

Kaplan, Paul D. - Frontiers of Modern Asset Allocation

John Wiley & Sons, 2012, [Finance] Grade ★★★★★

Paul Kaplan is one of the more innovative thinkers in finance. After leaving Northwestern University Kaplan has spent over two decades at Ibbotson Associates and later Morningstar – after they bought Ibbotson – currently as the research director for Morningstar Europe. Kaplan's thinking spans over almost any topic in finance apart from perhaps individual security selection. Kaplan's eclectic thinking is on full display in this book that collects a number of the author's best papers grouped under a number of headlines.

It's impossible to cover all the topics in the book. However, a few papers stand out. One is "The Long and Short Commodity Indexes" where the author presents a convincing argument that commodity futures' indexes' should be constructed as long-short-indexes instead of normal long-only-indexes. With a rule based trend following long-short strategy the index can reap the benefits of markets that are both in backwardation and in contango. A few texts cover fundamental indexes. One pleasant feature in this book is that a number of papers on the same topic often are rounded up by a debate. A discussion between Kaplan and Robert Arnott of Research Affiliates ends the topic of fundamental indexes. Consensus is reached on that these might be effective strategies as they combine a value reweighting of the index constituents with a flexibility to increase or decrease the bet that is taken versus a market cap weighted index depending on the grade of over- or undervaluation, but they do not represent a new way to define the equity market per se.

Arguably, the most important paper in the book is Markowitz 2.0 (also discussed by Harry Markowitz and Sam Savage with Kaplan as the moderator). The topic is what could be done to update and improve the mean variance optimization framework. The improvements include using the geometric mean of returns, risk measures that better account for the fat tails, using scenario

analysis to understand the time varying nature of correlations etc.

My favourite paper however is another one. In fact, it might be one of my favourite papers all time. How often have you heard that asset allocation determine 90 percent of the returns in asset management? In the paper "Does Asset-Allocation Policy Explain 40 Percent, 90 Percent, or 100 Percent of Performance?" Kaplan addresses the fact that most people misunderstand the classic 1986 paper by Brinson et. al. There are actually three questions with three very different answers. The first question is how much of the variability of returns across time in the average fund is ascribed to asset allocation as opposed to security selection? The answer is that asset allocation accounts for 90 percent of the variability in the returns from one year to another for asset managers in general. This is the question Brinson et. al. answered. The second question is how much of the variation between different funds that is explained by asset allocation in a specific year. This is the question most people think Brinson et. al. answered. In Kaplans study the answer is 40 percent and hence security selection accounts for the main difference between competitors a specific year. Finally, the question could be what percent of the returns for the average fund that is explained by asset allocation. As alpha is zero for all participants in the market the answer is obviously 100 percent.

Based on the papers above this is clearly a book that deserves the highest rating. The problem is that some texts are unique and cutting edge, others are fairly plain. Some texts are highly mathematical while others are very short and simple. The book isn't coherent enough.

I highly recommend reading the top five or so of these papers. They are clearly in the forefront of the thinking in asset allocation. If you can't get them in another way, buy the book.

Mats Larsson, March 10, 2012