Cuffelinks
Connecting investors with ideas

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Introduction to best-selling author, Burton Malkiel

Burton Malkiel was born on 28 August 1932 and is author of the classic *A Random Walk Down Wall Street,* and eight other books on investing. He has long held a professorship at Princeton University and is a former Dean of the Yale School of Management. Recently, at the splendid age of 81, he became Chief Investment Officer for a new online investment adviser, Wealthfront.

It's important to understand Malkiel's basic views before reading the interview. A 'random walk' as defined by Malkiel when it applies to the stock market " … means that short-run changes in stock prices cannot be predicted." Malkiel is a leading supporter of the efficient market hypothesis, which argues that the prices of publicly-traded assets reflect all the publicly-available information.

But Malkiel also accepts that some markets are inefficient, and while he strongly supports buying using index funds as the most effective portfolio management strategy, he does think it is viable to actively manage 'around the edges'.

In his book, he gives four determinants affecting the value of shares. He argues a rational investor should be willing to pay a higher price for a share, other things being equal:

Rule 1: … the larger the growth rate of dividends

Rule 2: … the larger the proportion of a company's earnings that is paid out in cash dividends

Rule 3: … the less risky the company's stock

Rule 4: … the lower are interest rates.

With two caveats:

Caveat 1: Expectations about the future cannot be proven in the present

Caveat 2: Precise figures cannot be calculated from undetermined data.

He summarises in his book: *Thus, when all is said and done, it appears there is a yardstick for value, but one that is a most flexible and undependable instrument.*

Before my interview, Malkiel made some comments in a 'fireside chat' with Harry Markowitz and John West of Research Affiliates.

"If someone's gone up more than average, someone else must be holding the securities that went down more than average. The beauty of indexing which I still take as almost a religion is that you are investing with minimal fees and competition has driven the ETF fees down almost to zero.

We need to be very modest about what we know and don't know about investing. The only thing that I'm absolutely sure about is that the lower the fees paid to managers, the more there will be left for me.

What you also find within active managers is that it is hard to pick the winners. Morningstar has run a study to see whether the stars they were giving to mutual funds were good predictors of future mutual fund performance. What they found is the best way to predict performance is to simply look at the fees. And there are all kinds of problems with high turnover, especially if you're a taxpayer.

I think markets are reasonably efficient. I don't mean prices are necessarily right, in fact, I think prices are always wrong, it's just nobody knows for sure whether they're too high or too low. But if there's some inefficiency in the market, it's the amount paid to investment managers. The finance sector has gone from 4% of GDP to 8% and about one third of that is asset management fees. There ought to be economies of scale, it only costs a tiny bit more to run $200 million as $100 million but active fees as a percentage of assets have if anything gone up. Fees have been stable overall but that's because index fund fees have fallen.

So why do people pay those kinds of active fees? My colleague at Princeton, Danny Kahneman, would say that it's over optimism. People are convinced against overwhelming evidence that they will outperform. It's like a positively sloping demand curve, they really think that by paying more they're getting a better product. And the mutual fund industry is this enormous advertising machine to convince people to use the professionals.

What David Swenson, the CIO of Yale who has an enviable long-term track record, told me was that when he's investing in securities which a lot of people follow, and are heavily traded, he indexes. Where he makes his extra money is in private placements."

Malkiel is also Chief Investment Officer of Wealthfront, which not surprisingly makes heavy use of ETFs in its solutions, using online investment advice focussed on the Silicon Valley community. It has a minimum account size of $5,000 and manages the first $10,000 for free, and 0.25% thereafter (this is the advice fee, separate from the management fee cost of the fund). It achieves the low cost using its online solution and the principles of modern portfolio theory as the basis for asset allocation. Malkiel believes this is the way to deliver professional advice to retail investors who cannot justify, or who do not want, a full fee relationship.

On with the interview …

The Burton Malkiel Interview

Graham Hand: Thanks for signing my copy of *Random Walk.* Note it is the sixth edition from 1996 so I didn't just buy it for you to sign. And your book's now into its 10th edition.

Burt Malkiel: And I'm about to start working on the 11th edition.

GH: Can you tell me what's changed in investing over the decades since the first edition?

BM: What's changed is that the first edition, there were no index funds. First edition was in 1973, the first index fund was in 1976. It is meant to be an investment guide, and there have been dramatic changes in the kinds of instruments available to investors.

There are three major things I do in different editions. One, the new instruments available. For example, more recent editions have featured ETFs. Two, the changing regulations like tax laws facing investors. Then finally, the academic research over the period. Two things I will put in the 11th edition are the low volatility products available, and I think that option writing is interesting. I have some colleagues who have done fascinating research that they can replicate the hedge fund index and get 300 to 400 extra basis points by writing puts. You're basically selling insurance.

You know, in the early days when I said "Just go and buy index funds," I had a reviewer say in Business Week, "This is the biggest load of garbage," so I keep saying, "I said go buy index funds, did it work?" and every time I look at the last four or five years, yes it did work. The book has changed a great deal, but the basic message hasn't changed, even if the advice on what to use has changed.

GH: If I look at some of the criticisms of the book, where people say there are some managers who have had long-term success outperforming the market, but as I read your book, you acknowledge this. For example, in my edition it says, "I walk a middle road. I believe that investors might reconsider their faith in professional advisers, but I am not as ready as many of my academic colleagues to damn the entire field. While it is abundantly clear that the pros do not consistently beat the averages, I must admit that there are exceptions to the rule of the efficient market. Well, a few." So you're not just an efficient markets person.

BM: And that was actually another change. I'm not saying you should necessarily index everything, but there's enough evidence in favour of it, the core of your portfolio ought to be indexed, and then if you want to trial something active around the edges, you do so with much less risk. But just remember, there is this distribution of returns (Burt draws a normal bell curve, then a vertical line near the y-axis representing 1% fees) and if there were no fees, half would be above and half would be below. If you can get the market return, the typical active manager will be 1% less than the market. You're much more likely to be on the negative side of the distribution with active managers. But you can definitely try it.

I will also be writing about financial repression in the next edition (*GH comment, this is where the government interferes with free market operation*). I would not buy a bond index fund today.

GH: It's really interesting to hear that because if we focus on asset allocation rather than manager selection, how do you feel about the various investing models that are recommended to retail clients, say invest 70/30 and stick with that.

BM: There's no question that in my advice to the Princeton widows, they want to be able to draw some income out without having to sell all the time. They want to do it easily. I don't want them to get their income from a US bond portfolio, they should get it from emerging markets bonds where there’s no financial repression, or in dividend growth stocks, which takes me back to a low volatility strategy. This is asset allocation, but I don’t feel badly about doing it. If there’s somebody in retirement who wants income, yes, I don’t want them to buy Google and Facebook, I want them to buy a particular type of stock, but that’s fine.

GH: And you also don’t want them to buy a bond yielding 1%.

BM: Exactly, because I think they’re going to get killed.

GH: So in that situation, the so-called lifecycle funds with an increasing allocation to the bond market …

BM: I don’t like them, that’s another thing going into the next edition. I’ve been a director of Vanguard, I’m on the Vanguard International board now, but I don’t like lifecycle funds because at the end, they’re putting 80% into precisely the securities that I think are going to give people an enormous amount of trouble.

GH: Let’s turn to Wealthfront, which looks like it’s gaining some good momentum.

BM: It’s amazing. As I said in the panel discussion, I’m not sure about a lot of things, the only thing I’m absolutely sure about is that the lower the fee I pay, the more there’ll be for me. So what we do at Wealthfront is we’re using the lowest cost ETFs, we are also charging a wrap fee for doing the asset allocation of 25 basis points. So it’s kind of ‘Vanguardising’, if you wish, the advice business. I have been with them since the end of 2012 and they’ve got $210 million of assets from almost nothing in that time. They are doing this using a lot of technology – we’re not going to hold your hand, you can’t do that for this price – and the marketing is done through e-invites, the clients are from places like Google and Facebook and Salesforce and they are happy to be serviced online. I don’t think my Princeton widows would be comfortable with this approach, and if you want to pay more for advice, fine if there’s someone who will hold your hand.

GH: I assume there’s some process of risk assessment.

BM: Yes, we use some of the expertise from behavioural finance people, Meir Statman was one who helped us design the questionnaire so it’s not simply age. That’s too simple, people are all different. There are people for whom a very aggressive portfolio makes them sick to the stomach when it goes down.

GH: They can’t sleep at night.

BM: More than that. They can’t sleep at night, but one of the things we know about the mistakes people make is that they’re more likely to sell when the market falls. They can’t take any more. When people try to time the market, they usually get in at the top and get out at the bottom. You see it with mutual fund flows, you see it with pension funds. Are we doing it perfectly, probably not, this is not an easy thing to do. We have added people who know something about survey techniques, people who know behavioural finance, we get the questionnaire filled out and then we put people in particular buckets.

Just to give you an idea, I’m a client, and given my age, they had me in a safer portfolio than I wanted to be, and I said you can’t just do it with age because I’m not investing for myself, I’m investing for my grandchildren. It’s the horizon of the people you are investing for.

GH: Given your comments about low bond rates, if someone profiled as conservative, where do they go?

BM: As I said, the bonds we are using are bonds from countries not engaged in financial repression, have younger demographics, have reasonable interest rates, low debt and better fiscal balance. I am the Chief Investment Officer and I design these things for exactly the reasons we discussed earlier.

Let me tell you the other things we can do. We do rebalancing with an automatic formula, and for taxable accounts, we do tax loss harvesting. Let's say you've got a US equity position, and the equity has gone down. We'll sell the Vanguard ETF and buy the Schwab ETF, it is essentially the same thing but it's not a wash sale when you do it that way, and take the tax loss, and particularly for the clients we have now, they can use the tax loss because their portfolios might be 98% in Facebook stock which they will be taxed on. This works well.

GH: One last question. You said recently, "We should be modest about what we actually know." Do you have any feeling of disappointment about progress we've made in investing. If I were a surgeon or a pianist, after 35 years, I'd be very good.

BM: I think the reason we have not made much progress is that it is probably one of the most overpaid professions there is. It's an inefficiency, with investment professionals paid regardless of the results. I've been an educator, and I just try my best in everything I do. I went to Wealthfront because I like the idea of doing good for humanity and I get paid in stock and I might do well financially at the same time. The real problem with us making enough progress in our industry is the misaligned incentives. But now, at least there's a lot of competition in ETFs and fees have been driven down to close to zero.

How I manage the Third Link money

Chris Cuffe

One of the important principles of *Cuffelinks* is that we don't promote specific investment products. However, I am going to break that rule and talk about Third Link Growth Fund ('Third Link'), in recognition of its five year track record. Third Link is a managed investment scheme which I created and manage on an ongoing basis. I am confident that after reading this article you will feel it is less about a product promotion and more about an innovative community service.

Third Link invests in Australian shares. It is what is known as a 'fund of funds' in that it invests primarily in other Australian share funds managed by professional investors. I select and monitor these managers and decide how much to invest with each. My aim for Third Link is to outperform the S&P/ASX300 Accumulation Index after fees over rolling five year periods.

Third Link commenced in 2008 and currently has around $55 million under management. It is open to anyone (minimum $20,000) and many of the investors are SMSFs. Investors pay a management fee of 1.4% per annum. Third Link's website (www.thirdlink.com.au) explains all aspects of the Fund and contains the legally required Product Disclosure Statement and application form.

Well, you may think that so far this is a blatant product promotion and hardly conforms to the independent nature of *Cuffelinks*. But here is the twist. The 1.4% management fees generated for my management company, less costs incurred in running the Fund (which are minimal), are donated to charity. And obviously, the more Third Link grows in size from either new applications or growth in the market value of its assets, the greater are the regular contributions to the supported charities. In its five year history the Fund has generated nearly $2,000,000 for the charitable sector, with the monthly amount donated exceeding $50,000 and growing. Not a bad regular annuity stream!

The theme of the charitable giving is helping children and young people thrive. Third Link now supports the following not-for-profit groups:

- *Australian Indigenous Mentoring Experience (AIME), whose mission is education equality, where indigenous students perform and finish school at the same rate as every Australian child*
- *Batyr, whose mission is 'giving a voice to the elephant in the room', bringing young people's social and mental health issues out in the open*
- *Beacon Foundation, whose mission is to influence the attitudes and culture of Australians so that each young person develops an independent will to achieve personal success through gainful activities for themselves and their community*
- *The REAPing Rewards Program, to benefit early childhood learning establishments in Australia's regional, rural and remote communities with infrastructure and resourcing needs*
- *National Centre for Childhood Grief (NCCG), who provide loving professional support and guidance in a safe place where children grieving a death of a parent can share their experience as they learn to live with the impact on their lives and*
- *Outward Bound Australia (OBA), who provide challenging outdoor experiences that help young people to discover, develop and achieve their full potential.*

More information on each of these groups can be found on the Third Link website.

So I'm sure you can see that Third Link is a winner for the charitable sector, but what's in it for investors? I believe there are multiple advantages.

Firstly, through a single investment in Third Link, investors get exposure to a range of underlying Australian share portfolios of different investment managers. These managers include Aberdeen Asset Management, Bennelong Funds Management, Colonial First State Global Asset Management, Cooper Investors, Eley Griffiths Group, Goldman Sachs Asset Management, JBWere, Montgomery Investment Management, Paradice Investment Management, Pengana Capital, and Greencape Capital. The particular fund of these managers that Third Link invests in is listed on the website.

Secondly, each of the underlying managers waives its fees (both management fees and performance fees, if applicable). This ensures my costs of managing Third Link are kept to a minimum, meaning more is donated to charity. Since the underlying managers forgo the normal performance fees they may receive, the total 1.4% fee that investors pay makes the Fund good value. If you invested in these managers directly in the same proportion as Third Link, then for most periods, the fees would be materially more compared to accessing them via Third Link.

Thirdly, I have been in the investment management industry for nearly three decades (and have the grey hair to prove it!), which means Third Link investors have access to my considerable professional experience in selecting and monitoring the underlying managers.

And finally, the investment performance of Third Link has added value, as shown in the table below, which shows the Fund performance (after fees and assuming income distributions were reinvested) as at the end of March 2013 (the most recent quarterly figures available):

	THREE MONTHS	SIX MONTHS	ONE YEAR	THREE YEARS	SINCE INCEPTION (JUNE 2008)
Third Link Growth Fund	+9.2%	+16.1%	+19.6%	+8.7%pa	+7.5% pa
Benchmark[1]	+8.0%	+15.4%	+19.2%	+7.8%pa	+3.7% pa
Relative performance	+1.2%	+0.7%	+0.4%	+0.9%pa	+3.8% pa

[1] Since February 2012 the benchmark has been the S&P/ASX 300 Accumulation Index. Before that it was the Morningstar Multi-Sector Growth Market Index.

Returns greater than 1 year are expressed as annual compound returns. Past performance is not indicative of future performance. Returns can be volatile.

Most investment managers crow about good performance when they have achieved it, so I'm not going to be the exception. Generally, over the history of the investment management industry, fund of funds structures such as Third Link often underperform their benchmark. Why is this? My theory is that 'investment technicians' who construct fund of fund portfolios fail to appreciate that good investment management is more about art than science, and more prone to fear and greed rather than logic. Others construct a portfolio of managers in a very 'scientific' way, combining value and growth managers with small cap and large cap managers, etc etc … and the end result is often a defacto replication of the benchmark they are trying to beat. After they subtract their management fees, they naturally underperform.

For me, picking good investment managers is about taking a long-term view of how they manage money and what their results have been over long periods of time and in different environments. I don't get obsessed about their particular style of management or the volatility of their portfolios over short periods of time. I just want to be convinced that they have the ability to significantly outperform the market they operate in. I need to be convinced they don't hug benchmarks and they must think independently of the herd. Not many do this but they are out there. Great investment managers, like great artists or musicians or craftsman, often have an innate ability that is impossible to obtain from a text book.

While I have the microphone, it would be remiss of me not to acknowledge the many other service providers who do pro bono work for Third Link. Because they waive their fees, the costs of administering Third Link are kept to a minimum meaning more is donated to charity. This list includes Treasury Group Investment Services Limited (the responsible entity), RBC Investor Services Limited (the custodian and administrator), Minter Ellison (legal work in connection with the Fund), BlueChip Communication Group (communications & PR strategy), Ernst & Young (auditors of the Fund and the investment manager), Deloitte (tax advisers to the Fund), Nexia Australia (tax advisers to the investment manager), CompliSpace (risk management tool provider), Gallagher Broking Services (insurance broking service provider), DUAL Australia (insurance provider), BT Financial Group (administrative platform for superannuation investing), Mercer (Investment data and analytics provider), Zenith Investment Partners (investment research provider) and Vince Sorrenti (MC and entertainer at Third Link thank you events).

I conclude from the above (and I hope you do too) that Third Link Growth Fund is a win win for both the charitable sector and investors. It also demonstrates a great generosity of the many players in the financial services industry that have participated to help make it a reality.

And I'll finish with a favourite quote from Woodrow Wilson, the 28th President of the United States (1913–1921):

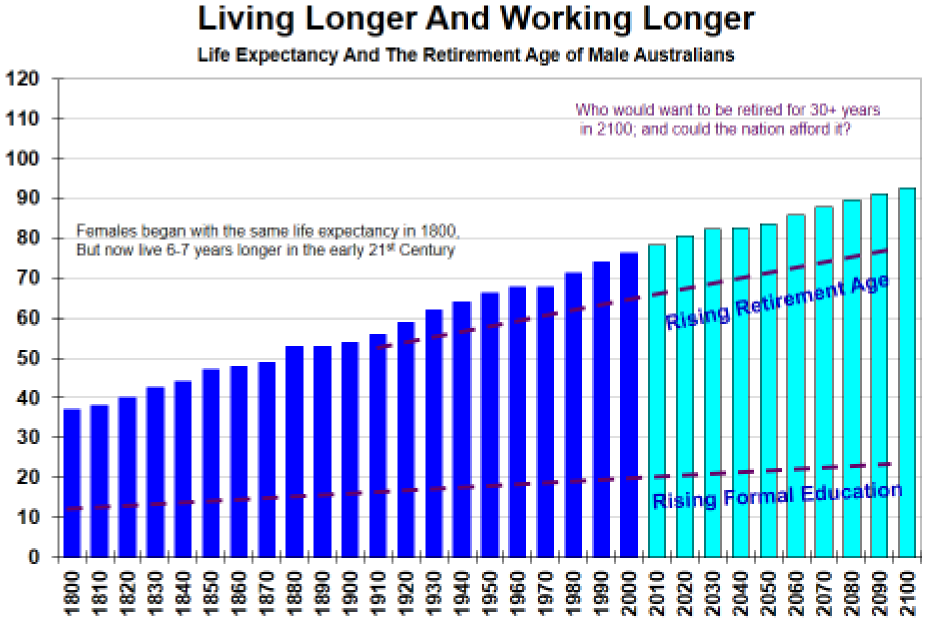
"*You are not here to merely make a living. You are here in order to enable the world to live more amply, with greater vision, with a finer spirit of hope and achievement. You are here to enrich the world, and you impoverish yourself if you forget the errand.*"

Treasury Group Investment Services Limited (TIS; AFSL 227326) is the responsible entity and issuer of the Third Link Growth Fund (Fund). Third Link Investment Managers Pty Limited (Third Link; AFSL 321611) has been appointed by TIS to invest and manage the investments of the Fund. Applications can only be made on the form in the current PDS, dated 20 February 2012. You should consider the PDS before deciding to invest or continuing to invest.

Retiring with dignity

Phil Ruthven

We live a lot longer these days, thanks to better diets, modern medicine and health services, less accidents (OH&S) and other developments. The first chart traces this increased longevity over several centuries and on to the end of this 21st century.



Source: ABS, Australian Historical Statistics, IBISWorld

Life expectancy has more than doubled from the 38 years early in the 19th century, and may rise a further one-third by 2100 to be close to 100 years of age on average.

Interestingly, the amount of paid work in a man's lifetime has never varied over many centuries: always 75-80,000 hours. All that has changed is that this amount of work is spread over 50 years, not the 25 years of the early 1800s. In essence, we work half the number of hours in a year. Further, we tend to begin our working lives with part-time or casual work, and finish that way: it makes for a more tapered start and finish. Much more civilised.

So retiring comes later and later in life, and given that most jobs are now cerebral rather than physical, the only way to wear the brain out is to stop using it!

Indeed, retiring closer to 80 years of age in 2100 will probably be the norm. Already, 65 is too young for more and more people.

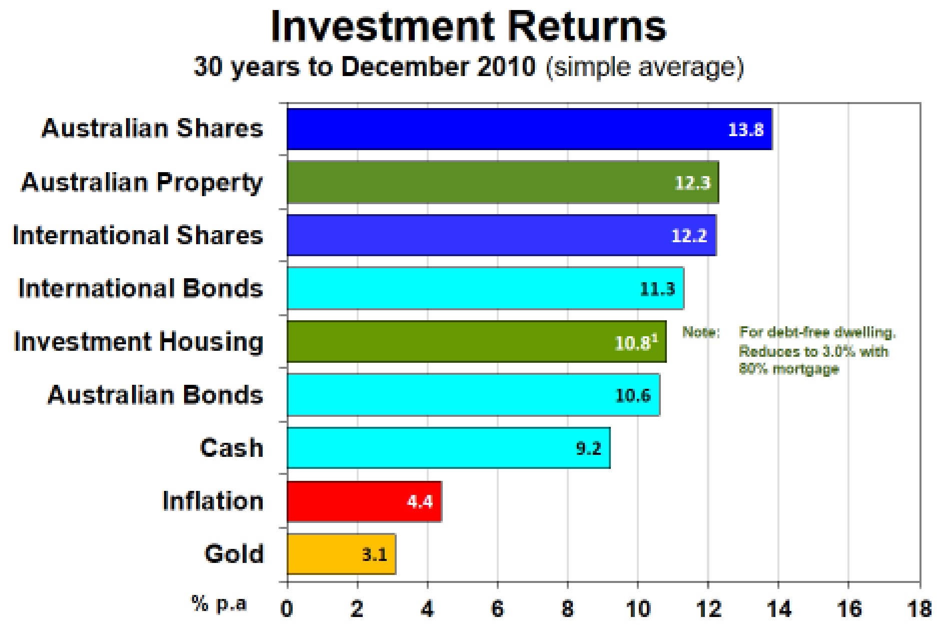
In case we think work is very different for females, it is becoming less different. The total amount of paid and unpaid (household) work has been the same for both genders anyway for centuries at 125-130,000 hours; but now - due to more education, more equality and flexibility in the workforce, and the outsourcing of household functions – the female ratio of paid to unpaid work is favouring the former.

Apart from longevity, modern economies have underpinned the eventual retirement of its members in several ways: pensions, other forms of social security and superannuation.

Australia is one of the world's leaders in the last mentioned along with Singapore and a few others. Our scheme, begun under the Keating Government in 1993, now sits at 9% of wages and rising to 12% in the 2020s. A level of 15% would be even better – enabling life-long super-contributors to retire for the rest of their life, however long – on a half or more of their final annual wage.

In today's money terms that would be over $70,000 per household (and keeping pace with inflation), plus any other sources of income they had. A comfortable retirement.

But where to put one's nest egg to safeguard such a dignified and independent retirement? History provides a useful guide. The chart below shows the return on various asset classes over a 30 year period to 2010.



Investment Returns

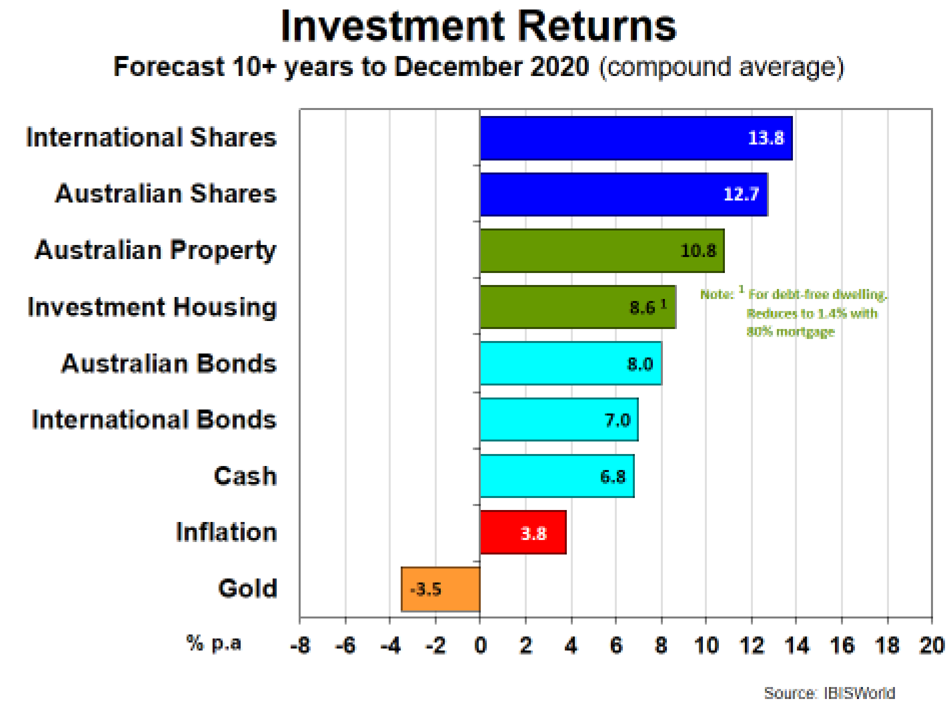
30 years to December 2010 (simple average)

Note: For debt-free dwelling. Reduces to 3.0% with 80% mortgage

Source: AXA Financial Services/IBISWorld 21/03/11

However, the decade to decade changes are significant in the pecking order of returns.

In the 10 years to 2010, gold topped the performance ladder for the first time in living memory; aided and abetted, of course, by the GFC. After all, these days, gold should be seen as a panic-metal or security blanket rather than having a currency-backing role which it lost in 1971 under the US Nixon Administration. So gold went from the worst performing asset to the best in the first decade of this new century. IBISWorld thinks the performance ladder will change again in the 10 years to 2020. The next chart is their current best guess.



Investment Returns

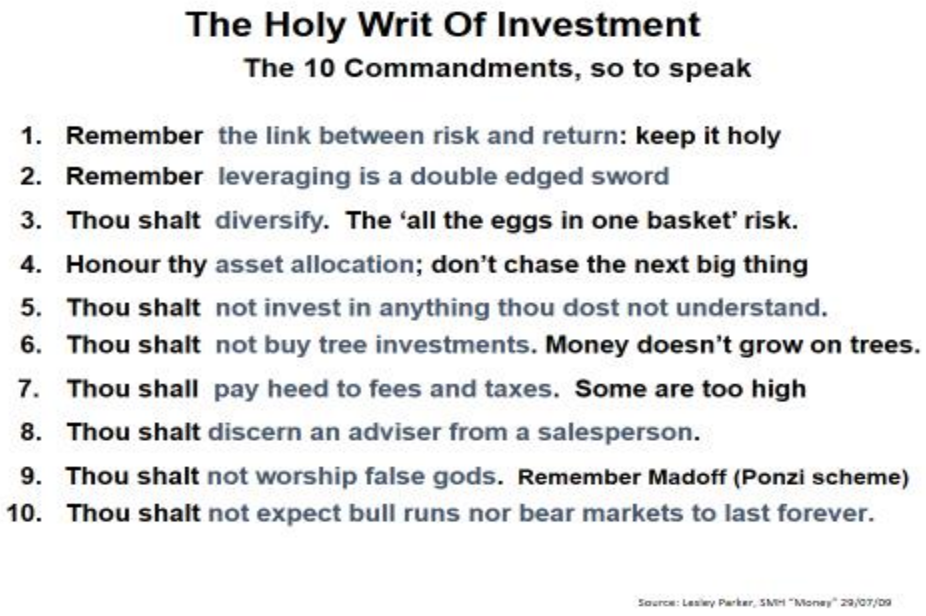
Forecast 10+ years to December 2020 (compound average)

Note: [1] For debt-free dwelling. Reduces to 1.4% with 80% mortgage

Source: IBISWorld

All this is a salutary reminder that investment is a tricky business. The year to year changes are just as volatile, if not more so, leading to the wisdom of having a 'balanced portfolio' and avoiding having 'all one's eggs in one basket'. This rule has been broken often in recent years and decades, leading to less and less sympathy from friends, relatives and the public at large for those that 'lost everything' through their own ignorance, stupidity or greed.

But perhaps the last word is best provided by Lesley Parker who published the following advice in the Sydney Morning Herald almost four years ago. Good sense then, and still is today.



The Holy Writ Of Investment

The 10 Commandments, so to speak

1. **Remember** the link between risk and return: **keep it holy**
2. **Remember** leveraging is a double edged sword
3. **Thou shalt** diversify. **The 'all the eggs in one basket' risk.**
4. **Honour thy** asset allocation; **don't chase the next big thing**
5. **Thou shalt** not invest in anything thou dost not understand.
6. **Thou shalt** not buy tree investments. **Money doesn't grow on trees.**
7. **Thou shall** pay heed to fees and taxes. **Some are too high**
8. **Thou shalt** discern an adviser from a salesperson.
9. **Thou shalt** not worship false gods. **Remember Madoff (Ponzi scheme)**
10. **Thou shalt** not expect bull runs nor bear markets to last forever.

Source: Lesley Parker, SMH "Money" 29/07/09

Phil Ruthven is Chairman of IBISWorld, Australia's best-known business information corporation, and he is also a director of other companies, advisory boards and charitable organisations.

Past returns are not even a reliable guide to the past

Towers Watson

We are often warned by investment managers that past performance is not an indicator of future returns, but Towers Watson goes even further: past returns are not even a reliable indicator of past returns.

They point out that retail investors are not good at ‘buy and hold’ and suffer from switching at the wrong time as they chase better results. Investors rarely achieve the reinvestment of dividends assumed in compounding calculations, which rarely allow for tax payments. A quoted return which assumes reinvestment of gross dividends is very difficult to achieve. And then there’s the emotional drain of feeling losses more than enjoying profits, as investors struggle to distinguish between a noise and a signal.

The full Towers Watson research paper is on the Cuffelinks website, and it will make investors think again about the merits of past performance numbers.

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