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## PRACTITIONER'S DIGEST

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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.



### **INSIGHTS**

#### **PHASE SHIFTS**

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*Dean LeBaron*

This brief article by investor and advisory group member, Dean LeBaron, illustrates one of the costly disconnects between attempts to understand the present, to say nothing about the future, and our personal quest of unachievable order in economic circumstances. He provides several strong examples and a clue to how difficult it is to cross the bridge between the two worlds: the one we are and the one we live in.

#### **GREAT MOMENTS IN FINANCIAL ECONOMICS:**

##### **II. MODIGLIANI-MILLER THEOREM**

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*Mark Rubinstein*

Great ideas often have surprising histories. To reach a mature understanding of great ideas and be able to apply them better, it helps to know the history of the development of the idea—what are its origins? By what paths of thought was it elaborated? How does one idea lead to another? Why was there once confusion where now the matter seems obvious? This paper is the second in a series in this journal that looks at ideas in investments from just this perspective. The idea examined in this issue is the "Modigliani-Miller Theorem," which popularized the use of arbitrage arguments in financial economics.

#### **A PRACTICAL FRAMEWORK FOR PORTFOLIO CHOICE**

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*Richard O. Michaud*

Optimal portfolio choice is the central problem of equity portfolio management, asset allocation, and financial planning. Common optimality criteria such as the long-term geometric mean, utility function estimation, and return probability objectives have important theoretical or practical limitations. A portfolio

choice framework consisting of resampled efficient portfolios and geometric mean analysis is a practical alternative for many situations of investment interest. Mean-variance optimization, the typical framework for defining an efficient portfolio set in practice, is estimation error sensitive and exhibits poor out-of-sample performance characteristics. Resampled efficiency, a generalization of mean-variance efficiency, improves out-of-sample performance on average and has important additional practical benefits. Geometric mean analysis gives the distribution of the multiperiod financial consequences of single-period efficient investments to clearly visualize the tradeoffs between risk and return and for assessing an appropriate level of risk. While Monte Carlo financial planning is a more flexible framework, geometric mean analysis may be less error prone, theoretically justifiable and convenient. Controversies that have limited geometric mean analysis applications are resolvable by improved understanding of distributional properties and rational decision-making issues. The special case of asset allocation for defined benefit pension plans is addressed. Geometric mean analysis is also useful in rationalizing a number of interesting investment paradoxes.

### **SHORT VOLATILITY STRATEGIES: IDENTIFICATION, MEASUREMENT, AND RISK MANAGEMENT**

**PAGE 30***Mark Anson and Ho Ho*

Certain hedge funds pursue trading strategies that create option-like payout functions. These option strategies are not obvious because they are created synthetically. Therefore, position transparency will not reveal the true risk exposure for certain hedge fund strategies.

This paper examines the risk profile of two hedge fund styles that create synthetic short put options through their trading strategy. Merger arbitrage and event-driven hedge fund managers essentially sell insurance contracts against the successful completion of the merger or other corporation transaction. If the merger or other corporation transaction is completed successfully, the hedge fund manager earns a premium locked in advance through long and short equity positions. However, if the transaction unravels, the hedge fund manager can incur substantial losses.

We measure the nature of this off-balance sheet risk of merger arbitrage managers and event-driven managers, measuring their risk exposure to large market movements. We find that merger arbitrage and event-driven strategies are adversely impacted by increases in market volatility.

### **FISCAL POLICY AND INFLATION: PONDERING THE IMPONDERABLES**

**PAGE 44***Eric M. Leeper*

An asset-pricing perspective reveals that inflation depends on current and expected monetary and fiscal policies. There are three ways to carry \$1 today into the future: money, bonds, and real assets. That dollar's purchasing power varies inversely with the price level. Expected money growth, tax rates, and government spending directly impinge on the expected rates of return of these assets, and determine the price level and its rate of change, the inflation rate. The paper considers a tax reduction that is financed by new government debt. It examines how alternative responses of current and future policies to the tax cut can imply very different outcomes for inflation.

To determine the inflation consequences of today's policies, one must decide how likely are the various possible reactions of future policies to the resulting changes in government liabilities. This is a difficult task. The range, timing, and likelihood of future policies depend on imponderables like the political and economic environments that will prevail in the future. Will Americans tolerate tax increases better in the twenty-first century than they have in the past 20 years? Will geopolitical realities call for higher or lower expenditures on national security? Will the persistent imbalances in social security get resolved through higher taxes, lower benefits, or some other creative policy?

Because inflation is intrinsically a dynamic phenomenon, pondering these imponderables is essential to predicting the impacts of fiscal policy on inflation, now and in the future.

## THE TREYNOR CAPITAL ASSET PRICING MODEL

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*Craig W. French*

This manuscript will appeal to readers interested in the foundations of modern financial economic theory and practice. The subscriber should be motivated to read this manuscript because it explores, for the first time in any journal, the famous—but difficult-to-find—unpublished early works of Jack L. Treynor. These early papers of Mr Treynor served as the inspiration for what Stephen Ross has called “the most successful theory not only in finance, but in all of economics,” the elegant options pricing model of Fischer Black and Myron Scholes. Mr Treynor's early work also inspired Professor Ross' own magnificent Arbitrage Pricing Theory. Thus, this topic should be of interest to both financial practitioners and academics alike.

The author investigates Fischer Black's claim, in a 1981 letter published in the *Financial Analysts Journal*, that Mr Treynor “developed the capital asset pricing model before anyone else.” This manuscript discusses the possibility that, having begun work on an equilibrium model of asset pricing in 1958, Mr Treynor was, apparently, the first ever to develop the CAPM as we understand it today. The manuscript shows how Mr Treynor's early work clearly derived the linear relation between expected return and covariance with the market portfolio, and points out that Mr Treynor appears to have been the first person ever to have the direct intuition that in equilibrium, the market itself is the single mean–variance efficient portfolio of risky assets. Mr Treynor showed his model to John Lintner in 1960. Mr Treynor's earliest unpublished work still available is the August 8, 1961, draft that one of Mr Treynor's colleagues sent to Merton Miller in 1961, titled “Market Value, Time, and Risk.” This paper led directly to Mr Treynor's most famous unpublished paper, “Toward a Theory of Market Value of Risky Assets,” which he developed in 1962 while studying under Franco Modigliani at MIT during the 1962–1963 academic year.

Although Mr Treynor's “Toward a Theory of Market Value of Risky Assets” presents the model we now call the CAPM and offers the first lucid exposition using the first-order conditions, Mr Treynor was never conferred with the Doctoral degree from MIT, was not honored as a co-recipient of the Bank of Sweden Prize in 1990, and has, in general, been overlooked by the financial community as an architect of the CAPM. It would be a shame for history to subjugate the earliest pioneering and visionary accomplishments that Mr Treynor contributed to financial economics. Readers may appreciate this manuscript as an effort to prevent such an outcome.