

7th Paul A. Samuelson Award

Remarks from Luis Viceira

I want to start my brief remarks by expressing my most sincere gratitude to TIAA-CREF and the members of the award panel for this distinction. Since its inception seven years ago, the Paul Samuelson Award has deservedly won a reputation for recognizing original research on savings and investments that meets the most rigorous intellectual standards. Therefore, I feel deeply honored that this year's panel of judges has elected my work with Professor John Campbell to join previous recipients of this award.

This award means even more to me because it bears the name of someone for whom I feel the highest respect and admiration, a feeling which I think I share with my colleagues in the wider community of both scholars and practitioners of finance. Paul Samuelson's work has had, and it still has, an extraordinary influence on the research, teaching and practice of economics. Finance is one of the fields of economics where Paul Samuelson's work inspires generation after generation of economists. I count myself as one of those, and the book receiving the award, as fruit of this inspiration.

I still remember vividly my first encounter with Paul Samuelson's work in graduate school. In my first year in graduate school I glimpsed at the economics of uncertainty in the introductory courses in economic theory. It was then that I became immediately fascinated by financial economics, so I went on to study the discipline during my second year. I had the fortune to study investments and asset pricing with professors John Campbell and Robert Merton, both of whom made Paul Samuelson's classical work on life-cycle investing and saving a required reading in their courses. This reading requirement would be providential for me.

At that time I had gone through mean-variance analysis, and I had appreciated immensely its relatively simple, yet extremely powerful implications for investments (for example, the need to hold well-diversified portfolios) and valuation (the capital asset pricing model). However, I was not completely satisfied with the treatment of investing in a mean-variance context as a one-shot game. At first sight, this seemed unrealistic to me. Surely most investors had investment horizons that extended well beyond one quarter or one year, and most often than not they had the opportunity to rebalance their portfolios along the way—probably at a cost. Did this mean that such a powerful theory was not valid for long-term investors? It was only until I read Paul Samuelson's work and Robert Merton's work of the late 60's and early 70's that I

could precisely connect mean-variance analysis to the larger, repeated game of life cycle investing.

Paul Samuelson established precisely under which conditions mean-variance investing would be valid for conservative long-term investors. Among other things, it would be valid as long as investment opportunities were constant; in other words, as long as interest rates and expected returns on all asset classes were constant over time. In that environment, the world is ex-ante always the same, so that long-term investing reduces to a repetition of identical, one-shot games. Otherwise, mean-variance portfolios might not be appropriate for conservative long-term investors. Robert Merton developed this point extensively and showed that in a world of changing investment opportunities, conservative long-term investing should also include “intertemporal hedging portfolios” that protect investors’ spending needs from adverse changes in interest rates, expected returns on equities, bonds, and other asset classes, or risk.

At the time that Paul Samuelson, Robert Merton and others developed their theory of long-term investing, there was widespread consensus among academics and practitioners of finance that the assumption behind mean-variance analysis of constant investment opportunities was probably a good approximation to reality. This, plus the technical complexity involved in making their investing theory practically implementable (in sharp contrast with the relative simplicity of mean-variance analysis), was responsible perhaps for the relative lack of appreciation for the practical implications of their ideas (unlike their ideas about option pricing, for example).

However, as another previous recipient of this award, prof. John Cochrane, has put it, the new stylized fact in finance that has emerged from the 90’s is that investment opportunities do vary over time. Real interest rates can oscillate widely over time, bond premia are predictable, and the premium that investors require from equities seems to change at business cycle frequencies. Risk also changes over time. This empirical evidence demands a closer look at the work of Paul Samuelson and Robert Merton on long-term investing.

My book with John Campbell on strategic asset allocation that receives today the Paul Samuelson award has sought to provide of empirical content their theory of long-term investing, and to give a step forward towards its practical implementation.

This is only a small step forward, probably only a footnote in the history of ideas and practice of finance. But I do hope that it will motivate other scholars and practitioners to develop a modern asset allocation paradigm that helps conservative long-term

investors, whether individuals or institutions, to protect their spending needs from the savage of unhedged adverse shocks to the productivity of their savings. Finance is not, as people usually understand it, what economists who want to make money study (though there is some truth to that), but a discipline that seeks to understand the uncertainty that inescapably characterizes our future, and the instruments and institutions that mankind have created to cope with that uncertainty. I believe that the institution of insurance (in the widest sense of the word) is perhaps one of the greatest and most genuine human creations. I hope that this book provides people with a better understanding of the uncertainty that veils our future and its implications for investment planning. If it also inspires them to design better instruments and institutions to help others cope with that uncertainty, I will consider the task of this book fully accomplished.

Thank you very much once again for this honor.