the reading room

a random walk down wall street

By Burton Malkiel
W. W. Norton & Company
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review rating

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One imagines that there is some exclusive club in America, where only the wisest and most truthful old guard in the finance industry may enter. If such a club exists, Professor Malkiel could well be the president. He holds the Chemical Bank Chairman's Professorship at Princeton University, and amongst his many directorships is that of the Vanguard Group of Investment Companies and the Prudential Insurance Company. There is the first clue: Vanguard, the world's largest indexer, built by one of his friends (and fellow club member?) – John Bogle, for which see other reviews in this web site.

It is therefore unsurprising that the text gives active funds management a thorough thumbs down and indexing a big tick. And, in terms of the US market, the evidence, in general terms and for most investors, is overwhelmingly in support of the random theory espoused in this book – which starts with a chart over 30 years showing that investing in the S & P 500 (ie, an indexed fund replicating this index) would have given nearly double the return from the "average equity fund".

However, it would be a mistake to take this book as a simple damnation of stock picking, for it contains numerous sound lessons for private investors who engage in portfolio management – including those who pick stocks. As with many US finance texts, the book should be viewed in the context of the Australian market, which empirical studies have shown, is less efficient than the US equity market – or, until the last 3 months, this has widely been accepted as being the case! With this qualification, this book may be accepted as an invaluable tool when it comes to the fundamentals of investment, stock picking and interface with the capital markets generally. It is not an academic work full of algebra and dense maths, but rather a practical book for the everyday investor – although mature market participants could do worse that brush up on the imponderables covered in this book.

Above all, Malkiel is irreverent and castigating on some market/industry practices, and he has the courage to question everything. And why not, he has been revising this text for nearly 30 years since the first edition, which has been accepted as a classic. He has seen theories come and go, he has identified charlatans when most others were deifying them, and he has built upon his own wisdom, year by year through engagement with the markets and market participants. His irreverence and humour is best illustrated by reference to his observations on "technical analysis" – often called "charting" whereby an analyst will track price or volume movements over a given period in order to extrapolate into the future.

The Professor recounts that "technicians" often have holes in their shoes and frayed shirt collars – which I have also observed. He has "never know a successful technician, but I have seen the wrecks of several unsuccessful ones… Curiously, however, the broke technician is never apologetic. If you commit the social error of asking him why he is broke, he will tell you quite ingeniously that he made the all-too-human error of not believing his own charts. To my own embarrassment, I once choked conspicuously at the dinner table of a chartist friend of mine when he made such a comment. I have since made it a rule never to eat with a chartist. It's bad for the digestion."

On a more serious note, this book looks into: the madness of crowds; stock valuation (sobering historical data and insights into P/Es); random walk theory and how difficult it is to beat the market; security analysts ability to pick winners (grave doubts and questioning that foretold what is happening right now in relation to conflicts of interest); modern portfolio theory and the role of bonds, equities and property in risk management; the life cycle and how it can impact upon asset allocation; indexing or stock-picking for yourself, with or without professional advice.

This book is chock-a-block with controversial contentions, some of which are arguably inapposite in the Australian context. However, an understanding of all these issues will only enhance your knowledge base, and they contain observations that are potentially germane to the tumultuous events of to-day – eg, the wisdom of international equity exposure and the performance of international fund managers. Although many of the charts and data end in 1997 or 98 the reader will gain the clear impression that Burton Malkiel would not be entirely surprised with market performance of the last two years. His thesis is as valuable today as it was 30 years ago.

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