

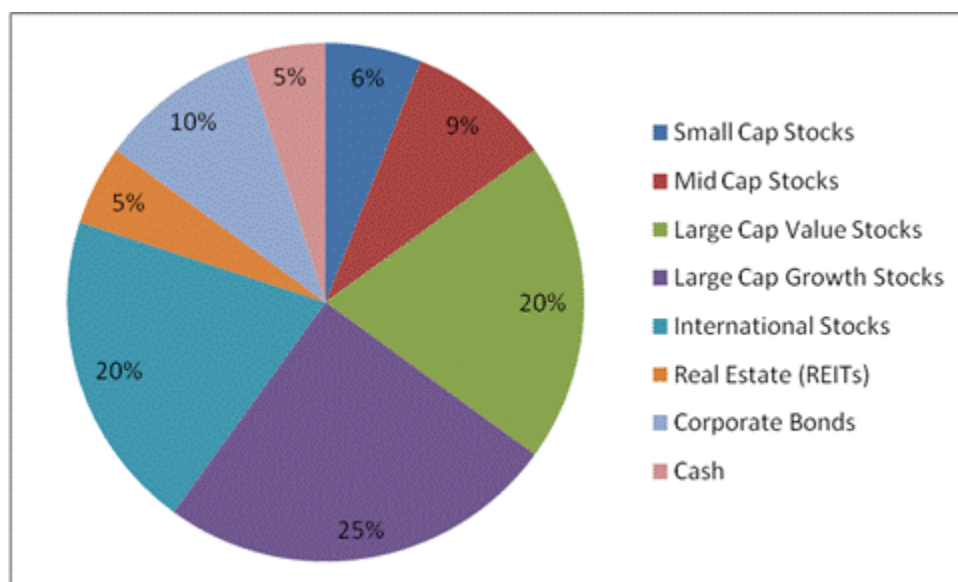
## Death to the Pie - a/k/a Modern Portfolio Theory Failed, Again

Dear Friends,

**“Static (Strategic) Asset Allocation is like playing bridge and not looking at your cards.”**

- Attributed to Warren Buffett

You have seen countless charts like the following.



Portfolios like the above are often calculated using Modern Portfolio Theory (MPT). Once the portfolio is constructed, a “strategic asset allocation (SAA)” strategy is deployed for the investor. Basically, SAA says that you should hold this exact mix and rebalance the portfolio at some frequency. Rebalancing means that if say Large Cap Value stocks grow to 22% of the portfolio, you should rebalance the portfolio back to the original 20% percent – in effect, you sell winners and buy losers.

**Asset allocation has been sold as a way to reduce risk, but it has failed miserably in both the bear market of 2000-2002 and the bear market of 2007-????.**

**Here’s why I don’t believe in MPT nor SAA:**

- The basic premise is erroneous, that stocks always go up (look at Japan’s Nikkei 225, it was 38,957 in 1989, it is now 20-years later at 7,645, 80% below its all time high),

- It is **an academic theory**, written in 1952 by then 25-year old Harry Markowitz doing research for his dissertation. Markowitz was awarded the Nobel Memorial Prize in Economic Science in 1990 for his mathematical theories of portfolio allocation under uncertainty, that, I believe, is why there is such widespread use of MPT – it’s a “Nobel Prize Winning Strategy.”
- It is based on historical performance, volatility and correlation of asset classes, thereby assuming that the past will continue in the future,
- As it is applied today, an asset class of large cap growth stocks is a different asset class, than say foreign stocks – to me it is one asset class, stocks – MPT says you get diversification from holding small value stocks and large cap growth stocks – but to me they are all stocks – and that is not diversification,
- MPT says that you should hold a diversified mix of asset classes that are not perfectly correlated. But, just as performance changes for asset classes, correlations change as well. When an MPT portfolio is constructed, correlation coefficients of asset classes are used in designing the portfolio. However, the reality is that correlations change – if you calculate the correlations for the prior 5-year period they will be different than the past 3-year period, for example. In the year 2008, all asset classes moved toward a correlation of 1.0, as all asset classes declined, except for treasuries.
- MPT measures risk using historical standard deviation of an asset class. Again, standard deviation in reality changes, it is not static.
- MPT uses complex mathematics in constructing portfolios. This complexity adds to its sex appeal, but the inputs are historical, so to me, the outputs are suspect,
- SAA sells winners and buys losers, the exact opposite of successful investing. You want to let your winners run and sell your losers. The application of SAA during 2008 would have you selling government bonds (winners) and buying stocks (losers) as your stocks went down and government bonds went up,
- MPT says that an investor who wants higher returns must accept more risk. As if there is a “magic dial” that you turn up and you get more return. My experience is that more risk usually ends up with lower, not higher, returns.
- There is no thought given to current economic conditions or trends. Real estate may be crashing, but under SAA you must continue to hold real estate as an asset class, for “diversification.” I’m not making this up!
- MPT says that investment returns are normally distributed, when in fact investment asset returns are not normally distributed, they are skewed with “fat tails.” The beautiful bell curves exist only in academia.
- MPT’s basic premise is grounded in the efficient market hypothesis (EMH), which says that risky assets reflect all known information – it’s a classic argument for a “random walk” and why you should buy and hold index funds. If EMH were true, you would not have asset bubbles. To me, markets are just that – a collection of people with all the behavioral deficiencies we all possess: overconfidence, bias, etc., etc.

Complex mathematics has been used to try and bring order to an uncertain world.

We have seen countless failures of mathematicians and markets, here’s a couple:

- Mathematicians gave us credit default swaps
- Mathematicians gave us subprime mortgages with carved out tranches – something like 40,000 different mortgage pools now exist, adding tremendously to the complexity of analyzing these instruments,
- look at the mathematical models used to price Alt-A mortgage portfolios or to give them AAA ratings – they have failed miserably,
- Long-Term Capital Management lost \$4.6 billion in less than four months in 1998 and closed in 2000 – they had two Nobel Prize winners directing their strategy,

The crisis we are in now is driven by the failure to factor in **behavioral finance** – that humans, with all their foibles, not mathematical models, drive markets. **Emotions like fear and greed drive markets – not discrete mathematical models.**

**The vast majority of financial advisors use SAA as their primary investment strategy.**

**How I practice trend following investing and why I like it so much:**

- Diversified portfolios,
- Let winners run (buy/hold market leadership),
- Sell losers (sell/avoid market laggards),
- No predictions or forecasts,
- No mathematical predicting models,
- Risk averse,
- Based on behavioral finance,
- Attuned to current market conditions,
- Just go with the flow – let the markets tell us where to invest.

Warmest Regards,

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