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Procedia Economics and Finance 26 (2015) 167 – 173

Procedia Economics and Finance

www.elsevier.com/locate/procedia

4th World Conference on Business, Economics and Management, WCBEM

Risk of the Collective Investment and Investment Portfolio

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Abstract

Currently, the investing method of the available funds in the form of collective investing is going to be more popular. This method that is based on the common interest of a greater number of individual investors as efficiently as possible to evaluate their available funds. The basic starting point for collective investment is to minimize the risk of investors, through the diversification of the portfolio. The benefits of collective investment is more efficient diversification of risk, professional management of savings, availability and expansion of investment opportunities for small investors. There are also large selection of funds, high liquidity, lower transaction costs, and insufficient information and tax advantages compared to bank deposits. And these are what is attracted for more and more investors to invest their funds right this way. In the case of investment funds, however, is to get the cash in form of subscription of shares, which investors buy, thereby increasing the risk that investors will run regardless of the amount of the income. Along with the theme of collective investment came also to the fore the portfolio theory and its application of this theory as well as in the field of collective investment. The principle of portfolio theory is diversification which is used to achieve the objective of investment enterprises and their funds, mutual funds and pension funds, and the creation and management of the portfolio that provides to the clients the highest effect. The present paper deals with the analysis and optimization of the investment portfolio. There is also mentioned the founder of the portfolio, M. H. Markowitz and his selective model. This paper is also dedicated to the measurement of risk and return of portfolio and their calculation – correlation and covariance.

Peer-review under responsibility of Academic World Research and Education Center

Keywords: investing methods, funds, collective investment, theory of portfolio.

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Peer-review under responsibility of Academic World Research and Education Center
doi:10.1016/S2212-5671(15)00910-7

1. Collective investment

Collective investment may be conducted only through mutual funds under the conditions laid down in this Act (n.593/2003) and in accordance with the rules of risk spreading.

The main advantages of collective investment through investing and mutual funds are recorded in the following facts: *(i) leads to savings from economies of scale, (ii) there is a saving of professional management, (iii) collective investment in all countries subject to State supervision and control, (iv) the funds invest money into a large number of different securities and that diversification can significantly reduce the risk of the investor*.

Particular advantage of the collective investment is that offers quite a wide divergence of investment strategies. Subsequently, each investor can choose the type of fund that suits its approach to risk, mainly of time and investment preferences.

Disadvantageous aspect of the collective investment for investors are (according to the Valach, 2010), *(i) the entry fees to be paid by the investor, (ii) the administrative fees for fund management, (iii) the volatility of share prices and units of funds fluctuations affecting profitability, and (iv) the lack of insurance.*

2. Risk of the collective investment

Like any investment, including collective investment faces to risks that are classified to the specific risks and market risks.

Specified risks associated with the insolvency of the issuer to perform its obligations divided into the following risks:

(i) *Management risk* – the quality of management is involved in the development of the enterprises, its loss or prosperity. It depends on the age of the enterprises, its experience, human errors or possible fraud,
(ii) *Operating risk* – this risk occurs in the absence of sales covering fixed costs. It is therefore necessary to know the volatility of turnover and operational lever and a suitable combination to avoid losses,
(iii) *Financial risk* – the risk scores in the ratio of debt and equity. The higher this ratio is, than the higher risk is, due to scales that are not able to override the fixed interest charges and loan repayments,
(iv) *Backup or security risk* – this risk arises from the fact that in case of bankruptcy and liquidation of all investors have equal rights,
(v) *The risk of early repayment* – occurs if there is a redemption of securities before maturity because of unfavourable market conditions for issuer,
(vi) *The risk of conversion* – the fund may also suffer losses by the conversion, for example the change in long-term securities for securities with shorter maturities.

In term of global-economic, political and social impact, there are market risks which consist of the following types of risk:

(i) *Interest rate risk* – a change of interest rate affects the prices of securities, i.e. an increase in interest rate leads to decrease in securities prices and a decrease of interest rate leads to increase lead to increase in securities price. Both of these cases, there is an impact to issuer of securities and also to investor to securities. With increasing securities prices, the issuer must bear the loss and the investor the gain, vice versa.
(ii) *Reinvestment risk* – as well as the interest rate risk, the reinvestment risk is associated with the change of market interest rates. However, if there is a decreasing in interest rate, both issuer and investor bear the loss because of reinvestments at the low interest rates.
(iii) *Inflation risk* – inflation bring the devaluation of money, which resulting the higher interest rate for investor which take into account a given inflation.
(iv) *Foreign exchange risk* – this risk occurs when the investor entrances to the international markets and threatened with unexpected changes in exchange risk.
(v) *Market liquidity risk* – the risk associated with type of security, the administrative and legislative law and the functioning of financial markets.