

Modern Portfolio Reality (MPR)©

The Failures of Modern Portfolio Theory

DAVID B. LOEPER, CIMA
CHAIRMAN/CEO

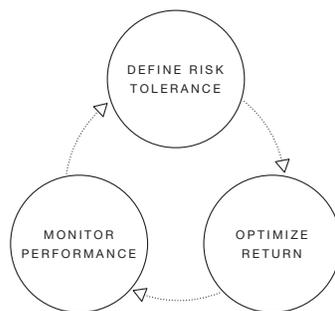
For the last thirty years, financial advisors have been forced to adapt to revolutions within their business. First it was “May Day” of the 70’s when “customer’s men” were forced to adapt to the world of deregulated commissions. Dis-inflation and tax reform in the mid 80’s pulled the rug out from under advisors who made their living selling tax advantaged and inflation sensitive oil & gas and real estate limited partnerships. The explosion of consumer financial media and index funds in the early to mid 90’s effectively reduced the value of financial advisors when the performance records advisors used in their sales process became a commodity through an ever growing list of consumer fund surveys and ranking systems. And today, thousands of advisors who have promoted their value based on the theory of asset allocation and MPT are facing the reality of asset allocation’s practical failure being exposed by the mathematical facts of sophisticated Monte Carlo and probability analysis.

However, this decade is different. In contrast to the past when advisors were forced to adapt or wither, we are now merely facing an evolution. This evolution can be particularly easy to make if one has basic competency and just slightly above-average listening and cognitive skills. The adaptation is made easier because the general “story” that advisors have used to communicate their value proposition to potential and existing clients remains unchanged. No, this time it isn’t a revolution at all, but instead an evolution of actually being able to deliver what the advisor has been promising his potential and existing clients. This time it is different because the evolution recognizes that each client is different and each advisor can uniquely add value to the client. For the first time, the value added can be truly measured and demonstrated.

THE “E”VOLUTION HAS ALREADY BEGUN

The basic value proposition most advisors articulate to potential clients today generally follows this concept:

“Mr. Investor, the service I provide is a process of helping you meet your financial goals. First, we start with an investor profile (*objectives questionnaire, attitude survey, etc.*) so we can clearly understand your tolerance for risk and expectation of return. Then, because over 90% of your return is based on asset allocation, we optimize your portfolio to position it to achieve the highest return for the amount of risk you can tolerate. Finally, each quarter, we review your progress by reporting your performance to you relative to your stated goals.”



That has been the basic story. Variations have branched from different fields of financial services. “Investment Consultants” developed written investment policies and sophisticated performance reporting and measurement tools while implementing investments through “wrap” programs utilizing independent money managers or mutual funds. “Financial Planners” have focused on defining the personal financial lifestyle goals of the investor. The popularity of asset allocation over the last decade, however, has caused many planners to succumb to the pressure of defining a specific risk tolerance and to create an optimized portfolio based on asset allocation theory.

Garbage In, Garbage Out. . . The Perils of Profiling

At the center of these services is an important element that advisors have been struggling with since the beginning of Modern Portfolio Theory (MPT)...the tolerance for risk must be meaningful.

The whole process starts with defining the investor's tolerance for risk, thereby creating a struggle to identify the investor's risk tolerance in a way that can be understood and measured. The process as a whole falls apart if you have not definitively nailed that client's risk tolerance level. For years advisors have been attempting different variations of the measurement of risk. Standard deviation (*the MPT measurement of risk*) was mathematically too abstract to be personalized by investors. This lack of understanding by investors caused academics to create other measures of risk that could be adapted to fit in the MPT model, such as maximum draw down and semi-variance. These attempts treated only the symptom of investors really not "buying in" to defining their risk tolerance under these methods instead of curing the disease of, or created by, a theory that fails in practice.

Having exhausted mathematical attempts to come to a meaningful definition of risk tolerance, advisors turned to profiling methods. Some migrated toward simplification, which eliminated the math of MPT by having investors choose from asset allocation baskets describing general investment characteristics through written words. Another school of thought was to bring in psychologists to create a survey uncovering the investors' psychological attitudes about tolerance for risk. Both the survey and the profiling failed because they turned abstracted investment choices into feelings that were not measurable in the mathematical terms needed for MPT. For over fifteen years, academics and advisors have been frustrated by the difficulty in identifying a meaningful and measurable tolerance for risk. The process could be simplified if investors would simply "know" their tolerance was a standard deviation of 15.22 % or a maximum draw down of 20%. They could plug the number in the optimizer and, WHAM, out comes the perfect portfolio for that investor. What is ironic about this history lesson is how much smarter investors have become and how we have, in the past, ignored them simply because their practical desires don't match MPT. As financial advisors, who are we serving? Are we serving our clients or are we serving the likes of Bill Sharpe, Harry Markowitz, and Roger Ibbotson? If identifying a meaningful and understandable risk tolerance were part of investors' practical decision making, then why have we had so many problems getting investor buy-in? They have been telling us the answer to the problem for years and we haven't been listening.

Rule number one in a personal advice business is to hear and listen to what your clients are saying.

Are You Listening?

Take this little quiz to see if you have been listening to your clients. Think back over your career of asking investors the following question (*or your variation of it*) and check those responses you recall having heard from clients.

"Mr. Client, as I described to you, my goal is to help you achieve the highest return of the risk you can tolerate. For me to accomplish this, I need to have an understanding of your tolerance for risk. What is the maximum risk you can tolerate?"

___ I can tolerate a beta of 1.12

___ I measure risk by maximum draw down of which I can tolerate 15%

___ A standard deviation across all my assets of 14.31%, provided my tracking error is low and my managers all maintain an r-squared relative to their style benchmark of more than 92.

- I hate risk
- I'd like to take as little risk as possible
- If you are going to lose my money, I don't need to hire you
- As much as I need to meet my goals
- How much risk should I take?

The first three answers fit well into the theory of MPT. The last five fit better into the reality of MPR (*Modern Portfolio Reality*).

As skilled communicators, advisors have managed to counsel their clients into checking the box on the questionnaire that managed to fit into MPT, whether or not the investor really accepts the response as their definitive tolerance for risk. When investors told us they'd like to take "as little risk as possible," visions of the Capital Asset Pricing Model (CAPM) chart danced in our head and we suggested that T-Bills would be inefficient. We assumed that the investor was communicating in our theoretical terms instead of what they really meant. What the investor may have meant by "taking as little risk as possible" was not the risk-free rate of return of MPT, but instead their desire to avoid risks they can afford to avoid and still meet their financial lifestyle goals. But we didn't listen.

Moving on to the definition of measuring performance, we would ask investors how they would evaluate investment success. We needed a benchmark we could use to measure the relative performance of their portfolio using a time-weighted rate of return. Again, take the quiz below to see if you have been listening to your clients. How many clients have responded to the following question (*or your variation of it*) with each of the following options?

"Ms. Client, having identified your tolerance for risk (*yeah, right*), we need to determine the yardstick we will use to measure investment success. How will you measure investment success?"

- By the time weighted return of a blend of Russell style indices combined in relative proportion to my long term strategic allocation targets
- By beating the S&P 500
- If my Sharpe ratio shows high portfolio efficiency
- If my portfolio alpha is positive after 10 years
- If I make a lot of money
- If I can afford to retire early
- If I can live comfortably in retirement
- If I know my grandchildren's education is sufficiently funded

Like the risk questions, investors have been telling us how they would like to measure and monitor investment success. But, because performance-reporting systems merely report returns instead of progress made toward the investors' real goals, we have once again ignored what our clients want, forcing their response to fit into the tools and methods we use.

It Is Time to Listen. . .

We really should not feel guilty for our failings. Advisors and the top academics have been working hard to help us improve the service we provide our clients. Just think of all the asset classes that have been created over the last 20 years...we have gone from plain old stocks to small cap value stocks, mid-cap growth stocks...pretty soon every stock will be its own asset class!

If only:

- 1)there was a way to combine the goal setting of financial planning with asset allocation, enabling investors to quickly and easily learn the choices they must make to balance financial lifestyle goals with investment risk.
- 2)performance monitoring systems measured the progress of meeting financial lifestyle goals instead of relative performance where 3/4 of money managers lag.
- 3)there was a way to demonstrate to potential clients how meaningless their current advisor's MPT portfolio is relative to their goals.
- 4)there was a way to measure and demonstrate to investors the millions of dollars of value a skilled advisor provides.

Oh wait...there is a way. It is Financeware. This is what we represent. A lot of advisors have been drawn to us because we use Monte Carlo (*probability analysis*), the latest academic trend. But Monte Carlo is going down the same road as asset allocation only at a much faster clip. Already there are practically meaningless but theoretically interesting debates being waged on the relative value of stochastic vs. Latin hyper cube modeling and the accuracy of 1,000 versus 10,000 simulations.

If you want to participate in this next folly, don't look to Financeware. We are about a very simple new advisory service we call Modern Portfolio Reality (MPR). It can be represented in a similar process to that of asset allocation. It looks like this:



More and more financial planning and asset allocation tools will be adding Monte Carlo simulations to their feature set over the coming months and years. This time, instead of leading the charge of the next revolution and betting your future on a math formula, consider evolving your business to truly servicing your client's desires.

Our whole system is focused around demonstrating the value of your skills in helping investors achieve their meaningful personal financial goals. Probability analysis alone will not make it possible for you to deliver this service or advice. You need a process for demonstrating the need for your services, a means of efficiently identifying and prioritizing investors' financial lifestyle goals, and a system to monitor the progress toward meeting those goals.

If you would like to learn more about how to deliver this service, contact us at Support@financeware.com.