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Legendary economist and financial thought leader, Burton Malkiel shares investment lessons learned more than four decades after writing his classic book, *A Random Walk Down Wall Street*.

Burton Malkiel
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A Random Walk Down Wall Street

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CONSUELO MACK: This week on WEALTHTRACK, legendary economist and financial thought leader Burton Malkiel on investing four decades after writing his classic *A Random Walk Down Wall Street.* Next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack.
It's been more than 40 years since Burton Malkiel wrote his investment classic *A Random Walk Down Wall Street*. The book sent shock waves through the investment community with its research showing that "*A blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one carefully selected by experts."*

Through numerous editions since it was first published in 1973 *A Random Walk* has challenged just about every investment theory on Wall Street that promised consistent market beating performance. And it said it was nigh impossible once you figured in transaction costs and taxes.

Malkiel's conclusion: outperformance can and does occur randomly but you can't depend upon it. The street has undergone tremendous changes since 1973. To name just a few:
Deregulation, starting with stock commissions in 1975…
Jack Bogle's launch of the first index fund in 1976…
Online trading for individuals was created in early 90s…
Globalization of capital markets and trading…
The digital revolution with its quantitative models, algorithms and high frequency trading….
Tax deferred investment accounts including the IRA in 1974 and 401(k) in 1978…
The first ETF, the SPDR was created in 1993…

And while interest in investing has spread because of these self directed retirement vehicles the number of publically traded stocks in the U.S. has decreased by over 46% from more than 8,000 in 1996 to 4,000 in 2016. Meanwhile flows out of actively managed portfolios into index funds have surged.

Professor Malkiel has more than kept up with all of these changes. He continues to write books (11 books to his credit), editorials, do research (almost 200 papers published) serve on boards, he spent 25 years on Vanguard's, is now on robo advisor, Wealthfront's where he is also Chief Investment Officer and he is one of three CIOs with another financial thought leader and WEALTHTRACK regular Charlie Ellis on the Rebalance IRA board, which combines automatic rebalancing with a personal consultation with a personal touch.
I asked Malkiel given all of the changes we have seen if his view of the markets has changed at all.

BURTON MALKIEL: Well, obviously there's been a great deal of change. When I first wrote *A Random Walk Down Wall Street* in 1973, I recommended, I thought that people should be invested in broad-based index funds. There were no index funds and I said there ought to be. In fact, what I suggested is some institution, maybe the New York Stock Exchange, ought to put one together. It was three years later when Vanguard introduced what was called the first index fund.

CONSUELO MACK: Right, 1976.

BURTON MALKIEL: It was not a commercial success at all, that was underwritten. They sold a small fraction of what they had hoped to do. It was very slow to take off. I joined the Vanguard board in 1977, and I used to joke with Jack Bogle that he and I were the only shareholders in the first index fund. But over time indexing has taken hold, and one of the other huge changes is of course the proliferation of ETFs, Exchange Traded Funds, and most of them are basically index funds. The large ones are basically index funds. So the thesis that I had suggested in 1973 I believe in even more firmly than when I first wrote it.

CONSUELO MACK: And why is that?

BURTON MALKIEL: Well, because the evidence has accumulated, and it just gets stronger and stronger. Standard & Poor's is the kind of de facto scorecard keeper for active management, and every year at the beginning of the year you can count the number of articles that said, "Well, indexing worked okay last year, but this is going to be the year of the stock picker," and every year it turns out that probably two thirds of the active managers are outperformed by the index, and the third that outperform in one year are not the same as the ones who do it the next year. What Standard & Poor's did this year in their report, called the SPIVA report.

CONSUELO MACK: SPIVA.

BURTON MALKIEL: Standard & Poor's Versus Active. What they found, they were able to do 15-year histories, and then it's not two thirds. It's 90 percent. So it's not that it's impossible to outperform, but what I've often said, it's like looking for a needle in a haystack, and at least the core of your portfolio ought to be invested in broad-based indices. You want to go out and take a flyer on a manager you think is good. You want to buy an individual stock. Fine, but you can do it with much less risk if the broad core of your investments is invested in index funds. In terms of the changes that you talked about, the one thing that is wonderful now for the individual investor is with the deregulation of commissions. Commissions are essentially zero today. There are many online brokers who will actually do trades for zero commission, and the competition, the ETF competition has meant that you can now buy broad-based index funds with an expense ratio of three basis points, three one hundredths of one percent. So that's been just wonderful for individual investors, and as far as I'm concerned it makes the advice to buy index funds even stronger than it was before.

CONSUELO MACK: Needless to say, I talk to a lot of active managers, and there are some pretty good arguments out there as well that would suggest that maybe going with the herd – and it is now a herd. The momentum going into index funds to passive funds is just enormous. So let me raise some of the objections that I've heard.

BURTON MALKIEL: Absolutely.

CONSUELO MACK: One of them is that the market capitalization weighted structure of most passive funds means that you are at any given period of time going to have let's say a concentration in the most expensive stocks, an example being the FANG stocks and the fact that at some point during the last year 50 percent of the performance of the S&P 500 was in five tech stocks. You have this real concentration in tech stocks just like a lot of people did in the late 1990s, just like in the '60s they did with the Nifty Fifty. Isn't that a problem in this kind of broad-based recommendation that everyone should own indexes?

BURTON MALKIEL: First of all, I don't think that indexing to me means you want to buy the S&P 500.

CONSUELO MACK: All right, so that's important, but that's the most popular vehicle.

BURTON MALKIEL: So it's very important. I want you to buy a total stock market fund. I want you to buy everything, and if you buy everything, everything, the whole market is capitalization weighted, and when you think about the logic of this if you're buying the whole market, everybody is going to get on average what the market gives you.

CONSUELO MACK: The whole market, are you talking about the whole U.S. market? Are you talking about the entire world market?

BURTON MALKIEL: Well, actually I'm talking about the whole world market, but let's think of the U.S. market for example. Just as an example, investing has to be what is called a zero sum game. That is to say, if someone is holding the stocks that go up more than the average of the whole market, it has to follow that somebody else is holding the stocks that go down. So in that sense it's got to be a zero sum game, but in the case of costs where you can buy the market at zero cost and the average active manager charges about one percent, it has to be a negative sum game; that is to say, the people who are active will get the market return minus those costs and, therefore, the index investor won't be average. The index investor will be better than average..

CONSUELO MACK: So a couple of things. Number one, if you were to look at the Russell 2000 for instance, 33 percent of the Russell 2000 companies in that index don't make any money. So why would I want to buy 33 percent of 2,000 stocks that aren't making any money? Another example is that right now the U.S. market has shrunk tremendously over the last 20 years. We have 50 percent fewer publicly traded companies. So in fact we're becoming less diversified. So how do you answer those questions?

BURTON MALKIEL: First of all, in terms of owning stocks that don't make any money, for many, many years Amazon – one of today's great favorites – was making no money and yet growing very rapidly. It's always going to be the case that some of the smaller growth companies are not making any money, and eventually like Amazon - some of them fail - but eventually some of them make a lot of money. So when you own the whole market, you not only own the very profitable companies, but you also own some of the smaller growing companies. Now on your second question about the U.S. market shrinking, I've long believed that we have what we economists generally call a home country bias, that we sort of think we live in the United States. We'll just buy U.S. stocks, or the U.S. companies sell all over the world, so we don't need anything else. I don't think that's true. We are only about a third of the capitalization of the whole world. The rest of the world may be in some sense more reasonably valued than the U.S. Emerging markets are growing much more rapidly than the developed markets. The demography favors the emerging markets. So you really want to be completely diversified, and so when I say buy a broad-based index fund, I want you to buy one that holds all of the stocks throughout the developed world and the emerging markets.

CONSUELO MACK: What about not using market capitalization weighted indexes? What about – Rob Arnott's been a guest on WEALTHTRACK for instance, and he's looking at fundamental indexes which he basically pioneered – and instead looking at the economic footprint that companies can have and taking the same indexes but basically ranking them not by what the market is judging that they're doing, not by their price but by their fundamentals, by their revenues, by their earnings, by their dividends. What about cash flow? What about that kind of a reconfiguration of indexing? Still indexing but ...

BURTON MALKIEL: Rob, who has developed so-called fundamental indexing, is probably one of the most brilliant marketers that I know. This was really the beginning of what might have been called smart beta. It is possible that there are some of these funds that are weighted a little differently that might outperform. Rob has done a tiny bit better than the market over his history, but I believe it is because with his different weighting he has taken on a lot more risk. Let me give you an example. To the extent that he has outperformed, this was done in the 2008, 2009 period. In that period, he had Bank of America and Citicorp 15 percent of his portfolio. He had bank stocks double weighted because they looked cheap.
At that point, you may remember that it wasn't clear whether the government was going to bail them out, whether they might simply take the stockholders and tell them goodbye. There's no value there. That was a brilliant bet because the government bailed out the financial system. The banks then increased in value, but don't tell me that by that different weighting you were not taking on more risk, and Rob's expense ratio has come down a little, but it was over 50 basis points, and I've said that sometimes the problem with smart beta is that it's often expensive beta, and smart beta has been unfortunately much too much a marketing ploy than it's been good for investors. There's nothing wrong with some different weightings. A value weighting may actually make sense for certain people but not at the very high expense ratios that you see most of them marketed for in the United States. I think if you can do this with a low or zero expense ratio and you can do it where it's tax-efficient – and incidentally that's another problem with fundamental indexing – we should think of things after tax. Remember you're doing some turnover.

The nice thing about indexing is you don't sell anything. With fundamental indexing you've got 20 or 30 percent turnover in a year, and that often means you're taking short-term capital gains and so you're after-tax return is even ... not only do you typically underperform, but after tax you really underperform.

CONSUELO MACK: You are the chief investment officer of two robo advisors, one being Wealthfront. You're the chief investment officer of Wealthfront, but you are one of the three investment committee members for Rebalance IRA.

BURTON MALKIEL: Exactly.

CONSUELO MACK: Now that is you, a really smart human being who's making investment decisions. You're investing in index funds or ETFs, but you're making decisions as well. Right? So there is a human factor that you still think has an important role in investing.

BURTON MALKIEL: What we do is we make sure in both cases, both for Rebalance and for Wealthfront, that the investor is broadly diversified. So you don't want simply stocks. You want to make sure that you have some safer income-producing securities that will be an anchor for you to the extent that we get a sharp market sell-off. We want some real estate stocks. We want to be broadly diversified internationally as well as domestically.
So part of the activity in the thing would be that we want to make sure that the diversification is done properly, and it's not stock picking. In neither case, do we stock pick, but we do have certain things where we are making judgments, and I think probably the biggest judgment that we make in both cases is how should an investor deal with the bond market during a period that has been called a period of financial repression.

CONSUELO MACK: Where interest rates have kept, some people would say artificially low by the central banks.

BURTON MALKIEL: Exactly, and so looking at that, we do think that there is something useful one can do. Now you could buy a ten-year Treasury. The yield today is 2.1, 2.15 percent, and with the inflation rate about two percent, that means in the net the investor is going to get a zero rate of return. If you want to call this active, it's not stock picking, but if you want to say that this is a decision, absolutely this is a decision.

CONSUELO MACK: So in the income portfolio of Rebalance IRA or any portfolio, you've got a bond component.

BURTON MALKIEL: We've got a bond component.

CONSUELO MACK: Or an income component.

BURTON MALKIEL: But we are not using ... and here's where I will say that I actually do not like ...

CONSUELO MACK: Indexing.

BURTON MALKIEL: ... the index because the total bond market index in the U.S. is over two thirds government bonds or government guaranteed bonds, and there we do not use it. So what do you do? You call that active? Fine. One of the things that we do is we use a stock substitute, and the other thing that we do is we use preferred stocks. So let me describe both of them.

CONSUELO MACK: Yes, please.

BURTON MALKIEL: Let's take the stock substitute. You could buy an AT&T ten-year bond and get three and a half percent. You don't get two. You get about three and a half or ...

CONSUELO MACK: Not a lot.

BURTON MALKIEL: Not a lot, but it's a little better, but you can buy AT&T stock and you get a five percent yield. So there are some stocks that we will overweight because we think of them as bond substitutes To be sure, that's riskier than buying the bond, but we think the risk-reward ratio favors doing that. Let me give you another example, and the other example – and we use this in the Rebalance IRA portfolio – is we use preferred stocks.
Now preferred stock isn't a bond because the bondholder gets paid first, but the preferred stock is safer than the stock because the preferred stockholder has to get his or her dividend before the stockholders get their dividend. So preferred stock today yields something between five and six percent. We also use foreign bonds which in many cases, particularly in some of the emerging markets of the world, give you five or six percent rates of return.
So yes, in the bond portfolio we're making an active bet. We are not going to use a United States Total Stock Market bond. We're using some bond substitutes, and at least thus far this has worked extremely well in the Rebalance IRA portfolio. It's given us a considerably higher rate of return with a bit of additional risk but with where we think the risk-reward tradeoff is worth it.

CONSUELO MACK: At some point if there are better bond indexes for instance, or if there were a terrific preferred stock index, would you go that route? Just they haven't been created yet. Is that ... ?

BURTON MALKIEL: They have not been created for preferred stocks, but what we will do is there are ETFs that are very close to that, so absolutely, and within you can do this with ETFs. There are emerging market bond ETFs. There are Real Estate Investment Trust ETFs. So they're not exactly index funds, but they are certainly serviceable and very useful, and I would simply say to people look carefully at the expense ratios because, Consuelo, I'll tell you one thing.

I think all of us need to be very modest about what we know and don't know about the stock market, but the only thing that I am really 100 percent sure of and that is that the lower expense ratio I pay to the purveyor of the product, the more there's going to be for me.

CONSUELO MACK: So my last question to you is the one investment for a long-term diversified portfolio. What should we all own some of in a long-term portfolio?

BURTON MALKIEL: I would say particularly for young people who can have the time period to ride out the ups and downs of the stock market. I think I said this to you the last time we were talking. I'm going to say the same thing again, a broad, total world stock market fund which is available either as a mutual fund or an ETF.

CONSUELO MACK: Would you recommend one in particular? I know when you were on last you were on with Mitch Tuchman from Rebalance IRA, and he mentioned VT which is the Vanguard Total Global.

BURTON MALKIEL: VT is the ETF, very low expense ratio. That's certainly a fine one to do.

CONSUELO MACK: All right, and we'll leave it there. Professor Burt Malkiel, thank you so much for being with us on WEALTHTRACK.

BURTON MALKIEL: Thank you, Consuelo. My pleasure.

At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term.
This week's Action Point is: Read the latest edition of *A Random Walk Down Wall Street.*
It is a classic for a reason. It combines financial history, theory, analysis, and timeless advice that is clearly written and entertaining. And as you just saw with Professor Malkiel he and it is up to date and in the forefront of sound financial thinking for individuals.

Next week top global value investor Tom Russo explains why he invests in iconic brand name companies willing to take short term pain to achieve long-term gains.

In the meantime please visit our website's EXTRA feature to hear more of my interview with Burt Malkiel on why he remains such an optimistic investor. Also keep reaching out to us on Facebook And Twitter.

Thank you for watching. Have a great weekend and make the week ahead a profitable and a productive one.