FACULTY OF COMMERCE AND MANAGEMENT

COURSE: BBA (DM)

SUBJECT: SECURITY AND PORTFOLIO MANAGEMENT

SUBJECT CODE:BBA (DM) 602

LECTURE: 18

NAME OF FACULTY: DR. NITIN GUPTA

Central Concepts of Markowitz's Modern Portfolio Theory

In 1952, Harry Markowitz presented an essay on "Modern Portfolio Theory" for which he also received a Noble Price in Economics. His findings greatly changed the asset management industry, and his theory is still considered as cutting edge in portfolio management. There are two main concepts in Modern Portfolio Theory, which are;

- Any investor's goal is to maximize Return for any level of Risk

- Risk can be reduced by creating a diversified portfolio of unrelated assets

Subject Matter of the Markowitz Theory

- Before the development of Markowitz theory, combination of securities was made through “**simple diversification**”. The layman could make superior returns on his investments by making a random diversification in his investments.
- A portfolio consisting of securities of a large number will always bring a superior return than a portfolio consisting of ten securities because the portfolio is ten times more diversified.
- The simple diversification would be able to reduce unsystematic or diversifiable risk. In securities, both diversifiable and un-diversifiable risks are present.

- Unsystematic risk was supposed to be independent in each security. Many research studies were made on diversification of securities. It was found that 10 to 15 securities in a portfolio would bring adequate returns. Too much diversification would also not yield the expected return.

- Some experts have suggested that diversification at random does not bring the expected return results. Diversification should, therefore, be related to industries which are not related to each other.

- A person having on his portfolio about 8 to 10 securities will reduce his risk but if he has too many securities as described above it would not lead to any gain.

- If systematic risk is reduced by simple diversification, research studies have shown that an investor should spread his investments but he should not spread himself in so many investments that it leads to "**superfluous diversification**". When an investor has too many assets on his portfolio he will have many problems. These problems relate to inadequate return.

- The investor will also find it impossible to manage the assets on his portfolio because the management of a larger number of assets requires knowledge of the liquidity of each investment, return; the tax liability and this will become impossible without specialized knowledge.

- The research studies have shown that random diversification will not lead to superior returns unless it is scientifically predicted. Markowitz theory is also based on diversification. He believes in asset correlation and in combining assets in a manner to lower risk.