In Praise Of Innovation
What Investors Should Consider
About Both MPT And
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Sometimes an idea can come from an unrelated field. Here's an example.

For several months, rumours circulated on the internet about an unorthodox medical break-through that dealt with a heart-wrenching disease called Multiple Sclerosis (MS).

Conventional thinking said MS was an auto-immune disease whereby the body's own defence system attacked the nerves' myelin coating, rendering them inoperative. There is no known cure and treatments vary.

While doing research to help his wife who was afflicted with MS, Dr. Paolo Zamboni, a professor of Medicine at the University of Ferrara in Italy, became convinced that MS was actually a vascular problem related to blockages in veins that lead to the brain.

Furthermore, a relatively simple procedure (akin to angioplasty) would remove the blockages and restore normal blood flow. When he performed the procedure on his wife, the results were immediately positive.

Canada's media jumped on this story, fuelling considerable excitement and re-focusing worldwide attention on this oft forgotten illness.

While Dr. Zamboni's findings do not represent a cure, it holds the possibility of being a much better treatment.

What's important (aside from the medical aspect) is that by ignoring the conventional, profound change occurred. Throughout history, whether accidental or deliberate, innovation has led to great change. Likewise in finance. Currently, the bedrock of finance is Modern Portfolio Theory (MPT) which had its genesis in the '50s by Prof. Harry Markowitz.

His research focused on how to incorporate risk into investment decisions in order to optimize portfolios. The key assumption, all rooted in economics, is that rational people want lower risk whenever it is achievable (or risk aversion). Mathematically, standard deviation became our statistical proxy for risk.

An optimal portfolio minimized risk by adding securities. Real diversification occurred whenever the newly-added securities had low, or negative, correlations.

However, regardless how many securities were added, risk was never eliminated. Rather, it fell to the same level of the asset class.

Now applying this concept to multiple asset classes, it was possible to create 'optimal' portfolios that targeted return and risk. All that was needed was computing power. For his insight, Markowitz won the Nobel Prize in 1990.

Market volatility over the past few decades resulted in considerable attention being focused on MPT's assumptions. Chief among them are:
- people behave in a rational manner
- asset class correlations remain relatively static in the long run
- returns are distributed normally

Was it truly reasonable that just two statistics, expected return and standard deviation, were really the key decision drivers?

As in other fields, non-conventional views arose and it led to development of Behavioural Finance. At its core, behaviouralists say all decisions are rooted in human psychology. They reject the premise that people make decisions mathematically and point to numerous studies which show humans have built-in biases. These biases often lead to sub-optimal decisions.

Behaviouralists believe one reason behind recent market volatility is herding. Herding can make capital markets erratic and explains why correlations can spike dramatically during crises. Furthermore,

studies indicate people normally make decisions on shorter timeframes than MPT predicts. Essentially, people's timelines are aligned to their personal perspectives. This is vastly different for everyone.

MPT's supporters say their theories work well in the long-run and any short-term deviations from expectations revert back to the long-term norms, provided sufficient time and patience exist. Paraphrasing Benjamin Graham, markets work like voting machines in the short run (emotionally), but like weighing machines (logically) in the long run.

While behavioural finance is innovative, it's not predictive on timing and direction. By contrast, MPT is predictive, but offers no assurance that short-term results match long-term data. In other words, both offer theoretical ways to avoid risk.

While finance seeks to answer some big questions, it's still a young field. So like medicine, expect innovation to continue.

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