

Discussion of

Subjective Beliefs and the Portfolio
Allocations of Institutional Investors

By Andonov, Coutts, Gonçalves, Loudis, and Rossi

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Discussant: J

Overview

- **Question:** the link between beliefs and portfolio allocation
- **Answer:** public pension allocation \approx mean-variance + constraints

- My two cents
 - A good, solid paper
 - Analysis is thorough and convincing

- My comments will reflect my *idiosyncratic* interests/views

Comment 1: What is the null hypothesis?

Which beliefs matter for portfolios?

- Core inputs: subjective beliefs
 - Expected return $\mu = (\mu_1, \dots, \mu_N)'$
 - Volatilities: $\sigma = (\sigma_1, \dots, \sigma_N)'$
 - Correlations $P = (\rho_{i,j})_{i,j}$, where $\Sigma = \text{diag}(\sigma) \cdot P \cdot \text{diag}(\sigma)$

- Mean-variance:

- $w = \frac{1}{\gamma} \Sigma^{-1} \mu$

PORTFOLIO SELECTION*

HARRY MARKOWITZ

The Rand Corporation

1) Response to μ ?

- It seems a bit weird for institutions to not respond. For retail:

Five Facts about Beliefs and Portfolios[†]

By STEFANO GIGLIO, MATTEO MAGGIORI, JOHANNES STROEBEL,
AND STEPHEN UTKUS*

- “... the average *sensitivity* of an investor’s equity share to that investor’s subjective expected stock return is *substantially lower* than predicted by benchmark frictionless macro-finance models”

My personal sense

- For profit-seeking investors that *do* adjust portfolios (including retail), “not responding to μ ” is almost impossible
- My suspicion is the Giglio et al evidence has more to say about *belief measurement* than the belief-portfolio choice link
 - This paper also brings up portfolio constraints
- Responsiveness to μ is important, or we do not have market clearing

2) What about response to σ ?

- This is less clear for retail investors
 - It might explain certain margins (stock vs bond) but not others
- A conversation with my grandma reveals that she does have approximately mean-variance preference, but cannot articulate
- Without response to σ , we have no risk-based pricing

3) Response to ρ ?

- This is where I think prediction breaks down for many retail investors
 - Ample evidence of correlation neglect
 - I failed to teach MV to most undergrads
- Even for institutions, evidence of “weak substitution” w/in asset classes
 - Kojien-Yogo (2019) used a demand function with (almost) no substitution
 - I know less about across asset classes (what this paper is about)
- Matters for the interconnectedness of pricing across assets

Comment 2: can the paper tell us more about the role of each piece of beliefs?

Last sentence in the abstract

liefs to portfolio allocations. Overall, our results show that **beliefs** play a central role in institutional portfolio decisions and that **frictions** critically shape their transmission into observed allocations.

- The paper does show that belief (as a whole) matters
 - It does not separate the individual belief components

ω^* Specification	Variation =	Across Asset Classes	
	Control =	None	ω^b
$\omega_{c,n,t}^* = \frac{1}{\gamma} \cdot \mu_{c,n,t} / \sigma_n^2$	Slope	-0.04	-0.02
	(t_{stat})	(-3.48)	(-1.21)
	R^2_{within}	1.4%	1.1%
$\omega_{c,n,t}^* = \frac{1}{\gamma} \cdot \mu_{c,n,t} / \sigma_{c,n,t}^2$	Slope	-0.02	-0.00
	(t_{stat})	(-2.00)	(-0.16)
	R^2_{within}	0.9%	0.0%
UMVE ($b = 0$ & $\gamma = 3$)	Slope	-0.02	0.01
	(t_{stat})	(-2.35)	(1.17)
	R^2_{within}	3.5%	2.4%
CMVE ($b = 0$ & $\gamma = 3$)	Slope	-0.17	0.15
	(t_{stat})	(-1.62)	(2.51)
	R^2_{within}	3.7%	11.1%
CMVE ($b \neq 0$ & $\gamma = 3$)	Slope	0.66	0.26
	(t_{stat})	(6.01)	(3.49)
	R^2_{within}	46.3%	21.3%

Interpreting the results

- μ does nothing
- (μ, σ) still nothing
- (μ, σ, ρ) still nothing
- + Short-constraint does a lot
- + Benchmarking even more

Where does explanatory power come from?

- Criterion: $R^2(\mu, \sigma, \rho, \text{Constraints})$
- Paper establishes the marginal explanatory power of *Constraints*
 - $R^2(\mu, \sigma, \rho) \approx 0$, while $R^2(\mu, \sigma, \rho, \text{Constraints})$ large
- But what about the marginal explanatory power of μ, σ, ρ ?
 - To be clear, the paper shows that (μ, σ, ρ) matters *collectively*
 - What is the incremental contribution of each component, though?
 - For instance, what is $R^2(\mu, \sigma, \rho, \text{Constraints}) - R^2(\mu, \sigma, \text{Constraints})$?

Summary

- I do like the paper
 - Solid analysis of how public pensions form portfolios
 - Convincingly shows that MV + constraints is a fairly good model
- Perhaps can teach us more about the importance of *each piece* of belief
 - I recommend against revising the paper in response to my discussion