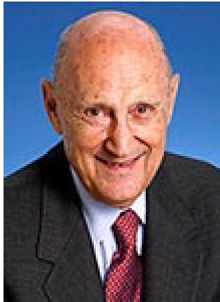
ADVISOR PERSPECTIVES

Burton Malkiel Talks the Random Walk

By Robert Huebscher
July 7, 2009



Passive investing has no more outspoken advocate than Burton Malkiel. At age 72, Malkiel remains every bit as committed to the efficient market hypothesis as when he wrote *A Random Walk Down Wall Street* in 1973.

Malkiel, who has taught finance at Princeton for the last 20 years, was a featured speaker at the *Forbes* Advisor Conference last week. He insists that investors should buy and hold index funds and defended his position against a series of challenges put to him by John Dobosz, a *Forbes* editor.

Against institutional investors, who are responsible for 98% of all trading, individuals don't stand a chance, Malkiel said. "Institutions can't beat the market because they are the market," he said, and individuals can't expect to do any better.

Fundamental analysis does give investors an edge, but Malkiel said that it works so well that any valuable information gets reflected so quickly in stock prices that investors cannot make any money by using it. Malkiel agrees with Steve Forbes, who learned from his grandfather that you make more money selling information than trading on it.

Investors who choose stocks with certain characteristics, such as low P/E ratios, high growth rates, or upward EPS revisions, are likely to fail because these metrics are "too isolated" to work in the long run. There is "some evidence" that value stocks do a little better than growth stocks, Malkiel admitted, and it would be a reasonable strategy to tilt portfolios in that direction. But he cautioned that value stocks don't beat growth stocks consistently – certainly not in the late 1990s. "And if it does work," he said, "it doesn't mean that the market is inefficient but that in some sense those stocks are riskier." On a risk-adjusted basis their returns are not exceptional, he said.

On a similar note, Malkiel conceded that small companies have historically outperformed larger companies, based on data going back to 1926. "But that doesn't happen all the time," he said.

"To the extent that you get a higher rate of return it may just be a compensation for higher risk," he added.

Malkiel finds other active strategies even flimsier. "Technical analysis," he said, "is most akin to astrology." It does not give investors a dependable way to beat the market. He

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conceded that there is a “modicum of truth” that momentum helps explain stock prices. But he said the resistance to momentum can be enormous and “there is not enough momentum to make excess profits.”

In 2001 MIT Professor Andrew Lo wrote the rebuttal to Malkiel’s book, *A Non-Random Walk Down Wall Street*, demonstrating that stock prices do not follow a pure random walk. Malkiel dismissed Lo’s findings. “Whatever irregularities exist in stock prices, such as momentum, are so small that after transaction costs investors cannot profit,” he said.

Malkiel scoffed at the suggestion that investors like Bill O’Neil could profit by detecting patterns in stock movements. Malkiel said he hears claims like this “all the time” from his students. “If you massage the data long enough you will eventually find a pattern. There are lots of patterns that look like they work,” he said, “but very few will continue to work – and nothing that is truly dependable.”

Buying stocks that pay high dividends hasn’t worked either, according to Malkiel, who said investors following this strategy would have owned a lot of financial stocks in 2008 – precisely when their prices collapsed.

Even behavioral finance – a field pioneered by Malkiel’s Princeton colleague and Nobel laureate Daniel Kahneman – fails to give investors an edge. It explains why investors are overconfident and over-optimistic, but doesn’t offer any sure-fire way to beat the market.

If stock picking and fund picking are out of the equation, can financial advisors still add value?

Unquestionably, Malkiel said, the answer is yes. His view of financial advisors has evolved, and he now believes they should play a much bigger role for investors. “The most important thing is to keep investors in a steady state,” he said.

Widows and widowers of his fellow Princeton professors seek Malkiel’s advice for investments, he said. Many came to him in late 2008, weakened by the market and wanting to sell, which he said would be the “biggest mistake” they could make. Advisors can help in those situations by “keeping people on an even keel.” Even younger people can benefit from financial advice, such as encouragement to dollar-cost average rather than “quit the program” when markets turn down.

Malkiel recited the results of numerous studies showing that investors, on average, underperform the funds in which they invest, because they tend to sell at the bottom and buy at the top. “I am absolutely convinced financial advisors can play a critical role in addressing this,” he said.

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Telling someone you can't beat the market is like telling a six-year old that Santa Claus doesn't exist. Malkiel said it is okay for investors to allocate a portion of their funds to active management, but only after the core funds have been safely invested in index funds.

Malkiel actively manages a portion of his funds, specifically in China, which he said is the "fastest growing place in the world," with companies that have reasonable P/E multiples in line with the rest of the world.

He invests in closed-end funds when they are priced at a discount of at least 20% to their net asset value, such as was recently the case with the Templeton Dragon Fund. He also owns HAO, an ETF that tracks an index of small Chinese companies. HAO is offered by Alpha Shares, where Malkiel serves as Chief Investment Officer.

As for gold, Malkiel said it works as a hedge against Armageddon and recommended keeping a "sliver" of your portfolio in commodities. Three months ago he bought Freeport McMoRan Copper & Gold (NYSE: FCX), which gives him exposure to both copper and gold. China will lead the world out of the recession, and its natural resource needs make Freeport a very good way to play this scenario, Malkiel explained.

Malkiel did not say when he expects the economy to recover, but he forecast higher interest rates. He ruled out the possibility of hyperinflation – "we have learned enough" to prevent that scenario – but said the monetary authorities will have trouble draining liquidity from the system. Unemployment will remain high and political pressures will prevent Democrats from taking measures to restrain federal spending, which will be the primary force pushing interest rates up.

Although the economy looks "frighteningly like the 1929-1932 period," Malkiel said, another Great Depression is off the table – at least that is what the stock market is saying. "How strong the recovery will be remains to be seen," he cautioned.

Returning to the message that he has preached for the last four decades, Malkiel concluded by warning advisors that "anything you find that will make money will eventually self-destruct. There are too many smart people looking for those opportunities."

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