Voice

Outbox

Stephen and Todd, We Hardly Knew Ye

Remember TheGlobe.com? Could it have been only six years ago that the world fell in love, crazy love, with Stephen Paternot and Todd Krizelman and their $9-to-$97 IPO—for a company whose business had neither revenues nor profits?

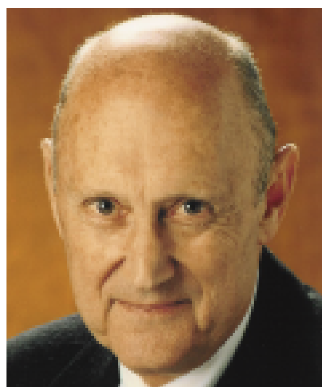
Burton Malkiel remembers it well. In fact, he remembers sitting in the "green room," waiting to go on an early morning television show in November 1998 with Paternot and Krizelman, the first superstars of the Internet boom. TheGlobe.com's IPO was an infamous day, remembers Malkiel, the subject of this month's "10 Questions With" interview: "We learned that investors would throw money at businesses that only five years before would not have passed normal due diligence hurdles." It was, he says, the catalyst that launched the pathological phase of the Internet bubble. Less than three years later, TheGlobe.com closed its Web site and went out of business—taking millions of investor dollars with it.

The re-telling of TheGlobe.com and its ilk (anybody recall Flooz.com, IAM.com, SwapIt.com, and Zing.com?) is reason enough to revisit ***A Random Walk Down Wall Street,*** Malkiel's now-30-year-old book. It has an additional chapter devoted to market bubbles (tulipmania, the South Sea Company) and the fools who inhabit them, if only while we're temporarily insane. Malkiel has been updating *Random Walk* about every four years and he wouldn't bet that its next edition, scheduled for 2007, won't have yet another chapter on market mania. Still, he thinks the Internet bubble—lest we forget—may be the biggest bubble of all time. "Indeed," he says, "comparing the Internet bubble to the tulip-bulb craze is undoubtedly unfair to the flowers."

Shelley A. Lee
Voice Editor

10 Questions with…

Burton Malkiel on *A Random Walk Down Wall Street*



Who: Dr. Burton G. Malkiel
What: Chemical Bank Chairman's Professor of Economics at Princeton University and author of *A Random Walk Down Wall Street*
What's on his mind: "The support for index funds is stronger than ever."

He's been called the intellectual midwife of the indexing phenomenon. The book has been called a classic. Both are rightly so. When Dr. Burton Malkiel wrote *A Random Walk Down Wall Street* in 1973, now in its eighth edition, he offered up the premise that a blindfolded chimpanzee throwing darts at the *Wall Street Journal* could select a portfolio that performs as well as those managed by the experts. It was, says Malkiel, a clever metaphor; but the better one is, "Just throw a towel over the stock pages and go buy as broad-based an index fund as you can find." That might not be what financial advisors like to hear, but Malkiel maintains that advisors and planners still play a critically important role in individuals' lives—in particular, keeping people from harming themselves with colossal mistakes. Malkiel has consistently tested his premise and says that the evidence suggests that, long term, few professional money managers outperform a passive index—and those who do so in one period regularly fail to repeat it in another period. He says he recognizes that telling investors there's no way to outperform the market is like telling a kid there's no Santa Claus: "It takes the zip out." He also says that, based on the stock market "going to the loony bin" during 1999 and early 2000, the market is not always perfect: "I call myself a random walker with a crutch." But he holds fast to his essential advice: Rather than looking for the needle in the haystack, buy the haystack.

Malkiel holds degrees from Harvard and Princeton, began his career with Smith Barney & Co., and has long held professorships in economics at Princeton, where he also was chairman of the economics department. Voice recently talked with Malkiel on the continuation of the random walk, fools and Motley Fools, "amusing"

10 Questions continued on page 12

10 Questions

continued from page 10

but useless technical analysis, and one very fortunate son.

1 Thirty-two years ago, investing books were almost oddities, while today it seems like there are a dozen published every week. In 1973, what made you think you could even get *Random Walk* published?

My argument, which the publisher agreed with, was that the premise was a unique idea—not your normal run-of-the-mill investing book which, as you note and I agree, there weren't very many of. But the publisher, W.W. Norton, thought we'd try a general market edition and if that didn't sell, there might be an academic market. It was a hedged bet. And indeed, the results have been that it's sold well to the investing public *and* found a place in many business school programs and for training professionals such as CFAs. I have to say that Norton, one of the few independent publishers left, took a risk. While many publishers want to publish books that will be a commercial success, Norton simply wants to publish good books. They had a unique way of advertising it: they put big ads for *Random Walk* on garbage cans throughout Wall Street so potential buyers saw them as they were walking. I wasn't happy about that at first, but it is clever and now I can't argue with it. It worked.

2 What were your own expectations for the book?

This is a great story—I actually gave the book to my then-infant son. When it was being published, my lawyer suggested to me that I get the value of the book appraised and gift it to my son. The publisher appraised it for what they thought the royalties would be: $20,000. That sounded about right to me. My son owns the book and gets all the royalties, and it's sold well over a million copies. Needless to say, he's pretty happy. You could call it the best bit of estate planning I ever did.

3 Why do you regularly update the book if your thesis of efficient markets and passive investing hasn't changed?

Since it is an investment guide, it needs to be updated often to reflect the remarkable changes in financial products during the last 30 years. Remember, at the time I wrote it there were no index funds, even though I said in the first edition that index funds should be available to investors. There also were no money funds, zero coupon bonds, ETFs, REIT funds, or Roth IRAs. The landscape today is so different and it's important to bring investors up to date. The other reason for regular updates is to continually test the premise—that the average person would be better off with index funds. I always ask myself, "Well, how did it go?" In fact, the premise has been validated quite brilliantly over the past 30 years. Finally, *Random Walk* is also a book of stock market history. In my first edition I discuss early bubbles, such as tulip-bulbs and the South Sea Company. I simply couldn't overlook the biggest bubble of all—the Internet craze.

4 That period brings up the issue of investor psychology and behavioral finance, and where that fits with your belief in efficient markets. What do you think of behavioral finance?

Nobody who puts several chapters in a book about bubbles is a nonbeliever in the importance of psychology. There are marvelous insights from behavioral finance that we can apply to investing, and that's another reason to update the book regularly. One of the most important insights from the behavioralists is how investors simply can't stand losses—they really hurt. If you have a taxable account and have one stock way up and one way down, the proper thing to do is sell the loser because the government will subsidize at least part of your loss. Behavioralists found that people do exactly the opposite—they usually sell their winners. It's so strange.

Although in the final analysis we're pretty close together, the difference I have with some of the behavioralists is that they believe you can use behavioral finance to beat the market. I don't believe that. Their idea is that when the market is overreacting, you can lean into the wind and go the opposite way—for example, buying market losers because everybody else is just too pessimistic. I don't think any of those types of theories work, and I've tested them. There's always a reversion to the mean, and stocks exhibit that. You won't make any money because by reverting to the mean, they all do about the same.

Behavioralists I know disagree with my view that, by and large, the market is efficient. I had a debate with Richard Thaler at Wharton last year. My view is that from time to time, yes, the market does go nuts, but most of the time it's very efficient. Thaler's view is that those times upon which we agree, such as the dot-com bubble, are just the tip of the iceberg—that the market is really very, very inefficient. We disagreed on that and yet at the end of the debate he and I came to absolute agreement on what an individual should do: buy a broad-based index fund! That's what I find very interesting about all this.

5 You believe that the book's message is enduring and that there's proof of it. Why do so many people still not "get it"?

Because most individuals get "sold" financial products. Brokers and advisors don't make any money if they put you in a Vanguard

10 Questions continued on page 13

10 Questions *continued from page 12*

index fund, but they do get paid for selling you a hot, actively managed fund. That's why only 10 percent of individual money is indexed. But 25 percent of institutional money is, which I find extremely interesting. People ask me if I'm disappointed that after 30 years of talking about this, only 25 percent of institutional money is indexed. I prefer to look at that as the glass half-full, not half-empty. I think 25 percent is great.

6 Is it fair to say that financial advisors don't like your advice that investors should essentially invest in low-cost index funds or ETFs and sit back? Do you feel that advisors work against the best interests of clients?

I certainly have heard that financial advisors believe I wish they'd go away. Look, I'm not dissing advisors. They have an extremely important role to play. Their biggest role is to put together a portfolio of asset classes that meets the age and risk tolerance needs of each individual. This is critical, and that's what advisors should do. What I don't think they should be doing is moving investors from fund to fund. Nor do I think they can pick individual stocks particularly well. They're extremely valuable to investors for age- or situation-specific advice and for a lot of handholding. And one of the absolutely most important roles they can play is to prevent people from making horrendous investing mistakes, which is a major part of successful investing.

7 If investors don't take the index-and-relax route, is the 1 or 2 percent a client may pay to an advisor and money managers worth it for the peace of mind they might receive?

I can only answer that by providing an example and a bit of a forecast. We're probably in a single-digit-return environment for a while. We may be lucky to get 7.5 or 8 percent. Paying 2 percent can be devastating for your return. A young person who invests $1,000 at 8 percent will accumulate $25,000 after 45 years with the magic of compounding. Suppose you give up 2 percent—it amounts to only $12,000. You don't get three-fourths of the return, you actually get half. That's a big difference in the world of single-digit returns. After all, most people need money and returns on it—not in the abstract, but for real needs, such as college.

8 What validations of your premise have you observed or tested since the eighth edition in 2003?

I just updated everything through 2004. The support for indexing is as strong as ever in this sense: indexes continue to outperform the typical actively managed fund. It will all be in the ninth edition, including how I believe you can predict mutual fund returns. You can't do it by looking at how they've done in the past and here's an example: the best-performing funds in the last four years of the 1990s were the worst performing in the first four years. What you can use to predict is the expense ratio and the portfolio turnover. Those two things make the typical actively managed fund underperform. Rule of thumb: 100 percent turnover in a portfolio costs the investor 100 basis points—way too much. The evidence just gets stronger and stronger, in my view. Another new section for the ninth edition will be about ETFs. They're great, and they may have an advantage over mutual funds because when a fund sells a security,

10 Questions continued on page 14

Can They—or Can't They?

You needn't look too far for proof of the central premise of *A Random Walk Down Wall Street:* that professional managers underperform. The *Hulbert Financial Digest* tracked the performance of Morningstar five-star funds for the period 1993–2000 and found that the total pre-tax return during those eight years averaged 106 percent. During the same period, the Wilshire 5000 Equity Index had a 222 percent total return. Those top-rated funds also carried more than 25 percent greater risk than the market.

A recent study by professors from the Wharton School at the University of Pennsylvania, Harvard Business School, and New York University approached the can-they-or-can't-they question slightly differently. While acknowledging that it's not clear whether the few managers who do outperform the market do so from skill or luck, the study's authors note that most studies have focused on long-term results but failed to consider the element of risk. What they call the "joint-hypothesis problem"—more than one possible explanation for results—led them to focus their study on three days surrounding companies' quarterly earnings announcements, looking only at the stocks that active fund managers bought and sold before the announcement. The results showed that fund managers do have some ability to determine which stocks will do well and which will do poorly. Still, the authors agree that managed funds can be costly to investors: "What's gained through stock picking may be lost to costs," says Jessica Wachter, a finance professor at Wharton. "Are managed funds earning back their fees? That, we can't answer." To read about their methodology and their results, go to www.knowledge.wharton.upenn.edu and search the index for "Can Fund Managers Pick Good Stocks? Yes, They Can, But…"

10 Questions

continued from page 13

it's a taxable event for the investor, but that's not the case with an ETF.

9 What kinds of attitudes do your students in your financial markets class at Princeton have these days? Are they jaded, optimistic, skeptical, reverent, or irreverent?

I'll give you another story. One of my former students was convinced that markets were efficient and that my indexing thesis was wonderful—until he went to work for a very hot mutual fund company in 1999. He wrote on a Christmas card to me that he was questioning everything he learned in school because of what his company had been able to do. He said there was no doubt in his mind that you can indeed beat the market. A year later he wrote me and, well, you probably know the end of this story. It was quite different a year later, and he no longer worked for them. It's simply the old adage of preparing young minds but knowing that they have to learn things for themselves.

10 Given the staying power and stature of *Random Walk,* how does it strike you that you've been followed, so to speak, by two guys who wear jesters' caps and call themselves the Motley Fools?

I love them! They're very bright. We have a kinship—my book is somewhat irreverent and they're even more irreverent than I am. I'm happy to be in their camp—or them in mine.

A Random Walk Down Wall Street, *eighth edition, 2003, can be bought at most major bookstores. Stay tuned for the ninth edition in 2007. For further reading on Dr. Malkiel and* Random Walk, *see the May 2003 interview in* Registered Representative *magazine* **(www.registered rep.com)** *or the June 20, 2003, PBS transcript from* Wall Street Week with Fortune *(www.pbs.org).*

Coming Soon...

Do you have "just enough" in your life? Do you even know what "just enough" is—or how to get to that point? Success is clearly about more than making money, but it's also not just about happiness. So, what is real success and what does it take to achieve it in lasting terms that benefit you, your business, your family, your clients? In their book, *Just Enough: Tools for Creating Success in Your Work and Life,* authors and Harvard Business School professors Laura Nash and Howard Stevenson present results from their years of study of high achievers and make the case for success that comes from the art of complex decision-making about noncomparable goals, against outsized measurements of celebrity success, and how to use the kaleidoscope strategy.

Talking Point

Reflections on Your Next-Generation Planner

You've either heard the griping, read about it, or done it yourself: young professionals are oh, so full of expectations about their value in the workplace and oh, so—dare we say—pushy about wanting too much too soon. It's the great generational gulf—and it may be because today's Millennials (those born in the '70s and early '80s) grew up in a bubble of self-esteem resulting from teachers counseled not to use red ink when grading papers (too negative), a parenting philosophy that reinforced protecting children from failure, and those ubiquitous "awards" (10th Place Just for Participating!). In a February 16, 2005, article in *USA Today* ("Yep, life'll burst that self-esteem bubble"), Millennials—possibly your newest planner—are described in contradictory terms. Neil Howe, author of *Millennials Rising: The Next Great Generation,* believes that Millennials are a very connected, team-oriented generation. On the other hand, a recruitment executive at an entertainment firm is rather horrified at what she describes as an incredible sense of entitlement: "They'll come in right out of college and don't understand why they're not getting promoted in three months."

What do you think? And how can you help bridge the gulf? Do your next-generation planners contribute to this perception—or do they contribute to your firm's team effort? What lessons are you learning from your experiences with Millennials? And what are the best lessons about career path, including having patience to take the long term view, you're offering them?

Discuss it here: **www.journalfp.net** and go to the April Talking Point.

Viewpoint

Coming of Age

by Kevin P. Condon, Ph.D., CFP®

Every profession has its milestones as it evolves and matures. Few would argue that the financial planning profession is maturing. Unfortunately, we have served only a narrow slice of the population so far and we now have reached the milestone where we decide whether our services are available to most consumers or just for those of high net worth.

Authentic professions serve all of society. As with technology, many begin narrowly but they generally unfold their availability to the public as they mature. Medicine, for example, shifted from a service restricted to nobility to one serving the public. Physicians' skills and practices changed over time to fit the needs of this new mission. They took off their powdered wigs and rolled up their sleeves. There's a parallel here for financial planners. As with illness and injury, money issues face everyone, regardless of net worth. Individuals need what we can do in order to relate well to money and money problems. Unfortunately, most of us have not taken our formidable skills to "jus' folks," and that's a shame. They need us and they will appreciate us. We've taken some justified heat from the press because of the perception of our inadequate service to "jus' folks." If we pursue only the small slice of high net worth clients, we stunt the growth of our profession inappropriately.

Societal forces are now propelling us past this point. Rapidly aging baby boomers, proposed tax reform, burgeoning health care costs, Social Security restructuring, the growth of a ubiquitous, user-friendly Internet as a place of community and action (not simply data exchange), and increasingly complex financial products are all trends that cry out for new service propositions. Of course, we need to generate clients in sufficient numbers to make a living and sufficient efficiencies to manage our practices well. If again we look to physicians, we see that during their evolution they made themselves available, taking their "bag" with them at all hours to meet patients where they needed care. The docs kept their overhead down and their sense of mission up. Not only is this a good model for us, it is not a difficult one given the possibilities unleashed by computers and the Internet.

The seeds of need are generating quality responses. The Garrett Network is one approach. Another is our work at www.Myfinancialadvice.com, where we have created and packaged a "bag" of integrated practice-management and regulatory compliance tools and created client access and marketing methods to deliver them to aggregated online consumers. With this bag, tools, and market access, it is easy and inexpensive to serve the vast middle market.

Advice seekers can be hyperlinked to the desktop and telephone of *any* advisor who wants to serve them in real-time, which is awesomely efficient. Through database filtering and vetting, advisors on our site match up exactly to advice seekers. Middle-market consumers can pick and choose from an array of advisors open for contact. These advisors have already passed through our demanding screens, but the advice seeker can see experience, credentials, practice descriptions, photos, regulatory brochures, licensing disciplinary records, and other biographical information, all of which helps them make comfortable decisions. Searching can also be customized to fit special needs. For example, practitioner types can be specified. Some consumers might want only CFP practitioners or only members of a particular association such as the National Association of Personal Financial Advisors or the Financial Planning Association. Or they might only want tax services or debt counseling and not insurance and investment advice. Whatever they search for, they can have. After an initial free consultation, via phone or e-mail, the advisor prepares the scope of the engagement, a written proposal, and a flat-fee quote to the consumer online. Because we can co-brand or private label with other financial services providers such as retirement plans, discount brokerage firms, labor unions, and membership associations, flexibility and access to the middle market has enormous potential.

Physicians healed "jus' folks" because their profession chose to serve society. As the many changes that assail financial life accelerate, the need for advice continues to grow in importance. We, too, must find ways to serve because good financial decisions are that critical. Politely, we would like to suggest that it is time for us to step up to this task. Like the Mavens (information brokers who have the knowledge and social skills to start epidemics), Connectors (those who know lots of other people), and Salesmen (people with the skills to persuade others when they are unconvinced by what they're hearing) described in Malcolm Gladwell's book *The Tipping Point*, the financial planning community could become the leading edge of a new tipping point. Its existence is not in doubt. Our response to it—letting it pass us by and

Editor's note: The Voice Talking Point last month mentioned Myfinancialadvice.com as a potential model to expand financial planning's reach into the middle markets and noted its consumer press coverage. We invited the founders of Myfinancialadvice.com to submit an essay with their rationale for the business model. To comment on the essay or to post a comment to the Talking Point, go to **www.journalfp.net.**

Viewpoint continued on page 17

Your Voice

Fast-Food Approach to Getting Answers

"Beware the Hooves of the Teflon Giants" (February 2005) is a well-written and important viewpoint. To it, though, I add the fact that people have been gravitating for some time toward a preference for simplistic answers. People really like a fill-in-the-blank, easy-workbook, get-it-on-the-Internet-or-from-software, Life-for-Dummies approach. To me, this means that our target market is not a universe of people of certain age and financial profiles, but those who can understand the value of using a professional. A little arrogance can go a long way.

David W. Hayes, CFP®
Financial Products & Services

Fighting a Bias with a Bias?

In "Reading Between the Lines of Investor Biases" (January 2005), I was surprised to see the author recommend a mental bias as a cure for a mental bias. More than once in the article, dollar-cost averaging is recommended as a way to compensate for a bias.

But a probabilistic analysis of dollar-cost averaging shows that it is nothing more than a mental bias. Dollar-cost averaging produces a lower expected return with lower expected risk versus fully investing. If an investor needs a lower-risk portfolio, it should be done by adjusting the target allocations of the portfolio, not by timing the market through dollar-cost averaging.

Steve Scruggs, CFA
Bragg Financial Advisors
Charlotte, North Carolina

Here's a response to our February Talking Point: "Rational Investing, Irrational Behavior, and Media Conflict of Interest."

Can Common Sense Overcome Sophisticated Hearsay?

Unfortunately, common sense will lose more times than hearsay wins! But this does not mean we should stop trying.

The most effective way for financial planners to overcome hearsay is through face-to-face client meetings. This, of course, assumes that you do these meetings on a regular schedule. Remember, that current magazine of choice arrives every month irrespective of how busy you are.

Another interesting way is to alert clients with Special Bulletins that emphasize that reading finance magazines is positive behavior but executing magazine advice is dangerous behavior. Do this as often as you can through newsletters or sending out Special Bulletins with this month's dumb idea highlighted. Suggest as strongly as you can that readers are welcome to check with their financial advisor (you) to confirm this great idea *before* they write the check or make the telephone call. Notice I've referred to this as a positive idea since no right-minded person would call you asking about a dumb idea. Would they?

I'd suggest having fun with this kind of education. Make it work for you as a way to get your clients to talk with you more often without fear of being charged or being pitched a product to buy. When possible, probe as to the reason for this behavior. Get ready to be amused and educated about your client's hidden desire as it relates to greed and over-confidence.

Don't be surprised, at least not in front of your client, at the types of calls you'll get regarding financial matters that are just plain stupid! There I go again—not appropriate! Here's one for today. Should I prepay my car insurance three months in advance just so I won't forget to pay the bill when it is sent? Pretty difficult stuff to figure out! This might be a good example of over-confidence since he (a lawyer) just won a big case!

At the top of my list would be CEOs, CFOs, attorneys, and business owners of public corporations and large law firms. My experience over the last 30 years is that the more education my client has the more susceptible they are to dumb but nonetheless appealing financial ideas.

Now go and do some good!

Stan Hargrave, CFP®
IFA, LLC
Riverside, California

Viewpoint *continued from page 16*

benefit others who are prepared to deal with it, or leading it ourselves—is still open for debate.

Kevin Condon, Ph.D., CFP®, is executive vice president of advisor services at Myfinancialadvice.com. He was founder and president of Baltimore-Washington Financial Advisors Inc. and has served in leadership roles with the International Association for Financial Planning, the Institute of Certified Financial Planners, NAPFA, and FPA.