**UNIT – IV**

**Portfolio Construction**

**Objectives**

The basic objective of portfolio management is to maximize yield and minimize risk. The other objectives of the portfolio management include (i) regular income or stable return, (ii) appreciation of capital, (iii) marketability and liquidity, (iv) safety of investment and (v) minimizing tax liability.

**Diversification**

Holding securities of a single company is more risky than those of two or more companies. It is further analyzed that holding securities of two companies in a particular industry is more risky than holding securities of two companies belonging to two difference industries. To put it in other words, two companies say, one in electronic industry and the other in automobile industry are less risky than two in either electronic industry or automobile industry. So, proper diversification and holding number of security types across industry lines such as electronic, steel, chemical, automobile, utility, mining etc., minimizes risk.

**Methods of diversification**

Diversification relates to the principal of “putting all eggs in different baskets”. The discussion that follows introduces methods of diversification as conceived by the experts in portfolio management. As such, methods of diversification are based on three principles, namely, (1) random selection, (2) optimum selection; and (3) adequate diversification.

1. **Random selection :** Random selection means selecting securities of any companies in random manner. Random selection is believed to avoid statistical error of choosing wrong companies in which money is to be invested. Randomness of selection as a statistical technique has more probability of reducing risks.
2. **Optimum selection :** Optimum selection involves the selection of optimum number of companies whose securities are to be bought. If the number of companies considered for investment portfolio is small, risk cannot be reduced adequately. On the other hand, if the number of companies is too large, risk will be more due to diseconomies and difficulty of supervision, analysis and monitoring. Analysis of portfolio means knowing the return and risk on individual securities and also the interactive risk that exists between securities. Monitoring of portfolios involves continuous upgrading and changes in asset composition to take advantage of the market conditions and economic and industry performance.
3. **Adequate diversification :** Under adequate diversification as many industries and companies or securities as possible are selected to get the best results. This method is based on the assumption that if there are adequate number of companies and industries in a portfolio, it will reduce the risk to zero.

**(1) Markowitz model**

Harry Markowitz model, shortly knows as HM Model, was developed by Harry Markowitz in 1952. It analyses the various possible portfolios of a given number of securities and identifies the most efficient portfolio.

Harry Markowitz introduced new concepts of risk measurement which are quite useful while selecting portfolios. In fact, Markowitz started his work by taking into account the idea of risk aversion of the average investor. Generally, the average investors wish to maximize their return with least risks. With this objective in mind, Markowitz related his model to the analysis of risk and return and their interrelationship. He employed statistical analysis for measuring risks and mathematical programmes for selecting investments for portfolio. His framework analysis paved the way for the concept of efficient portfolio. An efficient portfolio is one which assures the investor the highest yield for a given level of risk or lowest risk for a given level of return.

Risk and reward are the aspects which are closely associated with the investors. Risk is statistically measured by the variance or the distribution around the mean. If the investor wants to earn more, he has to take more risks. But a wise investor prefers a higher return but a lower risk and thus the need for trade off between the risk and return arises.

**Assumptions of Markowitz theory**

Markowitz theory is based on the following assumptions.

1. Investors are generally rational. They attempt to maximize their return from investment with minimum risk.
2. The market is efficient and all investors have a complete knowledge about the market. This is possible because the investors have a free access to correct and precise information on returns and risks.
3. The investment decisions taken by the investors are based on the expected rate of return on an investment. Variance or standard deviation of these returns is the important parameter for ascertaining the worthiness of the investment.
4. Security returns are correlated in such a way that an investor could get maximum returns at a given level of risk.
5. Before selecting any portfolio, the factors to be considered are (i) returns, (ii) standard deviation; and (iii) coefficient of correlation.
6. The markets are so efficient that they can absorb the information quickly and perfectly.
7. Investors are risk-averse and they attempt to minimize risk and maximize return.
8. The investor can reduce his risk if he adds more investments to his portfolio.

**Features of Markowitz model**

The broad features of Markowitz model can be discussed under the following heads :

1. Investment portfolio criteria
2. Efficient portfolio
3. Portfolio selection

**UNIT – V**

**SECURITIES AND EXCHANGE BOARED OF INDIA**

For proper development of Indian stock market, the functioning of stock exchanges must be brought under the control and supervision of an independent regulatory agency. Central government, therefore established SEBI.

**SEBI**

The SEBI was set up as an administrative body in April 1988. It was given statutory status on 30.1.92by promulgation of SEBI ordinance. The ordinance is considered to be an Act of parliament.

**Objectives :**

1. The basic purpose of establishing SEBI is to protect the interest of the investorsa in securities.
2. To promote, develop and regulate the securities market and deal with the matters connected therewith or incidental thereto.

When SEBI was established as a board in 1992, the task before it was to regulate the functions and conduct of intermediaries in the stock market, check insider trading and ensure fair play in takeover bids by a code of conduct.

**Features of SEBI**

1. The SEBI shall be a body corporate established under SEBI ACT, with perpetual succession and a common seal.
2. The head office of the board shall be at Mumbai. SEBI can have branch offices at other places in India.
3. The board shall consist of the following members.
4. A chairman
5. Two members from amongst the officials of the Ministries of the Central Government dealing with finance and law.
6. One member from amongst the officials of the Reserve Bank of India.
7. Two other members

Chairman and other members of the Board are appointed by the central Government.

1. The general superintendence, direction and management of the SEBI shall vest in the Board of members. Those members exercise all powers and do all acts and things which may be exercised by the Board (SEBI).
2. Central Government shall have the power to remove a member or the chairman appointed to the Board.
3. Central government shall provide finance and also make appropriate grants to the Board.
4. Central government has power to issue direction to the board on the policy matters and shall supersede the board in the event of default by the Board.

**Functions**

To provide the development of, and to regulate the securities market SEBI undertakes the following function.

1. Regulating the business in stock exchanges.
2. Registering and regulating the working of stock brokers, sub-brokers, issue bankers, underwriters and such other intermediaries who may be associated with securities markets in any manner.
3. Registering and regulating the working of collective investment schemes including mutual funds.
4. Promoting and regulating self-regulatory organizations.
5. Prohibiting fraudulent and unfair trade practice relating to securities market.
6. Promoting investor’s education and training of intermediaries of securities market.
7. Prohibiting insider trading in securities.
8. Regulating substantial acquisition of shares and take-over of companies.
9. Calling for information from, undertaking inspection, conducting inquires and audits of the stock exchanges.
10. Performing such functions as may be delegated to it by the central government.

**ROLE OF “SEBI” IN A STOCK EXCHANGE**

The Securities and Exchange Board of India (SEBI) Act, 1992 was passed by Central Government for establishing a board to protect the interest of investors in securities and to promote the development of and to regulate the securities market and for matters connected therewith or incidental thereto.

Every stock exchange needs recognition from Central Government. SEBI helps the Government in ensuring compliance of rules for recognition. Any stock exchange, which is desirous of being recognized, may make an application to the Central Government. The application should be accompanied by a copy of the bye-laws of the stock exchange for the regulation and control of contracts and a copy of the rules relating, in general, to the constitution of the stock exchange. The application forms received are scrutinized by SEBI. Recognition may be given to a stock exchange subject to the fulfillment of the following conditions:

1. Bye laws of the exchange should ensure fair dealings and it must protect the interests of investors and the trade.
2. Compliance of other conditions imposed by the Central Government.

**SEBI’s powers in relation to stock exchanges**

The SEBI ordinance has given it the following powers:

1. It may call periodical returns from stock exchanges.
2. It has the power to prescribe maintenance of certain documents by the stock exchanges.
3. SEBI may call upon the exchange or any member to furnish explanation or information relating to the affairs of the stock exchange or any members.
4. It has the power to approve bye-law of the stock exchange for regulation and control of the contracts.
5. It can amend bye-laws of stock exchange.
6. In certain areas it can grant to licence the dealers in securities.
7. It can compel a public company to list its shares.

Securities Contract (Regulation) Act empowers Central Government to delegate some of its powers, to SEBI. They are as follows:

1. Power to grant recognition to a stock exchange.
2. Power to direct any stock exchange to amend the rules relating to constitution of stock exchange, admission of new members, etc.
3. Power to supersede governing body of any stock exchange.
4. Power to suspend business of a recognized stock exchange.
5. Power to prohibit contracts in certain cases.

**Working of SEBI**

SEBI has been carrying on its duties successfully. It has issued and clarified guidelines on disclosure and investor protection. It has also issued guideline for merchant bankers, advertising code for mutual funds.

To safeguard the interests of investors, it has registered a number of investors associations. A series of advertisement are also being issued by SEBI to educate investors. Also, it has recognized many self-regulatory organizations.