MODULE V

Investment Management

Meaning

Investment management refers to the handling of financial assets and other investments—not only buying and selling them. Management includes devising a short- or long-term strategy for acquiring and disposing of portfolio holdings. It can also include banking, budgeting, and tax services and duties, as well.

The term most often refers to managing the holdings within an investment portfolio, and the trading of them to achieve a specific investment objective. Investment management is also known as money management, portfolio management, or wealth management.

The Basics of Investment Management

Professional investment management aims to meet particular investment goals for the benefit of clients whose money they have the responsibility of overseeing.

These clients may be individual investors or institutional investors such as pension funds, retirement plans, governments, educational institutions, and insurance companies.

Investment management services include asset allocation, financial statement analysis, stock selection, monitoring of existing investments, and portfolio strategy and implementation.

Investment management may also include financial planning and advising services, not only overseeing a client's portfolio but coordinating it with other assets and life goals.

Professional managers deal with a variety of different securities and financial assets, including bonds, equities, commodities, and real estate. The manager may also manage real assets such as precious metals, commodities, and artwork. Managers can help align investment to match retirement and estate planning as well as asset distribution.

In corporate finance, investment management includes ensuring a company's tangible and intangible assets are maintained, accounted for, and well-utilized.

Running an Investment Management Firm

Running an investment management business involves many responsibilities. The firm must hire professional managers to deal, market, settle, and prepare reports for clients. Other duties include conducting internal audits and researching individual assets—or asset classes and industrial sectors.

Investment refers to investing money in financial physical assets and marketing assets.

Major investment features are risk, return, safety, liquidity, marketability, concealability, capital growth, purchasing power, stability and the benefits. Tax Benefits Stability of Income Return Marketability Liquidity Safety Concealability Capital Growth Risk Purchasing Power Stability Investment

Fund Management Meaning

Fund management is the act of taking the collected pool of funds and taking the necessary decisions regarding the same. The decisions are usually related to investing in new securities and selling off securities that are depreciating. This requires:

Exhaustive knowledge of the market and the current trends in financial affairs

A clear understanding of fund flows (both inflow and outflow).

Capability to analyse complex financial information and draw statistical conclusions.

Importance of Fund Management

Diversification

It is the process of allocating funds across asset class to make it as risk-free as possible while maintaining the desired return potential. Based on the expectations of investors, there is a distribution of funds in assets and securities that match the risk tolerance of investors.

Asset Allocation:

Asset allocation is closely related to diversification. While diversification focuses on reducing the risk involved in investments, asset allocation focuses on maximising the benefits earned from the investments.

Confirming to the Regulatory Guidelines

The Securities and Exchange Board of India (SEBI) is the regulatory body that governs the mutual fund industry. A fund manager ensures the investment decisions are within the regulatory guidelines.

Performance Tracking

Fund managers are responsible for tracking of a fund's performance and ensuring the investment strategies are adjusted to meet the goals the fund intends to achieve.

Emotion-Free Investing

Fund managers keep emotions out while making investment decisions. These decisions, rather than being governed by sentiments, are backed by careful analysation of data that helps them understand the best value of security they invest in. This helps them decrease or increase the weightage of security without attaching sentiments and emotions into it.

Strategy Based Investing

There are various styles of fund management that these professionals adhere to while making investment-related decisions. For instance, a fund manager may choose top-down investing where they look for best investment opportunities based on how good or bad the economy is performing. Or they could use a technical analysis strategy where past trading patterns of a stock govern the investment decision. This strategy-based investing ensures that the fund remains true to its goal for the investors.

What Is Risk?

Although it is often used in different contexts, risk is the possibility that an outcome will not be as expected, specifically in reference to returns on investment in finance. However, there are several different kinds or risk, including investment risk, market risk, inflation risk, business risk, liquidity risk and more. Generally, individuals, companies or countries incur risk that they may lose some or all of an investment.

In an investor context, risk is the amount of uncertainty an investor is willing to accept in regard to the future returns they expect from their investment. Risk tolerance, then, is the level of risk an investor is willing to have with an investment - and is usually determined by things like their age and amount of disposable income.

Risk is generally referred to in terms of business or investment, but it is also applicable in macroeconomic situations. For example, some kinds of risk examine how inflation, market dynamics or developments and consumer preferences affect investments, countries or companies.

Additionally, there are many ways to measure risk including standard deviation and variation.

Risk in Investing

In investing, risk is measured by the standard deviation equation (commonly used in statistics) - and, logically, it makes sense. The equation measures how volatile the stock is (its price swings) compared to its average price. The higher the standard deviation, the higher the risk for a stock or security, and the higher the expected returns should be to compensate for taking on that risk.

Low-risk stocks tend to have fewer swings in price and therefore more modest returns on investment. However, high-risk stocks typically swing dramatically (or are expected to) in price and can often see huge returns. However, because they are more risky, the investor is taking more of a chance that the return on their investment won't be what they expect (and may in fact cause them to lose their entire investment).

Types of Risk

While the term "risk" is fairly general, even verging on vague, there are several different types of risk that help put it in a more concrete context. So, what are some of the kinds of risk, and how do they affect investors or businesses?

Business Risk

In a nutshell, business risk is the exposure a company has to various factors like competition, consumer preferences and other metrics that might lower profits or endanger the company's success.

Within the general blanket of business risk are various other kinds of risk that companies examine, including

- Strategic risk
- Operational risk
- Reputational risk and more.

Volatility Risk

Particularly in investment, volatility risk refers to the risk that a portfolio may experience changes in value due to volatility (price swings) based on the changes in value of its underlying assets - particularly a stock or group of stocks experiencing volatility or price fluctuations.

Inflation Risk

Inflation risk, sometimes called purchasing power risk, is the risk that the cash from an investment won't be worth as much in the future due to inflation changing its purchasing power. Inflation risk primarily examines how inflation (specifically when higher than expected) may jeopardize or reduce returns due to the eroding the value of the investment.

Market Risk

Market risk is a broad term that encompasses the risk that investments or equities will decline in value due to larger economic or market changes or events.

Under the umbrella of "market risk" are several kinds of more specific market risks, including equity risk,
interest rate risk and currency risk.

Equity risk is experienced in every investment situation in that it is the risk an equity's share price will drop, causing a loss. In a similar vein,

Interest rate risk is the risk that the interest rate of bonds will increase, lowering the value of the bond itself.

And currency risk (sometimes called exchange-rate risk) applies to foreign investments and the risk incurred with exchange rates for currencies - or, if the value of a certain currency like the pound goes up or down in comparison to the U.S. dollar.

Liquidity Risk

Liquidity risk is involved when assets or securities cannot be liquidated (that is, turned into cash) fast enough to ride out an especially volatile market. This kind of risk affects businesses, corporations or individuals in their ability to pay off debts without suffering losses.
-term debts, they are at liquidity risk.

Risk Management

Risk management is the process and strategy that investors and companies alike employ to minimize risks in a variety of contexts. Risk management can range from investing in low-risk securities to portfolio diversification to credit score approval for loans and much more.

For investors, risk management can be comprised of balancing or diversifying portfolios with a range of high- and low-risk investments, including equities and bonds. The general rule seems to go that the wider range of investments that are deemed more or less risky (based on how volatile the security is or how drastic its price swings are), the more risk-managed the portfolio and less risky the investment.

There are various strategies companies and individuals alike employ to avoid incurring too much risk.

Avoidance of risk is a commonly used strategy by businesses to, well, avoid risk. While the strategy is rather vague, avoidance of risk includes things like opting not to purchase a new factory if the risks to the business outweigh the benefits (which, presumably, the company has determined through cost benefit analysis).

Additionally, strategies like risk mitigation seek to minimize the effects of risk instead of avoiding them entirely. For example, a beverage company like Coca Cola (**KO**) - Get Report could avoid having to recall a product for health reasons by conducting an inspection of their product before it goes into the retail space and into consumers' hands.

Transfer of risk is also a strategy employed to minimize risk by transferring it to another party - a common example of which is insurance. A company or individual could transfer the risk of damage or loss to a building (or similar asset) by paying a premium for insurance and protecting themselves from having to pay in full if the property is destroyed.

Efficient Market Hypothesis (EMH) Definition

The Efficient Market Hypothesis, known as EMH in the investment community, is one of the underlying reasons investors may choose a passive investing strategy. Although fans of index funds may not know it, EMH helps to explain the valid rationale of buying these passive mutual funds and exchange-traded funds (ETFs).

The Efficient Market Hypothesis (EMH) essentially says that all known information about investment securities, such as stocks, is already factored into the prices of those securities[1].

Forms of EMH

There are three forms of EMH: weak, semi-strong, and strong[1]. Here's what each says about the market.

Weak Form EMH: Suggests that all past information is priced into securities. Fundamental analysis of securities can provide an investor with information to produce returns above market averages in the short term, but there are no "patterns" that exist. Therefore, fundamental analysis does not provide long-term advantage and technical analysis will not work.

Semi-Strong Form EMH: Implies that neither fundamental analysis nor technical analysis can provide an advantage for an investor and that new information is instantly priced in to securities.

Strong Form EMH. Says that all information, both public and private, is priced into stocks and that no investor can gain advantage over the market as a whole. Strong Form EMH

Modern Portfolio Theory (MPT)

Modern portfolio theory (MPT) is a theory on how risk-averse investors can construct portfolios to maximize expected return based on a given level of market risk.

MPT can also be used to construct a portfolio that minimizes risk for a given level of expected return. Modern portfolio theory is very useful for investors trying to construct efficient portfolios using ETFs.

Investors who are more concerned with downside risk than variance might prefer post-modern portfolio theory (PMPT) to MPT.

Benefits of Modern Portfolio Theory (MPT)

MPT is a useful tool for investors trying to build diversified portfolios. In fact, the growth of exchange traded funds (ETFs) made MPT more relevant by giving investors easier access to different asset classes.

Stock investors can use MPT to reduce risk by putting a small portion of their portfolios in government bond ETFs.

The variance of the portfolio will be significantly lower because government bonds have a negative correlation with stocks.

Adding a small investment in Treasuries to a stock portfolio will not have a large impact on expected returns because of this loss reducing effect.[3]

Criticism of Modern Portfolio Theory (MPT)

Perhaps the most serious criticism of MPT is that it evaluates portfolios based on variance rather than downside risk.

Two portfolios that have the same level of variance and returns are considered equally desirable under modern portfolio theory. One portfolio may have that variance because of frequent small losses.

In contrast, the other could have that variance because of rare spectacular declines. Most investors would prefer frequent small losses, which would be easier to endure. Post-modern portfolio theory (PMPT) attempts to improve on modern portfolio theory by minimizing downside risk instead of variance.[3]

Capital Asset Pricing Model

The Capital Asset Pricing Model (CAPM) describes the relationship between systematic risk and expected return for assets, particularly stocks. CAPM is widely used throughout finance for pricing risky securities and generating expected returns for assets given the risk of those assets and cost of capital.

The goal of the CAPM formula is to evaluate whether a stock is fairly valued when its risk and the time value of money are compared to its expected return.

The expected return of the CAPM formula is used to discount the expected dividends and capital appreciation of the stock over the expected holding period. If the discounted value of those future cash flows is equal to $100 then the CAPM formula indicates the stock is fairly valued relative to risk.

Problems With the CAPM

There are several assumptions behind the CAPM formula that have been shown not to hold in reality.

Modern financial theory rests on two assumptions:

(1) securities markets are very competitive and efficient (that is, relevant information about the companies is quickly and universally distributed and absorbed);

(2) these markets are dominated by rational, risk-averse investors, who seek to maximize satisfaction from returns on their investments.

Despite these issues, the CAPM formula is still widely used because it is simple and allows for easy comparisons of investment alternatives.

The most serious critique of the CAPM is the assumption that future cash flows can be estimated for the discounting process. If an investor could estimate the future return of a stock with a high level of accuracy, the CAPM would not be necessary.

Arbitrage Pricing Theory (APT)

fa Arbitrage pricing theory (APT) is a multi-factor asset pricing model based on the idea that an asset's returns can be predicted using the linear relationship between the asset's expected return and a number of macroeconomic variables that capture systematic risk. It is a useful tool for analyzing portfolios from a value investing perspective, in order to identify securities that may be temporarily mispriced.

The CAPM only takes into account one factor—market risk—while the APT formula has multiple factors. And it takes a considerable amount of research to determine how sensitive a security is to various macroeconomic risks.

APT factors are the systematic risk that cannot be reduced by the diversification of an investment portfolio. The macroeconomic factors that have proven most reliable as price predictors include unexpected changes in inflation, gross national product (GNP), corporate bond spreads and shifts in the yield curve. Other commonly used factors are gross domestic product (GDP), commodities prices, market indices, and exchange rates.

Unlike the CAPM, which assume markets are perfectly efficient, APT assumes markets sometimes misprice securities, before the market eventually corrects and securities move back to fair value.

Using APT, arbitrageurs hope to take advantage of any deviations from ir market value.