Are Index Funds for You? Malkiel Says Yes

Burton Malkiel's *A Random Walk Down Wall Street* was originally published in 1973, and the most recent edition, the twelfth, appeared a few months ago. I reviewed the book myself in the late 1980s, and I wonder if it has ever been out of print. Malkiel, a Princeton economics professor, became known as an early proponent of index mutual funds before they were available to the public. The idea, which has been confirmed by mounds of evidence, is that "actively managed" funds carry burdensome management fees and almost always underperform the indexes. The performance of stocks and bonds is unpredictable and professional market forecasters are generally wrong. This is what a "random walk" means—the past success of a fund manager says little about his future prospects, and short-term moves in prices are unforeseeable. According to Malkiel, targeted strategies fail: "Investment advisory services, earnings forecasts, and chart patterns are useless." The point is that the market has all of the information needed to price a stock. Unless an investor trades on inside knowledge, which is illegal, she cannot hope to outperform the market.

John Bogle founded Vanguard in the early 1970s and made index funds a standard offering of the company. The firm ultimately attracted trillions of dollars, and Fidelity, Schwab, and a host of other brokerages eventually followed suit. The approach to investing, in which managers buy a basket of securities that duplicate a stock or bond index, has helped to upend the conventions of an entire industry. Employees who formerly identified themselves as “brokers” have been rechristened “financial advisers.” As my account manager at Wells Fargo remarked to me last year, “In the old days, brokers sat at their desks eating lunch, because they had to be able to take calls from clients. Now some of them work from home.”

More so than most financial analysts, Malkiel is bullish on stock indexes. Bogle, who died in 2019, encouraged investors to modify the stock-bonds allocation as they aged—if you’re 55 years old, then 55 percent of your portfolio should be in fixed income. My impressions is that he relaxed this standard in his later years. Malkiel has always been less conservative, and offers a collection of pie charts indicating asset allocations suitable to the varying ages of investors. Young people in their middle twenties should have 70 percent of their assets in stock index funds. The balance can be given over to bonds, REITs, and cash. In their thirties and forties, older investors can maintain a position of 65 percent in stocks. The recommended proportion declines to a still relatively high 55 percent in middle age and falls to 40 percent only as investors reach their later years. Some would dispute these numbers, but there isn’t any doubt that the formula has been especially effective in the last decade. Brokerages have also introduced life-cycle funds that automatically rebalance a portfolio and shift clients' funds into safer categories as they age.

Maintain these positions for as long as you can, Malkiel recommends. To justify the value of a long-term holding period, he cites the research of financial analyst Roger Ibbotson, who claims that stocks have offered a compounded rate of return of 8 percent for over two hundred years. But returns were negative in every three years out of ten. "A substantial amount (but not all) of the risk of common-stock investment can be eliminated by adopting a program of long-term ownership and sticking to it through thick and thin," Malkiel asserts.

Homo economicus is a thing of the past. The concept of men and women as rational investors has been modified by the findings of behavioral finance. Psychology has never been absent from market analysis, of course, because herd thinking is so pervasive in many categories of life. But after the dot.com bubble of the late nineties and the housing crash that came a decade later, Malkiel believes that the public needs a reminder. But other dangers disclosed by behavioral finance go further, including overconfidence in one's investing or trading ability, especially after initial initial successes. Amateurs also overestimate their ability to resist selling in a prolonged bear market, or to tolerate unexpected bad news. We're not quite as tolerant of risk as we imagine we are.

Another result of finance psychology is a new understanding of loss aversion. People are more distressed by investment setbacks than they are buoyed by their successes. This has implications for the investing style: They hold on to losing positions longer than they should, hoping to recover their losses. I've done this myself, when I look at the performance of companies like Allied General and New York Community Bank. Lured by a strong dividend, I maintained positions in these firms long after I should have let go. On its face, this might seem antithetical to a long-term buy-and-hold strategy, but it is obvious that at times it can be better to liquidate an investment when the prospect of recovery is remote.

Traders and managers will always exist to buy individual stocks and manage funds unrelated to indexes. They add liquidity to the market and expedite the process of price discovery. But for most of us, the safest path is an index fund, and Malkiel lists dozens at the very end of his book, a list that is well worth consulting.