

Modern Portfolio Theory (MPT): The Precursor of Modern Mutual Funds Theory Selections (MMFTS)

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Markowitz's Modern Portfolio Theory (MPT), published in 1952, was an important step in the development of portfolio management. It used science to discourage the then prevailing risky *buy - hold* strategy of a single stock in a portfolio. The introduction of diversification and reduced risk in portfolio management proved a major advance in portfolio management for the next half century.

However since 1952, the investment markets have seen drastic changes, not the least of which is the exponential growth of mutual funds, from about 100 to currently almost 13,000 and rising. Funds have eclipsed stocks as important components of portfolios. Mutual funds now offer more than 200 million investors the allure of diversification with less risk and greater average real returns. Surely this must have been a great boon to most investors...

Not exactly.

Investors have benefited from diversification with less risk, but have seen no significant improvement in net *real* returns.

Why?

Overwhelmed with about 13,000 funds the investor, planner, and adviser are unprepared to cope with the sheer volume of data and the inevitable noise accompanying them. These factors have succeeded in offsetting the *real* return benefits of Markowitz's ground-breaking 1952 work.

It is generally agreed mutual fund portfolios do create diversification, and in so doing should reduce risk and improve returns. However, real net returns since 1952 have not reached positive sum *real* returns.

The following table shows the effect of costs/expenses, taxes and inflation on the *real* net return of various mutual fund investments relative to Certificates of Deposits and the relative risk to principal for each:

INVESTOR REAL ANNUAL RETURNS (1985-2005)				
	C. D. Investor	Managed Fund Investor	Unmanaged Fund Investor**	Superior Fund Investor*
Initial Investment	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000
Gross Total Return	\$ 10,400	\$ 10,700	\$ 11,150	\$ 12,300
Loads/Expenses***	\$ -	\$ 214	\$ 22	\$ 246
Taxes****	\$ 120	\$ 210	\$ 345	\$ 690
Inflation*****	\$ 447	\$ 460	\$ 479	\$ 529
Net <i>Real</i> Return	\$ 9,833	\$ 9,816	\$ 10,303	\$ 10,835
% Net <i>Real</i> Return	-1.7%	-1.8%	3.0%	8.4%
Principal Risk	None to Low	Medium to High	Low to Medium	Low to Medium
Sources:	*Regen Associates Modern Theory of Mutual Fund Selections **Standard & Poor's 500 Stock Index ***Securities & Exchange Commission ****Internal Revenue Service *****Bureau of Labor Statistics			

The table shows Certificates of Deposit (CD) and Managed Mutual Funds (MMF) on a *real* net return basis result in a zero sum outcome at -1.7 % and -1.8%, respectively. Taking into account lower exposure to principal risk with the same minus sum results, C.D s are a more favorable investment than MMFs.

However, Unmanaged Mutual Funds (UMF) and Modern Mutual Fund Theory Selections (MMFTS) posted *real* annual net returns of 3.0.% and 8.4%, respectively. Taking into account the same exposure to principal risk and a higher positive sum results of over 5% in *real terms*, MMFTS are a significantly more favorable investment than UMFs.

The following table shows the effect of costs/expenses, taxes and inflation on the *real* net return of various mutual fund investments relative to Municipal Bond Funds and their exposures to principal risk:

INVESTOR REAL ANNUAL RETURNS (1985-2005)				
	Municipal Bond Fund Investor	Managed Fund Investor	Unmanaged Fund Investor**	Superior Fund Investor*
Initial Investment	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000
Gross Total Return	\$ 10,450	\$ 10,700	\$ 11,150	\$ 12,300
Loads/Expenses***	\$ 209	\$ 214	\$ 22	\$ 246
Taxes****	-	\$ 210	\$ 345	\$ 690
Inflation*****	\$ 449	\$ 460	\$ 479	\$ 529
Net <i>Real</i> Return	\$ 9,792	\$ 9,816	\$ 10,303	\$ 10,835
% Net <i>Real</i> Return	-2.1%	-1.8%	3.0%	8.4%
Principal Risk	None to Low	Medium to High	Low to Medium	Low to Medium
Sources:	*Regen Associates Modern Theory of Mutual Fund Selections **Standard & Poor's 500 Stock Index ***Securities & Exchange Commission ****Internal Revenue Service *****Bureau of Labor Statistics			

The preceding table shows Municipal Bonds (MB) and Managed Mutual Funds (MMF) on a *real* net return basis result in a negative sum outcome at -2.1 % and -1.8%, respectively. Taking into account lower exposure to principal risk and better minus sum returns, Municipals are an equivalent investment when compared to MMFs.

However, Modern Mutual Fund Theory Selections (MMFTSs) with *real* annual net returns of 8.4% outpaced UMFs by more than 5% .Taking into account the same exposure to principal risk and significantly higher sum results, MMFTSs are significantly more favorable than UMFs .

For some time now, the academic community has held firmly to the orthodox belief that UMF cannot be consistently outperformed over time because of costs, expenses and loads. While intuitively attractive, it does not explain why thousands of MMFs funds outperform UMFs every month based on focused analyses of past performance. The real question is not whether they exist at all but how to find them, in an objective way.

MMFT was designed to identify “superior performing “ funds on a timely basis to consistently outperform UMFs over time. Our research studies over the last decade of 100 million data cells

evaluating past performance returns (alpha) and risks (beta) show significantly higher positive sum *real* returns and no higher principal risk - *low to medium level* - a counter-orthodox conclusion.

Currently there are at least USD \$ 7 trillion invested in MMF funds by investors who are relying on positive net *real* outcomes for retirement, college education ... and whose expectations have been not been realized over time because of negative *real* net returns.

In view of the impact of fund selection on MMF zero sum results, it is vital for investors, planners and advisers to focus on UMF and MMFTS. Current median MMF funds, USD \$ 5 trillion, are exposed to minus sum outcomes in *real* terms unless the investor, planner and adviser are exposed to an improved selection system.

Since it is impractical and unrealistic to assume loads/costs, taxes and inflation can be drastically reduced some time soon, the use of MMFTS represents an unprecedented opportunity to significantly improve *real* net returns and prevent the further erosion of investor expectations.