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BOOK REVIEWS

Mark Kritzman, Senior Editor

THE BOND KING: INVESTMENT SECRETS FROM PIMCO'S BILL GROSS

By Timothy Middleton
(Reviewed by Bruce Grantier)

Given the size and importance of the fixed income asset class, it is great to finally see a book about a bond guru. There have been many books about stock gurus: ranging from *The Money Masters I* and *II* by John Train (late 1970s) to the recent *The Investment Titans* by Jonathon Burton. Even the AIMR *Investment Classics I* and *II* (late 1980s) devote less than 10 out of almost 200 readings to pure fixed income related topics (most of the bond readings were contributed by Sydney Homer[1] and Martin Liebowitz).

Timothy Middleton has recognized Gross's preeminence, referring to his recent status as the 10th most important business person in Forbes' 2003 annual review (Buffet being the first, and the only other investor). It is interesting to note Middleton's philosophical comparison of Bill Gross and Warren Buffet: they both use fundamental approaches, but Buffet is pure bottom-up, Gross is mainly top-down. The book is written for a primarily noninstitutional audience, so the technical bond discussion may be well known to institutional readers, but both institutional and noninstitutional readers will no doubt enjoy the insights and anecdotes on Gross himself and PIMCO.[2] Like the Buffet books and the equity guru books in general, *The Bond King* will hopefully lead to more fixed income books.

The book has three parts: (1) The evolution of Gross, PIMCO the firm, and the modern bond market, (2) A discussion of the workings of the bond market, and (3) PIMCO's current outlook and how to structure an individual's portfolio.

The first part of the book is great reading for all. It outlines a day in Bill Gross's life, then retraces his roots, education, and formative experiences—including four months in Las Vegas, during which he applied his knowledge about odds to beat the house at blackjack. Part 1 includes the growth and success of PIMCO in an evolving bond market and the approach to total return investing that has, by beating the odds over the long term, created the largest fixed income mutual fund today. Part 1 concludes with a fascinating review of the three most influential investors in Gross's life: Jesse Livermore, Bernard Baruch, and J. Pierpont Morgan.

The second part of the book is on the total return investing approach. This approach is certainly not proprietary and, as, I am sure, Gross himself would admit, not attributed to Gross or PIMCO. However, the breadth and depth

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of PIMCO's research and the extent of resources they bring to bear on secular and cyclical issues is what makes this an excellent section. Unfortunately, this is where reality creeps in and the individual investors may start to question whether they should really "try this at home." Part 2 concludes with a primer on bonds and sectors of the bond market.

The third part of the book deals with PIMCO's current outlook and how to structure a bond portfolio. While the information contained in these chapters is factual, it is time sensitive. Notwithstanding, PIMCO's views are an interesting part of the book, and provide the reader with examples of how to translate views into portfolio structure—lessons which will outlast the views themselves.

Some comments of interest: Dr. Ed Thorpe, author of *Beat the Dealer* (1962), is cast as a gambler (and is no doubt proud of it), although in fact he teaches Finance at UC Irvine and taught at Gross' *alma mater*, UCLA, when he published *Beat the Dealer.* His interest in gambling and heuristics has been influential in the lives and careers of many other investment practitioners. Duration is used throughout the book. In the introduction by Peter Bernstein, American economist Fred MacCaulay gets full credit for duration. While he indeed coined the term, the concept received significant contributions from Scottish actuary F.M. Reddington and (independently) American economist Paul Samuelson. Middleton, in his explanation of duration, rightly points out how important a measure it is.

A note of caution: individual investors might want to seek further advice before acting on the sample strategies. With respect to TIPS,[3] for example, Middleton correctly points out that they have very long real duration (not to be confused with nominal duration). He also suggests that they should form part of a defensive portfolio. The average investor may not surmise, though, that a widening in the real yield of nominal bonds could transmit into a widening of the real yields of TIPS. One hopes that the individual investor appreciates this and is aware of the risk.

Middleton brings to the attention of the public the accomplishments of Gross and PIMCO and their contribution to the modern bond market. *The Bond King* is a welcome addition to guru books and long overdue in the bond world. While bonds are a difficult and often dry topic even to institutional investors, this book is fascinating and informative. You will not be disappointed.

Notes

[1] "An Informal History of Interest Rates" by Sidney Homer in *Investment Classics II* is a must read for fixed income investors. Its introduction begins, "Did you know that a wife, if pledged for a loan in Babylonia, could be seized by a creditor, or that doors (since wood was scarce) were valuable collateral."

[2] Pacific Investment Management Company, of which Gross was a cofounder and major shareholder.

[3] Treasury Inflation Protected Securities.

PORTFOLIO THEORY AND PERFORMANCE ANALYSIS

By Noël Amenc and Véronique Le Sourd
(Reviewed by Craig W. French)

Here is a very readable and comprehensive book, produced by practitioner/academics Amenc and Le Sourd (Misys Asset Management Systems/Edhec). It is well suited as an MBA level investments course text, and the material is presented in a very accessible fashion for the practitioner. CFAs will especially appreciate this book as it references AIMR standards throughout (my rough count indicates more than 50 references to AIMR throughout the book, mainly in Chapters 1, 2, 7, and 8). Francophiles may also

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especially appreciate the international flavor of many of the discussions.

Chapter 1, "The Portfolio Management Environment," defines portfolio management and describes how it works in practice. Asset classes, including alternative investments, are first introduced. The distinction between passive and active management is reviewed, and then the investment management process is described in terms of strategic asset allocation, tactical asset allocation, and security selection. Performance analysis is then covered with a nice discussion of market efficiency and an excellent review of the performance persistence literature.

Chapter 2 focuses on performance analysis, and shows how to calculate both absolute and relative returns. Here, I found the introduction to the "Portfolio Opportunity Distributions" (POD) as developed by Surz to be fascinating, and along similar lines as the recent research by Kritzman and Page ("Asset Selection Versus Security Selection," 2003) which addresses one of the commonly misunderstood aspects of the Brinson *et al.* (1986, 1991) model, which decomposes historical performance and concludes that more than 90% of the variation in portfolio returns over time is related to asset allocation. As Kritzman and Page correctly note, "The Brinson *et al.* studies and others like them present a joint test of investor behavior and capital market opportunities. They do not answer the question, which activity is more important: asset allocation or security selection, which is what we propose to do [by measuring the potential for dispersion]." In Chapter 7 Amenc and Le Sourd also provide an interesting summary of one researcher's finding that 98% of subsequent writers on the topic have either misinterpreted or erroneously quoted the Brinson studies. The advantage of the POD approach is that it does not suffer from being a joint test of investor behavior and capital market opportunities and, as Amenc and Le Sourd describe, offers a plausible and useful way to potentially distinguish skill from luck in a manager's performance. Risk measurement is covered next, including introductory level discussions of VaR, extreme value theory, and scenario analysis. The appendices to Chapter 2 provide methods for calculating returns and descriptions of global market indices.

Chapter 3 covers pre-CAPM MPT (the Markowitz (1952) model), with nice discussions of the critical line method, Wolf's (1959) simplex method, Sharpe's (1963) single-index model, and the Elton, Gruber, and Padburg (1977) simplified method that employs the Treynor ratio. A useful appendix presents Merton's (1972) Lagrangian resolution of the efficient frontier. Chapter 4 covers CAPM pretty thoroughly, though Treynor (1962) is inaccurately referred to as a 1961 paper (as most of the literature also erroneously reports), Fama's (1968) clarification is ignored, and while Amenc and Le Sourd discuss Lintner's first exposition from February 1965 in the *Review of Economics and Statistics*, they inexplicably ignore the best Lintner paper (in my opinion), Lintner's second paper of December 1965 in the *Journal of Finance*. A nice comparison of the Sharpe, Treynor, and Jensen measures is provided here, and more recent concepts of tracking error, information ratio, Sortino ratio, M-squared, Morningstar's ranking system, VaR, and style analysis are also discussed. A very nice section on the analysis of timing is provided, covering the models of Treynor-Mazuy (1966), Henrickson and Merton (1981), Henrickson (1984), and Grinblatt and Titman's (1989) decomposition of the Jensen measure.

I was surprised to find Roll's (1977) criticism of *tests* of the CAPM to be presented in this book as a criticism of the CAPM *itself*. I suspect that Amenc and Le Sourd were lulled by Roll's introductory remarks,

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which refer to his argument as a "broad indictment of one of the three fundamental paradigms of modern finance"; I would strongly urge that a careful reading of Roll indicates that he is *defending* CAPM by critiquing the *tests* rather than the *model*—for example, on pp. 142–143 Roll (1977) examines Black, Jensen, and Scholes' (1972) empirical analysis as follows: "Black, Jensen and Scholes rejected the Sharpe-Lintner theory…[however] …we are entitled to be suspicious of their conclusion. Unless Black, Jensen and Scholes were successful in choosing [the true] market portfolio, their results are fully compatible with the Sharpe-Lintner model."

Chapter 5 examines performance measurement, first presenting ARCH, GARCH, and ARMA models, and then presenting conditional CAPM (including discussions of conditional beta and conditional alpha). Here, again, we find the Jensen measure, the Treynor and Mazuy model, and the Henrickson and Merton model applied to performance measurement. Also valuable here is a nice presentation of nonmarket model dependent methods of performance analysis, including the Cornell (1979) measure and the Grinblatt and Titman (1989, 1993) measures.

We find the APT model of Ross (1976) and Roll and Ross (1980) in Chapter 6. Fama-MacBeth's (1973) procedure is discussed, as well as the models of Fama and French (1993), Carhart (1997), and the BARRA model that eventually grew out of Rosenberg and McKibben (1973). Factor modeling is discussed, with overviews of maximum likelihood and principal components approaches presented. Next is a useful section on applying factor models to portfolio risk analysis, covering commercially available models from BARRA, Quantal, and Advanced Portfolio Technology. I would like to have seen a discussion of the Northfield model as well. Sharpe's (1992) style analysis model is presented, as well as Roll's (1997) approach. An appendix derives the arbitrage valuation relationship.

Chapter 7 covers the portfolio construction process utilizing the approaches of Markowitz (1959), Treynor and Black (1973), Black and Litterman (1991, 1992), Scherer (2002), as well as others. Amenc and Le Sourd is one of the few good descriptions of Fama's (1972) selectivity model, though they fail (as, I believe, have all else) to note the identity relationship of Fama's (Gross) Selectivity measure with Treynor and Black's (1973) Appraisal Premium metric. Perhaps had Amenc and Le Sourd presented their figure 7.2, illustrating Fama's decomposition, to more closely reflect Fama's figure 2 this identity would have been apparent to the authors. But Fama illustrated a case in which Net Selectivity is negative, whereas Amenc and Le Sourd illustrate a case in which Net Selectivity is positive, and they do not depict [Gross] Selectivity at all. Brinson's (1986) model is presented along with a nice discussion of the interaction term. Multiperiod and international aspects of performance attribution are covered well, and Engström's (2001) and Grinblatt and Titman's (1989) replicating portfolio techniques are also discussed briefly.

The text covers fixed income securities in the final chapter. Yield curve analysis, portfolio construction, and performance analysis for bond portfolios are covered, with introductory discussions of various fixed income models.

Amenc and Le Sourd include a bibliography at the end of each chapter, and I found this very useful. A colleague of mine bought the hardcopy, and after reviewing it I decided to purchase the e-book version, which I am enjoying very much. The authors have produced a well-researched and readable exposition that most practitioners would find to be a handy reference, and students would be well served with as a text.

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