Market Portfolio

The market portfolio is an entirely theoretical concept: It comprises every type of asset one can invest in, weighted proportionally to the value of the entire universe of investment possibilities. – The concept is not only relevant in benchmarking the relative performance of an individual asset, though. It also helps to distinguish risks into such related to the overall market environment vis-à-vis such specifically linked to an asset itself.

As previously shown, the earnings volatility and risk profile of a food producer differs markedly from that of a luxury goods manufacturer. Latter is characterized by a cyclical performance pattern, in essence amplifying the ups and downs of the overall economy. - Even though a food producer and a luxury goods manufacturer may have quite distinctive risk profiles, there are certain risks having an impact on both of them: If, for example, the global economy slows down, then both firms will likely report weaker financial results. Even though, the luxury goods manufacturer will almost certainly suffer significantly more.

However, certain risks will affect a certain firm only: For example, the risk that the luxury goods manufacturer´s new production facility may run behind schedule. Or, that the food producer´s recently appointed management may turn out to be less than impressive.

And finally, certain categories of risks will be linked to an industry sector only: Mentioned luxury goods manufacturer as well as its competitors will lose revenues from much cheaper fake designer products. Or, the majority of the food industry will be negatively impacted by a disastrous harvest resulting in higher purchasing costs of grains.

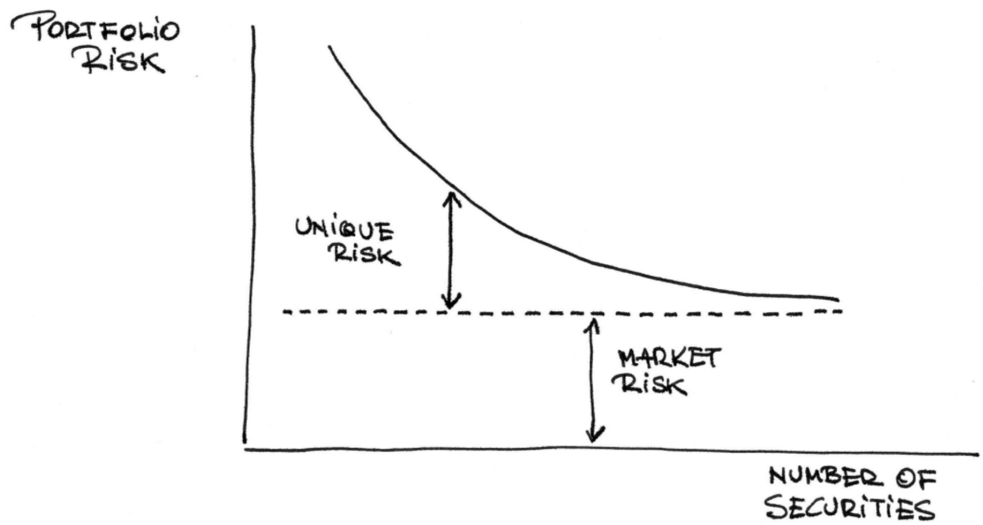
This distinction of risks between such directly affecting a firm or a certain industry or, on the other hand, such, which are more general, market-wide ones and therefore impact all firms and industries (in consequence: all stocks) is important.

Assumedly, someone intended to invest in the luxury goods sector as a whole and built a portfolio around it: Hence, the investor may acquire next to stocks of a luxury handbag manufacturer also that of a high-end automotive manufacturer, a prestigious champagne producer, an haute-couture fashion designer, a top-notch boutique hotel, an exclusive jewelry chain and some more of the like. Whilst this investor is now certainly exposed to the luxury goods sector, at the same time some of the risk (as well as return) has been diversified: If, for example, this year´s wine harvest failed and consequently the champagne producer´s shares performed badly, then this specific risk would be mitigated due to the investor´s portfolio spread across several investments. Hence, by investing in a portfolio, even if this were (only) industry-focused, risks linked specifically to an individual company can - more or less – be diversified away.

Of course, an investment portfolio can be spread and – hence - diversified much more broadly, such as across different industry sectors or geographies. Then, next to firm-specific risks also industry-specific ones can largely be diversified away.

However, there is a limit: Whilst empirical and statistical research indicates that a well-diversified portfolio of around 15-20 different stocks almost eliminates all major company- and industry-related risks, the so-called market risk will (stubbornly) remain: It actually cannot be diversified away. Market risk combines a whole range of risks which affect the performance of the entire spectrum of industries and firms, therefore all financial markets (and all stocks along with them). A macroeconomic shock is a good example for a market risk.

The market portfolio itself is well-represented by some of the global stock indices: Whereby a good, reputable index, such as the S&P 500, may be composed of hundreds of stocks. - Indices are important tools for institutional investors: They often serve as benchmarks for investment strategies in regards to both, risk and return.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