

## Posted to the Gilder forum - May 3, 2000

### My take on MPT

I became acquainted with Modern Portfolio Theory when I subscribed to Louis Navellier's MPT Review. I was looking for help in stock picking and found his newsletter well worth while. Since it was, supposedly, based on MPT (I have no idea how Navellier does his asset allocation), I decided to learn about MPT. If you ever suffer from insomnia, I recommend you read an erudite book on the subject.

To sum up MPT, it is a method of asset allocation that tries to reduce risk while maximizing, if possible, the portfolio's return by diversifying. This is also known as: "Don't put all your eggs in one basket" but MPT does it scientifically!

MPT defines two classes of risk that need to be lowered, business risk also referred to as unsystematic risk and market risk or systematic risk.

Business risk is, in a word, the risk of a company going broke. If you only own the stock of one company and it goes broke, you loose all, very risky indeed. You reduce business risk by owning more than one stock. If the companies belong to various industries, you are safer than if they are all in the same industry. How MPT picks the right companies and the amounts to invest in each is somewhat more complicated but I don't feel that it is necessary to look at that here.

Market risk is, of course, the risk of the whole market collapsing. Again you reduce this risk by diversifying into other kinds of values or securities: cash, bonds, CDs, etc. As with business risk, MPT has a way to tell you how to allocate your funds into these various asset classes as they are called. Again, we need not pay any attention to it here.

MPT does not take into account your investment horizon, the relation between your liquid needs and your portfolio size and your creditworthiness. Maybe these are valid assumptions for a fund, but most definitively they are not valid for most individual investors.

MPT equates volatility to risk but this is not strictly true for several reasons:

- If you need cash short term it is risky to put it into a volatile asset class (stocks) and you should put it into more liquid assets, maybe a savings account or a CD. If you only need the funds long term, say in 15 years when you retire, volatility, which is a short term phenomenon, is not an issue.
- If you have a large portfolio in relation to your liquid needs, again volatility is not an issue because you will never be forced into a fire sale.
- MPT assumes that you have no margin credit

MPT's method of reducing market risk is to allocate part of the funds to assets outside the stock market, for example, money market funds, bonds and cash. Sounds good but it does not necessarily reduce risk and it certainly does NOT maximize returns.

Let's first talk about maximizing returns. If you believe Jeremy J. Siegel's argument in [Stocks for the Long Run](#), then you should only invest in stocks to maximize returns. I urge you to read the book. But what about market or systemic risk you ask. It most definitely it exists, specially if your investment horizon is short. But if your horizon is long term, forget about it until the horizon gets close enough to make you worry about it, otherwise, during all those intervening years, you will be getting less than the optimum returns. As your horizon shortens, or as certain events draw near (school tuition for the kids, etc.) start converting some of your stocks into other types of assets such as short term bonds or CDs. How do I handle emergencies if I don't have some cash on hand, you ask. Use cash management! You can borrow cost free for an average of 12 to 15 days from your credit card. Then pay back the credit card with a margin loan from your broker. And as the final step, reduce your margin at your convenience, for example, when you are rotating something in your portfolio for investment reasons. To use this system you have to fulfill two requirements. One, have a large but UNUSED credit limit on your credit cards. Credit card credit is way too expensive to use it on a regular basis anyway! So use it as part of you cash management system instead. If you don't have a sufficiently large credit limit on your credit cards, then get a debit card or a checkbook from your broker and omit the first step (get the margin loan directly with the broker's debit card). A final consideration about market risk. MPT advises you to put a certain percentage of your portfolio into non-stock assets but it does not take into account the size of your portfolio or the amounts that you will need to disburse short term. A billion dollar fund would have the same percentage of money market funds as a million dollar account. Since you hold low return non-stock assets to deal with near term payments it makes sense that the amount removed from stocks should reflect the amounts due and not the size of the overall portfolio.

We still have business risk to deal with. The best hedge is to have a basket of stocks and to use very keen stock picking abilities. Some of us have learned to pick stocks and others have not. Here is where the advisors come in, you need a good one, but not an expensive one. Whatever you pay your advisor reduces the return of your portfolio so it is important to find a good one who is also cheap relative.

Denny