

## The Challenges of an Innovative Investment Portfolio Consisting of Reliance, Infosys and Ultratech Cement

Nitesh Patel's mind drifted from the sharp focus in the class to the problem he was confronted with. He knew that later this week he would need to make his choices clear. The instructor was summarizing the portfolio revision strategies. It had been a useful period of two days attending this special training session called "Current trends in Portfolio Management". Although he was adequately comfortable about the theoretical aspects of portfolio construction and revision (things which he had picked as one of the top performers in the second-year Finance specialization of the 2-year full-time Management program he had done with a leading B-school a few years back), he had felt that a quick refresher course would hone his skills and help him in the difficult decision he was to take. So at the eleventh hour he had registered for this course.

As the instructor reached the last stages of the summary on Portfolio revision, Nitesh checked the notes he had assiduously made over the last two days.

**Money market portfolios** consist of securities which have a short period of maturity, and which do not involve a great deal of risk.

**Bond and fixed-income portfolios** consist of fixed-income securities and bonds, yielding a steady rate of return. These securities also have price risk, since the value of the bonds and fixed-income securities




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have an inverse relationship with the market yield. A portfolio actively manages these securities to have a good overall return with a relatively low level of risk, which it would not be possible to achieve with an individual investment in a single bond.

**Stock portfolios** consist of a basket of stocks from the market. Stocks are by nature riskier than fixed-income securities, but they are also capable of yielding very high returns. Portfolio management here requires good analysis of the securities chosen in the portfolio, their active management, and proper combination of these securities to come to the highest possible return at the lowest possible risk.

**Balanced portfolios** have a combination of fixed-income securities and stocks as per a predefined proportion. Here, the idea is to balance the risk levels by having bonds in the portfolio, since bonds are less risky as compared to stocks. At the same time, the return is expected to be high, thanks to having securities with high return potential

**Replicating portfolios** tries to match the returns of a benchmark index, which could be an equity index or a bond index. For this purpose, the portfolio will be rebalanced periodically to make it conform to the parent index. Here, the portfolio manager will be deemed successful if the benchmark index's returns are achieved by the portfolio.

### **Portfolio Construction**

The first step in portfolio management is to construct an ideal portfolio. Even before that, there is a need for clarity in respect of the objectives of a portfolio and as to what return it seeks to achieve and at what level of risk. The following points have to be reckoned:

- Portfolios should address the specific risk-return profiles of the owners. In case of a corporate treasury, the objective might be to achieve a return marginally higher than a safe fixed-income investment, without taking undue risks. Occasionally, corporates dedicate a portion of their funds for the purpose of getting above-average returns with higher corresponding risk. We can have portfolios in which the contributors are pensioners who desire

basically a very low-risk portfolio but marginally higher returns than would be available to them individually. Lastly, a group of people may set up a portfolio to be aggressive in the market and seek very high returns. In the process, they could end up taking high risk as well.

- The second aspect is the tenure of the portfolio. This could be a fixed-term period which could then be renewed from time to time, or an open-ended tenure. Tenure assumes significance in that some of the components of the portfolio would work well only over a medium or long term, and unless the portfolio has a sufficiently long tenure, these securities cannot be included therein.
- Based on the broad objectives and tenure of the portfolio, a further decision is as to the extent of equity to be included. Portfolios intended to be totally safe would generally not have a great deal of equity composition. Even among equity, the question arises as to the extent of risk—measured by beta, say—that the portfolio ought to take. The extent of balance required in the portfolio, the periodicity of revision that needs to be made, the level of discretion given to the portfolio manager are all matters that need to be firmed up.
- Generally, at the time when portfolios are constructed, the trigger points for urgent revision are determined. This is to ensure that portfolios do not erode value (particularly those that have an equity component therein) all of a sudden. So the degree to which depreciation can be taken place in a segment of portfolio before corrective action is taken will be spelt out in advance.
- Portfolios can also have a buy and hold emphasis. Here, a lot of time and effort is spent in picking the components of the portfolio and over a medium term they are left to themselves. Buy and hold strategies have been known to succeed over a fairly long run. In many cases, a passive buy and hold strategy has been known to outperform the active strategies.

### **Portfolio Management - Some Aspects**

Portfolio management encompasses a wide range of analysis and monitoring. While all this is not capable of being put down to theories or essentials, the following points merit attention:

- Portfolios can be managed actively or passively. A passive management essentially looks at a buy and hold strategy and emphasizes stock picking and analysis more than actual monitoring. An active management of portfolio, on the other hand, seeks to outperform market alternatives. In fact, the success of the portfolio manager in an active portfolio lies in the extent to which this outperformance is done consistently.
- In case active management involves replication, this can be done either by total replication or by a proxy replication. Total replication involves having the same securities as in the benchmark index in the same proportion. But proxy replication can achieve approximately the same result by having synthetic products. For instance, if the weighted average beta of a portfolio is one, this can be assumed to be replicating the market portfolio without actually having the same composition.
- Another strategy that portfolios use is to have systematic investments in the same groups of shares. This tends to average the prices over a period of time and achieves good returns eventually, provided the picking has been good.
- All said and done, an active strategy involves a number of challenges for the fund manager. High transaction costs that need to be incurred for every revision as well as the possibility that risk levels can go up make active management a formidable exercise.

It is also possible to include derivative products as a part of an active portfolio. Futures and options have payoff which in combination, can look very similar to the payoff from holding the underlying shares. Portfolio managers use this principle for short term replication. Further, effective use of futures and options helps in protecting the portfolio against temporary swings.

## Portfolio Revision

Having constructed a portfolio and taken into account the various principles in setting up an active portfolio, the next task is to approach revision from time to time. Revision is basically necessitated on account of the following reasons:

- The fund's objectives might have undergone a change, and it wishes to turn itself into a less-risky fund, or alternatively into a fund wishing to generate higher returns with corresponding higher risk.
- The original estimates and calculations on which the portfolio was constructed have undergone changes, necessitating a revision.
- Basic risk parameters and return parameters spelt out in the fund document and taken into account at the time of portfolio construction have undergone changes.

## Revising the Components of Individual Stocks within an Overall Limit in the Equity Portfolio

Coming to the equity component itself, the composition of shares can be changed to include different types of securities. This can be done by any specific approach. Two broad approaches are given below.

### Constant Proportion Strategy

In this case, the portfolio allocates equal funds to the various individual securities in the portfolio. At various intervals the proportions are restored to equality.

Now, after three months when the revision takes place (assuming that revision takes place after three months, though can be at whatever intervals as decided by the fund), the prices the prices of the securities in the portfolio will be determined. This will, in turn, give the new proportion of individual securities within the portfolio. Those that have gone up from the originally determined proportion will be sold off and those that have come down will be bought. Assuming that in

Nitesh's case, it was originally decided that each of the three securities in the portfolio should have 33.33% weight, after three months when the prices are reckoned, it is found that the three have proportions of 45%, 30%, and 25% respectively. Here the one having 45% will be sold to the extent of making it around 33.33% of the new total, and shares in the other two securities will be bought to make these also around 33.33%

### **Constant Beta Portfolio**

Here, the objective before the portfolio manager is to maintain the same portfolio beta throughout. The portfolio beta that is desired will be set out right in the beginning and the initial construction of the portfolio will be based on this. After some time, on account of changes in prices and market conditions, the portfolio's beta would have overall slipped down or come up. It is revised to bring the weighted average beta back to the originally set out figure. Here, Nitesh would need to exercise caution. On the one hand, a high Beta would ensure above average performance, but would also expose the portfolio to risk.

The fund has left the matter entirely to Nitesh's discretion. However, he needs to record the specific strategy he is following. He can freely change from one strategy to the other, but again these shifts have to be recorded. The essential thing was that he should not be arbitrary in his decision-making.

### **Company Outlook**

Having studied the environment in which a company operates and the dynamics of the industry, the next thing is to look at company-specific fundamentals. This involves the following aspects:

- The starting point can be the financial statements of the company for the past few years. Ratio analysis will enable an understanding of key parameters in these years. Further, the analysis can be extended to other players in the same industry for comparison

purposes. Ratios are not conclusive as value indicators, but they do give us an excellent comparison of key parameters over the years and with the competition.

- Among the ratios, the asset turnover ratio and debt-equity ratios afford comparison with other players in the industry in a greater degree and offer explanations for differences in profitability.
- Very often, ratios lead the analyst into further enquiry of the indicator. For example, a fall in the asset turnover ratio will start an enquiry on why the asset utilisation was not adequate and as to the existence of obsolete machinery. Analysis becomes easier when a direction to the enquiry is obtained.
- Further, an analysis of financial statements might reveal issues that show inconsistency. This could be in terms of collection of receivables and sales volume, holding of inventory and production and changes in levels of depreciation. Financial statements ought to reveal the “true and fair” position, but occasionally they do not do so.
- Company analysis will also involve study of the strategic parameters the company appears to be following. Models like SWOT analysis or the BCG matrix enable the analyst to check the position of the company from the strategic perspective.

### **Technical Analysis**

Contrary to the use of fundamental analysis, a number of dealers in stock exchanges use a different approach called technical analysis for valuing securities. The practice of technical analysis for valuing a company is based on the following inherent assumptions:

- Market value of a company is governed by the demand and supply for its shares and not necessarily by its inherent worth. While it can be argued that the demand and supply itself is a function of the inherent value, the emphasis is on the perceived value in creating demand, rather than a deep analysis of worth.

- Demand and supply for the shares of a company depend on a host of factors, some of which could be called mere intuition. The so-called “sentiment” factor which governs the market movements can be explained by this element of intuition. Ultimately analysis is available to all, either directly or through others’ publication. But market movements do not always correspond to these. The explanation for that can be had from the element of intuition.
- The other assumption is that movements of securities follow a “herd” mentality and there are specific trends in the market, upwards and downwards. That securities, by and large, follow this pattern is the argument used by the supporters of technical analysis
- Trends can be analyzed in a variety of ways and over a period of time. Supporters of this theory say that explanations for conclusions cannot be given the way we can for fundamental analysis, but these are reliable all the same.

Technical analysis is also widely criticised as a diagrammatic representation which is random. Some researchers and analysts go to the extent of not considering this as a professional method at all. Be that as it may, a large number of end users do use this and hence a brief understanding of the techniques is a must for all serious students of securities analysis.

Nitesh was the Assistant Portfolio Manager in Cat-Eye Securities, a leading portfolio management organization based out of Mumbai, India. Among several responsibility centres in the portfolio framework of Cat-Eye Securities he was in charge of the Special Limited Securities Fund (SLSF). SLSF was a new initiative of Cat-Eye Securities intended to concentrate on a small portfolio of 2 or 3 securities but having total investments of close to Rs. 1 crore. The investment horizon would typically be two to three years, by which time the portfolio ought to make substantial gains. The selection of the companies into the portfolio involved an elaborate process of several teams working on



past performance, managerial changes and outlook. Typically, these were supposed to be high growth companies who would flourish even more in the next three years. Working in a competitive environment it was recognized that decisions on the selection of these shares into the portfolio involves high strategic acumen and sharp analysis. Nitesh had been involved in the selection which now had 3 securities in the portfolio:

His challenge in Portfolio revision was centred on the distribution of the Rs.1 crore among the three securities and the criteria that he would have to use to:

- a) Determine the exact component of each security in the portfolio – the proportion thereof
- b) Identify the signals that would tell him when to exit
- c) Constantly work on substitute companies in case he wishes to abandon any of these securities
- d) Use derivatives to value add to the portfolio. This would involve the use of Covered Call Writing, Synthetic Increase or Decrease in Beta, Bull spreads and Bear spreads for short periods during the 2/3 years of the project horizon to value add. All use of derivatives will be with the cover of the stocks and no short naked position will be taken.
- e) The analysis by the company showed that this type of portfolios will attract a number of clients. Nitesh was to show phenomenal value add in the short run and the model can then be replicated for a series of small portfolios which the company intended to launch

Initially, Nitesh had severe apprehensions about the idea behind the portfolio. Intuitively, diversification results in risk-reduction and so an undiversified portfolio like the one that he was handling would be fraught with risk. But his boss argued that this aspect of the risk being there was the key to the success of the portfolio. The boss's arguments were:

- High risk results in high return. By diversifying a portfolio, we are nullifying the risk aspect and consequently are settling for lower returns

- The selection of the portfolio involves looking into individual companies' inherent risk absorption measures.
- Since this sort of portfolio is not much in vogue there exists a definite possibility of making a mark before others catch on.

Nitesh's task boiled down to a few specifics:

- Deciding on the horizon of investment – 2 or 3 years.
- Does it look likely that the three securities picked by him would be high performers in this period? What makes him think so?
- How frequently would he like to revise the portfolio?
- What criteria would he follow for this?
- Would he be keeping a close watch on the index and other market parameters?
- As fundamental analysis has already been done on these securities in the beginning, would he continue the exercise? To what extent?
- Would a little bit of charting or technical analysis help?
- When and how would he use derivatives to enhance the portfolio?
- In choosing derivatives, would he use index derivatives or stock-specific derivatives?
- What would be the criteria to decide that enough growth has been achieved in a specific security and that it would be time to exit?
- What other strategic considerations would he need to reckon from time to time?
- What are the specific areas by which the portfolio is an active one and not a passive one?

The three securities chosen for his portfolio for the time being were:

1. Infosys
2. Reliance Industries
3. Ultra Tech Cement

Nitesh realized that he has a task on his hand. How should he approach the situation?

Rs. In crores			
Co_Name	INFOSYS TECHNOLOGIES LTD.		
Year End	Mar-15	Mar-14	Mar-13
<b>SOURCES OF FUNDS (LIABILITIES)</b>			
Share Capital	574	286	287
Reserves Total	47494	41806	35772
Total Shareholders' Funds	48068	42092	36059
Secured Loans	0	0	0
Unsecured Loans	0	0	0
Total Debt / Loan Funds	0	0	0
Other Liabilities	30	364	120
Total Liabilities	48098	42456	36179
<b>USES OF FUNDS(ASSETS)</b>			
Gross Block	12869	10420	8060
Less: Accumulated Depreciation	5522	4688	3607
Net Block	7347	5732	4453
Capital Work in Progress	769	954	1135
Investments	6857	6717	4344
Inventories	0	0	0
Sundry Debtors	8627	7336	6365
Cash and Bank Balance	27722	24100	20401
Loans and Advances	5654	5052	4392
Total Current Assets	42003	36488	31158
Current Liabilities	5670	4139	3005
Provisions	8045	6117	3788
Total Current Liabilities	13715	10256	6793
Net Current Assets	28288	26232	24365
Deferred Tax Assets	749	845	640
Deferred Tax Liability	316	303	318
Net Deferred Tax	433	542	322
Other Assets	4404	2279	1560
Total Assets	48098	42456	36179
Contingent Liabilities	189	193	6170

Source : Capitaline Databse

Rs. In crores			
Co_Name	RELIANCE INDUSTRIES LTD.		
Year End	Mar-15	Mar-14	Mar-13
<b>SOURCES OF FUNDS (LIABILITIES)</b>			
Share Capital	3236	3232	3229
Reserves Total	212923	193842	176766
Total Shareholders' Funds	216176	197091	180020
Secured Loans	2227	11203	6626
Unsecured Loans	95393	78765	65801
Total Debt / Loan Funds	97620	89968	72427
Other Liabilities	1404	0	0
Total Liabilities	315200	287059	252447
<b>USES OF FUNDS(ASSETS)</b>			
Gross Block	236062	222565	213154
Less: Accumulated			
Depreciation	121499	113159	103406
Net Block	114563	109406	109748
Capital Work in Progress	75753	41716	19116
Investments	112573	86062	52509
Inventories	36551	42932	42729
Sundry Debtors	4661	10664	11880
Cash and Bank Balance	11571	36624	49547
Loans and Advances	12854	11743	11454
Total Current Assets	65637	101963	115610
Current Liabilities	65054	64142	49523
Provisions	4854	4167	4348
Total Current Liabilities	69908	68309	53871
Net Current Assets	-4271	33654	61739
Deferred Tax Assets	279	161	100
Deferred Tax Liability	12956	12376	12293
Net Deferred Tax	-12677	-12215	-12193
Other Assets	29259	28436	21528
Total Assets	315200	287059	252447
Contingent Liabilities	59207	49438	47403

Source: Capitaline Data Base

Rs. In crores			
Co_Name	ULTRA TECH CEMENTS LTD.		
Year End	Mar-15	Mar-14	Mar-13
<b>SOURCES OF FUNDS (LIABILITIES)</b>			
Share Capital	274.4	274.24	274.18
Reserves Total	18583.28	16823.27	14960.64
Total Shareholders' Funds	18857.68	17097.51	15234.82
Secured Loans	3234.19	2677.74	2655.98
Unsecured Loans	4179.99	2521.58	2752.56
Total Debt / Loan Funds	7414.18	5199.32	5408.54
Other Liabilities	164.7	140.24	135.83
Total Liabilities	26436.56	22437.07	20779.19
<b>USES OF FUNDS(ASSETS)</b>			
Gross Block	31780.26	24997.73	21382.22
Less: Accumulated			
Depreciation	10832.8	9125.89	8259.86
Net Block	20947.46	15871.84	13122.36
Capital Work in Progress	2073.69	2041.63	3505.37
Investments	5208.75	5391.67	5108.72
Inventories	2751.41	2368.36	2350.47
Sundry Debtors	1203.19	1281.02	1017.24
Cash and Bank Balance	213.94	277.5	142.66
Loans and Advances	1220.9	1327.52	1178.88
Total Current Assets	5389.44	5254.4	4689.25
Current Liabilities	4846.73	4186.09	3788.58
Provisions	1139.65	835.02	935.18
Total Current Liabilities	5986.38	5021.11	4723.76
Net Current Assets	-596.94	233.29	-34.51
Deferred Tax Assets	353.21	179.07	167.67
Deferred Tax Liability	3145.22	2474.9	2073.59
Net Deferred Tax	-2792.01	-2295.83	-1905.92
Other Assets	1595.61	1194.47	983.17
Total Assets	26436.56	22437.07	20779.19
Contingent Liabilities	1773.73	1200.79	964.87

Source: Capitaline Data Base

