Title:
How Modern Portfolio Theory Could Wreck Your Retirement!

Word Count:
395

Summary:
Modern Portfolio Theory is a standard investment theory but has inherent dangers for investors who don't understand it.

Keywords:
investments, stock market timing, timing the stock market, asset allocation, modern portfolio theory

Article Body:

Modern Portfolio Theory altered the investment landscape forever when it was introduced in the 1950s by Nobel Prize winning economist Harry Markowitz.

Virtually every financial planner and money manager touts its tenets of asset allocation and risk management but is it even valid? And if it is, does anybody understand it well enough to put it into efficient practice?

What is it, anyway?

Modern Portfolio Theory (MPT) was developed in the 1950’s by a graduate student at the University of Chicago named Harry Markowitz who later went on to win the Nobel Prize in 1990 for his work in finance and economics.

Published under the title, “Portfolio Selection” in 1952 in the Journal of Finance, MPT says an investor must diversify to reduce risk and increase return.

For example, an investor who buys a stock that profits on cloudy days and buys another that profits on sunny days, will theoretically profit regardless of the weather.

An over simplification of MPT is a fixed asset allocation portfolio invested in bonds, gold, large companies and small companies. Bonds and gold assets would typically under perform when large and/or small company stocks are doing well — and vice versa — assuring that some portion of the portfolio is always increasing in value. But does it really work?

Like all theories, Modern Portfolio Theory has serious short comings when applied to the real world.

Here are some of the significant problems for investors looking for solid returns and a safe retirement:

1. MPT guarantees that a large portion of your portfolio will under perform the market at all times.

2. MPT assumes that assets will act without correlation, that is, they will act differently from one another. However, market historians have proven that this isn’t always true.

3. MPT doesn’t keep up with or perform as well as the overall markets.

4. MPT is based on a 70 year investment time period. If you can invest for 70 years, MPT can work for you. However, most investors don’t have a 70 year time horizon.

Your retirement money is the most important money in the world, and it’s only good common sense to make certain it’s deployed in a portfolio that is both risk averse and at the same time offers significant upside potential.

However, it’s quite likely that Modern Portfolio Theory is not the right answer for many modern investors.