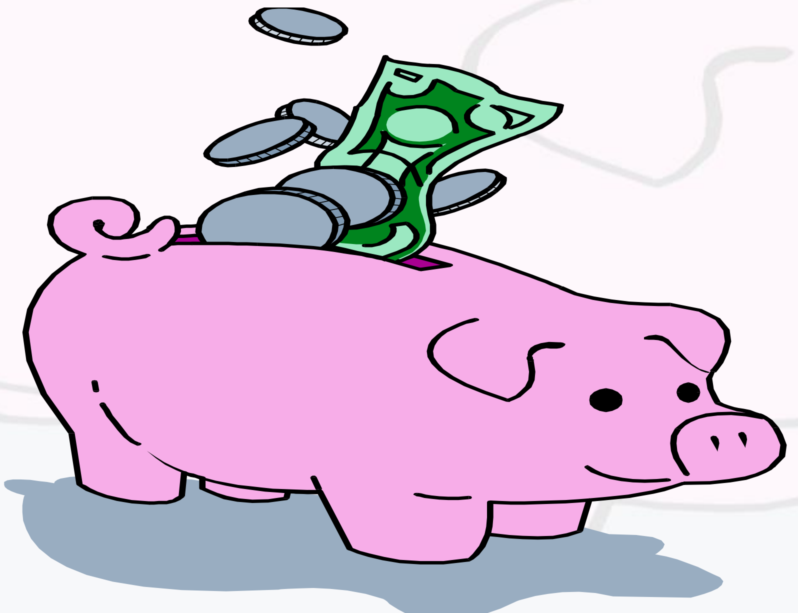
The Big Picture of Investing



Step 1- Understanding the Client

- Client’s needs
- Client’s risk preferences
- Size of portfolio
- Time horizon
- Client’s tax status
- Utility Functions

Step 2- Portfolio Construction

- How to allocate the portfolio across different asset classes broadly defined as equities, fixed income securities and real assets (such as real estate or commodities)
- Asset allocation should also be viewed in terms of investments in domestic assets and foreign assets
- The above would be based on the portfolio manager's views on markets, inflation rates, interest rates, growth, etc.

Step 2- Portfolio Construction

Which stocks, bonds and real assets?

- Would be the result of valuation based on cash flows, comparables, charts and indicators and also private information that the portfolio manager possesses.

Step 2- Portfolio Construction

- Execution part
- How often do you trade?
- How large are your trades?
- Do you use derivatives to manage or enhance your risks?
- Function of:
- Trading costs like commissions, bid-ask spread, price impact and trading speed

Step 2- Portfolio Construction

- Risk and Return
- Measuring risk
- Effects of diversification
- Market efficiency : Can you beat the market?
- Trading Systems: How does trading affect prices?

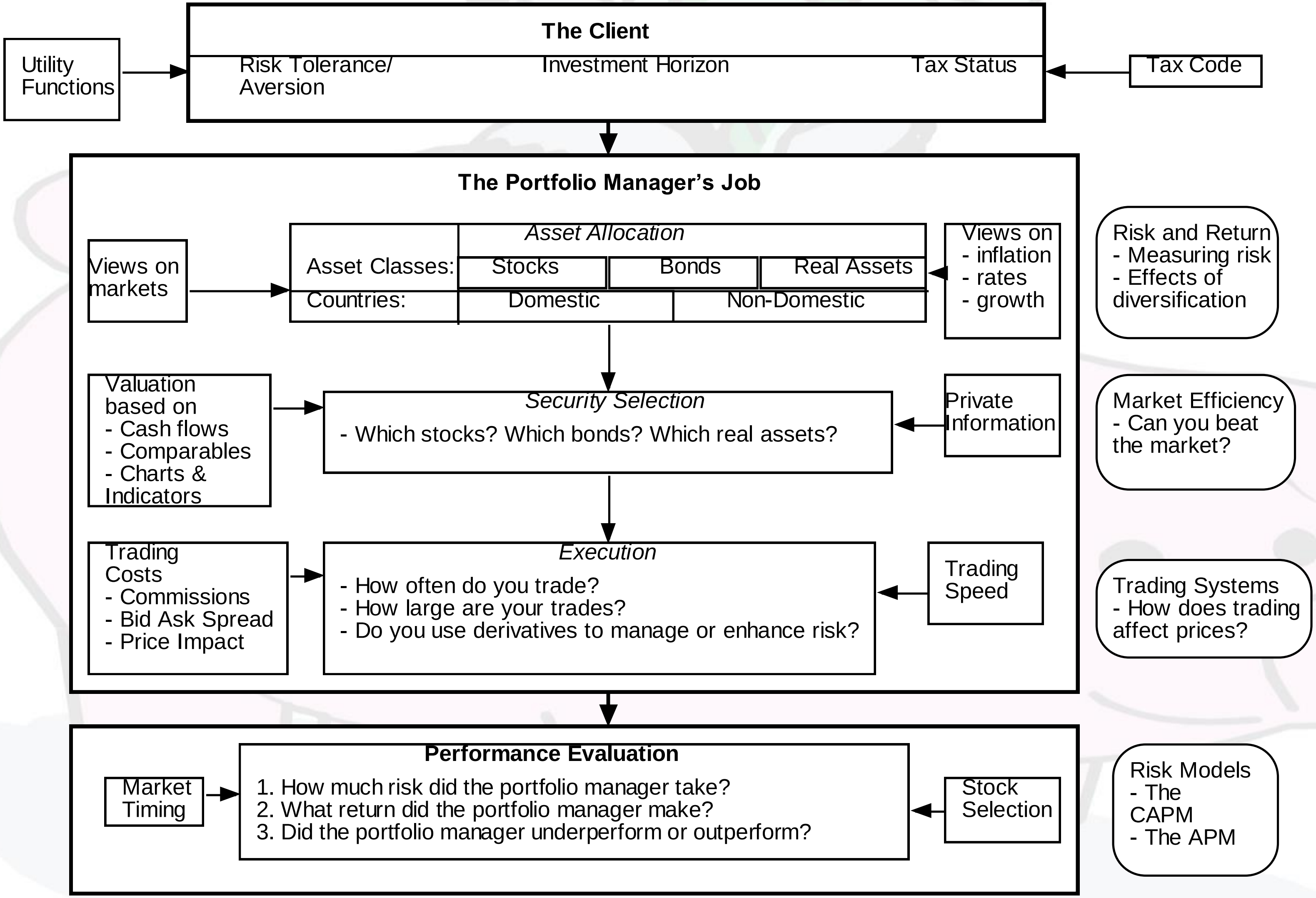
Step 3-Evaluate Portfolio Performance

- Objective – making most money you can given your risk preference
- Evaluation questions:
- How much risk did the portfolio manager take?
- What return did the portfolio manager make?
- Did the portfolio manager under perform or over perform?
- These will be a function of
- Market timing
- Stock selection

Step 3-Evaluate Portfolio Performance

- Risk Models
- The CAPM
- The APM
- Measures of portfolio evaluation

Figure 1.1: The Investment Process



Investment Philosophy

- Is a coherent way of thinking about markets, how they work (and sometimes do not) and the types of mistakes that you believe consistently underlie investor behaviour

Human Frailty

- All investment philosophies is a view about human behaviour

Why do we need an investment philosophy?

- Lacking a rudder or core set of beliefs, makes you a prey for charlatans and pretenders
- Switch from strategy to strategy will cause high transaction costs
- Given your objectives, risk aversion and personal characteristics you need to decide what do you want

Investment Philosophies - Categories

- Market Timing versus Asset Selection
- Active versus Passive Investing
- Time Horizon

Market Timing versus Asset Selection

- Market timing – Overall markets (could include broader range like stock, currency, bond and real assets markets)
- Asset selection – Individual assets that are mispriced (could be based on technical or fundamental, value or growth)

Active versus Passive Investing

- Passive – invest in a stock and wait for your investment payoff that will come when market recognizes and correct a misvaluation
- Active – invest in a company and try to change the way the company is run

Time Horizon

- Short term strategies – markets overreact to new information, market timing
- Long term strategies – buying neglected companies, passive value investors

Coexistence of Contradictory Strategies

- Market timers who trade on price momentum and contrarians
- Security selectors who are growth investors and value investors