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SHOULD A SKEPTICAL PORTFOLIO INSURER USE AN OPTIMAL OR A RISK-BASED MULTIPLIER?

Abstract:

Following recent evidence of out-of-sample stock market return predictability, the authors aim to evaluate whether the potential benefits suggested by asset allocation theory can actually be captured in the real world using expected return estimates from a predictive system. The question is addressed in the context of an investor maximizing the long-term growth rate of wealth under a maximum drawdown constraint, and compare the optimal strategy using the predictive system with a similar risk-based allocation strategy independent of expected return estimates. The authors find that the risk-based strategy implies nonetheless very variable and relatively high expected returns, and report important potential benefits in using the expected return estimates of the predictive system they used.

Keywords:

financial econometrics, return predictability, asset allocation, portfolio insurance.

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