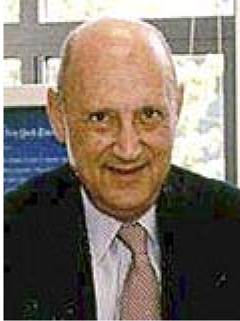
ADVISOR PERSPECTIVES

Burton Malkiel on Indexing, Active Management, China, and the Value of Financial Advisors



Burton G. Malkiel is the author of A *Random Walk Down Wall Street: The Time-Tested Strategy for Successful Investing, 9th edition (published 2007)*, which has sold over 1 million copies. The newly revised ninth edition is available now through Amazon. He is working on a new book about opportunities in China titled *From Wall Street to the Great Wall*, due out in December. In an exclusive interview, Mr. Malkiel talked with Elaine Floyd about darts and blindfolded chimpanzees, ETFs, hedge funds, commodities, and why he has come around to appreciating the value financial advisors bring to their clients.

You were one of the first proponents of the efficient markets hypothesis. Your vision of a blindfolded chimpanzee throwing darts at the Wall Street Journal stock tables is has endured through three decades of bubbles, crashes, and a raft of studies purporting to discredit your theory. According to the latest edition of your book, you are still a believer. Has anything happened in recent years to weaken your position that indexing is the best way to invest?

> Nothing has happened to weaken my position. Indeed, I believe more strongly in the thesis of the random walk than when I first wrote the book in 1973. One thing I might change -- although the vision of the blindfolded chimpanzee throwing darts at The Wall Street Journal was very cute -- would be to throw a towel over the stock pages. The idea is that you should not select a portfolio by throwing darts, but rather buy an index fund that buys and holds all the securities in the market.

By the way, who won The Wall Street Journal's contest between the darts and the experts?

> They actually had me throw out the first darts for that contest. Who won depends on how you measure it. There was always a pop in prices the day the article came out as the experts gave their reasons for their picks, and the market reacted. If you bought at the close of the day before the article came out, the experts won. If, however, you bought at the open on the day the article came out (once the public information had been incorporated into the market prices), the darts won. Measured correctly, it certainly cannot be shown that the experts beat the dart throwers.

You and many other experts believe we are entering a low-return environment for stocks. What if an endowment with specific spending goals or a baby boomer who hasn't saved enough needs to earn more than your projected 7.5% to 8%? Is it ever justifiable to adjust portfolio allocations (e.g., put more in emerging markets when they are doing well, less when they are not) or concentrate on select, smaller slices of the market in an attempt to earn more than the broad-market average?

> In a low-return environment you would have to believe in indexing even more. If you're making 20% you don't mind paying 2% in costs. But if you're making 8%, paying 2%

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makes a huge difference. If you compound $1,000 at 8% for 40 years you get $21,000. But take away 2% and compound the $1,000 at 6% and you get only $10,000 -- less than half. As far as whether you should adjust your portfolio allocations and put money where things are doing well, that's the mistake most investors make. In early 2000 they saw that high-tech funds were doing well so they put their money into high-tech funds and it was exactly the wrong thing to do.

One thing that has changed my view since the book was first written is the impact of China on the world economy. China is probably more capitalist than any country in the world. So, over time, as conditions change, you might very well change your allocation. I would put much more in emerging markets today than I would have 30 years ago.

In your book you give do-it-yourself investors some rules on how to pick stocks. How do you reconcile this advice with your stance on indexing?

I've always said that telling people they can't beat the market is like telling a 6-year-old that Santa Claus doesn't exist. The market is fun, and if you want to buy some individual stocks, go ahead. But make sure the core of your portfolio is indexed. Then you can by stocks with less risk.

How is your own portfolio invested? How much is indexed versus active? Do you manage it yourself?

The vast majority is indexed. In my IRA, 403(b) and Keogh plans I own a variety of indices that include bonds, stocks, developed and emerging foreign markets. Outside of retirement plans I'm more active. For example, I own an ETF based on the FTSE Xinhua 25 Index (FXI). And yes I manage it myself because it's fun. [Editor’s Note: See our article about how to allocate ETFs in portfolios in a tax efficient manner.]

The portfolio allocations in your book include stocks, bonds, cash, and real estate. What role can commodities, currencies, private equity, or other alternative investments play in a portfolio managed by an advisor for a HNW/UHNW investor?

Let me talk about currencies first. Going back to my own portfolio I own currencies indirectly through un-hedged holdings of international stocks. I wouldn't buy currencies directly. In general, I am not a fan of alternatives and in particular of hedge funds. When you adjust the measured returns for survivorship bias and a number of other biases you don't do any better after expenses with hedge funds than in the stock market.

I've become a bit more positive on commodities. This is probably a change in my thinking over the years. Commodities for many years were trendless. But with the growth of China and India and their voracious appetite for commodities -- and the fact that commodities are good diversifiers -- I might put them in a portfolio. But I would do it with an index of commodity producers as opposed to buying the commodities themselves.

What do you think of the vast proliferation of ETFs that cover every conceivable slice of the market?

I'm not sure that buying ETFs for every slice of the market is a good idea, but I'm not negative on ETFs. I'm actually a fan of ETFs for the active part of the portfolio. Let me give you an example of where ETFs can play an important role. Let's say I've got the core indexed and I think that biotech is the place to be for the future. If we're going to conquer

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cancer it's probably going to be by a biotech company, not a Merck or a Pfizer. But it's such a crapshoot. The way to play biotech is with an index fund that holds all the biotech companies. I call this active management, and where ETFs make considerable sense.

What do you think of the new methods of indexing that weight stocks by fundamental criteria rather than market capitalization?

I've had many debates with Robert Arnott on this and I think that fundamental indexing is essentially active management because it alters the portfolio to give it two biases, a small cap bias and a value bias. Now, fundamental indices have done very well over the past six years because value stocks and small cap stocks have done well. Will they do well over the next six years? I'm not so sure.

How can financial advisors add the most value for their clients?

By pushing their clients to diversify more and keeping them on an even keel. I appreciate this so much more now than I did in the beginning. It's not about telling them to sell DuPont and buy Dow, but rather allocating assets to categories that clients might not go into on their own. In October of 2002 everybody wanted out of stocks, but advisors who told their clients to stay the course did exactly the right thing. Advisors also add value by putting bonds in the IRA and stocks in the taxable account, that kind of thing.

How do you recommend constructing a globally diversified portfolio?

Investors should put far more into foreign stocks, both developed and emerging markets. The U.S. stock market is only about 42% of the world's stock market capitalization. Unfortunately, most people don't have the stomach to invest over half their money internationally. But advisors can play a big role in encouraging their clients to invest more overseas and in assessing risk tolerances and educating clients about how long they may need to hold these assets. The word 'volatility' was invented for the Chinese stock market, so clients may need some hand holding. I will say that I have much more admiration for advisors than I might have had early in the game, when I would have said buy an index fund and forget the advisor.

How often should an advisor rebalance a diversified passive portfolio?

Once a year, not more often.

Your descriptions of previous bubbles make for very compelling reading. It's quite a history lesson! If we were to reenter a time like 1999-2000, when it was apparent we were in a bubble, would that be justification for reducing our stock allocation to zero or should we stick with our same allocations even when we know the market is getting ready to crash?

One of the changes in the book was to add the Internet, the biggest bubble of all time. Would knowing a crash is imminent be justification for trying to time the market? I would say no. You only know these things after the fact. Everyone is so smart now. Everyone knew you should have been out of the equity market in early 2000. Alan Greenspan made his irrational exuberance speech in 1996. My friend Robert Shiller thought we were in a bubble in 1992. To try to time this you have to be right twice and nobody can do that. I say rebalance, take some money off the table, but don't try to make the active bets of knowing when the crash is coming.

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What is your current outlook?

Within the next 10 to 20 years China is going to be a bigger economy than the U.S. when adjusted for purchasing power. People ought to have more exposure there than they currently have. My new book is going to try to make that case. I would pick China over India but I also think India will grow rapidly.

What is the best way to invest in these countries, ETFs, index funds, or actively managed funds?

My work suggests that actively managed funds don't do any better than the indices. I would invest through ETFs, with one exception, and this is just for today. If you asked me today I'd tell you to buy the Templeton Dragon Fund (TDF), an actively managed closed-end fund that is selling at a 15% discount. The discount is variable and could be 8% tomorrow. Generally, though, I do it through ETFs and index funds, unless low-cost actively managed closed-end funds are available at substantial discounts. [Editor's Note: TDF is owned very sparsely in the Advisor Perspectives universe, held by only two advisory firms in three accounts.]

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