ABSTRACT

Modern Portfolio Theory (MPT) indicates that, by diversifying their portfolios, investors can reduce risk without sacrificing expected return. Hence, the present study attempts to examine whether the rate of return on well-diversified low risk portfolios is indeed significantly lower than the return on well-diversified higher risk portfolios and to show how diversification can be utilized to offset the riskiness of individual securities. This is so that portfolios consisting of large numbers of higher risk securities are less risky than portfolios consisting of small numbers of low risk securities, and yet earn a substantially higher rate of return.

Fifty-four securities, which have an assigned bond rating by Thai Rating and Information Services (TRIS) and have a complete set of data during January 1996 through December 2001, have been selected to construct two types of portfolio. The first classification of portfolios, involves dividing the fifty-four securities into three equal groups based on their corporate bond rating by Thai Rating and Information Services (TRIS). Eighteen companies with class A bond rating are grouped in portfolio A. Eighteen companies with class B bond rating are grouped in portfolio B. Eighteen companies with class C bond rating or the companies under rehabilitation specified by Stock Exchange of Thailand are grouped in portfolio C. In addition, the second classification of the portfolio is constructed to show the effects of changing number of stocks in the portfolio, so eighteen stocks are selected from class A quality stocks to create one-stock portfolio to eighteen-stock portfolio.

The result of the present study indicates that there is a negative relationship between the quality rating of a portfolio and the risk of a portfolio, measured by beta, which means that when the quality rating of the portfolio increases, the risk of the portfolio measured by beta will decrease. The present study also indicates that there is no significant relationship between the quality rating of the portfolio and the average return of the portfolio. Although the average returns on class B portfolio are greater than the average returns on class A portfolio, the average returns on class C portfolio are not greater than the average returns on class B portfolio.
Moreover, the present study indicates that there is no significant relationship between the number of holdings in the portfolio and average return of each portfolio. Portfolios composed of different number of securities in the same quality class have the same level of systematic risk; even the level of unsystematic risk varies. The return of the portfolio relates only to that risk, which cannot be diversified, i.e., the systematic risk. Finally, the present study indicates that there is a positive relationship between the number of holding in the portfolio and the coefficient of determination between the monthly portfolio return and the monthly market index return. Portfolios of a small number of securities are very undiversified, whereas the portfolios of as few as fourteen to eighteen securities have a strong relationship to market index.

This empirical findings would be helpful for the investors in improving the investment performance by expanding the list of qualified securities to include the higher return, the higher risk securities, while offsetting the increase in market risk by holding many securities in one portfolio. The appropriate numbers of holding are fourteen to eighteen securities in one portfolio, and the investors with small account should exploit these possibilities.