



Random Walk Redux

Landmark investing volume still holds up 35 years later

“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 the experts.” Imagine the scornful reception this premise received back in 1973. Burton Malkiel’s strongly worded viewpoints, expressed in his pivotal investing treatise, *A Random Walk Down Wall Street*, were about as welcome as fire ants at a family picnic.

Eight editions, a million copies, and thirty-five years of market results later, Malkiel’s opinions are still an irritant to fundamental and technical analysts and much of the mainstream investment establishment. Nonetheless – his bold and colorful language aside – the central plank of Malkiel’s platform has shown to be completely sound. Malkiel, a Princeton finance professor, describes the movement of stock prices as a “random walk in which future steps or directions cannot be predicted on the basis of past actions.”

This simple random walk assertion, strongly supported by decades of empirical data, confounds the notion that a smart investor or analyst can recognize a stock that is more likely to rise than fall. Like a coin flip, each move in a stock’s price is independent of all previous moves.

The random walk is closely aligned with the efficient-market theory, which says that any information that could provide an advantage in picking stocks is so quickly (efficiently) reflected in stock prices that trying to make any stock choices based on new information is pointless. As Malkiel states: “Investors would be far better off buying and holding an index fund than attempting to buy and sell individual securities or actively managed mutual funds.”

Clear evidence

Malkiel was brash in his assertions. And clearly on target. With each *Random Walk* edition he points to a longer history of stock returns that support his theory. As he predicted, the S&P 500 index has outperformed the average active manager by more than 50 percent over the last 38 years. Ten thousand dollars invested in 1969 in the S&P 500 is now worth \$422,000, versus \$284,00 for the average actively managed mutual fund. Furthermore, in the after-tax real world,



where individual investors live, the index triggers a much smaller tax tab than the actively managed portfolio. The difference is too vast to ignore.

Buying and holding market-matching indices is not very exciting. But the payoff has been exquisite. The average stock market performance over the last 80+ years has been a 10% annual return. That means that, on average, money is doubling every seven years, and multiplying eight times every 21 years. Those who want even higher potential returns can seek riskier investments like emerging markets and distressed situations – these are available as indices too. With so many index instruments available, working hard to beat the averages seems of little incremental value, especially when taxes are considered.

Simple, powerful advice

So what does Malkiel recommend for the individual investor? Despite all of the technology changes since his first edition, his fundamental suggestions are as relevant today as during the early 70s. His recommendations include:

Index heavily – A broad index is likely to outperform a portfolio of securities selected through some kind of analytical technique. Malkiel asserts there’s just no evidence A) that an active money manager can beat the market over an extended period, or B) that an investor could reliably pick a genuine outperforming manager if one existed.

Beyond the significant implications of efficient markets, high expense charges, trading costs and capital gains taxes can severely erode actively managed returns. (See our March 2007 article: “Fees Matter: *How investment costs drive bottom line results*” and our May 2007 article: “Tax Efficient Portfolio Management: *Keeping more of what you make*”.)

At OCM, we recommend that clients rely on indexing for a majority of their total portfolio, turning to active management only when indexes are not available (e.g., municipal bonds) or where specialized knowledge or access is important (e.g., private equity). And actively managed assets should be relegated to tax-deferred accounts, such as 401(k) plans.

Accept and use the efficient market – “The market prices stocks so efficiently that the chances of using professional winners is a fool’s errand.” Fundamental analysts are tripped up by random unpredictable events – breakthrough products (iPod), natural disasters, war, defects, and scandals (Enron).



Even Warren Buffett, possibly the greatest active manager of modern times, favors low cost index funds for most investors. As he said at the most recent Berkshire annual meeting, “A very low cost index is going to beat a majority of the amateur managed money or professionally managed money.” At OCM, we think this is especially true on an after-tax basis. We have never seen a documented case of an active manager beating the Dow or S&P on an after-tax basis over a generational (20 year) timeframe. What we have seen supports our strategy of buying and holding these mainstream indexes.

Use the changes – When *Random Walk* was in its first edition, being an index investor was a lonely endeavor, with few index funds available and Exchange Traded Funds (ETFs) still 18 years off. Now investors have hundreds of index ETFs and index funds choose from. Index instruments are now available that track not only the major exchanges, but also countries, continents, industries, currencies and so on. Investors can now enjoy the benefits of indexing across almost any asset class.

Know thyself – Understand behavioral finance – why people invest the way they do. Overconfidence, biased judgments, herding, loss aversion and impulse buying can subvert any strategy. Many poor investment decisions relate to risk. It is important to understand that risk can be managed in two primary ways – through time and through asset allocation. Longer holding periods have shown historically to reduce risk, and so does a prudent distribution of money across different asset classes. Reducing volatility can be as simple as increasing the allocation to bonds, rather than seeking some magic combination of active managers.

The OCM Advantage
Osbon Capital Management is a fee only advisor specializing in tax efficient, globally diversified portfolios for individuals. Our goal is to index where we see the potential to add after-tax value, and to access active or specialized managers we believe will add value across the full range of investments.

Practice common sense – When it comes to common sense, diversification is at the top of the list. An avalanche of books, articles and research studies preach the proven benefits of diversification. Still, many portfolios fail to take advantage of spreading assets across domestic, international, emerging markets, REITs, bonds and other classes.



Know the score

Based on the wisdom of Malkiel and other index advocates, we encourage investors to gauge the performance of their own portfolios against relevant indices. Ask for benchmark indices to be added to your quarterly performance reporting for comparison purposes. Check your performance – apples to apples, and after-tax – against the indices to see if you are getting what you pay for. OCM can help you do this analysis if you like.

John Osbon, Chief Investment Officer
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