Intelligent Investing Transcript

Transcript: Burton Malkiel

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Efficient Doesn't Mean Perfect

Steve Forbes: Well Burt, good to have you with us. And before we begin our conversation, I'll plug your books, because one is a classic. You have a new version coming out in November, *A Random Walk Down Wall Street*. Absolute classic and I'm delighted that *Forbes* magazine did a cover story on this in the early 1970s. Give ourselves a pat on the back. And then for every investor, *The Elements of Investing*, that you and Charles Ellis came out with a few months back.

Burton Malkiel: It's a great pleasure, Steve, for me to be here. And it was that cover story that I think helped start *Random Walk* on its successful path, because now it's done over a million and a half copies, and you guys were the ones who gave it its start, so I appreciate that.

Forbes: I only wish we'd gotten a part of the royalties. But now let's begin by talking about efficient markets, which have been attacked now because of what's happened in the last couple of years. And define efficient markets and as you recognize, you say markets make mistakes. It doesn't mean the market is going to be perfect all the time.

Malkiel: No. And I think that's one of the mistakes people make when they talk about efficient markets. Efficient markets does not mean that the price of every security at every moment in time is correct. In fact, prices are always wrong. Let's say that stocks are valued, just as I teach my students, they're valued as the present value of all of the dividends you expect to receive from them in the future. Well, that's the key element. It's in the future. I guess it was Yogi Berra and lots of other people have said, "It's hard to make predictions, especially about the future." And so prices are always going to be wrong. And the problem is we don't know at any time whether they're too high or too low. And so I am not one who says that this experience suggests that the efficient market theory is dead.

And I think the best evidence that markets can't be really terribly inefficient is that when you look at active managers as a group, you look at actively managed mutual funds, and sure, there are a few who outperform. But the evidence, and every time I write the book, I ask whether the data were consistent with the evidence. And every time that I do it, I find it's always two thirds of active managers who are beaten by a simple index that does nothing but buys and holds all the stocks. And the one third that beat the index in one period aren't the same ones who beat it in the next period. So to me, what efficient market

means is it's kind of, there's an old academic joke about it. The efficient market professor is walking along with a couple of graduate students. The graduate students see a $100 bill on the ground and one of them stoops down to pick it up.

And the efficient market professor says, "Don't bother to pick it up. If it were really a $100 bill, it wouldn't be there." Well, I don't quite go that far, but I tell my students, "Pick it up right away because there are too many smart people around who are going to pick it up and it sure won't be there for long."

Why Indexing?

Forbes: Great. Now in terms of why, then, indexing, you've sort of already answered it. And you made the point that, over a period of time, I think it was from 2007 to a 20-year period, stocks went up an average of 11.6%, but individuals were about barely one-third of that, a little over 4%.

Malkiel: Well, you know, that's another thing. And one of the reasons that individuals don't do as well is that--

Forbes: So it's not just money managers. Individuals can't do it, either.

Malkiel: Money managers and individuals. And there is a lot of very interesting stuff that's been done with behavioral finance. My colleague at Princeton, Danny Kahneman, who wasn't even an economist, won the Nobel Prize in economics for behavioral finance. We know that there's a lot of hurting in the market; that when everyone's optimistic, when you go down to the golf club and someone tells you how well they did in the stock market, when CNBC and the other financial networks are telling you how good things are, you tend to put your money in. And when everyone says the sky is falling, you take your money out.

And it's just almost like clockwork. More money went into the stock market during the last quarter of 1999 and first quarter of 2000, when now we know there was this Internet bubble, more money went in at that time than ever before and it didn't go into value stocks, it went into these high-tech funds. More money went out of the market in the third quarter of 2002 when the sky was falling and it turned out to be about the low of the market and again, in 2008, just at the low of the market, scads and scads of money went out of the market. And the reason, and it's not just individuals. If you look at the cash position that professionals hold because they know how to time the market, you look at that, and they invariably hold most of the cash at the bottom and almost no cash at the top of the market.

And that's why, in some sense, it sounds so counterintuitive that it's sometimes sloth and just standing there and doing nothing will give you a better performance than trying to

think you're so smart and you can get in and out at the right time because you don't get in and out at the right time. We know that you get in and out at the wrong time.

Timing is a Loser's Game

Forbes: So timing is for suckers.

Malkiel: I think timing is, I do think that timing is for suckers. I like to quote my friend Jack Bogle, who says he has never in 40 years in the business known anyone who could consistently time the market, nor has he known anyone who knows anyone who has consistently timed the market.

Everyone in the Pool

Forbes: Now if everyone followed your good advice on indexing, would it still work?

Malkiel: Well, that is a paradox because you do need some active people around. You do need the hedge fund guys. You need the private equity guys to make the market efficient. And what I often say is that when 95% of the market is indexed, I'm going to start worrying about that problem. But when only about a third of institutions' index and only 10% to 15% of individuals do, I'm not going to worry about that.

And some people say to me, "Hey, you've been on this soap box now for almost 40 years. Are you disappointed that the numbers are so small?" And I say, "I'm not disappointed at all. It's that, you know, it's 'Is the glass half empty or half full?'" The fact that an idea that was an academic idea has, in fact, had that much traction in the real world makes me you know, I'm very satisfied. And more and more money is being indexed all the time. And when it gets to be 90%, 95%, I am going to worry about that.

Forbes: But you're probably going to be protected by human nature.

Malkiel: I think so. I think so, yes.

Dollar-Cost Averaging

Forbes: Now in dollar cost averaging, another thing that seems so passé, works. And you make the point it would have worked in this past decade.

Malkiel: It would have worked. I mean there are two techniques. One is dollar cost averaging and one is rebalancing. And by dollar cost averaging, I simply mean you put a certain amount of money into your investing program every couple of weeks, every month, every quarter. You put the same amount of money in as you would if you were funding a 401(k) plan.

Rebalancing says suppose you decided, given your risk tolerance, that you couldn't stand to have 100% in stocks and you wanted 50% in bonds. Well, what rebalancing says is that every year, and no more than once a year, you look at where you're at. And if one of the asset classes has gone over the 50%, like to 60%, you bring it back into balance and put the money into the other one. And interestingly enough, the period from 2000 to 2009 was often referred to as the lost decade.

Forbes: Right.

Malkiel: If you simply put a dollar into it, and even an index fund, you ended up with less money at the end of the decade than you had at the beginning of the decade. But if you rebalanced and dollar cost averaged, you actually would have done extremely well. And in fact, again, it sort of puts things on automatic pilot and protects you from buying when everyone's optimistic and selling when everyone's pessimistic. And look, just why would it have worked in the decade? Well, let's take my 50/50 investor. It's Jan. 1, 2000. You don't know it's the top of the market or just about the top of the market, but you would know that the Federal Reserve was increasing interest rates, bond prices were falling and your bonds were only about 40% and your stocks had gone way up, they were 60%.

Dollar cost averaging says, OK, you take some money off the table, out of the stock market and put it in the bond market. You then get to January of 2003, just after the bottom. You don't know that it was just about the bottom, but what you know is the Federal Reserve had lowered interest rates, bond prices were way up, stocks were way down and so you were 60% bonds and only 40% stocks. And what the rebalancing says is that you take some money out of the bonds and put them in stocks. Similarly, dollar cost averaging says that you will buy more shares. You put the same dollar amount in, but you buy more shares when the price is low. And these two techniques really they do a terrific job.

One of the things that I've tried to show, and there's one other technique I think I'd like to mention that I have put in this 10th edition of *Random Walk*. The other is that I don't think that people are nearly diversified enough internationally. The U.S. is only about 40% of the world economy. And the rest of the world economy is growing a lot faster. Not Europe, but the emerging markets. China may be a Communist country, but I'll tell you, there's more bare knuckled capitalism there than sometimes I see in the United States. China's been growing at 9%, 10% a year. And so if you also rebalanced, dollar-cost averaged and put some of your money internationally and, in particular, into emerging markets, it wasn't a lost decade at all. In fact, you could have doubled your money.

Diversifying Internationally

Forbes: Now in terms of talking about diversifying outside the United States, in terms of percentages, do you go by GDP, by equity values of the various markets? How should it be chopped up?

Malkiel: Well, look, as an indexer, I probably, to be consistent, should tell you, you just put it in depending upon where the capitalization is. I mean that's really what an indexer does. If China is 2% of the world's capitalization, then 2% in China.

But for some very peculiar reasons, China is under-weighted in that scheme. And there are two reasons for it. When people look at the capitalization of a market, they so-called float weight it. It's only the float that trades freely that gets counted. Now the Chinese have an alphabet soup of shares. They have so-called A shares that trade in Shanghai and Shenzhen and are only available for local investors because China has currency controls and China has controls whether the money can move in and out. So the main part of the Chinese equity market doesn't count in the capitalization. The other thing that happens is that if there is a so-called control holding and it doesn't trade freely, that's not part of the float. And China has been getting to be a more and more capitalist system, but the government still owns half of the shares of the banks, of the oil companies, and so those aren't included in the float.

And so I think China gets a little short shrift in terms of its weight because, if you just, it's only about 2% of the world indexes. And so I would tend to maybe go a little away from cap weighting into looking at GDP. And incidentally, that could have protected you from the great Japanese bubble because when Japan had its real estate and stock bubble, Japan got to be 50% of the world's capitalization. And I mean it was kind of crazy. So I do like the idea of getting close to GDP. Now look, these markets are risky. And--

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The Risks Abroad

Forbes: Well that leads to perhaps why you need an index fund. You have problems with transparency, you have problems with governance. You mentioned you have A shares and you have Hong Kong and other shares trading and since people in China, investors, have so few outlets, you get a distorted market there when there's a lot of money created.

Malkiel: Yeah, no, you're absolutely right. But the only shares that you can buy, then, are the Chinese companies that have registered with the Securities and Exchange Commission, report under GAAP. I mean a company like Baidu, that is listed in New York. In fact, it isn't even listed in Hong Kong.

And what my friends on the Hong Kong stock exchange tell me is that the companies who list there are more transparent. They report by international accounting standards and they're a lot better. I mean, yes, there are problems and I'm certainly not suggesting that anyone try to buy the A shares.

Forbes: Right.

Malkiel: It's only the more transparent. But you're absolutely right. This is a risky world. But one of the things that I'm not worried about, about the Chinese, is a lot of people say, "Look, it's a Communist country."

"They are going to go back, and the government will clamp down and they'll control everything." And I don't think that's going to happen. When Deng Xiaoping took over from the extreme--

Forbes: Right.

Malkiel: --radical socialism of Mao, Deng was a pragmatist. He said, "Well, you know, stock markets aren't supposed to be consistent with Communism, but let's see whether they'll work." Here, Deng Xiaoping said, "To be rich is glorious."

When China started on this introducing capitalism and engineered this enormous growth, and I spent a lot of time talking to government officials in China, boy, they know that capitalism works. I wish Nancy Pelosi knew as well as the Chinese, as the Communists on the Chinese government that capitalism really works.

Forbes: And I guess, too, without growth, they don't survive.

Malkiel: That's right. That's absolutely. Without growth, they don't survive because they've got a problem. All the growth is in the East. The center and West is poor. That's where there's a lot of the unrest.

And that's why the government is trying to make sure that that growth moves to the center and West. The factories are moving there. And look, there's no doubt, the main objective of the Chinese government is to stay in power. And they see the growth as something they need to continue in order to stay in power.

Forbes: As you say, if only Washington had the same attitude.

Malkiel: Yes, indeed.

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