TRADE

Financial Portfolio: What It Is and How to Create and Manage One

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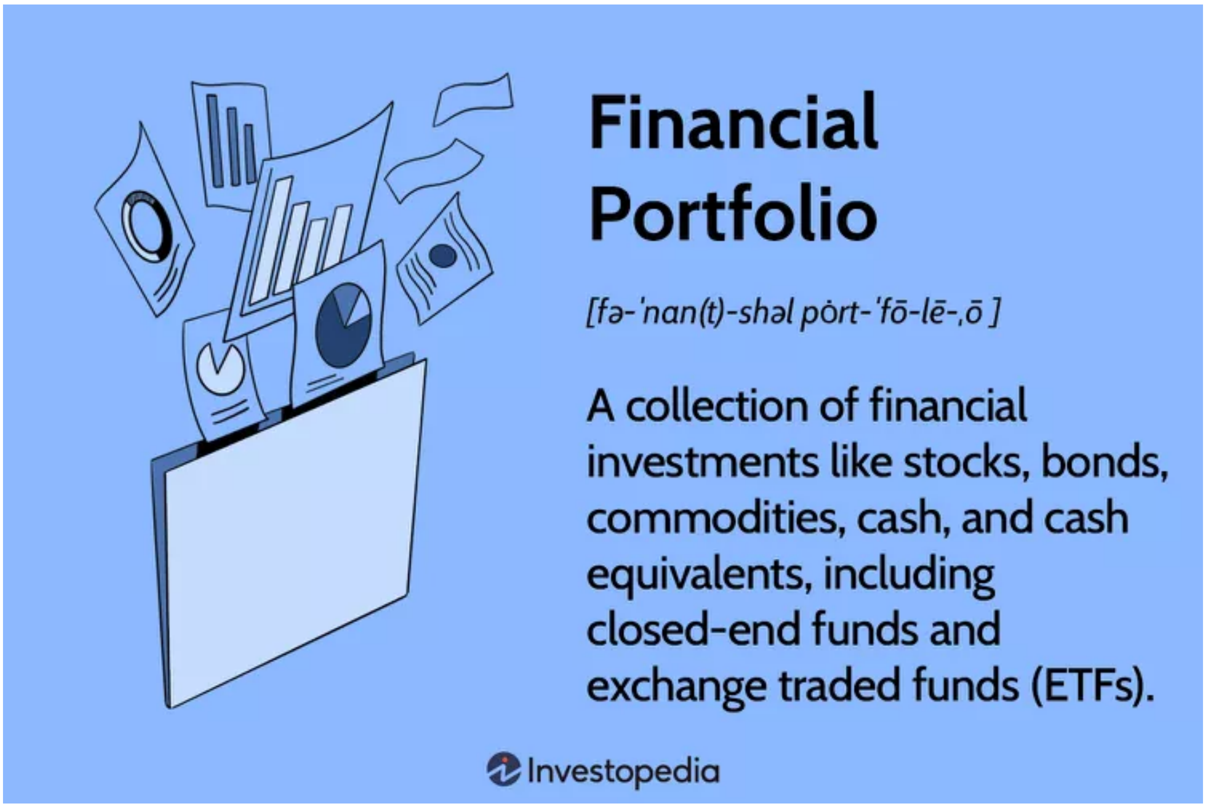

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DEFINITION:

A portfolio is a collection of financial investments like stocks, bonds, commodities, cash, and cash equivalents, including closed-end funds and exchange-traded funds (ETFs).

What Is a Financial Portfolio?

A portfolio is a collection of financial investments like stocks, bonds, commodities, cash, and cash equivalents, including closed-end funds and exchange-traded funds (ETFs).

People generally believe that stocks, bonds, and cash comprise the core of a portfolio. Though this is often the case, it does not need to be the rule. A portfolio may contain a wide range of assets, including real estate, art, and private investments.

You may choose to hold and manage your portfolio yourself, or you may allow a money manager, financial advisor, or another finance professional to manage your portfolio.

KEY TAKEAWAYS

- A portfolio is a collection of financial investments like stocks, bonds, commodities, cash, and cash equivalents, as well as their fund counterparts.
- Stocks and bonds are generally considered a portfolio's core building blocks, though you may grow a portfolio with many different types of assets—including real estate, gold, paintings, and other art collectibles.
- Diversification is a key concept in portfolio management.
- A person's tolerance for risk, investment objectives, and time horizon are all critical factors when assembling and adjusting an investment portfolio.
- Portfolio management is an important financial skill for active investing.

Understanding Financial Portfolios

One of the key concepts in portfolio management is the wisdom of diversification—which simply means not putting all of your eggs in one basket. [1] Diversification tries to reduce risk by allocating investments among various financial instruments, industries, and other categories. It aims to maximize returns by investing in different areas that would each react differently to the same event. There are many ways to diversify.

How you choose to do it is up to you. Your goals for the future, your appetite for risk, and your personality are all factors in deciding how to build your portfolio.

Regardless of your portfolio's asset mix, all portfolios should contain some degree of diversification, and reflect the investor's tolerance for risk, return objectives, time horizon, and other pertinent constraints, including tax position, liquidity needs, legal situations, and unique circumstances.

FAST FACT

The word "portfolio" comes from the Latin "folium," meaning to "carry leaves" (as in papers). Stock and bond certificates were once only issued in paper form, from which this terminology was adopted. Portfolio is also used to describe an artist's collection of works, for similar reasons. [2]

Managing a Portfolio

You can think of an investment portfolio as a pie that has been divided into pieces of varying wedge-shaped sizes, each piece representing a different asset class and type of investment. Investors aim to construct a well-diversified portfolio to achieve a risk-return portfolio allocation that is appropriate for their level of risk tolerance. [1] Although stocks, bonds, and cash are generally viewed as a portfolio's core building blocks, you may grow a portfolio with many different types of assets—including real estate, gold stocks, various types of bonds, paintings, and other art collectibles.

50% bonds, 30% short-term investments, and 20% stocks provide an example of a conservative investment portfolio.
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The sample portfolio allocation pictured above is for an investor with a low tolerance for risk. In general, a conservative strategy tries to protect a portfolio's value by investing in lower-risk securities. In the example, you'll see that a full 50% is allocated to bonds, which might contain high-grade corporates and government bonds, including municipals (munis).

The 20% stock allocation could comprise blue-chip or large-cap equities, and 30% of short-term investments might include cash, certificates of deposit (CDs), and high-yield savings accounts.

Important: Most investment professionals agree that, though it does not guarantee against loss, diversification is a key component for reaching long-range financial goals while minimizing risk.

Types of Portfolios

There can be as many different types of portfolios and portfolio strategies as there are investors and money managers. You also may choose to have multiple portfolios, whose contents could reflect a different strategy or investment scenario, structured for a different need.

Hybrid Portfolio

The hybrid portfolio approach diversifies across asset classes. Building a hybrid portfolio requires taking positions in stocks as well as bonds, commodities, real estate, and even art. Generally, a hybrid portfolio entails relatively fixed proportions of stocks, bonds, and alternative investments. This is beneficial, because historically, stocks, bonds, and alternatives have exhibited less-than-perfect correlations with one another.

Portfolio Investment

When you use a portfolio for investment purposes, you expect that the stock, bond, or another financial asset will earn a return or grow in value over time, or both. A portfolio investment may be either strategic—where you buy financial assets with the intention of holding onto those assets for a long time, or tactical —where you actively buy and sell the asset hoping to achieve short-term gains.

Aggressive, Equities-Focused Portfolio

The underlying assets in an aggressive portfolio generally would assume great risks in search of great returns. Aggressive investors seek out companies that are in the early stages of their growth and have a unique value proposition. Most of them are not yet common household names.

Defensive, Equities-Focused Portfolio

A portfolio that is defensive would tend to focus on consumer staples that are impervious to downturns. Defensive stocks do well in bad times as well as good times. No matter how bad the economy is at a given time, companies that make

Income-Focused, Equities Portfolio

This type of portfolio makes money from dividend-paying stocks or other types of distributions to stakeholders. Some of the stocks in the income portfolio could also fit in the defensive portfolio, but here, they are selected primarily for their high yields. An income portfolio should generate positive cash flow. Real estate investment trusts (REITs) are examples of income-producing investments.

Speculative, Equities-Focused Portfolio

A speculative portfolio is best for investors who have a high level of tolerance for risk. Speculative plays could include initial public offerings (IPOs) or stocks that are rumored to be takeover targets. Technology or healthcare firms in the process of developing a single breakthrough product also would fall into this category.

> ### Impact of Risk Tolerance on Portfolio Allocations
> *Although a financial advisor can create a generic portfolio model for an individual, an investor's risk tolerance should significantly reflect the portfolio's content.*

Time Horizon and Portfolio Allocation

Similar to risk tolerance, investors should consider how long they have to invest when building a portfolio. In general, investors should move toward a conservative asset allocation as their goal date approaches to protect the portfolio's earnings up to that point.

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.

For example, take an investor saving for retirement who's planning to leave the workforce in five years. Even if that investor is comfortable investing in stocks 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 their entire portfolio in stocks, as they may have decades to invest, and the ability to ride out some of the market's short-term volatility.

How Do You Create a Financial Portfolio?

Building an investment portfolio requires more effort than the passive, index investing approach. First, you need to identify your goals, risk tolerance, and time horizon. Then, research and select stocks or other investments that fit within those parameters. Regular monitoring and updating are often required, along with entry and exit points for each position. Rebalancing requires selling some holdings and buying more of others so that most of the time, your portfolio's asset allocation matches your strategy, risk tolerance, and desired level of returns.

Despite the extra effort required, defining and building a portfolio can increase your investing confidence and give you control over your finances.

What Does a Good Portfolio Look Like?

A good portfolio will depend on your investment style, goals, risk tolerance, and time horizon. Generally speaking, a good degree of diversification is recommended regardless of the portfolio type, in order to not hold all of your eggs in one basket.

How Do You Measure a Portfolio's Risk?

A portfolio's standard deviation of returns (or variance) is often used as a proxy of overall portfolio risk. The standard deviation calculation is not merely a weighted average of the individual assets' standard deviations—it must also account for the co-variance among the different holdings. For a two-asset portfolio, the standard deviation calculation is:

$$\sigma_p = (w_1^2\sigma_1^2 + w_2^2\sigma_2^2 + 2w_1w_2Cov_{1,2})^{1/2}$$

The Bottom Line

A portfolio is a cornerstone of investing in the markets. A portfolio is composed to serve the investor's financial goals, constrained by their risk tolerance and time horizon.

Portfolios can be constructed to achieve various strategies, from index replication to income generation to capital preservation. Regardless of the strategy, diversification is seen as a good way to reduce risk without sacrificing the portfolio's expected return.

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