

# [Optimal versus naive diversification: how inefficient is the 1 n portfolio strate...](https://assignbuster.com/optimal-versus-naive-diversification-how-inefficient-is-the-1n-portfolio-strategy-a-critique/)

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“ Optimal Versus Naive Diversification: How Inefficient Is The 1/N Portfolio Strategy” – A Critique Title: The title of the paper “ Optimal Versus Naive Diversification: How Inefficient Is The 1/N Portfolio Strategy” has been reasonably well phrased.

However, it can be argued that the title is a little misleading as the principal objective of the paper is to test how efficient different optimal diversification strategies are using the 1/N portfolio strategy as the benchmark and not to try and elucidate the merits of the 1/N strategy, which the authors are certainly neither advocating for practical purposes nor seemingly seeking to foster greater intellectual attention on the simplistic strategy. The title could have simply been “ How Efficient Really Are Today’s ‘ Optimal’ Diversification Strategies? But, care has to be taken before coming to the above conclusion that the authors might have appreciably so, intentionally used the title they have in order to attract further attention to their paper by stressing the obvious irony and possible iconoclasm in their conclusions. Abstract: The abstract has been very well written. It captures the essence of the study and conveys the crux of it lucidly to the reader. However, it would have augured better to start the abstract by stating the objective of the study in addition to it being mentioned in the text of the article just as the authors have.

That way, the abstract would have had greater clarity. Motivation: The inherent motivation behind the study is laudable and the implied motivation derived from the conclusion is obvious. However, the motivation itself has unfortunately not been sufficiently expressed. Apart from a one-sentence objective, nothing else has been explicitly written about why the study was undertaken. There is one other sentence, which could be construed as the motivation. But, the authors themselves have not given the sentence the same attribute. The sentence itself is a reference to a revious study that found that many investors used the 1/N diversification strategy ignoring several other sophisticated theoretical models and is stated to only justify their usage of the 1/N diversification strategy as the benchmark. It could have been elaborated upon with additional related facts and further evidence supported by literature. Also, a separate paragraph with a heading called “ Motivation” would be desirable to the readers. Introduction: The topic covered by the article has been adequately introduced. The brief description of the various asset allocation models and how they are related to each other is commendable.

The introduction has also carefully introduced the methodology, the observations and the results and the conclusions in a logical and concise manner such that readers might understand the study by just reading this part. However, the literature on the Bayesian and non-Bayesian approaches has only been briefly mentioned in one paragraph. Considering how significant the contribution of the stated articles to the current study might be, it would have only been fitting to include a section called ‘ Literature Review’ elaborating on them substantially more than the authors have.

That way, they could have been able to make a clearer connection on how the previous studies relate to the motivation and methodology of their study. However, it should be noted that word limits might have been a constraint. In addition, the introduction must be a definite section that is called ‘ Introduction’. Methodology: The authors have adopted a robust methodology to evaluate the performance of the diversification strategies discussed. They have been explained in great detail with sufficient appendices in an easily understandable format.

There is not much scope for improvement in the methodology and the authors must be greatly appreciated for it. Data: The data has been obtained from highly reliable sources, thereby implying that there is hardly any margin for error in the data. No bias or subjectivity is evident. The data has been properly classified and well presented. Results: With well-defined methodology and credible sources, the results of the study are factually accurate even though it can be argued that conclusions from the same are a function of their interpretation just as in every other study. However, there is a drawback concerning the same.

The authors have only limited themselves to comparing the performance of models of optimal asset allocation that consider moments of asset returns and not other characteristics of the assets. The authors could have included a section within the discussion of their results in which they could have compared their results with that of other similar studies, even if they involved the analysis of fewer diversification strategies, and sought to establish a reasoning behind how the possible differences between the results of the studies might be related to variations in their respective methodologies or data.

They could have also sought to describe how their study and the underlying methodology have helped overcome previous voids in relevant literature. It might have even been advisable to express why their study is more accurate and hence superior to the others if they did think so. In case the study was known, to their knowledge to be unprecedented and unrelated to any comparative study of portfolio diversification strategies, it should have been explicitly stated as the reason why the above-said was not done.

But, it has to be noted that the authors have indeed done the above-said, but only withrespectto two of their important assumptions, i. e. , Brandt et al (2007)’s approach to constructing the optimal portfolio using cross-sectional characteristics of equity returns and the dynamic asset allocation models of Campbell and Viciera (1999; 2001) and Campbell et al (2003). Conclusions: The conclusions of the study are definitely iconoclastic and have huge repercussions for the research community.

It points out how inefficient the numerous theoretical models that have been developed on portfolio diversification are clearly indicates that an enormous amount of research has to be undertaken to address this serious shortcoming. The conclusions have been expressed concisely and the limitations of the study have been stated. Their recommendation on the direction for further research is well thought out and justified by their findings and is hence highly commendable.