Howard, C. Thomas – Behavioral Portfolio Management

Harriman House, 2014, [Behavioural Finance] Grade ★★★★

This is a book on how to exploit the irrationality of financial markets. Thomas Howard is the Denver University finance professor that converted from Modern Portfolio Theory (MPT) to Behavioral Finance and turned practitioner by founding AthenaInvest where he as the CIO oversees the research. The author's stated aim of the book is to teach the reader how to avoid being part of the mindless investor herd and instead becoming a Behavioral Data Investor, a BDI. Conventional wisdom concerning markets is often wrong and to discover what truly works requires analysis of data instead of anecdotal evidence.

The book is divided into three sections with the first two laying the foundations for the third. A large number of themes are presented in the first sections. Examples are; a catalogue of behavioral finance biases that make up a cheerful chapter, the premise that emotions drive most of the stock market volatility and not changes in fundamentals, the human inability to intuitively understand randomness is covered and the author lashes out against the MPT-proponents, their methods and their disappointing empirical results.

Several of my pet opinions get air-time: a) long term investors should measure volatility over longer time horizons, b) volatility isn't risk to start with if you're not a short term investor, c) that the market movements to a large extent are created by a tug of war between (in my parlor) momentum investors and value investors and d) that the so called style grid is doing savers a huge disfavor as it cages PMs into one section of the market, making them unable to exploit opportunities where they currently are. Despite this I still grew increasingly annoyed during reading the first two sections. The same topics are brought up too many times and the tone of the language that at first felt unpretentious started to feel almost patronizing. The subtitle of the book is *"How successful investors master their emotions and build superior portfolios"* but the preface never really explains who the intended reader is. Then one of the middle chapters mentions the dual target groups investment advisors and asset managers and this explains a lot. In my opinion the book should have benefited from choosing one of the audiences. They have different backgrounds, knowledge and interests.

Then comes the third section and saves Howard's bacon. In this part of the book the author shows that PMs are actually good stock pickers as their largest positions on average show positive alpha. However, they are bad portfolio managers since they over-diversify and nullify the positive alpha. Further, the author looks at investment philosophy in a valuable way. By dissecting 2800 mutual funds he singles out 10 investment philosophies in use and also a large number of strategy elements linked to the philosophies. For example a PM could have "*Competitive Position*" as a primary philosophy and "*Valuation*" as a secondary and by this use the elements "*Strong fundamentals*," "*Defensible market position*", "*Intrinsic Valuation*", "*Overall company growth*", "*Management quality*", "*Cash flow valuation*", "*Economic output*" and "*Price ratios*". Certain combinations are tested to perform better than others and style consistency is shown to be of huge importance for results. I think this is highly innovative research.

Texts that try to bring the academic findings of behavioral finance to the practical world of Wall Street are a rare and appreciated commodity. Unfortunately, even though Howard uses academic research the link to behavioral finance isn't always obvious and this makes the title of the book a bit misleading. There are too much sound opinions and interesting facts in this book not to rate it with four stars but the reader should be aware that the first two sections are perhaps more suited to investment advisors and the last to asset managers.

In the end Howard manages to build an interesting and - according to his investment results - profitable mosaic out of his theoretical knowledge.

Mats Larsson, March 25, 2015