## Market Portfolio

**The concept of the market portfolio is an entirely theoretical one: It comprises every category, every type of asset one can invest in, weighted proportionally to the value of the entire universe of possible investment alternatives. – The concept is not only relevant in benchmarking the relative performance of an individual asset: In addition, it helps separating 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 – therefore also risk profile - of a food producer differs markedly from that of a luxury goods manufacturer. Latter, for instance, is characterized by cyclical performance patterns, in essence amplifying the ups and downs of the state of the overall economy. – Despite a food producer and a luxury goods manufacturer having quite unique profiles, the risk of a slow-down of the global economy will in all likelihood have a negative impact on both of them, reflected in weaker financial results: Even though the luxury goods manufacturer will almost certainly suffer more.

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

Other sets of risks will be specifically linked to an industry sector: For instance, a luxury goods manufacturer as well as its competitors will suffer and lose revenues from much cheaper counterfeits. Or, a major part of the food industry will be adversely affected 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 have an impact on all firms and industries (in consequence: all stocks) is of utmost relevance.

Assume, someone intends to invest in the luxury goods sector by building a portfolio around it: Hence, this investor may acquire next to stocks of a luxury handbag manufacturer also those 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´s portfolio is exclusively exposed to the luxury goods industry, some of the risk (as well as return) has nevertheless been diversified: If, for example, this year´s wine harvest failed and therefore the champagne producer´s shares performed badly, then this specific risk would be mitigated as the portfolio is actually 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- as well as industry-related risks, the so-called market risk will (stubbornly) remain: This risk can not 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 concept of a market portfolio can be illustrated by some of the global stock indices: Whereby a well-established, reliable and reputable index, such as the S&P 500, may consist of hundreds of different stocks. – Nowadays, indices are important tools for institutional investors: Commonly, they serve as benchmarks for investment strategies in regards to both, risk and return.

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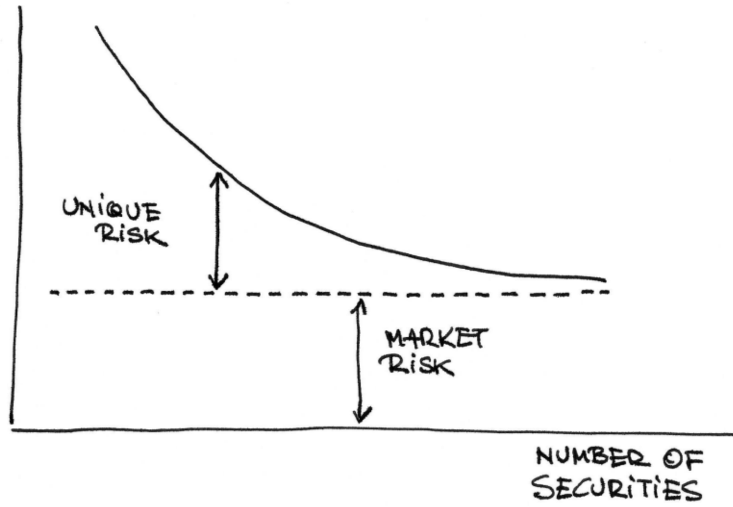


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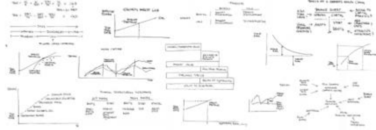

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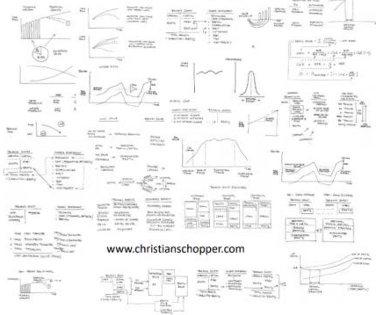


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