

Strategic Asset Allocation: Portfolio Choice for Long-term Investors

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John Y. Campbell

Otto Eckstein Professor of Applied Economics
Department of Economics, Harvard University

Luis M. Viceira

Assistant Professor of Finance, Harvard University
Graduate School of Business Administration

The authors of *Strategic Asset Allocation* begin with the simple observation that the best solutions to long-term portfolio choice problems may be very different from the best solutions to short-term problems. While traditional mean variance analysis can work well in the context of short-term decisions, long-term portfolio choices require a more intricate approach. When making long-term portfolio decisions, investors must take into account several additional risks, such as unexpected changes in investment opportunities, unanticipated fluctuations in labor income, and the dynamic relationships between these risks and those of asset returns.

Strategic Asset Allocation attempts to take the rigorous structure of modern financial theory and provide practical insights for making long-term portfolio choices in the same way that mean-variance analysis provides standard prescriptions for short-term problems. For example, using modern analytical and numerical techniques, the authors show that long-term inflation indexed bonds are the riskless asset for long-term investors. They also explain exactly what an investor must believe about how the world works in order for stocks to be safer for long-term rather than short-term investors. In addition, they illustrate how labor income and labor income risk should influence portfolio decisions.

The book contains several important conclusions that will be of practical use to investors. At the same time, it is by no means a “handbook” of investing. The authors sum up their objective: “...[O]ur book is no substitute for traditional financial planning advice. Nor do we provide cookbook formulas for optimal portfolio weights. Instead we try to explain carefully what it means to have a long investment horizon. Our objective is to provide a rigorous, empirically relevant framework that long-term investors can use to understand the tradeoff between risk and return.”

Their pioneering work goes a long way toward the establishment of a solid foundation for the provision of investment advice. They concisely point out the need for this foundation, as well as the reason why it is crucially important: “Traditional financial planning advices is...rarely accompanied by an explicit statement of the beliefs that support the advice. Investors are likely to make better decisions if they understand what they must believe about the world in order to accept a recommended portfolio.” *Strategic Asset Allocation* makes a strong argument that financial theory has an important place in helping investors to achieve lifelong financial security.