply the technique of diversification essentially we construct portfolios. A portfolio is "a combination of different securities such as bonds, shares and debentures". The main aim of constructing portfolios would be to generate a portfolio that provides "the highest return with lowest risk". Such portfolio is known as optimal portfolio.

Since, financial markets are continuously changing a portfolio that was optimal when constructed may not continue to be optimal with passage of the time. Thus in this dynamic environment a portfolio may have to be revised periodically so has to ensure that it continues to be optimal.

This paper addresses need for revision and revision strategies.

Key Words: Optimal portfolio, Active Revision strategy, Passive Revision strategy

INTRODUCTION

Portfolio Revision is the art of changing the mix of securities in a portfolio. The process of addition of more assets in an existing portfolio (or) changing the ratio of funds invested is called portfolio revision. The sale and purchase of security in an existing portfolio over a certain period of time to maximize return and minimizable is portfolio revision.

- **Need for Portfolio Revision :**

Financial markets is subject to risks and uncertainty. An investor might sell off some of his assets to meet fluctuation in financial markets. The need for revision arises when an individual has some additional money to invest.

Change in investment goal also gives rise to revision in portfolio. Depending on the cash flow an investor can modify his financial goal. Need to liquidate a proportion of the portfolio to provide funds for some alternative purpose.

- **Strategies for Portfolio Revision :**

There are 2 types of portfolio revision strategies. They are :

(i) Active Revision Strategy
(ii) Passive Revision Strategy

(i) Active Revision Strategy : Active Revision Strategy involves – "frequent changes" in an existing portfolio over a certain period of time for maximum returns of minimum risks. This strategy helps for a portfolio manager of sell and purchase securities on a regular basis for portfolio revision.

The basic assumption of this strategy are :

Security markets are not continues effective. Investors are heterogeneous in their expectations regarding risk and return. The main objective of this strategy is "to beat the market".

(ii) Passive Revision Strategy : According to this strategy a portfolio manager can bring changes in the portfolio as per the "formula plans". As per these plans, a portfolio can be changed only under certain pre-determined rules. These rules are known as formula plans. The basic assumptions of this strategy are :

(i) Markets are efficient

(ii) Investors are homogenous in their expectations regarding return and risk.

- **Formula plans under Passive Revision Strategy :**

Formula plans are certain pre-determined rules deciding when and how much assets and individual can purchase (or) sell for Portfolio Revision. These plans help an investor to make the best possible use of fluctuations in the financial market.

To apply formula plans, an investor should divide his funds as two types of portfolios, namely "Aggressive Portfolio" and "Defensive Portfolio".

"Aggressive Portfolio" consists of funds that appreciate quickly and guarantee maximum returns to the investor.

Ex: Equity shares

"Defensive Portfolio" consists of securities that do not fluctuate much and remain constant over a period of time.

Ex: Bonds and debentures

The basic purpose of formula plans is to facilitate an investor to "transfer of funds" from aggressive to defensive to aggressive when ever need arises.

There are different types of formula plans for implementation of passive portfolio revision. These are as follows:

(i) Constant Rupee value

(ii) Constant Ratio Plan

(iii) Dollar Cost Averaging Method

i) Constant Rupee Value Plan : This is one of the most popular and commonly used formula plan. In this plan the investor construct aggressive and defensive portfolios.

The Purpose of this plan is "keep the aggressive portfolio constant i.e. at the original investment".

As the share prices are fluctuate the value of aggressive portfolio keep changing. When prices are increasing total of aggressive portfolio also increases. Then, the investor has to sell some of his shares from aggressive portfolio and may be transferred to defensive portfolio. So, as to bring down the values of aggressive portfolio at original levels.

For effective transferring of funds, the investor has to fix up some "Revision points" (or) "Action points" based on past experience (or) Records. These points are pre-determined points.

Ex: 10% ; 20% etc.

When ever aggressive portfolio increases beyond the revision points we can make transfer of funds.

ii) Constant Ratio Plan :

In this plan also investor has to construct aggressive and defensive portfolios. Then a ratio between aggressive and defensive may be fixed on the basis of past information. It is a pre-determined ratio.

Ex: 1:1 ; 1:5:1 ; 1:2 etc.

The purpose of this plan is to be keep the "Ratio Constant" and then readjusting the portfolios.

Ex: If it is fixed has 1:5:1 ; It means that the Ratio between the values of aggressive and defensive portfolios moves up by this ratio, the funds may be transferred from one to another.

iii) Dollar Cost Averaging Method : This method is different from other two formula plans, however, all formula plans assumed that "stock prices fluctuate up and down according to cycles". The method utilizes that this moments in share prices to construct a portfolio at lowest average cost.

This plan states that the investor should invest a constant amount such as Rs.20,000/- (or) Rs.25,000/- in a specified share regularly at periodical intervals such as a month, every 3 months (or) 6 months etc. Irrespective of prices of shares this periodic investment is to be continued over a reasonable long period to cover a complete cycle of share price moments.

Really, this method is a new technique as revising the portfolios. But, however, this plans doed not tell us withdrawal of funds from the portfolio in between.

CONCLUSION

The various formula plans attempt to make portfolio revision a simple and almost mechanical exercise enabling the investors to automatically buy the shares when prices are low and sell them when prices are high.

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