Picerno, James - Dynamic Asset Allocation

Bloomberg Press, 2010, [Finance] Grade ★★★

James Picerno is a journalist who has been writing about finance for more than twenty years. Well, he sure picked up a lot of things on the way. Apart from a whole lot of knowledge he acquired a religion, the faith of Modern Portfolio Theory (MPT) and its belief in efficient markets in equilibrium. This book is one part biased chronological odyssey of academic papers on portfolio theory and one part useful discussion on how to compose a multi asset portfolio.

The first five chapters give the reader an overview of the development of the academic field of portfolio theory, but it doesn't begin with Harry Markowitz's Portfolio Selection in 1952 as would be customary. Picerno instead begins two decades earlier with the 1934 publication of Ben Graham's and David Dodd's book Security Analysis and the notion that the return on an investment depends on the price you pay for it. An obvious statement that was for a long time forgotten by financial academia. After this the author introduces the standard building blocks of MPT with a) Markowitz's notion that investors want to optimize returns and risk (measured as volatility); b) James Tobin's Security Market Line; c) Bill Sharpe's conclusion that the market cap weighted portfolio of all assets is the optimal portfolio and d) Paul Samuelson's research on the randomness of securities prices that lead Eugene Fama to proclaim markets efficient.

Enter the 80's and cracks in MTP start to emerge with the discoveries of numerous so called anomalies and the papers showing that CAPM doesn't do the job. Hence the current religious war amongst rationalist and behavioural explanations starts. The author is buried in the trenches of the rationalists. He even tries to make the crash in 1987 and the TMT-bubble into "rational bubbles". Well if those events were rational the distinction between rationality and irrationality ceases to exist! The core of the defence is that anomalies are previously unexplained risk factors, that the huge swings in market prices aren't caused by irrational herding behaviour but of rational changes in risk premias due to differences in investors utility during varying economic conditions and that investors don't beat the market. My humble opinion is that if you have a thesis on how the world works and this turns out to be untrue, it's intellectually dishonest, and frankly a bit childish, to simply incorporate the new evidence in the original thesis and say that you were right all along. As the old saying goes "If it looks like a duck, swims like a duck, and quacks like a duck, then it probably is a duck." However, even if Picerno insists on calling the market animal a donkey he still goes on to giving good practical advice on how to treat the duck.

The nursing instructions include adjusting the strategic asset allocation according to investor's unique situation and risk tolerance, incorporating the notions of time varying volatilities and correlations, using multiple time periods (as opposed to Markowitz one period mean variance portfolio optimization model) but more importantly, they take Ben Grahams insight of time varying expected returns due to differences in valuation levels to heart to develop a practice of dynamic asset allocation. Picerno also extends this last insight to the premias earned on the anomalies, i.e. small caps, value stocks etc. Perhaps the discussion on what actually constitutes risk ought to have been expanded but the author should be commended for trying to show the reader a contour of how portfolios could be constructed in a post-Markowitz world.

Still, this book isn't really satisfactory. For those interested in how capital markets theory has developed I would recommend the late Peter Bernstein's Capital Idea's Evolved from 2007. The problem is that apart from Picerno's book I haven't come across one with a comprehensive framework for dynamic asset allocation. Does this motivate buying the book? Yes, perhaps.

Mats Larsson, March 20, 2012