



Unit – 5

Portfolio Construction

Portfolio construction is the process of selecting and combining various assets into a portfolio to achieve specific investment objectives while managing risk. It involves strategic decision-making regarding asset allocation, security selection, and risk management. Here's an overview of the portfolio construction process:

1. *Establish Investment Objectives*:

- Define the investment goals, time horizon, risk tolerance, and return expectations of the portfolio. These objectives will guide the asset allocation and investment decisions.

2. *Asset Allocation*:

- Determine the optimal mix of asset classes based on the investor's objectives and risk profile. Common asset classes include equities, fixed income, cash, and alternative investments.

- Asset allocation is a critical determinant of portfolio performance and risk. It aims to achieve diversification and balance between different sources of risk and return.

- Consider factors such as historical performance, correlation between asset classes, and macroeconomic conditions when allocating assets.

3. *Security Selection*:

- Within each asset class, select individual securities or investment products that align with the portfolio's objectives and asset allocation strategy.

- Conduct fundamental analysis, technical analysis, or quantitative analysis to evaluate the financial health, valuation, and growth prospects of potential investments.

- Diversify holdings across sectors, industries, regions, and market capitalizations to



reduce specific risk exposure and enhance portfolio resilience.

4. *Risk Management*:

- Implement risk management strategies to protect the portfolio against adverse market movements and unexpected events.
- Utilize diversification, asset allocation optimization, and hedging techniques to mitigate various types of risk, including market risk, credit risk, liquidity risk, and geopolitical risk.
- Set risk limits and monitor the portfolio's risk profile regularly to ensure alignment with the investor's risk tolerance and objectives.

5. *Portfolio Monitoring and Rebalancing*:

- Regularly review the portfolio's performance and asset allocation to assess whether it remains consistent with the investment objectives and risk parameters.
- Rebalance the portfolio periodically by buying or selling assets to bring the actual asset allocation back in line with the target allocation.
- Rebalancing helps maintain the desired risk-return profile and prevents the portfolio from becoming overly concentrated in certain assets or sectors.

6. *Evaluation and Performance Measurement*:

- Evaluate the portfolio's performance relative to its stated objectives and benchmark indices over time.
- Analyze risk-adjusted returns using metrics such as the Sharpe ratio, alpha, beta, and standard deviation.
- Monitor key performance indicators and assess whether the portfolio's performance justifies the investment strategy and risk taken.



Effective portfolio construction requires a comprehensive understanding of investment principles, financial markets, and investor objectives. By following a disciplined and systematic approach, investors can build portfolios that align with their goals and withstand various market conditions.