Chapter 17: Investment Management

Systematic Risk, Specific Risk, and Diversification

1. Introduction
    a. Risk arises from uncertainty. When played out, uncertainty leads to returns and income that deviate from what is expected. There is a fundamental trade-off between return and risk.
2. Systematic and Specific Risk
    a. Systematic Risk: the risk created by general economic conditions.
    b. Specific Risk: risk that is specific to a company or security (also known as idiosyncratic, non-systematic, or unsystematic risk.)
    c. Specific risk can be reduced via diversification and by allocating a portfolio across assets that are uncorrelated.
    d. Systematic risk can not be reduced, as well assets are affected by general economic conditions.
    e. Modern portfolio theory suggests that taking on more specific risk does not necessarily lead to higher returns on average because specific risk can be reduced via diversification.
3. Diversification
    a. The benefit of diversification arises from the fact that when a portfolio is constructed with assets or classes with different characteristics, overall risk is typically reduced.
    b. A portfolio with two assets has an expected return equal to the weight average returns of the individual assets. Assuming that the two assets are less than perfectly correlated, the portfolio's risk will be less than a weighted average of the two asset's risk. However, diversification faces diminishing marginal returns.

Asset Allocation and Portfolio Construction

1. Strategic Asset Allocation
    a. Definition: the long-term mix of assets that is expected to meet the investor's objectives. This is determined by an investor's objectives and constraints. Strategic asset allocation requires predictions of returns, risk, and correlation.
    b. Rebalancing: reallocating capital to asset classes in order to meet the desired allocation. This is necessary to do when the relative values of assets inevitably change. This can be done constantly, at predetermined intervals of time, or at predetermined weightings.
2. Tactical Asset Allocation
    a. Definition: short-term adjustments to the allocation of assets within a portfolio, typically done in order to take advantage of short-term fluctuations.
    b. Some definitions of strategic asset allocation will provide acceptable ranges for portfolio composition, allowing for discretionary tactical asset allocation.
    c. Tactical allocation decisions can be made via:
        i. Fundamental analysis of economic and political conditions and their likely effects on market returns
        ii. Market valuation measures relative to past data
        iii. Trends and momentum in markets

    d. In essence, tactical asset allocation is an attempt to increase portfolio returns by deviating from the strategic asset allocation.

Passive and Active Management

1. Definitions and Introduction
    a. Passive Management: strategies aim to match the performance of a specified benchmark.
    b. Active Management: strategies aim to outperform a specified benchmark.
    c. The choice between active and passive management is a function of one's belief in active management and the relative costs of the two approaches.
    d. In informationally efficient markets, prices of securities accurately reflect the available information, and therefore active management is less effective. In informationally inefficient markets, prices of securities do not accurately reflect the available information, and therefore active management can be used to take advantage of these inefficiencies.
2. Passive Management
    a. Passive management strategies attempt to replicate the performance of specified benchmarks. These can include indices for specific market segments, as well as specifically constructed benchmarks. In passive strategies, investors must accept facing the risk of the market.
3. Active Management
    a. Active management strategies attempt to outperform specified benchmarks. There are many strategies that managers can use to achieve this, tactical asset allocation is an example.
4. Factors Needed for Active Management to Be Successful
    a. In order for active management to be successful, managers must accurately assess and predict prices more effectively than the aggregate market. This is difficult to do, as market participants have the same information at the same time.
5. Choosing Between Passive and Active Management
    a. Active management requires a greater degree of expertise, skill, technology, and analysis, ultimately resulting in higher costs. Passive management requires all of these things, but to a lesser extent. However, passive management generally underperforms benchmarks after fees.

Identifying and Capturing Market Inefficiencies

1. Fundamental Analysis
    a. Fundamental analysis is used to estimate the actual value of a security. This is done through a variety of methods, which each look at companies' business models, financial situation, and prospects. Of particular importance are: demand, costs, margins, competitiveness, quality of management, R&D, debt and financing, technological innovation, regulatory environment, and corporate structure and governance.
    b. One method of valuation is to estimate target price by equating it to the present value of all future cash flows.

2. Technical and Behavioral Analysis
    a. Technical analysis is used to predict the movements of stock prices by analyzing market conditions. Factors used in technical analysis include momentum, trading volumes, spreads, and general analysis of supply and demand.
    b. Behavioral analysis is used to understand the sentiment of market participants.
3. Quantitative Analysis
    a. Quantitative analysis is used to estimate the price and predict the movements of stocks based on mathematical and statistical models.