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PRACTITIONER'S DIGEST

The "Practitioner's Digest" emphasizes the practical significance of manuscripts featured in the "Insights" and "Articles" sections of the journal. Readers who are interested in extracting the practical value of an article, or who are simply looking for a summary, may look to this section.

CONSUMPTION, INVESTMENT AND INSURANCE IN THE GAME OF LIFE PAGE 5

Harry M. Markowitz

Financial theory considers the portfolio selection problem in isolation, typically for a lone investor whose life consists only of consumption expenditures and investment. In fact, the investment decision is part of a process that includes births and deaths, housing, insurance, education, illness, Social Security, etc. For the most part the investing family, perhaps with the aid of a financial planner, has little if any analytic support in considering these events and decisions, and their interrelations. Markowitz (1991) argued that financial decisions for the individual or family should be considered as part of the "Game of life" that the individual or family plays out. Even reducing this game to its essentials, it is surely too complex to solve analytically, therefore requires computer simulation to think through.

Late in the 1990s Sherrie Grabot, CEO of GuidedChoice (GC), explained to Markowitz that GC was a 401(k) advisory service with a different business model than then used by others in the industry, and invited Markowitz to create a design team for its "back-end." Markowitz gave Grabot a copy of Markowitz (1991), agreed to form a San Diego-based design and production team, and to consult for GC. GC would not try to build a complete Game-of-Life model, but to set it as an ideal—a North Star—toward which it would direct its model-building, starting with the immediate objective of helping investors save for their retirement. As it turned out, the GC design team designed and supervised the building of a set of interrelated programs and procedures that constitute GuidedChoice's Data Support System.

This article presents particulars and performance, including GC's "glide path" solutions that differ from those commonly used in that GC's glide paths are target-date/target-wealth rather than target-date only.

RETIREMENT READINESS AND BEHAVIORAL FINANCE PAGE 24

Burton G. Malkiel

The paper makes several practical suggestions that together could improve the retirement readiness of individuals.

First, it underlines the critical role of savings in preparing for retirement and offers suggestions for improving savings behavior.

Second, it emphasizes how high costs both in the investments used and the administrative costs of retirement plans can disadvantage those who have undertaken an appropriate savings program.

Third, it makes several practical suggestions to improve the design of 401k retirement programs and to help prevent the common mistakes made by individual participants.

Finally, it recommends that a mandatory component be added to current voluntary plans if we are to avoid a retirement crisis. A specific proposal is offered for a mandatory savings plan as an add-on to social security. While the government would collect the money, the administration and investment of the program would be handled by the private sector.

DECENTRALIZATION IN PENSION FUND MANAGEMENT PAGE 35

David Blake, Alberto Rossi, Allan Timmermann, Ian Tonks and Russ Wermers

Over the last 30 years, defined benefit pension funds have decentralized the structure of their delegated portfolios. First, pension fund sponsors have reduced their use of so-called "balanced" managers—those simultaneously managing several asset classes—in favor of "specialist" investment managers within each asset class. Compounding this decentralization has been a move from a single manager asset class framework to multiple, and often competing managers within each asset class. Our article explores the drivers of this secular move to decentralization, as well as the resulting impact on the risk and performance for pension fund sponsors. Since decentralization has occurred not only in pension fund management, but virtually across the entire spectrum of asset management (mutual funds, endowments, etc.), we believe that our study holds great importance in documenting the causes and consequences of the decentralization phenomenon.

Our study reveals some interesting factors behind the move to decentralization. First, the emergence of specialized asset managers—those with skills within one or a few asset classes—has provided pension fund sponsors with a "financial innovation" that has improved the performance of each asset class (especially equities). That is, specialization in asset management has, over time, improved the generation of benchmark-adjusted performance. Second, as pension funds have experienced a large growth in AUM, the hiring of multiple managers within each asset class has both furthered the move to specialization (e.g., replacing an all-equities manager with separate large-cap and small cap equity managers) as well as providing a competitive arena to incentivize those managers to improve

their performance in the face of the natural diseconomies-of-scale in pre-fee performance in asset management.

We find a "lifecycle" of decentralization by pension fund sponsors has emerged with the advent of specialized managers. When the asset pool is small, specialized management is too expensive, and sponsors must settle for a balanced manager to gain economies-of-fees. As the pension fund AUM grows, it becomes increasingly economic to employ specialist asset managers, as the higher fees of specialists are more than compensated by the improved economies in pre-fee investment performance.

AUGMENTED RISK MODELS TO MITIGATE FACTOR ALIGNMENT PROBLEMS PAGE 57

Anureet Saxena and Robert A. Stubbs

The primary objective of portfolio optimization is to create a portfolio having an optimal risk-return tradeoff. If a portion of systematic risk exposure of the portfolio is inadequately captured by the risk model then the resulting portfolio cannot be expected to be optimal ex-post, its ex-ante optimality notwithstanding. Factor Alignment Problems (FAP) symbolizes the difficulty that a portfolio manager (PM) faces in ensuring consistency between the ex-post characteristics of an optimized portfolio, and her ex-ante expectations. Examples of FAP include risk-underestimation of optimized portfolios, undesirable exposures to factors with hidden and unaccounted systematic risk, consistent failure in achieving ex-ante performance targets, and inability to harvest high quality alphas into above average IR. Detailed theoretical and empirical investigation of FAP constitutes the emphasis of this paper.

We argue that lack of alignment between the alpha and risk factors creates risk "blind-spots" that get exaggerated by virtue of employing an optimizer. The resulting optimized portfolios take excessive exposure to systematic factors missing from the risk model thereby compromising the over-arching goal of optimal risk-return tradeoff, as originally envisaged by Harry Markowitz. Based on a detailed analytical investigation, we demonstrate the usefulness of augmented risk models in addressing this issue. Our results indicate that augmenting the base risk model with an appropriate augmenting factor not only remedies the risk underestimation problem but also improves risk adjusted returns thereby restoring the notion of Markowitz efficiency. We present extensive computational experiments to corroborate our findings.

Among other things, our results suggest strong synergistic advantages of integrating alpha and risk research processes. In other words, we need to abandon the "one-size-fits-all" approach to risk management and take a more nuanced approach that is sensitive to the specific requirements of a PM. Ultimately, the primary responsibility of a risk model is to capture all un-diversifiable (i.e. systematic) sources of risk that are relevant to a given investment process. A risk model that is constructed in a manner which is agnostic to the very factors that the PM is betting on cannot be expected to accomplish that goal. We believe that augmented risk models partly accomplish this goal, and should act as precursor to fully customized risk models that shed the artificial barrier between alpha and risk research, and take a holistic view of the investment process.

BEWARE OF CHILDREN TRADING PAGE 80

Henk Berkman, Paul D. Koch and P. Joakim Westerholm

We show that the guardians behind the accounts of young children, aged 0–10 years, exhibit superior stock-picking skills on both the buy side and the sell side. Underaged accountholders perform especially well when they trade in the days before major earnings announcements, large absolute price changes, and takeover announcements. Further analysis shows that the guardians of these underaged accounts also outperform other adults when they purchase stocks through their own accounts. The guardians, however, outperform other adults by a greater margin when they trade through underaged accounts. It appears that observing the trading activity through underaged accounts provides an effective mechanism for filtering out valuable private information from informed guardians.

Based on these findings, we propose that the proportion of total trading activity through underaged accounts (*BABYPIN*) serves as a useful measure of the probability of information-based trading in a particular stock. We analyze the association between *BABYPIN* and future stock returns, and find strong empirical support for theoretical models in which investors demand a higher return for holding stocks with a greater likelihood of trading against an informed investor, as proxied by *BABYPIN*.

THE VALUE OF ACTIVE INVESTING PAGE 93

Craig William French

The aggregate cost of active investing has been estimated to be 0.67% annually. This seems to have led some investors to the conclusion that the typical investor would increase his or her average annual return by 67 basis points by simply switching to a passive market portfolio.

We note that there is a distinction between *cost* and *value*, and examine whether the value of active investment management can exceed its cost. We find that it can, by a substantial margin. We compare the 0.67% average cost estimate versus the expected value of a known active investment strategy.

For a "passive" benchmark, we develop a 225 year index of monthly U.S. equity market returns, from July 1789 through June 2014. We then estimate the long-run monthly returns of an active investment strategy based on the known active 11-year investment strategy. We present a new performance model and implement it to estimate monthly returns to the active strategy over the same 225 year period. The active strategy outperforms the passive benchmark by 168 basis points annually over the long run, with less than two thirds the risk (whether measured as variance of return or as beta).