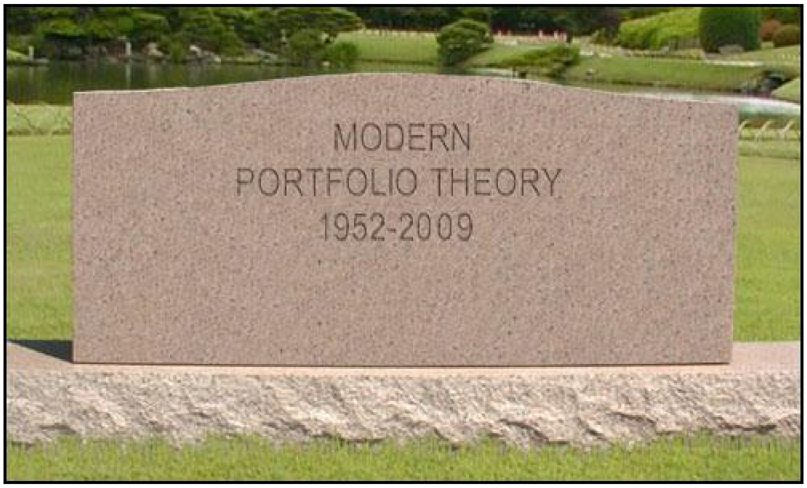
Is Modern Portfolio Theory...Dead?



"The report of my death was an exaggeration". Mark Twain

The market ups and downs of 2008 and 2009 had gurus and pundits crying that Modern Portfolio Theory (MPT) was dead and no longer relevant in the new world of investing.

Many market prognosticators predicted that we were headed to the next depression and the coming years would be filled with gloom, doom and despair. (See Harry Dent's The Great Depression Ahead). For many investors this was a period of emotional unrest has market swings made their stomach weak. The media and pundits didn't help as they fueled the fire with a barrage of bad news.

It was in this market environment that **Modern Portfolio Theory (diversification) was declared dead**.

So, let's take a look at Modern Portfolio Theory and explain what it is and why it is an important component of a portfolio and how MPT helped investors during this volatile and turbulent time.

Modern Portfolio Theory or MPT for short is the Nobel Prize winning work of Harry Markowitz. MPT explains how to build an optimal portfolio for a given amount of risk (think volatility). In other words, it is quite possible to achieve decent returns with relatively low risk. Here's how it works: by investing in a portfolio (think asset allocation) of asset classes (large stocks, small stocks, value stocks, international stocks, bond, etc.) you increase the mathematical odds of maximizing your returns since these asset classes tend not to move up and down together or in the same way (think diversification).

Many MPT critics look at the S&P 500 over the last few years or even the last ten years and make the bold claim that MPT is dead. Note: the S&P 500 had a 10-Year Annualized Return of 1.41%. However, there are a lot more asset classes that a global, diversified long-term investor invest in.

So is MPT (Diversification) dead?

Lets start in 2000 with a $100,000 with a portfolio that we will call **The DEATH OF MPT Portfolio**. It is made up of the following asset categories:

14% S&P 500 Index
6% US Large Value Index
6% US Small Cap Index
6% US Small Cap Value Index
18% MSCI EAFE International Index
40% US Aggregate Bond Index
10% Diversified Trend Indicator Index (DTI)

2000-2002 A Major Plunge

In the years 2000-2002, the stock market plummeted losing half its value. The S&P 500 scared investors as it returns looked like this:

2000 −9.10%
2001 −11.89%
2002 −22.10%

However, **The Death of MPT Portfolio** (since it was made up of asset classes that moved in an opposite direction (MPT), held up pretty well:

2000	4.41%
2001	−0.96%
2002	−3.68%

By the end of 2007, **The Death of MPT Portfolio** had grown to $170,987.00. In the words of Merton Miller, Diversification or MPT was our friend.

But another market crash was lurking around the corner.

2008 Another Major Plunge - OUCH

We all remember what happened. The global markets melted, the real estate bubble burst and investors panicked as they watched their portfolio values plummet.

This market plunge was different than the plunge of 2000-2002.

William Bernstein, investment academic and market historian stated:

In 2000-2 the markets functioned in an orderly fashion, whereas in 2008-9 they did not. And when markets do not function properly, there are only two kinds of assets: riskless ones and risky ones. And the risky ones, every single one of them, get taken out and shot en masse. This is what happened in 2008-9, whereas in 2000-2, because the markets functioned normally and the preceding bubble was limited to only a few asset classes, this didn't happen.

MPT Not Dead

At the end of 2010, **The Death of MPT Portfolio** was worth over $180,000. The only thing that was required by you, the investor, was to remain calm, focused, disciplined (rebalance the portfolio) and ignore the media and the gurus. The causes of market crashes will always differ so your best bet is to invest with the skill of a mathematician.

MPT is not dead.

Notes:

Portfolio shown is comprised of index funds and not actually mutual funds or ETFs. Investors cannot invest directly into index funds. Past performance does not guarantee future results. Returns shown do not take into account any investment mangement fees. The inspiration for this post is credited to Allan Roth, columnist and writer for CBS Money Watch. Read Allan's Irrational Investor column at http://moneywatch.bnet.com/investing/blog/irrational-investor/

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