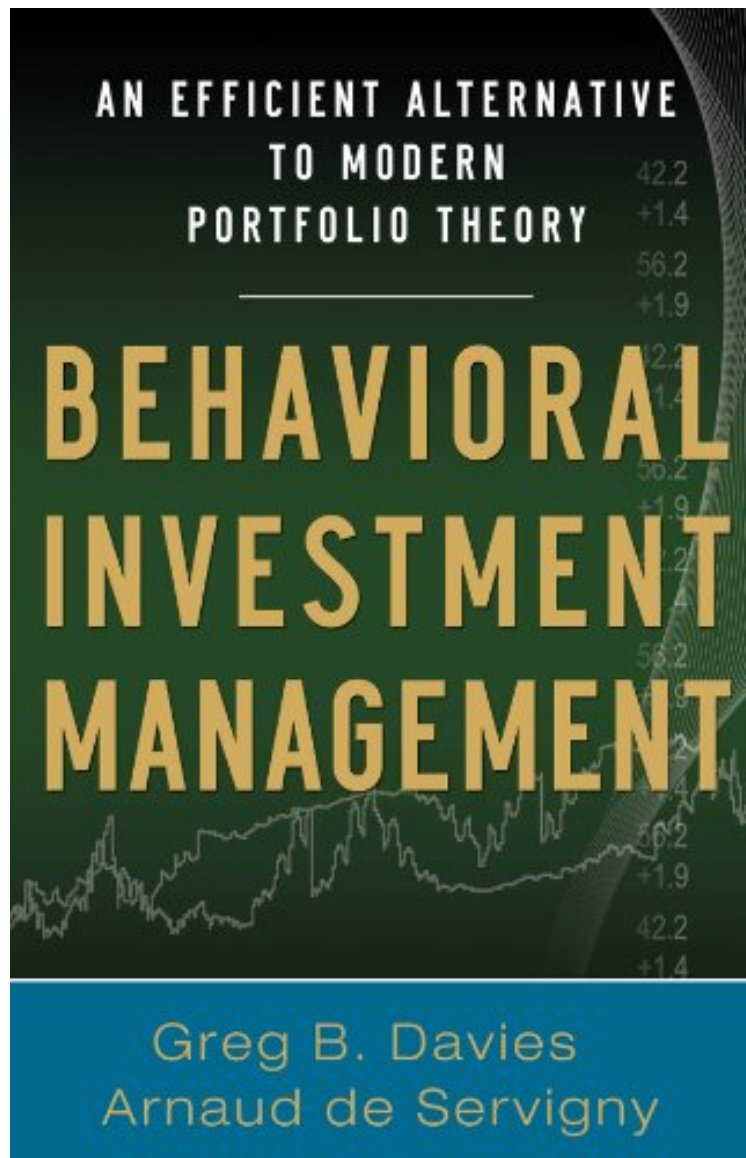


Behavioral Investment Management: An Efficient Alternative to Modern Portfolio Theory

de Servigny

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de Servigny : Behavioral Investment Management: An Efficient Alternative to Modern Portfolio Theory before purchasing it in order to gage whether or not it would be worth my time, and all praised Behavioral Investment Management: An Efficient Alternative to Modern Portfolio Theory:

0 of 0 people found the following review helpful. You have to applaudBy investingbythebooksWe live in troubled times. Since the dawn of time, which in this case means the late 70's, the asset allocation of pension funds has been

governed by a mean-variance-optimization (MVO) process that springs from the so called modern portfolio theory (MPT). Then came the TMT-crisis. Confidence was shaken, but the alternative that emerged - The Yale Model - never really threatened MPT as it was built on a parallel process but added illiquidity, leverage and (potentially) increased diversification to the recipe. Then came the Leman-crisis. As the authors state "We did not abandon modern portfolio theory; it abandoned us." The now emerging alternative - risk parity - thus abandons MVO. On the book cover it reads "An efficient alternative to [MPT]", yet in the introduction Greg Davies (Global Head of Behavioral and Quantative Investment Philosophy at Barkleys Wealth) and Arnod de Servigny (Global Head of Discretionary Portfolio Management and Investment Strategy at Deutsche Bank Wealth Management) says that they are not trying to "set a new holistic standard, a so called successor to [MPT]". Both statements are correct. The book presents a full MVO-model in the sense that it is possible to use in practice. However, it's not a theoretical alternative to MPT as some parameters are subjectively chosen. The model is an attempt to improve the MVO-process based on insights from behavioural finance. You have to applaud this approach. Behavioural finance excels in finding flaws with MPT but the discipline is seldom used in this more constructive way. So what are the issues with MPT that the authors aim to correct? First, the use of normally distributed variance as a representative of the statistical distribution is clearly invalid for most assets. On top of this, the normal distribution assumes a linear and stable trade-off between risk and return in investors utility function, where Daniel Kahneman and Amos Tversky with their Prospect Theory instead shows risk aversion to be non-linear and dependant on whether returns are positive or negative. Secondly, MPT assumes stable correlations between assets (giving stable diversification benefits) and hence ignores the evidence for time-variations and regime dependence in both correlations and returns. The 2 main features of the book are a) a "behaviourised" utility/risk function and b) a regime switching model to handle the different correlations and returns during times of stress versus more tranquil markets. The risk inconsistencies are handled first by adding the higher moments of the distribution, like skew and kurtosis, to the risk measure and secondly by adding an individual, subjective, risk tolerance factor to the equation. The regime switching model uses analysis of historical data to distinguish between different states of the world. The authors find that once their model has switched to a regime it stays there between 2 and 5 years. In the different regimes very different assumptions of correlations and returns go into a MVO-process with very different asset allocations as a result. This is a seriously geeky book with its combination of portfolio theory and financial psychology and it's a relatively heavy read for the less mathematically inclined. Yet it is an unusual and important book that addresses several of the most acute topics discussed in pension funds today. Regime switching models are quite the rage currently and as they often use volatility based signals to differentiate between regimes, the difference in resulting allocation versus risk parity-strategies might in effect not be that large. It is also obvious that these models are active allocation strategies and as such they cannot be used by all investors collectively, i.e. they are not macro consistent (in fact it would be highly un-stabilising for the market if too many used the strategy). That doesn't mean that the models couldn't be good for those who use them. However, the behaviourising of the utility function is clearly very innovative work. I've not seen it anywhere else. If I could have wished for a more comprehensive coverage of one related topic it would have been the time variance in expected returns. The authors show a clear understanding of psychology when concluding that it is better to have a slightly suboptimal portfolio that is possible to stay with, compared to an optimal portfolio that is psychologically unbearable and as such is sold at exactly the wrong time. As J.M. Keynes put it: "There is nothing so dangerous as the pursuit of a rational investment policy in an irrational world." This is a review by investingbythebooks.com of 9 people found the following review helpful. Confusing. There are much better books on this topic than this one. See for yourself. By Contrarian This book is framed in sound behavioral finance findings. It seems to be addressed to individual investors. But it doesn't really explain things in ways that individuals could understand it. It has lots of equations that are not explained well and the writing uses jargon unnecessarily (I give a sample paragraph below). It never gets tangible enough to make it clear what they are talking about. The advice varies dramatically from chapter to chapter. In chapter 7 (figure 7.21) they present a dynamic asset allocation model that moves from 70% in "safe assets" in late 2006 (I'm reading off a graph so I can't tell the exact dates) to 20% a few months later and ultimately down below 10% in June 2007. Then the "safe assets" are back up to 80% a few months after that and sit at 100% from July 2008 to Dec 2009. This is the less active, "target risk" model. Their "optimal" strategy frequently moves from 50% safe to zero and then back to 50% in a couple of months. This is because they estimate expected return and risk based on a short-term, backward-looking model. But, elsewhere in the book they emphasize the importance of sticking to a long-term plan and looking for a methodology that will reduce anxiety. So, I don't know how anyone will benefit from this book. The only reason I can imagine for their writing it is that they expect to hand it to potential clients who will probably (ideally?) not read it but will be impressed that they wrote it. Here is a "look inside" -- that is, a sample paragraph chosen more or less at random. "For September 2010, we see that each level of risk tolerance will pick the portfolio where the indifference curve is tangential to the efficient frontier, that is, the portfolio that optimizes expected utility or, equivalently, desirability. Notice in particular that the portfolio chosen by the middle investor with $T = 1$ has monthly volatility of 6.1 percent (annual volatility of 21.2 percent), which is substantially higher than the constant 8 percent annual target. This may seem extremely risky for a moderate-risk investor, but recall that we deliberately

selected this period because it represented a period of high expected returns. In this benign environment, when expected returns are high relative to risks, all investors should be taking more risk than usual rather than being stuck at an exogenously imposed constant level--in fact, even the low-risk-tolerant ($T = 0.5$) investor has an optimal portfolio with an annual volatility of 13.7 percent. This level will change optimally from period to period rather than being constrained by a constant target volatility that would be imposed without having the use of an appropriate indifference curve mapped to risk tolerance. Thus, even if we impose variance as a risk measure on the assets in our investment universe, the utility framework can still improve expected performance by choosing the right level of variance endogenously." Servigny, de (2012-01-04). Behavioral Investment Management: An Efficient Alternative to Modern Portfolio Theory (Kindle Locations 4370-4379). McGraw-Hill. Kindle Edition. Michale Pompian's books look much better Behavioral Finance and Investor Types: Managing Behavior to Make Better Investment Decisions (Wiley Finance) Behavioral Finance and Wealth Management: How to Build Optimal Portfolios That Account for Investor Biases (Wiley Finance) 1 of 2 people found the following review helpful. While the book is an excellent treatise worthy of the time required to study the ...By Uncle Jimmy the Pilgrim While the book is an excellent treatise worthy of the time required to study the material diligently, it's admittedly somewhat esoteric and likely beyond most who never had calculus or other advanced mathematics. Nonetheless, the authors' insights provide alternative ways to approach the investment management process. Keep an open mind, and let the inferences enter your cranium.

The End of Modern Portfolio Theory Behavioral Investment Management proves what many have been thinking since the global economic downturn: Modern Portfolio Theory (MPT) is no longer a viable portfolio management strategy. Inherently flawed and based largely on ideology, MPT can not be relied upon in modern markets. Behavioral Investment Management offers a new approach--one addresses certain realities that MPT ignores, including the fact that emotions play a major role in investing. The authors lay out new standards reflecting behavioral finance and dynamic asset allocation, then explain how to apply these standards to your current portfolio construction efforts. They explain how to move away from the idealized, black-and-white world of MPT and into the real world of investing--placing heavy emphasis on the importance of mastering emotions. Behavioral Investment Management provides a portfolio-management standard for an investing world in disarray. PART 1- The Current Paradigm: MPT (Modern Portfolio Theory); Chapter 1: Modern Portfolio Theory as it Stands; Chapter 2: Challenges to MPT: Theoretical--the assumptions are not thus; Chapter 3: Challenges to MPT: Empirical--the world is not thus; Chapter 4: Challenges to MPT: Behavioural--people are not thus; Chapter 5: Describing the Overall Framework: Investors and Investments; PART 2- Amending MPT: Getting to BMPT; Chapter 1: Investors--The Rational Investor; Chapter 2: Investments--Extracting Value from the long-term; Chapter 3: Investments--Extracting Value from the short-term; Chapter 4: bringing it together, the new BMPT paradigm; PART 3- Emotional Insurance: Sticking with the Journey; Chapter 1: Investors-- the emotional investor; Chapter 2: Investments-- Constraining the rational portfolio; PART 4- Practical Implications; Chapter 1: The BMPT and Wealth Management; Chapter 2: The BMPT and the Pension Industry; Chapter 3: The BMPT and Asset Management