

Market Efficiency and Active Management

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Overview

The stock market may be somewhat of a casino, but is better than Las Vegas because the odds are in your favor. In addition to the stock market's long-term uptrend, financial markets have become more efficient over the past 30 years as a result of more participation by institutions, greater influence from hedge funds, and the variety of new derivatives in use. Thanks to these factors, investors holding broadly diversified portfolios indexed to the market should earn returns equal or superior to those achieved by the experts. On the other hand, active management, especially of hedge funds, serves a useful purpose—getting new information into the market in a timely fashion. In addition, professional investment managers can offer valuable advice in specific circumstances.

Financial markets have become even more efficient since the first edition of *A Random Walk Down Wall Street* was published in 1973. Several factors have contributed to this improvement: the markets have become more institutionalized (institutions are now responsible for 90 to 95 percent of trading); the influence of hedge funds has increased; and the markets have changed because of the variety of new derivatives being used by institutions and individual investors.

Hedge funds, for example, try to take advantage of situations in which an underlying stock is mispriced relative to the derivatives contract or in which the market has not yet caught up with an event such as an earnings surprise or stock split. In this way, the hedge fund ensures that new information is reflected in the stock price without delay. The result is greater market efficiency.

Financial markets can be efficient even if they sometimes make errors in valuation. In the latest edition of *Random Walk*, I refer to the 1999–2000 Internet bubble when multiple trillions of dollars were lost because many Internet stocks were, in retrospect, overpriced. Because prices did not accurately reflect value during that period, too much capital flowed into Internet-related stocks. The stock market may have temporarily failed at efficiently allocating capital. But the fact that the market made a mistake during 1999–2000 doesn't mean it is inefficient just because we didn't know beforehand that it was going to make a mistake.

Individual Stocks Versus Index Funds

Although the stock market may be somewhat of a casino, it's a lot better than Atlantic City or Las Vegas because the odds are in your favor—there's a long-term uptrend in the stock market. Do I buy some individual stocks? Yes, because it's fun. I also go to Las Vegas and Atlantic City. But as a trustee for family trusts, or a member of foundation investment committees, and in my own 403(b) account, I believe in indexing stocks, bonds, and real estate.

Essentially all of my investments are indexed. This is a direct consequence of my belief that the markets are efficient and that, therefore, investors holding broadly diversified portfolios indexed to the market should earn returns equal or superior to those achieved by the experts. My advice to investors in search of better performance would be to buy a broad-based index fund.

Active Management Versus Market-Driven Efficiency

If the markets are efficient, why is an estimated \$6 trillion invested in actively managed equities? As I understand it, about 25 percent of institutional money is indexed, and about 10 percent of the assets of individual investors are indexed. That's something I've spent my life trying to change! The figure for individually held assets is only 10 percent because it's easier for individual investors to find a broker willing to sell actively managed funds rather than low-cost index funds because of the difference in commissions to be made.

Ideally, I don't know what percentage of institutional funds should be indexed. If 95 percent of the market were indexed, I'd start to worry. With the current figures, I don't worry at all. In fact, I think it could easily be 50 percent, maybe even 75. If markets were perfectly efficient, there would be no incentive to uncover the information that drives market prices. Someone has to quickly take positions to ensure that new information gets into the market in a timely fashion. That's where I think active management, especially of hedge funds, serves a useful purpose.

According to my data, an index fund will outperform a typical active manager by about 200 basis points, of which 150 points are attributable to the extra expense of management fees. The other 50 points can be attributed to trading costs associated with turnover, because a typical active manager turns over a portfolio 100 percent each year.

Mutual Funds

Mutual funds are the investment tool for which we have complete, accurate performance data. If your strategy is to buy the

mutual fund with the best return last year—or over the previous two, three, or five years—you cannot find any single strategy that consistently outperforms others. Picking the best mutual fund is like finding a needle in a haystack. My view is that investors should just buy the whole haystack.

I don't accept the idea that providing daily liquidity to investors has to impair mutual fund returns. What hurts returns is high fees. Still, investors in aggregate should pay a price to make sure markets are reasonably efficient. For example, hedge funds engaged in merger arbitrage incur research costs, and profits must be high enough to cover these expenses.

The Role of Active Management

Professional investment managers can offer valuable advice in certain circumstances.

- Unsophisticated investors often make imprudent decisions. I know of people who have held tax-exempt bonds in their Roth IRAs, essentially converting tax-exempt income into taxable income. A professional investment adviser could have been helpful in these instances.
- Investors with a fixed obligation in a few years (for example, college tuition) need to match their portfolio allocations to their financial needs by buying securities with a duration equal to the length of their planned holding period. An investment adviser could help them review their options.
- An investor who has inherited a sizable amount of stock in a specific industry probably doesn't need a stock index fund. Instead, this individual should invest in something to diversify a portfolio overbalanced in one industry. An actively managed fund could be of value in this situation.
- Consider the woman who worked at Enron and invested her entire 401(k) plan in Enron stock. When Enron went bankrupt, she lost the income from her job and her entire investment portfolio. An adviser could have helped her understand the risk of putting all her eggs in one company's basket and advised her to diversify with an index fund.

About the Author

Dr. Burton Malkiel, Chemical Bank Chairman's Professor of Economics at Princeton University, and a director of The Vanguard Group of Investment Companies; Prudential Insurance Company of America; BKF Capital Group; and The Jeffery Company, a private investment firm. He sits on the investment committee for the American Philosophy Association and is a past president of the American Finance Association and a past appointee to the Council of Economic Advisors. He holds a B.A. and M.B.A. degree from Harvard, and a Ph.D. from Princeton University. He began his career in the investment banking department of Smith Barney & Co.

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