Editorial: With difficulty

The last two centuries have seen biology transformed by Darwin, psychology by Freud and economics by Keynes. Have we yet seen investment management transformed by Markowitz?

It is true that significant slices of national and international equity portfolios are currently index matched, and that many of the attributes of modern portfolio theory are applied to portfolio construction and monitoring, notably various kinds of risk analysis. But these developments are no more than a part of the investment management profession, and the scientific theories which have been developed are not pervasive in their effect on the way in which portfolio management is addressed. And indeed they should be pervasive, in that the larger shares in the larger markets — by capitalisation, the vast majority of equity investments in the world — are efficiently priced. However efficiency may be defined, and whatever the correct analysis of risk, and whatever degrees of inefficiency may exist, especially in smaller markets or in smaller shares, the whole investment problem should now be looked at in the light of modern portfolio theory. The techniques of this approach should not be referred to as obtuse, peculiar and mathematical: one might just as well say that the details of a heart operation are too obtuse to be given real credibility. Judgmental fund management should be seen as a sub-theorem of overall efficiency, not as a route in itself.

And yet this is not the case. It has

been said that the only believers in the inefficiency of markets are Fidel Castro, North Korea and judgmental fund managers. In what other field as important as ours could it be said by a senior investment professional that he ‘did not believe in the efficient market theory’? Such obscurantism should not be admitted. The evidence for the substantial efficiency of the major shares in the major markets is now overwhelming both in the discrete manifestations of efficiency in particular situations and in the overall inability of active fund managers to maintain a consistent above-average performance. Why is the past performance of funds no guide to future performance, as publicly recognised by the Financial Services Authority? The very fact that it is difficult to distinguish between luck and skill is an indicator of significant efficiency. To persist in employing judgmental management as a separate discipline is not, in view of the evidence now available, intellectually respectable. And since the vast majority of those concerned are in a position of responsibility in the management of other people’s money, it is not respectable on a moral or professional basis either. What was acceptable in the 1970s or even the 1980s should not be acceptable now, 40 years after the academic evidence appeared and after so much further evidence has accumulated in so many markets.

It must be admitted that external forces are not very conducive to a

correct approach to this matter. Even very intelligent and well-educated observers from outside our profession simply cannot believe that the traditional methods of fund management, and the analysis of individual shares on an idiosyncratic rather than on a scientific basis may be inappropriate. To suggest that this is the case often causes a reaction similar to that noted by P. G. Wodehouse in the eyes of a parrot when offered half a banana by someone of whose bona fides it was not altogether sure. But in view of the importance and the technical nature of our profession, these views of laymen should not be given much weight. They may be clients, but would a doctor modify his method of operating because of the views of his patients?

Looking at markets rather than shares, it is possible — indeed perhaps probable — that in today's global environment markets are not efficient with respect to each other. Economic analysis appears to offer chances of analysis. But in this context as in others, we come across the fallibility of economic analysis. As Lord Bauer has pointed out, there is a dramatic contrast between the exalted status of economics and the inexact standards of the subject. When the many and brilliant economists contained in the

US Treasury do not forecast beforehand and cannot explain afterwards why the yen has made a sharp movement against the US dollar, it is clear that economic analysis in the traditional and judgmental way is of limited use to fund-managers.

Of course there are inefficiencies, and of course they should be pursued. But they should be pursued within the intellectual structure of the whole corpus of modern portfolio theory as it has now been developed. This may lead to a considerable increase in index-matched portfolios but, even if it does not, it must lead to a more scientific approach to active management and a more complex view of risk. It should lead to a considerable downgrading in the volume and perhaps the status of judgmental activity — perhaps, indeed, the restriction of judgmental inputs to specific applications, to clearly inefficient markets or sectors, or to special types of fund. Active management should be carried out in the same way as a porcupine makes love: it is possible and essential, but can be carried out only with difficulty.

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