Steve Huxley on Daniel Kahneman's Minimize Investors' Regrets by Splitting Portfolios

A recent article in ThinkAdvisor chronicles a discussion with Daniel Kahneman (Nobel Memorial Prize in Economic Science, 2002) at the MorningStar Investment Conference in Chicago (June 11-13, 2018) about the need to find strategies that will minimize investors' regrets. He theorized, based on Prospect Theory, that investors would be more comfortable with portfolios that consisted of two distinct parts: one for stable investments, the other for riskier investments.

Probably without realizing it, Dr. Kahneman was advocating for dedicated portfolio theory as applied to personal finance. Strategies based on this theory for personal finance splits the portfolio into two halves as he suggests. The "Income Portfolio" is stable because it holds individual bonds to maturity that are laddered to supply a cash flow stream over a specified time horizon. The "Growth Portfolio" is riskier because it holds stocks. In its most cautious form, the Growth Portfolio consists of index funds or passive mutual funds matching the same time frame as the Income Portfolio. It is used to replenish the Income Portfolio as each bond matures. The minimax principle is used to determine allocations among the various equity asset classes that will minimize the impact of worst case scenario, thus minimizing the amount of regret that Kahneman describes. It is a form of time segmentation.

Wade Pfau published a three-part article in Advisor Pespectives examining time segmentation strategies. In Part 3, "Is Time Segmentation a Superior Strategy?" (4/3/17), he points out the behavior aspects of the strategy right in line with Kahneman's observations. Pfau travels in good company.

For an article in the NAPFA Advisor Magazine that summarizes how dedicated portfolio theory compares to modern portfolio theory in practice and how it relates to Pfau's findings, click here.

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