Markowitz Misunderstood

MPT Should Come With A Warning Label

Modern Portfolio Theory ("MPT"), the investments model that led to a Nobel Prize, should come with a warning label: "Use with caution. It's only as good as your assumptions."

What did Harry Markowitz intend to impart with his earth-shattering research?

Harry Markowitz published his research titled "Portfolio Selection" in The Journal of Finance during 1952. He led with: *"The process of selecting a portfolio may be divided into two stages. The first stage starts with observation and experience and ends with beliefs about the future performances of available securities. The second stage starts with the relevant beliefs about future performances and ends with the choice of the portfolio. This paper is concerned with the second stage."*

> *"BUT, what if your timeframe isn't 75 to 100 years?"*

Help! What about the first stage? What do you mean that the assumptions are OUR responsibility?!!

It's been many decades since the article was first published. Many, many 'buy-and-hold' pundits have reiterated their mantra in concert with Dr. Markowitz. But that isn't what he intended. Yes, investors should only be rewarded for taking risks that can't be neutralized. Yes, stocks have more risk than bonds and over time have realized higher returns. BUT, what if your timeframe isn't 75 to 100 years?

Please Dr. Markowitz, help me with my 10 to 20 year investment horizon. For that, dear student, you should reflect upon historical 10 to 20 year horizons for your assumptions. That is the first stage to which Markowitz referred—before MPT can be applied to your portfolio.

Since 1900, there have been 85 twenty-year periods; the first was from 1900 to 1919 and there are eighty-four double decade periods thereafter. When divided into two groups, those above the average and those below the average, the top group averages returns of 10.5% and bottom group averages returns of 5.1%.

Well of course the average of all those scenarios presents the long term average return before transaction costs and taxes of 7.8%. But is there a way to determine whether the next twenty years is likely to be a top-half or bottom-half period? This would certainly enable us to improve our assumptions by using either 10.5% or 5.1%, rather than just the default of 7.8%.

One characteristic that is blatantly obvious for the two halves is the starting level of valuation in the market as determined by the price/earnings ratio (P/E). It's the bellwether measure of prices in the stock market. Almost unanimously throughout the past century, when the P/E is above average, subsequent returns are below average. As well, below average P/E's drive above average returns.

So since the current P/E is well above average, shouldn't the assumption for Markowitz's model be below average returns? Although the thud of that statement would be enough to trumpet the end of this article, we cannot conclude without driving home its implications.

Markowitz gave us the holy grail to portfolio management; conventional wisdom has forgotten or ignored the need to use appropriate assumptions—the essential “first stage” of developing appropriate assumptions. As Markowitz emphasizes, it is our responsibility to use “observation and experience” to develop “beliefs about the future performances.” Although future performance of the stock market cannot be predicted with certainty or precision, through observation and experience we may be able to at least refine the assumptions into above-average or below-average territory.

Based upon current market valuations, it is very likely that we’re in the ‘below-average’ batters box and should include a below average return assumption for the next twenty years. When we do, the allocation to equities will be significantly lower and the expected portfolio return will decline.

Oh no. Should I hang on to hope that this time will be different? Or should I rationally include, or at least consider, a scenario that presents below average assumptions to Dr. Markowitz? Dear Dr. Markowitz, what should we do if the assumptions for stock market returns are below average?

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