Concepts of Institutional Investing

Do you believe in magic?

Modern Portfolio Theory

- Harry Markowitz
  - Ph.D thesis in the mid 1950’s
  - Wanted to add risk analysis to understanding of stock prices
  - Won the Nobel Prize in Economics in 1990

Modern Portfolio Theory

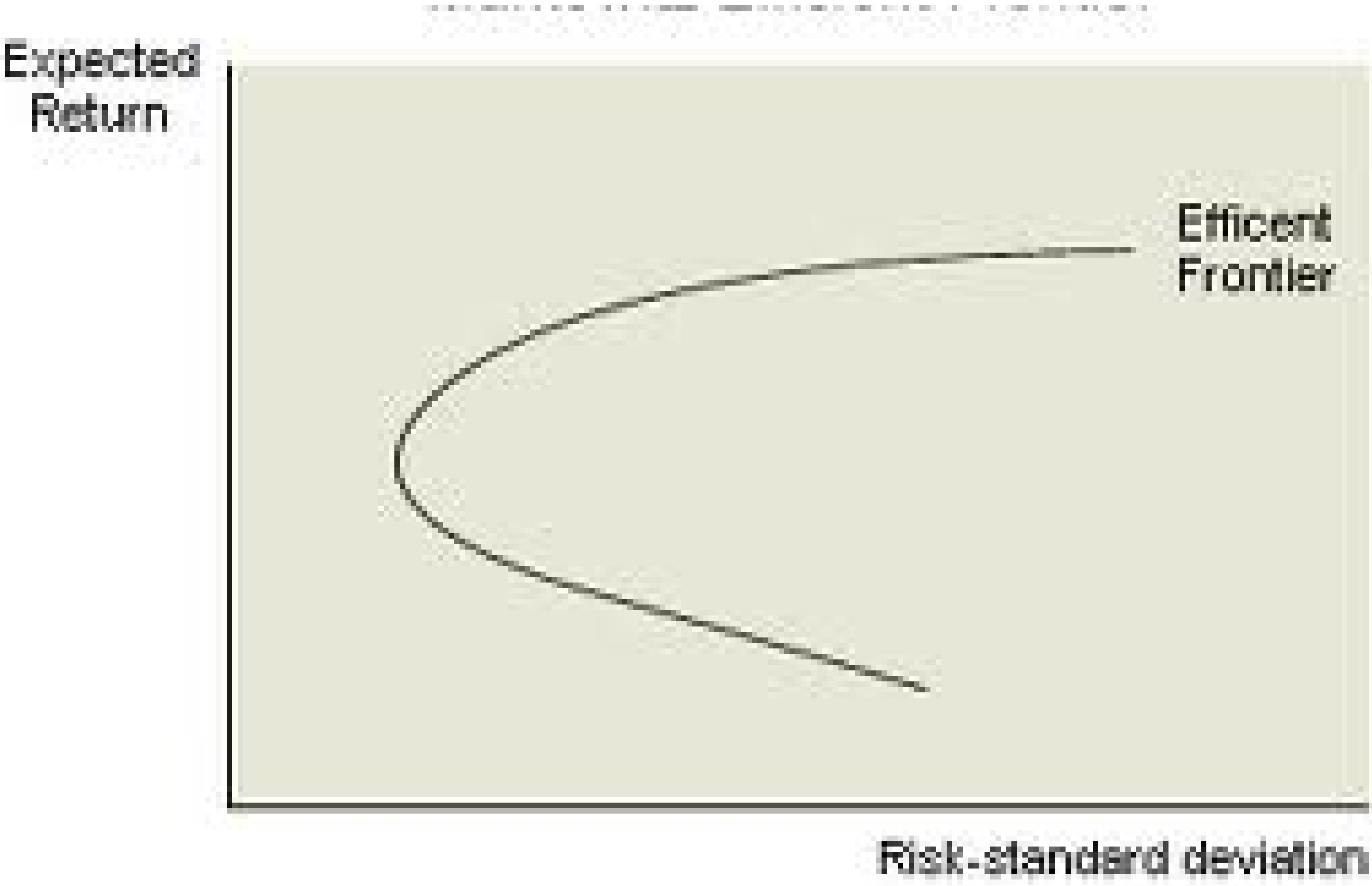
- Markowitz developed MPT

- Also called mean variance analysis

- Based upon expected “mean” (average) returns

- Defines risk as “variance” or variability

The Efficient Frontier



- Adding riskier assets can increase return

- But they can also reduce risk

- It depends on “correlation”

- But they KEY requirement is time

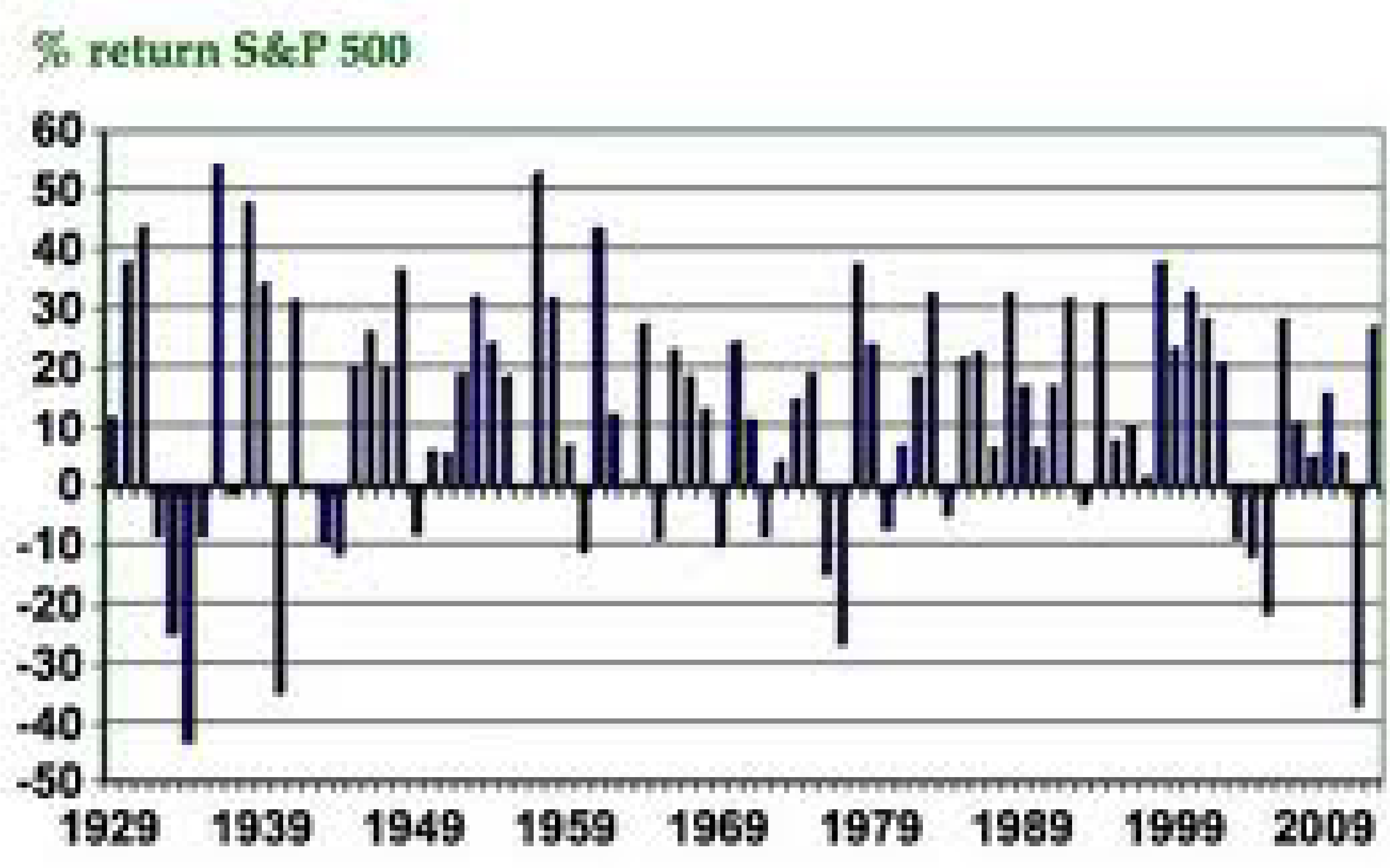
Long term returns

- Stocks---9.9%

- Bonds----5.5%

- Treasury Bills----3.6%

Stock market returns



All of this and Funding

- Asset allocation based on “mean” or average

- Any short term time period can be very different than the “mean”

- No one knows the future

- The last period effect and the “time fallacy”

So what rate do we use?

- Historic or predicted rate
- “Economic” rate
- Tremendous difference in funded status

Some more recent developments

- Active vs Passive in MPT context
- Alternative Assets
- A “low return” world?

And about those correlations

- Efficient frontier depends on stable correlations

- Assets without long history may or may not have stable correlations

- Only bonds maintained historical correlation in recent downturn

Alternative Assets

- What are they?
  - Asset classes
  - Manager skill
- Why are they attractive?
- How do they fit into MPT?