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The Black-Litterman Model for Structured Equity Portfolios

The Journal of Portfolio Management
Winter 2007, Vol. 33, No. 2: pp. 24-33
DOI: 10.3905/jpm.2007.674791

Robert C Jones , Terence Lim , and Peter J Zangari

The Black-Litterman model enables the development of sound inputs for portfolio optimization. Before Black-Litterman, investors were often frustrated by the seemingly unreasonable solutions that portfolio optimization techniques would produce. Many either abandoned the technology or relinquished most of its benefits by applying so many constraints that the solution was largely predetermined. In fact, any “unreasonable” solutions have been not so much a problem with optimization per se, but rather the result of feeding inconsistent risk and return forecasts into an optimizer. To be effective in optimization, risk and return forecasts must be consistent with one another. When structured equity portfolio managers who develop views based on factors (like value or momentum) want to use the Black-Litterman model to construct equity portfolios, they generally focus on returns relative to a benchmark. The basic Black-Litterman approach is robust in this case and easily adaptable to the problem at hand.

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