# the unbeatable market

By Ron Ross, Ph.D
Bookmasters, Inc. Ohio
240 pages

review rating
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Dr Ron Ross has written an unqualified indictment of active funds management, which, whilst certainly interesting, holds less value in Australia than it does in the US.

Ross is now an investment adviser, and has been so for 25 years, prior to which he was a professor of economics at Humboldt State University in California. He speaks with a wealth of practical experience, and he considers that the efficient market hypothesis (**EMH**) is now so well accepted and proven that it is beyond argument. It is therefore a little surprising that he states and then repeats his case repetitively throughout this text. He also overstates the case with unbridled dogmatism which wears thin as he continuously postulates only one blind faith. For example: “If you were smart, you wouldn’t be trying to beat the market in the first place”, p184, and then “The central message of this book is that truly beating the market is impossible”, p 222. Sometimes this strays into puzzling contentions: “After all, beating the market by definition means that you can make a higher rate of return than prevailing interest rates” – p 99, and this is especially odd when one considers that he wrote this book in 2000/01, when beating the equity market by a few points would still have seen an investor in the red for one, two or three years. And, set against the Australian context, some fund managers, who have consistently out-performed the Australian (eg, Perpetual) and international (eg, Platinum) equity markets might take issue with the claim that: “the evidence clearly indicates that mutual fund performance is determined by luck”.

To quote from a recent article in the Spring 2004 edition of Portfolio Construction Journal, Vol 1, Issue 2; Exploding another Industry Myth …: “So, despite a lot of noise to the contrary, many active Australian equity fund managers have outperformed the index, and their index peers consistently over time.”

This book initially takes the reader through the basics of economics and characteristics of the stock market, and this sets the tone for the target market of the book: it is really intended for individual beginner investors learning the basics of equity investment, and serves as a solid warning to those who think that they can outguess Wall Street. At this level, he answers the question: “what is a security”. Thus, it would be ideal reading for anyone contemplating the use of tip sheets or trading schemes (eg, software packages, for charting or other trading theories), or who are tempted to attend seminars on “share trading” or any get-rich-quick scheme. Such persons should read this book first, and thereby save themselves a great deal of money and possibly their life savings. Above that level, the book has more limited value in Australia, due to questioning of the EMH in the Australian market, although it must be recognised that our market is becoming progressively more efficient, and instances now abound when active managers under-perform the index – just compare the performance numbers over one and three years, published in the financial press, of the vanilla active Australian equity funds against Vanguard.

At the start, it is made obvious that this is not an academic work by the use of somewhat intemperate language. In two opening pages (pp 4 and 5) there appears: “irresponsible and clueless” (in reference to Peter Lynch), “grossly incompetent” (twice), “pathetic”, “Olympics of arrogance”, “ignorance”, and “mad as hell”. Such language is not normally associated with scholarly analysis. Perhaps intentionally, there are few references to research papers – the first I sighted was on p 53. It is more of an opinionated text.

The above accepted, this book does provide a practical explanation of the active/passive debate, which he refers to as the “Wall Street model” and the “academic model” – the latter covering the work of Fama and French, anors. He explains the basis for and application of the EMH, from its fundamental thesis (that stock prices reflect all available information) into its sub-variants. He outlines the two limbs of the EMH, which relate to securities selection (you cannot stock pick mis-priced securities, as everything is priced in) and market timing. The first limb is addressed compressively and upon numerous occasions, whilst the latter is not covered to any degree – which is a pity, as this is to me, one of the puzzles of EMH. The argument in favour of efficient pricing for individual securities does seem strong, even in Australia at the top of the market – at least in comparative terms. However, it seems equally clear that the whole equity market does stray miles away from fundamental value at times, eg the NASDAQ in March 2000; and this cannot be “efficient”. He does cover the point that market timing cannot be used with any confidence, to take advantage of such alleged inefficiency, and seems to imply that this is proof in itself that the overall market therefore must always be “efficient” – which is a non sequitur to this reviewer. It would have been both helpful and interesting to see more references to empirical research on tactical asset allocation (ie, market timing), and its failure to add value over time by exploiting emotional market swings.

In chapters 6 and 7 there is an excellent discussion of: “betting point spreads”; Hiesenberg’s “uncertainty principle”; standard deviation and risk; the benefits if diversification; and of the pitfalls of using optimization and efficient frontier theories – and it here that his experience as a teacher shines through. Having convincingly demolished active funds management, although not with the thoroughness or precision of Burton Malkiel through simple charts, he takes the reader into indexing and the work of Dimensional Fund Advisors (**DFA**); and there is a good introduction into the theories of Fama and French and the three factor model.

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This is a convincing story, and I would have been interested to read more of the practical application of these theories, which are proving themselves with considerable conviction in both the Australian and international markets. There is a brief (related to DFA) excursus into rebalancing, with recognition of the complications arising from tax. The new investor will find this area of the book, helpful and thought provoking.

In Chapter 8 he reverts to another onslaught on active management and rightly draws attention to the issues of fund turnover, tax and trading costs. As he puts it with some force: "The costs are hidden, the returns are exaggerated and the risks are ignored" – reading this, did resonate with my assessment of certain high turnover active Australian funds.

The book ends with an overview of long term determinants of market performance and the (correct) admonition to ignore current "noise"; then some observations on efficient decision making, and finally a recap – in which he addresses the issue of DIY investing or retaining a professional adviser. He recommends the latter, provided that the adviser is not wedded to the active camp!

This is undoubtedly an example of a book holding more relevance to the US than to Australia, but it is still of value to most individual investors. I would have liked to see more analysis of the EMH issues as applied to direct client portfolios and the tax issues/advantages that are germane to this approach. Not all investors are focussed upon index performance, and many actually prefer to hold direct stocks, and feel comfortable about the companies they are investing in. They might also be concerned with optimal tax management. From your reviewer's experience, many true HNW investors hold such direct portfolios, and not active or passive funds – however, perhaps in 20 years, this will have changed?

The index is brief – eg, it does not mention standard deviation, notwithstanding good coverage of this in the text. The book is rated 5.

**MARTIN EARP**
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