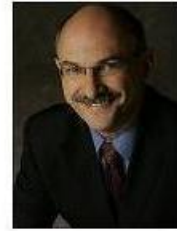


Steven L. Pomeranz

FINANCIAL MANAGEMENT



MPT and Me

Modern Portfolio Theory and related hogwash

When I watch financial news channels, it always strikes me as a little odd when commentators are asked to interpret the latest economic statistic to predict the fate of the economy and the stock market. They willingly oblige, sounding as confident as ever, and back their claims with charts and statistics.

But time after time, their predictions turn out to be just plain wrong because trying to predict an economy as complex, large and globally-linked as ours, is almost impossible.

Most economists are trained to glean statistical trends from mountains of historical data, and then develop predictive formulas. Many have even won the Nobel Prize for their efforts. And yet, these formulas have caused much investment misery over the years.

Modern Portfolio Theory

Developed in the 1950s, Modern Portfolio Theory (MPT) was one such concept that was all the rage in the 1990s and most of the 2000s. It assumed a world where share prices accurately reflected the company's worth, and where all investors acted in their own best interest and rationally all the time (if you've observed stock prices and been married for any length of time, you'll automatically see the folly in this.)

With *reality* safely banished, the model analyzed and correlated trends and went on to create all kinds of beautiful mathematical models. Then all you needed was a computer program to construct the perfect portfolio. Sounds nice, doesn't it?

MPT and Me

I came across MPT in the 90s when my employer at the time gave me the program to construct *model* portfolios. All I had to do was input my client's existing investments and his responses to a simple risk-tolerance questionnaire, and press enter. After a few seconds, a beautiful chart would appear, with an upward sloping *perfect portfolio* line.

But I kept running into a problem. You see, the program would repeatedly recommend assets that fared well in the past. But that as we know, presents a number of problems.

First, only a few assets would dominate the portfolio... so not much diversification. If small cap stocks did extremely well for the last 10 years, the model would suggest an 80% allocation to small caps. Absurd!

Second, it would recommend putting a lot of money into an asset that had already seen tremendous appreciation. Like the dot com stocks in 1999, investing after something has increased a lot in value portends disaster.

It was frustrating to work around the model's constraints while trying to put together a common sense portfolio for my clients. For me, MPT, with its beautiful charts, was a total waste of time.

Fed up, I abandoned model-based investing... and consequently avoided huge losses in the mortgage meltdown of 2008.

Instead, I started studying investment books - now a lifelong vocation for me - for insights from star investors like Warren Buffet, John Neff, George Soros, Peter Lynch, and many others.

Learn to Pick Value

Getting back to the financial news commentators - their predictions are of no more value than the esoteric formulas of the Nobel Prize winners.

Fortunately, we don't need either of them to do well.

You need to learn what makes something more valuable in the future. Is it a growing income stream? Is it diminishing supply?

Be it fine art, classic autos, stocks or comic books - the economy may impact their value in the near term, but if you get it right, you will have a winner over the long term, no matter what the economists think.

To succeed, learn the lessons of the masters, learn from their successes and failures. Successful investing doesn't require a Ph.D. and complex models. All it needs is common sense and a little math to help you along the way.