EMPIRICAL
WEALTH MANAGEMENT

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Market Insights from Dr. Burton G. Malkiel Ph.D.

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Introduction

I recently had the opportunity to hear Princeton economics professor and multi-book author, Burton Malkiel. He spoke to a small number of advisors in Seattle during an Investment Symposium sponsored by Vanguard. His book *A Random Walk Down Wall Street*, originally published in 1973 and now in its 9th edition, is a perennial bestseller and one of my favorite investment books. I was excited to hear Burton's current thinking on the market and the economy and we thought you may be interested in a summary of the insights shared during this unique discussion.

This short paper provides you with an overview on how the financial crisis took shape, the implications for our financial system, the economy, and Burton's advice for investors right now. I start with his advice for investors before moving to a summary of the financial crisis and its implications.

What should investors do now?

The title of Burton's discussion was a "Random Walk Down a ***Troubled*** Wall Street." The statement "random walk" refers to the tendency for investment markets to move in patterns that are unpredictable over the short run. The analogy that is often made compares daily stock market movements to the path a drunkard would take while stumbling down the street. The investment market, like the drunkard, moves in steps that are erratic and unpredictable. The implications of the random walk theory are that market timing and individual stock selection are of little value to investors. Three decades after his first edition of *A Random Walk Down Wall Street*, Burton's belief in the random walk theory has remained intact. Scores of additional research has confirmed his views. In fact, the only thing that has changed for Burton is a greater appreciation for the role a financial advisor plays. Advisors help investors make appropriate asset allocation decisions, stay diversified, and remain invested during difficult markets, among other things.

Burton's current investment advice is to **stay invested** in the market. He gives this advice in concert with his belief that we have further economic difficulties ahead of us. Why does he suggest staying invested if he believes the economy will continue to struggle in the near term? The reason is that the stock market is a forward looking mechanism that adjusts so that current prices already reflect economic estimates. He believes that investors should stick to their asset allocation and that they will be well-served by rebalancing their portfolios, adding to investments through dollar cost averaging (for those who are still saving), controlling investment expenses and taxes and remaining adequately diversified.

Below are a few direct quotes I noted during this portion of the discussion:

"We will get through this crisis, stay the course."

"Do not market time, getting out and waiting for things to get better is a recipe for disaster!"

"In the last 40 years I have not seen relative valuations (such as earnings, book values, and dividend yields) as low as they are today in certain asset classes."

"I do not believe that we will enter a depression."

It's important to note that Burton is not saying that markets could not continue to decline in the short run. In fact, he was clear that it is impossible to tell how the market as a whole will react as news continues to roll out. What he said is that even if the market declines further the strategy of holding the course is the most prudent approach. Capitalism will prevail and we will emerge from this situation to better times as we have in the past. Staying invested is the only way to assure that you will be there when the market recovers.

Penalties of Timing Markets

Investors have the tendency to be penalized with a reduction in long-term returns when they attempt to adjust their portfolios to reflect the news of the day. Malkiel divided the actions of investors into two categories of penalties:

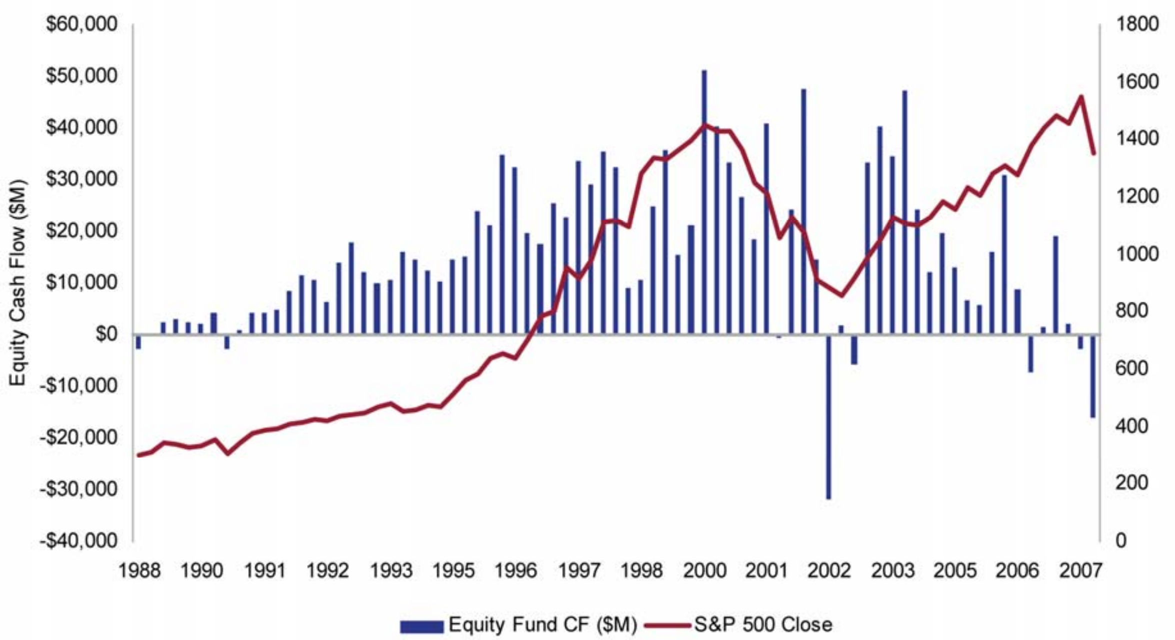
1. ***The Timing Penalty***
2. ***The Selection Penalty***

The Timing Penalty

The timing penalty is the reduction of returns experienced by investors who unsuccessfully attempt to pick the right time to be in and out of the stock market. Most of the time investors do this by projecting the recent trend of the market into the future. As such, they adjust their portfolios according to the trend by adding to stocks after stocks have increased and reducing exposure to stocks after stocks have declined. The news that investors are exposed to supports the market trend and often gives investors a sense that things will continue down the same path indefinitely. We can see how investors behave during up markets and down markets by examining the movement of money in and out of retail mutual funds. Figure 1 below provides quarterly cash flows in and out of equity mutual funds from 1988-2007 plotted along side the price movement of the S&P 500 index.

More money flowed into equity funds during the first quarter of the year 2000 than any other previous quarter going back to 1988. This inflow of investor money coincided with the peak of the S&P 500 stock index. Subsequently, the largest amount of money was taken out of equity mutual funds in 2002 just before the market bottomed and began to rise again. It's clear that investors were buying at the top of the market and selling at the bottom. Following the herd of investors by buying after the market has appreciated and selling after it has declined is a costly approach. To quote Warren Buffet, "be fearful when others are greedy and greedy when others are fearful".

Figure 1

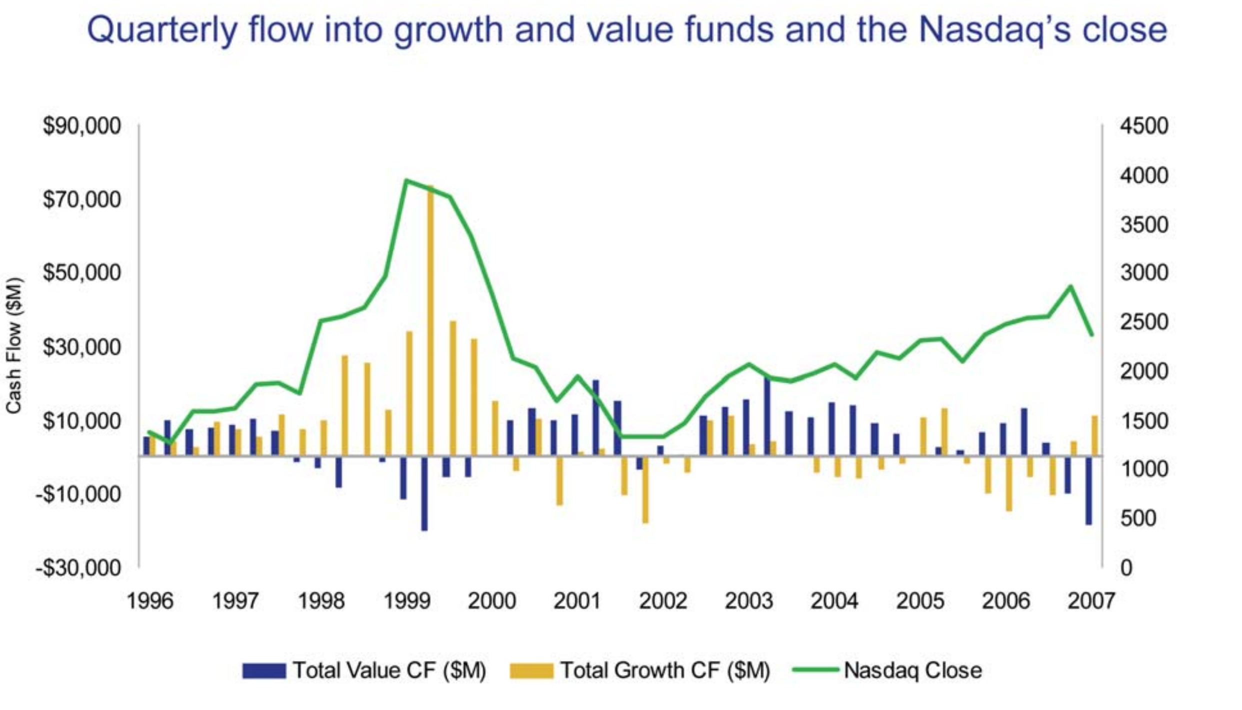


Sources: SimFund, Bloomberg, and Vanguard.

The Selection Penalty

The selection penalty is loss of returns many investors experience by adjusting their portfolio to be tilted toward a recently hot performing sector while reducing exposure to recently poor returning sectors. Figure 2 shows the success investors have had making those timing decisions. In this figure we have quarterly cash flows for growth and value equity mutual funds plotted with the price history of the NASDAQ index (a growth weighted index). As we can see from Figure 1 and Figure 2, investors were not only piling into stocks at the peak of the market, they were also pulling money out of poorly performing value funds to buy growth funds. Unfortunately for investors, when the market subsequently declined growth was hit significantly harder than value. From January of 2000 through December of 2002, the Russell 1000 growth index declined over 55.48% while the Russell 1000 value index declined only 14.66%. Figure 2 shows that most of the money going into equities prior to the market decline was directed toward growth.

Figure 2



Sources: SimFund, Bloomberg, and Vanguard.

Summary of Financial Crisis

Burton began his discussion with a recap of the credit crisis which precipitated the acceleration of declines in the stock market since September of 2008.

The credit crisis was precipitated by a bubble in housing prices that begin in 1999 and peaked in 2007. See Figure 3 below for Shiller* data on historical national housing prices to get an idea on the extent of this housing bubble. On a real (inflation adjusted) basis housing prices were basically flat from the late 1890s through the late 1990s. There was virtually no real appreciation across the country for an entire century. You can see the break in the trend line from 2000 to the peak in 2007 and the subsequent decline to date. If we believe that housing will continue to revert back to the long-term trend then we have further to go before seeing a bottom in the housing market. Yale economics professor, Robert Shiller, contends that there are a variety of reasons why housing should not be expected to offer significant price appreciation over the long run.

"What experience and history teaches us is that people and governments have never learned anything from history, or acted on principles deduced from it." -Georg Wilhelm Friedrich Hegel

We don't have to be as cynical as Hegel to ask a simple question: how did we go from a stock market bubble directly into a housing bubble? As a collective it seems that there are times when we do not know our market history so we make decisions based on our limited set of experiences. We have to realize that what we may not know is the market history that we don't know. In other words, just because we have not personally experienced the current market circumstances before does not mean that there are no historical references. Another mistake we make is to ignore market history and believe that this time it's different.

Figure 3

Sources: Robert Shiller and *Business Week*.

The exuberance in housing prices was fueled in large part by a fundamental change in the way lending was conducted (Burton refers to this change as the "new system of finance"). The traditional model where lenders would underwrite loans, hold those loans on their balance sheet, and service the loans (traditional banks lending to home buyers) was transformed to a new system. This new system is referred to as the "originate and distribute model." Under this model banks would originate loans and immediately sell the mortgages to investment banking firms. This was not only done with mortgages, but with all kinds of debt such as student loans, credit cards, business loans, and others. The effect of this was a loosening in credit standards because the banks knew they would only hold the loans long enough to sell them (maybe a few days).

The banks and other mortgage originators (like Countrywide Financial) began making sub-prime loans that would have been unheard of ten years earlier; these loans are often referred to as *NINJA loans* (meaning no income, no job and no assets). These *NINJA loans* seemed to be less risky because the market as a whole seemed to believe that housing would never go down. These loans fed the housing bubble as everyone could become a home owner. Further, it is my view that investors began looking at homes as viable investments, rather than places to live. With lending standards lowered and innovative mortgage products, people began purchasing homes as investments.

The price appreciation which could not continue indefinitely into the future was further spurred by what is referred to as "shadow banking." Shadow banking is the process of selling of mortgages to outside investors. These outside investors could use leverage that would be two to three times that of a traditional bank, compounding the losses when housing prices reversed. The popularity of CDOs (collateralized debt obligations) among investors increased with hopes of higher bond returns. Pools of mortgages were placed in different buckets (tiers or tranches) that were differentiated by the order in which defaults would be assigned to each bucket. The top tier was often given investment grade ratings by the rating agencies. This was in spite of the fact that the total pool of mortgages included sub-prime loans because the likelihood of defaults reaching the top tier was considered to be low. Further, derivatives like credit default swaps (CDS) exacerbated the risk exposures to many financial institutions when the inevitable decline in real estate occurred.

Implications of the Financial Crisis

Burton discussed some implications from the financial crisis during his talk. For financial institutions that are providing credit to businesses and consumers the adjustment period will extend through 2009. Credit will be more difficult to access as over 50% of the existing banks have made moves toward tightening their credit standards. Housing prices may have further to fall, as we discussed earlier housing prices are still above the historical long term trend on a national basis. This means that consumers will not be able to refinance and use their homes as ATMs.

While no one knows exactly how long it will take for the economy and the market to recover from the contraction we are experiencing it is clear that the market has adjusted to a lot of bad news. You can see this in the spreads between corporate bonds relative to treasuries and the low relative valuations of equities around the world. Equity holders are demanding a premium for the risks of being invested because of the tough climate. For those of us who stay the course, it means that the next ten years of investment returns should provide a premium over alternatives like cash or CDs. As we discussed in the first section of this paper, the results of following the herd into and out of markets can be devastating to your long term returns.

Knowledge from this Experience

In hindsight, it is clear that multiple parties (the government, investment banks, commercial banks, rating agencies, investors, and home buyers) ignored market history and treated the prospect of a declining real estate market as highly unlikely. It is our advice to maintain an investment discipline that protects you from the desire to chase hot investment sectors and avoid poor performing sectors. This is done in the context of a written plan that establishes long term targets to each asset class in your portfolio. It is imperative to rebalance the portfolio back to the targets regardless of how well or poor certain asset classes have been performing.

There are many benefits to this approach: you will protect yourself from being overexposed to a segment of the market that is overvalued and likely to decline significantly just after you bought in, you will save on taxes and costs by not transacting in pursuit of a hot performing investment, you will likely increase your returns because you will buy investment classes when they are cheap and sell those that have become inflated and most importantly you will maintain the appropriate amount of risk.

I hope this summary has been insightful; please feel free to contact us if you have any questions or comments.

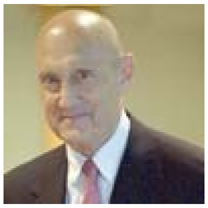
Sincerely,

Kenneth R. Smith CFP®, MS
Chief Executive Officer

Footnotes:

** We recently interviewed the co-creator of this housing index Professor Robert Shiller from Yale University. That interview can now be found on our radio website under the guest speaker section. Click here http://www.successfulinvestingradio.com/guest.php to go to the interview or visit the radio website at www.succesfulinvestingradio.com.*

Bio Information: Burton Malkiel



Burton Malkiel, the Chemical Bank Chairman's Professor of Economics at Princeton University, is the author of several highly regarded investment books, including *A Random Walk Down Wall Street*. Dr. Malkiel is a longtime economics professor at Princeton, where he was chairman of the economics department. He has also been dean of the Yale School of Management, as well as the William S. Beinecke Professor of Management Studies at Yale. He is a past appointee to the President's Council of Economic Advisers. In addition, he currently serves or has served on the boards of several financial services industry corporations, including Vanguard and Prudential Financial. He has served on several investment management boards, including the investment committee of the American Philosophical Association. He is a past president of the American Finance Association and is a member of the American Economic Association. Dr. Malkiel earned a B.A. and an M.B.A. from Harvard University and a Ph.D. from Princeton University.