

Introduction to Portfolio Management

Definition and Purpose

A portfolio is a collection of financial assets like stocks, bonds, real estate, or even SACCO savings, owned by an individual or institution. Portfolio management refers to the strategic process of selecting and managing these assets to achieve specific financial goals such as capital growth, income generation, or capital preservation.

For example, a Ugandan university endowment might aim to preserve capital and earn income, while a 28-year-old software engineer in Nairobi may want long-term growth for retirement.

Portfolio Theory & Investment Assumptions

Modern Portfolio Theory (MPT) proposes that investors can achieve better outcomes by investing in a mix of assets rather than a single one. It assumes that investors are rational and prefer higher returns with lower risk. A key concept is the risk-return tradeoff—higher returns often come with higher risk. Utility functions help determine an investor's satisfaction level based on risk.

Example: An investor may choose a mix of stocks and real estate instead of just putting all money into a SACCO. This reduces exposure to a single market.

Types of Risks

Risk in investment is the chance that the actual return will differ from the expected return. Risks include diversifiable (unsystematic) risks, like company scandals, and non-diversifiable (systematic) risks like inflation or political instability.

In Uganda, political unrest may raise systematic risk. Globally, a tech company like Apple missing earnings forecasts would represent unsystematic risk. Risk is commonly measured using standard deviation and beta coefficient.

Diversification & Risk Reduction

Diversification involves investing in different types of assets to reduce risk. When one investment underperforms, another may outperform, thus balancing the overall portfolio. For example, during COVID-19 lockdowns, Ugandan real estate slowed, but mobile money businesses performed better. Combining both in a portfolio offers protection. The diversification ratio quantifies the benefit of spreading investments across low-correlation assets.

Portfolio Composition & Asset Allocation

Asset allocation is the process of dividing investments among asset classes such as equities, bonds, real estate, and alternatives like unit trusts or crypto. Strategic allocation is long-term and stable; tactical allocation is short-term and responsive.

Active portfolio strategies involve frequent changes to capture market trends, while passive strategies simply follow a set index. Weighting each asset appropriately is essential, and portfolios must be rebalanced periodically to remain aligned with goals.

Downside Risk & Limitations of Diversification

Downside risk is the potential for an investment to lose value or deliver returns lower than expected. Even with diversification, if all markets fall together—as seen during global crises—portfolio losses may still occur.

Example: A Ugandan investor with stocks in Stanbic and MTN may still lose money if the Uganda Securities Exchange crashes. Hedging tools like options or insurance can help offset these losses, though they're more common in international markets.

Investor Types and Profiles

Investors differ by goals, time horizon, risk tolerance, and liquidity needs. Individuals may save for retirement or education, while institutions like pension funds focus on long-term obligations. Each investor type has unique constraints.

For example, a bank needs liquidity to meet customer withdrawals, while a charitable foundation might prioritize stable income. Behavioral biases like overconfidence and loss aversion also affect decision-making, particularly for individuals.

Characteristics of a Good Investment

A good investment should match the investor's objectives and constraints. Common characteristics include safety, predictability, regular income, and liquidity.

For instance, a short-term goal like school fees may be best served by a T-Bill, while long-term goals like retirement may fit real estate or equities.

Ethical Responsibilities of a Portfolio Manager

Portfolio managers must act in the best interests of their clients. Ethics include maintaining integrity, avoiding conflicts of interest, and complying with laws and industry codes such as those from CMA Uganda or CFA Institute.

Example: A manager should not recommend an investment just because it pays them a higher commission.

Foundational Tools for Portfolio Management

Basic tools include return and risk calculations, such as expected return, variance, and covariance. CAPM (Capital Asset Pricing Model) is used to determine the expected return of an asset based on its risk.

Other tools like the Sharpe Ratio help evaluate risk-adjusted returns. A refresher on the time value of money (e.g., present and future value) is also crucial for sound investment decisions.

Real-World Applications in Uganda

Ugandan investors typically use T-Bills, real estate, SACCOs, and unit trusts to build portfolios. Inflation, currency risk, and political stability heavily influence performance. Tools like MTN MoMo Y'Invest and platforms like Xeno or USE Uganda offer local access to investing.

For example, a 35-year-old teacher might allocate UGX 500,000 monthly into a mix of T-Bills, land, and a low-risk mutual fund.