JOIM
www.joim.com
Journal Of Investment Management, Vol. 1, No. 4, (2003), pp. 104–106
© JOIM 2003

BOOK REVIEWS

By Mark Kritzman, Senior Editor

WORRY-FREE INVESTING: A SAFE APPROACH TO ACHIEVING YOUR LIFETIME FINANCIAL GOALS

By Zvi Bodie and Michael Clowes
(Reviewed by Thomas J. Connelly)

By chance or design, *Worry Free Investing* is certainly a well-timed book. The authors, prolific academic Zvi Bodie and veteran financial writer and author Michael Clowes, have written a breezy, "how-to" investment book targeted towards the retail investing public. It builds an investment process for conservative individual investors that revolves around two fundamental points, continuously hammered home throughout the book:

1. stocks are risky—even in the long run; and
2. future cash flows should be defeased by inflation-indexed fixed income investments.

The timing is, of course, fortuitous because the book follows on the heels of the recent bear market, when many individual investors are, rightly or wrongly, seeking shelter from the volatility of the stock market. The authors provide an investment process that has sound theoretical underpinnings and should appeal to today's shell-shocked, conservative investor, and provides information on some investments that have only recently become available.

The investment process is plain vanilla financial planning of setting and computing goals, determining risk tolerance choosing investments, all the while keeping an eye on costs and taxes.

The major contribution this book makes involves implementation, and how investments are considered in light of investor circumstances. In covering how to save for retirement and college expenses, the minimum goal that the investor can live with (after accounting for social security and pension income) is computed, and funded with inflation-indexed fixed income investments (CollegeSure CDs for educational needs, and I bonds and TIPS for retirement income funding). If there are any excess assets or savings capacity, the investor may then consider equities. The implication is that the real risk-free investment for the individual investment is not Treasury Bills or bank CDs, but a portfolio of inflation-indexed investments, since the individual's future spending liabilities are so sensitive to inflation. Individuals should in effect, immunize their most basic spending needs with inflation-indexed investments. This is the first sign of the concept of asset-liability matching that I can remember seeing in the

Not for Distribution

retail press, and it is most welcome.

Other important contributions include the discussion of the riskiness of stocks over the long run, especially for those needing periodic withdrawals from their investment portfolio. The argument is not as compelling and complete as in Bodie's academic articles, but will probably be the retail investor's first exposure to this side of the time diversification debate.

The issue of human capital and how it should influence investment decisions is rarely discussed in public forums. Yet, in this book, the authors discuss the nature, riskiness, and correlation of investor earned income with respect to the stock market, and provide helpful examples of how these considerations might affect asset allocation decisions. Many investors already have a risky portfolio with equity characteristics that they are not aware of! I have actually derived some ideas and tools for use in my practice from this part of the book.

The problems with the book stem from what must be the authors' limited contact with some real world situations. As a veteran financial planner and investment counselor, the idea that many of my post-WWII generation clients will have any home equity to liberate during retirement gives me a chuckle—they have been refinancing every penny of equity from their homes for 15 years. When we go over the savings rates necessary to fund retirement needs at current TIPS and I bond yields I need to have smelling salts ready. Most of the investing public's return and spending expectations are far beyond what a portfolio of TIPS will generate. Will there be enough TIPS issued to fund the retirement needs of a large proportion of public investors? I also found the recommendation of buying options for individual investors' equity exposure in taxable accounts rather curious. The book also recommends Registered Investment Advisors (RIA) as a professional credential—which it is not, and it is against the law to hold it out as such. It merely means that the advisor is registered as an investment advisor with the SEC.

The book closes by answering a set of frequently asked questions, and provides an excellent toolbox of websites, web-hosted applications, and a "Risk Inventory Worksheet." It also gives recommendations for investors seeking professional help—but curiously omits Chartered Financial Analysts from the help list.

In summary, I enjoyed reading this book and have taken at least two ideas from it to use in my work. I will also put it on my clients' recommended reading list.

MODERN INVESTMENT MANAGEMENT: AN EQUILIBRIUM APPROACH

By Bob Litterman and the Quantitative Resources Group of Goldman Sachs Asset Management
(Reviewed by Edouard Stirling)

It is a noble endeavor to bring together a series of papers by a strong group of researchers under one cover. *Modern Investment Management* pulls together a range of issues which offer the interested reader an insight as to how the Quantitative Resources Group of Goldman Sachs Asset Management views the world.

The heritage of *Modern Investment Management* will inevitably open it up to two main sets of critique. The first would be that this work is stronger as a marketing tool than as a research tool. The reader may well be left with some residual concerns here despite some valiant attempts by Bob Litterman to defuse this problem in the early pages. The second critique would point to some consistency problems in pulling together a range of disparate

Not for Distribution

work under one cover. However, I would see these as slightly churlish complaints within the context of the broader contributions offered.

Litterman and team have ambitious goals in reviewing the underpinnings of systematic portfolio construction and applications thereof across a range of fields. The result will undoubtedly offer new insight to those wanting to bring consistency into the process of taking and then reallocating alpha bets and beta risk across multiple asset classes, against different benchmarks, under different market conditions, etc. This should ultimately help not only the beneficiaries of our industry, made up of asset managers, consultants, and trustees, but also of students trying to understand the industry better.

The book is broken up into six sections. These can be read relatively selectively according to requirement. The first section provides a short review of the foundations of asset pricing. It stops at the Black–Litterman model. The slightly more theoretical approach here may appeal more to students even if the notation should be accessible to all. The second section discusses aspects of portfolio construction particularly for institutional funds reviewing strategic asset allocation and sources of return. It was nice to see decisions around currency hedging placed squarely into the strategic camp. The next section reviews risk issues including risk budgets, monitoring, and attribution in some detail. The fourth and fifth sections drill down into respectively traditional and alternative asset classes as well as rebalancing or tactical problems. Lastly, four chapters touch on the increasingly important areas of private wealth management and tax sensitive investing.

The contributions of *Modern Investment Management* lie in a number of areas. The broad approach taken to building up portfolios in a coherent framework will be of use almost everywhere. More subtle, but arguably more important, is the theme of managing assets under equilibrium and disequilibrium conditions. In particular, value creation under equilibrium demands different approaches to those required in disequilibrium. Structural opportunities such as diversification become “free lunches” which investors should tilt towards. However, at the same time other opportunities become less attractive, for example, uncorrelated assets and asset classes cannot offer incremental risk premiums; alpha disappears. However, the opportunity for outperformance is still offered to all those who see a world of disequilibrium around them.

Modern Investment Management also helps to highlight how both art and science combine in order to generate successful management. The simplistic critique that optimizers are oversensitive to inputs is challenged across a range of chapters as Litterman and team explore the importance of understanding the connections between views, confidence in views, holdings, and returns. Larger risk budgets only make sense given stronger and more confident return expectations; portfolio holdings can be analyzed to understand information ratios expectations across managers, etc. From this perspective, it would seem that too much time is spent in the industry building up expectations and not enough time is spent checking the implications and consistency of these expectations given investor goals.

Litterman and team provide an ambitious work and share insights of value. *Modern Investment Management* is not a recipe book or “how-to book,” and does not provide complete details of the themes presented. However, it does present a menu of important topics. Those not very familiar with this approach to asset management would do well to familiarize themselves with this style of operating, and more experienced readers will find insights here to debate.

Not for Distribution