

Confronting the Big Questions

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The *Journal of Investing* has never been afraid to ask the big questions. What is risk? Is Markowitz optimization a good idea? Should the decision of which assets to hold be driven by the liabilities?

Investment management has become a science, with all the attendant jargon and symbols: alphas, betas, and autoregressive conditional heteroskedasticity (seriously). Is this progress? On a good day, I would say yes. Accurate performance measurement and sophisticated statistical analysis make it easier for good managers to demonstrate their skill and harder for bad managers to hide their lack of it. Benchmarks impose discipline and structure on what would otherwise be a Wild West of extravagant unfounded claims. Optimizers make management against a benchmark practical.

On a bad day, though, I would point out that all this earnest effort is an attempt to earn alpha by taking it away from someone else, where both the giver and taker get to charge a fee. The net supply of alpha has always been zero and will continue to be so, no matter how hard we try, how scientific we make the effort look, or how much we spend on analysts and portfolio managers—or, in this age of big data, on artificial intelligence.

In reflecting on the history of *The Journal of Investing*, I do not wish to highlight other people's work, for fear of insulting those not mentioned, so I will discuss my own. In 1994, when the *Journal* was young, Paul Kaplan and I were drawn into a now amusing, but at the time somewhat acrimonious, battle between those

who thought that risk was best measured by standard deviation and those who favored measures that homed in on downside risk (Kaplan and Siegel [1994]).

We argued that downside volatility does not always manifest itself in advance. Thus, upside volatility is a harbinger of future trouble because volatile assets can lurch in either direction. Standard deviation, capturing both upside and downside volatility, is therefore the better measure.

What Paul Kaplan and I missed at the time—and what we now know—is that *all risk is downside*. Investors do not, and should not, care about standard deviation other than as an indirect forecast of the future downside volatility of an asset. By carefully studying the work of our adversaries in this debate, we extracted a nugget. This is how the interplay of competing research teams should work. We thank our worthy opponents for their effort and for what we learned.

The Journal of Investing has always been an open forum where challenging accepted wisdom is regarded as positive and beneficial. It has been, and will be, a home for the debates needed to move the profession toward the best investment solutions over time. I look forward to many more productive debates here in the future.

REFERENCE

Kaplan, P.D., and L.B. Siegel. "Portfolio Theory is Alive and Well." *The Journal of Investing*, Vol. 3, No. 3 (Fall 1994), pp. 18-23.