ARTICLE:

Modern Portfolio Theory (MPT)

By Keith M. Lichtcsien, CFP®, AEP®

"MPT is a mathematical model of risk, return and diversification. Its key insight is that a collection of risky assets can have an overall level of risk lower than that of each individual asset. This insight contradicted the old common law tradition of the prudent man, which required that investments be judged individually as to their risk and ability to generate income. MPT illustrated that the inclusion of assets previously deemed "imprudent" didn't actually increase the risk of a portfolio, but could, in fact, reduce the risk of the portfolio as a whole. The drafting committee of the UPIA (Uniform Prudent Investor Act) codified these concepts in their work."

By Paul L. Comstock & Stephen C. Browne
December 2012 Trusts & Estates article
"Framework for Making Investment Decisions"

"We have also learned that the potential "smoothing effect" which may be realized by applying this theory in practice, not only provides obvious psychological benefits, but can also result in a higher geometric return and therefore greater wealth accumulation.

Through firsthand experience we typically find most investors have yet to acquire this knowledge, and analyses of their portfolios provide confirmation. Most investors (and ostensibly their advisors, unless investors are acting against their advisors' advice) are acting on outdated and disproven beliefs, exposing their portfolios to unnecessary and unrewarded risks for the level of potential return. Stated differently, we see portfolios with impaired growth potential, given the level of risks taken, and of this fact most investors are simply unaware."

— Keith M. Lichtcsien, CFP®, AEP®

If you have questions about this or other planning issues, please give us a call at 216-765-0121.