modern investment management

By Bob Litterman & the Quantitative Resources Group
Wiley Finance
626 pages

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A good deal of praise has already been bestowed on this work, and for good reason. This is an ambitious work, of wide scope. It does not contain an exhaustive or complete analysis of each topic, but is does provide a very useful menu for the student, practitioner, or the serious investor to identify and think about all the primary issues of modern portfolio management.

The reader should be forgiven for worrying as to whether this book is simply a flagship marketing tool for Goldman Sachs, and even if it is not, then – as Litterman quotes in his Preface: “If those folks at Goldman Sachs who wrote this book really knew anything worthwhile about investing, why would they put it together in a book where all of their competitors could find it?” Or, as he puts it another way: “somehow it doesn’t make sense for good investment managers to write books about their craft” – for, in a world of true efficient market equilibrium, when good ideas are promulgated within the market, then those ideas will be quickly priced in or applied by all, and so no longer provide any edge or alpha.

These questions are answered by propounding what the book is about. It is concerned with identification and analysis of those phenomena that are consistent with and will survive in equilibrium. Thus, if all investors implement them, the value of the phenomenon will still endure. Take diversification into international equities. If it can be shown, as they contend, that an allocation to international equities, when added to domestic equity exposure, does give a higher level of return for the same level of portfolio risk, then this is a phenomenon that is consistent with equilibrium, and it is what this book is concerned with. There is a lot in the book about equilibrium theory, and it is interesting to note how this word is now popping up with increasing regularity – sometimes in a seemingly incongruous context. The authors accept equilibrium, but are always looking for how to take advantage of deviations from it, and how to apply equilibrium consistent strategies to advantage.

Whatever the true motivation, what comes through in the entire text is a thoroughly professional quest for understanding the really challenging and important issues of portfolio management. It does not seem plausible, that twenty two senior investment managers in Goldman Sachs, would intentionally sit down and write a light-weight investment book, expurgated of ideas that their competitors might use! My reading tells me the opposite: they have endeavoured to provide an incredibly insightful and revealing analysis of the major issues of today. The qualifications and experience of this team is daunting, and it might be recalled that Goldman Sachs has been at the forefront of fundamental and quantitative research going back 50 or more years: see the review of Henry Kaufman’s book, A Wall Street Memoir on Money and Markets, this web site. Litterman worked extensively with the late Fischer Black, and he developed the Black-Litterman Global Asset Allocation Model, which is still used in Goldman’s asset allocation process.

Each co-author covers a topic within their area of expertise, and although it is possible to find superficial inconsistencies within the total text, the overall substantive result is a cohesive coverage of high consistent quality. The book is divided into six parts, and this works well, as the reader can focus on one general area at a time and then revert to other parts as required. For example, I initially honed in on Part Six: Wealth Management; and there found a most revealing analysis of many of the issues that have been troubling me of late, and on which I have seen scant mention in Australia. For example: Chapter 30 on “Real, After-Tax Returns of US Stocks, Bonds and Bills 1926 through 2001”. Not what we constantly see here: the last 20 years, or so, of a bull market; but 75 years of performance through two world wars and multiple economic cycles. Here the authors delve into the twin ravages of tax and inflation, and their analysis and findings are apposite to the Australian environment – even their tax numbers appeared to me to be broadly comparable to our history.

Thus, in Part Six, I was hauled back to the reality of after tax results, and how truly unattractive bonds can be over the long term. Other parts deal with topics of arguably weightier moment:

Part One, Theory on: modern porfolio theory, and value creation under equilibrium and disequilibrium conditions; risk management; CAPM; the equity risk premium; and global equilibrium expected returns

Part Two, Institutional Funds on: strategic asset allocation; international diversification and currency hedging

Part Three, Risk Budgeting – a fairly technical look at all the primary issues, including covariance matrix estimation, return attribution and equity risk factor models. Some, inevitable algebra, but couched in readable terms with practical observations and conclusions

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Part Four, Traditional Investments – oddly titled, but more concerned with practical implementation of an institutional mandate/portfolio, eg manager selection. Chapter 23 contains a frank assessment of active equity management in the US and cites Malkiel (also this web site) for the proposition that few active managers have out-performed the US equity market. There is also an overview of fixed interest risk and return, and this is as much as most investors will ever need to know

Part Five, Alternative Asset Classes, on: tactical asset allocation; hedge funds (note: Goldman Sachs does manage a major hedge fund); and private equity.

This is a major work that will be of value to both the student (some maths and terminology might be a challenge) and the industry/institutional practitioner. It can be consumed in digestible bite sizes, and it may be kept as a useful reference tool for later use – I have already found myself referring clients to sections of text. It is not a "how-to" book, but rather an indispensable component of any library on investments, where most macro issues are addressed by experts who practice their craft in – perhaps – the world's oldest and most professional investment research house.

MARTIN EARP
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