INVESTMENT HOLDINGS AND PORTFOLIOS

Holdings

Holdings are the contents of an investment portfolio held by an individual or entity, such as a mutual fund or a pension fund. Portfolio holdings may encompass a wide range of investment products, from stocks, bonds and mutual funds to options, futures and exchange-traded funds (ETFs), and relatively esoteric instruments such as private equity and hedge funds.

The number and types of holdings within a portfolio contribute to the degree of its diversification. A mix of stocks across different sectors, bonds of different maturities and other investments would suggest a well-diversified portfolio, while concentrated holdings in a handful of stocks within a single sector indicates a portfolio with very limited diversification.

Diversification and Acquisition of Holdings

The proportion of holdings within a portfolio has a significant impact on its overall return. The performance of the largest holdings have a bigger influence on portfolio return than small or marginal holdings in the portfolio. Investors routinely scour the lists of the holdings of top money managers to piggyback on their trades. These investors usually seek to replicate the trading activity of the best money managers by buying stocks where the manager has initiated a long position or added significantly to an existing position and selling positions where the manager has exited a stake. This strategy may not always be successful for the average investor, given the considerable lag between the period when the money manager or fund effected the trades and the time when the fund's holdings are disseminated to the general public.

Holding Companies

Holding companies are a closely related concept. In some cases, investors may choose to own their holdings through a limited liability company (LLC). They may do so to reduce their personal exposure to risk, minimize their taxes or pool their investments with other people, such as business associates or family members. Typically, a holding company does not engage in business directly but only serves as an ownership vehicle of other companies or investments. A very famous example of such a company is Berkshire Hathaway Inc., the Omaha, Nebraska company that Warren Buffett controls and manages. Berkshire Hathaway started as a textile manufacturing company, but for several decades, it has only been a holding company that Buffett use to acquire, hold and sell various investments in other companies. Some of Berkshire Hathaway's largest holdings include the Government Employees Insurance Company (GEICO), Dairy Queen Inc. and the Coca-Cola Company.

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Core Holding

Core Holding is a long-term investment that forms the foundation of an investor's portfolio. A common core holding strategy is to primarily own an investment that tracks the overall market, such as an S&P 500 index fund, and secondarily own investments that may deviate from the overall market, such as individual stocks. These secondary investments are called satellite holdings. A solid core holding gives an investor the flexibility to take a chance with riskier investments in other areas of the portfolio.

A properly constructed core/satellite portfolio will tend to outperform a portfolio consisting solely of individual stocks, since most investors are poor at assembling a properly diversified portfolio from stocks alone. A core/satellite strategy also results in a portfolio that is easy to monitor and rebalance because it only contains a few investments. The strategy minimizes volatility, which limits the negative effect of taxes and trading commissions on returns.

Core Plus

Core plus is a fixed-income investment management style that permits managers to add instruments with greater risk and greater potential return - high-yield, global and emerging market debt, for example - to core portfolios of investment-grade bonds. Investment advisors will advocate building portfolios with core holdings that consist of securities and/or mutual funds that reflect market positions and performance prospects that are so strong that these holdings may be maintained in the portfolio virtually forever. Such holdings might represent as much as 75% of the portfolio. The remaining balance would then consist of higher risk holdings, which may have shorter investment horizons than the core component of the portfolio. As such, a portfolio's core investments would represent a solid foundation to which more aggressive, diversified investments could be added.

With mutual funds, the core designation is used to describe categories of large-cap, mid-cap, small-cap, multi-cap and international funds that represent a blend of stocks in the value and growth investment styles.

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Portfolio

A portfolio is a grouping of financial assets such as stocks, bonds and cash equivalents, as well as their funds counterparts, including mutual, exchange-traded and closed funds. Portfolios are held directly by investors and/or managed by financial professionals. Prudence suggests that investors should construct an investment portfolio in accordance with risk tolerance and investing objectives. An investment portfolio can be thought of as a pie that is divided into pieces of varying sizes, representing a variety of asset classes and/or types of investments to accomplish an appropriate risk-return portfolio allocation. Many different types of securities can be used to build a diversified portfolio, but stocks, bonds and cash are generally considered a portfolio's core building blocks. Other potential asset classes include, but aren't limited to, real estate, gold and currency.

Impact of Risk Tolerance on Portfolio Allocations

While a financial advisor can develop a generic portfolio model for an individual, an investor's risk tolerance should have a significant impact on what a portfolio looks like. For example, a conservative investor might favor a portfolio with large-cap value stocks, broad-based market index funds, investment-grade bonds, and a position in liquid, high-grade cash equivalents. In contrast, a risk-tolerant investor might add some small-cap growth stocks to an aggressive, large-cap growth stock position, assume some high-yield bond exposure, and look to real estate, international and alternative investment opportunities for his portfolio. In general, an investor should minimize exposure to securities or asset classes whose volatility makes him uncomfortable.

Impact of Time Horizon on Portfolio Allocations

Similar to risk tolerance, investors should consider how long they have to invest when building a portfolio. Investors should generally be moving to a more conservative asset allocation as the goal date approaches, to protect the portfolio's principal that has been built up to that point. For example, an investor saving for retirement may be planning to leave the workforce in five years. Despite the investor's comfort level investing in stocks and other risky securities, he may want to invest a larger portion of the portfolio's balance in more conservative assets such as bonds and cash, to help protect what has already been saved. Conversely, an individual just entering the workforce may want to invest his entire portfolio in stocks, since he may have decades to invest, and has the ability to ride out some of the market's short-term volatility. Both risk tolerance and time horizon should be considered when choosing investments to fill out a portfolio.

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Portfolio Investment

A portfolio investment is a hands-off or passive investment of securities in a portfolio, and it is made with the expectation of earning a return. This expected return is directly correlated with the investment's expected risk. Portfolio investment is distinct from direct investment, which involves taking a sizable stake in a target company and possibly being involved with its day-to-day management. Portfolio investments can span a wide range of asset classes such as stocks, government bonds, corporate bonds, Treasury bills, real estate investment trusts (REITs), exchange-traded funds (ETFs), mutual funds and certificates of deposit. Portfolio investments can also include options, derivatives such as warrants and futures, and physical investments such as commodities, real estate, land and timber. The composition of investments in a portfolio depends on a number of factors. Some of the most important include the investor's risk tolerance, investment horizon and amount invested. For a young investor with limited funds, mutual funds or exchange-traded funds may be appropriate portfolio investments. For a high net worth individual, portfolio investments may include stocks, bonds, commodities and rental properties.

Portfolio investments for the largest institutional investors such as pension funds and sovereign funds include a significant proportion of infrastructure assets like bridges and toll roads. Portfolio investments for institutional investors generally need to have very long lives so that the duration of their assets and liabilities match.

Impact of Risk Tolerance, Age and Time Horizon

The investments that are made in a portfolio are dependent on the investor's individual circumstances. Those with a greater risk tolerance may favor investments in stocks, real estate, international securities and options, while more conservative investors may opt for government bonds and the stocks of large well-known companies. These risk preferences should also be weighed against the investor's goals and time horizon. A young person saving for retirement may have 30 years or more to save but isn't comfortable with the risks of the stock market. This individual may want to favor a more conservative mix of portfolio investments despite the long time horizon. Conversely, individuals with high risk tolerances may want to avoid large allocations to riskier growth stocks if they are nearing retirement age. A progression to a portfolio of more conservative investments is generally recommended as an investment goal nears.

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Portfolio Investments for Retirement

Investors saving for retirement should focus on a diversified mix of low-cost investments for their portfolios. Index funds have become popular in individual retirement accounts (IRAs) and 401(k) accounts due to their broad exposure to a number of asset classes at a minimum expense level. These types of funds make ideal core holdings in retirement portfolios. Those wishing to take a more hands-on approach may tweak portfolio allocations by adding additional asset classes such as real estate, private equity and individual stocks and bonds to their portfolio mix.

Modern Portfolio Theory – MPT

Modern portfolio theory (MPT) is a theory on how risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk, emphasizing that risk is an inherent part of higher reward. According to the theory, it's possible to construct an "efficient frontier" of optimal portfolios offering the maximum possible expected return for a given level of risk. This theory was pioneered by Harry Markowitz in his paper "Portfolio Selection," published in 1952 by the Journal of Finance.

A major insight provided by MPT is that an investment's risk and return characteristics should not be viewed alone, but should be evaluated by how the investment affects the overall portfolio's risk and return.

MPT shows that an investor can construct a portfolio of multiple assets that will maximize returns for a given level of risk. Likewise, given a desired level of expected return, an investor can construct a portfolio with the lowest possible risk. Based on statistical measures such as variance and correlation, an individual investment's return is less important than how the investment behaves in the context of the entire portfolio.

Portfolio Risk and Expected Return

MPT makes the assumption that investors are risk-averse, meaning they prefer a less risky portfolio to a riskier one for a given level of return. This implies than an investor will take on more risk only if he or she is expecting more reward.

The expected return of the portfolio is calculated as a weighted sum of the individual assets' returns. If a portfolio contained four equally-weighted assets with expected returns of 4, 6, 10 and 14%, the portfolio's expected return would be:

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(4% x 25%) + (6% x 25%) + (10% x 25%) + (14% x 25%) = 8.5%

The portfolio's risk is a complicated function of the variances of each asset and the correlations of each pair of assets. To calculate the risk of a four-asset portfolio, an investor needs each of the four assets' variances and six correlation values, since there are six possible two-asset combinations with four assets. Because of the asset correlations, the total portfolio risk, or standard deviation, is lower than what would be calculated by a weighted sum.

Efficient Frontier

Every possible combination of assets that exists can be plotted on a graph, with the portfolio's risk on the X-axis and the expected return on the Y-axis. This plot reveals the most desirable portfolios. For example, assume Portfolio A has an expected return of 8.5% and a standard deviation of 8%, and that Portfolio B has an expected return of 8.5% and a standard deviation of 9.5%. Portfolio A would be deemed more "efficient" because it has the same expected return but a lower risk. It is possible to draw an upward sloping hyperbola to connect all of the most efficient portfolios, and this is known as the efficient frontier. Investing in any portfolio not on this curve is not desirable.

Harry Markowitz was awarded a Nobel prize for developing MPT.

Portfolio Plan

An investment strategy applied to a personal or corporate portfolio that determines its general purpose and constraints. Once a portfolio plan has been determined, investments adhering to the plan are bought and sold accordingly. Individual investors have ranging risk tolerances, liquidity needs and investment time horizons. A proper portfolio plan must take these factors into consideration along with any other unique requirements.

Portfolio Manager

A portfolio manager is a person or group of people responsible for investing a mutual, exchange-traded or closed-end fund's assets, implementing its investment strategy and managing day-to-day portfolio trading. A portfolio manager is one of the most important factors to consider when looking at fund investing. Portfolio management can be active or passive, and historical performance records indicate that only a minority of active fund managers consistently beat the market.

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A portfolio manager has great influence on a fund, no matter if that fund is a closed or open mutual fund, hedge fund, venture capital fund or exchange-traded fund. The manager of the fund's portfolio will directly affect the overall returns of the fund. Portfolio managers, therefore, are usually experienced investors, brokers or traders with strong backgrounds in financial management and track records of sustained success.

A portfolio manager, regardless of background, is either an active manager or passive manager. If a manager takes a passive approach, his investment strategy mirrors a specific market index. With these funds, the market index used as a benchmark is extremely important since an investor should expect to see similar returns over the long term.

Conversely, a manager can take an active approach to investing, which means that he attempts to consistently beat average market returns. In this scenario, the portfolio manager himself is extremely important, since his investment style directly results in the fund's returns. Potential investors should look at the active fund's marketing material for more information on the investment approach.

Important Aspects of a Portfolio Manager

Regardless of investment approach, all portfolio managers need to have very specific qualities in order to be successful. The first is originating ideas. If the portfolio manager is active, then the ability to have original investment insight is paramount. With over 7,000 companies to choose from, active investors need to be smart about where they look. If the manager takes a passive approach, the originating insight comes in the form of the market index he's decided to mirror. Passive managers must also be smart about the index chosen. Additionally, the way in which a portfolio manager conducts research is very important. Active managers take a list of thousands of companies and pair it down to a list of a few hundred. The shortlist is then given to fund analysts to analyze the fundamentals of the potential investments, after which the portfolio manager assesses the companies and makes an investment decision. Passive managers also conduct research by looking at the various passive approaches and choosing the one best-suited for the fund.

Granular Portfolio

A type of portfolio that is well diversified across a wide variety of areas, typically with a significant number of holdings. Because these portfolios contain a large number of positions over many areas, they are considered to have a lower overall risk profile. Conversely, portfolios that have "low granularity" have fewer positions or contain highly correlated assets, are less diversified and have a higher overall risk profile.

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This term is typically applied to credit portfolios, but it can also be used when analyzing currency, equity and bond portfolios. Highly granular portfolios, sometimes referred to as infinitely granular, diversify most of the unsystematic risk (individual security risk) out of the portfolio so that the overall portfolio only faces systemic risk, which can't be easily diversified away. Highly granular portfolios tend to garner their income from a number of projects and/or sources, while less granular portfolios depend on a fewer projects or sources for their incomes.

Conservative Growth

An investment strategy that aims to grow invested capital over the long term. This strategy focuses on minimizing risk by making long-term investments in companies that show consistent growth over time. Conservative growth portfolios feature low asset turnover, or a high percentage of fixed assets on their balance sheets, and should employ a buy-and-hold investment philosophy. Although investment funds, portfolio managers and investment advisors may claim to employ a conservative growth strategy, the actual assets held in some of these funds vary considerably. When investing in a fund that uses a conservative growth model, it is a good idea to perform regular checks on your portfolio's holdings to make sure they match the investment strategy the portfolio claims to use.

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