Mr. Jacobs Responds

To the Editor: In my Aug. 22 article, "The Portfolio Insurance Puzzle," I tried to balance the benefits of portfolio insurance with an assessment of costs of the technique so that plan sponsors could make a well-reasoned decision.

John W. O'Brien of Leland O'Brien Rubinstein Associates in his Sept. 19 letter to the editor threw up several smoke screens that appear to cast doubt on the validity of my research. I will attempt to clear the fog so my original points can stand on their merit.

Mr. O'Brien objects to the time period I chose for analysis, stating my "comparisons, for some unexplained reason, relate to a single period: the 55 years from Jan. 1, 1928 through Dec. 31, 1982."

This 55-year period is representative of the most complete data base of equity returns available for empirical analysis both in the financial community and in academia. Standard empirical analyses use all available data unless there are well-established reasons to toss out observations.

Mr. O'Brien also claims most of the reduction in returns of the insured Standard & Poor's 500 strategy for the period is due to the 5% loss incurred in 1933 when the technique was shut out of a major rally in a year when the S&P 500 rose 54%. This claim is false.

First of all, there was another major shut-out period in 1938. Moreover, I have given Mr. O'Brien's contention the benefit of the doubt and have analyzed the period from 1939 to 1982, the longest available period during which there were no such major losses of opportunity, that is, shut-out conditions. The analysis of this period confirms the conclusions reached in my article, namely that portfolio insurance reduces long-run returns.

During this 1939-1982 period, a $1 investment in an insured S&P 500 strategy would have grown to $28.28 compared with the $79.44 achieved by a buy-and-hold S&P 500 strategy.

Also, a portfolio "allocated" between the S&P 500 and Treasury bills and having the same volatility (as measured by the annual standard deviation) as the insured S&P 500 strategy, would have outperformed the insured strategy by 87 basis points on average annually. This is because transaction costs averaged 60 basis points annually for the insured strategy.

The fees of the portfolio insurance vendor would further magnify the net return reduction of the insured strategy.

Mr. O'Brien prefers to analyze the 10 years ending December 1982, a period very favorable to portfolio insurance.

The insured S&P 500 strategy outperforms both the buy-and-hold strategy and the allocated strategy during the period merely because equities performed so poorly. An investor who believes this pattern will persist, should not buy portfolio insurance, because during this period, Treasury bills returned as much as the insured S&P 500 strategy and with less volatility.

Regarding the risks of a buy-and-hold S&P 500 strategy, Mr. O'Brien is correct to assert that this strategy is much riskier than an insured strategy, but this is a red herring.

I compared the returns of these strategies merely to dispel the incorrect notion that an insured strategy should be expected to outperform a buy-and-hold strategy, a notion created by promotional examples based on subperiods of poor equity returns.

Mr. O'Brien asserts the implementation of portfolio insurance that I used must be flawed because of the dramatic shut-out condition that prevailed in 1933. The risk of being stopped-out of common stocks and shut-out of rallies arises as a consequence of assuring a limit to losses.

Mr. O'Brien has implied his firm's method would not have stopped-out. While the Prudential Insurance Co. has requested a research subscription to Leland O'Brien's portfolio insurance implementation to examine this and other issues; our request has been denied.

Robert Ferguson, of Leland O'Brien, in the Sept. 19 article, "Two Approaches to Asset Allocation," creates a semantic smoke screen. He contrasts the "dynamic" strategy of portfolio insurance with a "static" strategy.

My article contrasted the turns of portfolio insurance with that of a "strawman" – a static "allocated" strategy – and showed that even a "naive" static strategy having similar volatility would have outperformed portfolio insurance. I did not suggest a static strategy is the best investment strategy.

Additionally, since portfolio insurance does not forecast returns, but rather trades based upon changing wealth levels, it is not "dynamic" but rather "mechanical."

A truly dynamic strategy would reallocate assets based upon a forecast of returns.

While Mr. Ferguson asserts portfolio insurance triggers "stop-loss" and "start-gain" orders, a more accurate description is that portfolio insurance triggers equity sale and equity purchase orders.

In a real time example of portfolio insurance presented by Hayne E. Leland of Leland O"Brien at the University of California Berkeley Program in Finance, the portfolio insurance program was begun on March 4, 1982, with an initial allocation of equities of 74.2%.

By April 2, the value of the equity portfolio increased by 4%, triggering a purchase of equities that increased the equity allocation by 7.7 percentage points. This did not, however, start a gain but rather a loss since the value of the equity portfolio subsequently fell by 5.3% from April 2 to Aug. 10, triggering a sale of equities.

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