Diversification still holds water

Nobel laureate Harry Markowitz says investments in diversified portfolios give the best returns despite debt crisis, writes **GENEVIEVE CUA**

IF YOU consult a financial adviser for your investment portfolio, it is highly likely that in the process of designing that portfolio, he or she used a computer to model its risk and returns in the effort to find a combination of assets that suited you.

That process and structure is a legacy of Nobel Prize laureate Professor Harry Markowitz, whose research in the 1950s crystallised the concept of portfolio diversification – a concept that is still very much alive in today's advisory practices.

Late last month, managed futures fund manager Superfund linked its local and regional distributors – banks and financial advisers – to a video conference with Prof Markowitz, where the audience could e-mail questions.

Not surprisingly, many of the questions centred on this issue: Are portfolio theory and diversification still relevant, particularly in the light of the current sub-prime loan crisis and credit crunch when correlations among various assets are suddenly and visibly higher?

Mr Markowitz's reply is unequivocal. "As far as the model goes, and portfolio theory goes, the sub-prime mess doesn't change anything. You have some kind of time horizon. You have the universe you're investing in, which can be asset classes...

"You know there is inflation, volatility... So you make your estimates of expected returns and variances and covariances, and you have the portfolio theory."

He adds: "Is it applicable in bull or bear market? You don't know in advance whether it's a bull or bear market. Usually I say you have a little money, invest it, put it into a diversified portfolio, somewhere on the efficient frontier." The efficient frontier is a line in a risk/reward graph, which represents the most optimal portfolios. That is, they deliver the highest return for the least amount of risk.

Prof Markowitz first published his doctoral thesis "Portfolio Selection" in 1952 on what is today known as modern portfolio theory. Prior to his work, investors focused on the risk and return of individual securities. The standard advice then was to pick the securities that offered the best return with the least risk and to construct a portfolio from these.

Prof Markowitz proposed that investors should instead select a portfolio based on its overall risk/reward profile, rather than focusing on each underlying stock's risk and return.

He sought to demonstrate mathematically that a diversified portfolio consisting of assets that have low correlation to each other can deliver higher returns at a lower risk than portfolios that are not diversified. In 1990, he shared a Nobel Prize with Merton Miller and William Sharpe.

One of the main insights for individuals and institutions is that they should think of their investments as a portfolio, rather than scrutinise individual securities.

In a separate interview with Superfund chief Christian Baha, Prof Markowitz said: "The main point I would make is that (the average investor) needs to concentrate on the portfolio as a whole. It's not about the risk of an individual investment as much as how different investments react to each other.

"Do they go up and down together or do they react independently of each other? We speak of that as covariance or correlation. If the investments within the portfolio react independently of each other, they have zero correlation and almost no risk."

On the recent rise in correlations, Prof Markowitz points to the fact that securities and commodities, for instance, have been historically uncorrelated for long periods of time.

"You cannot take a short period of time when everything is going up or down, and you observe that everything is correlated...

"I predict that one day the Fed is going to notice inflation. The Fed doesn't see inflation – that I don't understand. The price of coal is going up, oil is going up, wheat is up. The price of housing is down, but forget about that. (The Fed) will say, 'Hey, there's inflation' and they're going to step on the brakes and you'll go through the windshield if you haven't got your safety belt.

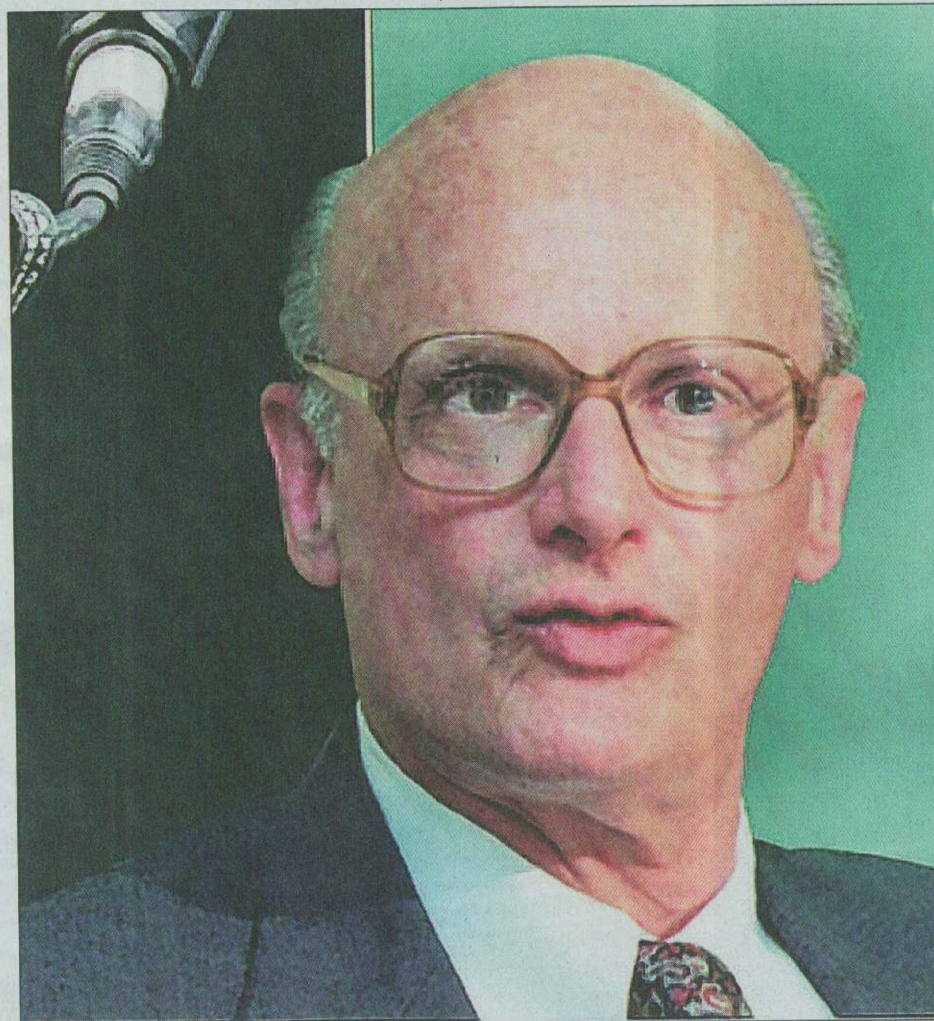
"Commodities would maybe come down, or drift up while stocks come down ... Commodities versus securities have been uncorrelated in the past and will be no more correlated in the future as well."

So how does Prof Markowitz himself invest? Into a diversified portfolio, "somewhere on the efficient frontier", he says. "Once a year, when you do your taxes, you see how you're doing. That's what I do."

"I made a recent exception," he says, when news broke earlier this year of a Bear Sterns hedge fund which suspended redemptions. The fund bet heavily on bonds backed by sub-prime mortgages.

"I said, 'I don't like this market. I'm going to sell my ETFs (exchange traded funds)'.

"I didn't sell all my equities. I have something called the college retirement equity fund; I kept those. But I got rid of ETFs like SPDRs (which mirrors the S&P 500 index). Then when the Fed dropped rates by 50 basis point, I said I should be in commodities. But almost always with the current exception, I'd say put it in a diversified portfolio."



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'I used to work for Daiwa. I got fired in about 2000 because my portfolio was lagging. They got someone new in January 2000 to reposition the portfolio, just before March 2000 (when the tech bubble burst).'

'If you say you want to win a Nobel Prize, you'd never win one. You have to say to yourself, every theorem I think about, every subject I deal with, is important...The first person you have to please is yourself.'

– Prof Harry Markowitz