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## A Random Walk Off a Cliff: ‘Beating’ the Market

By [Bob McTeer](#)



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I’ve always been fascinated by the question, “If you’re so smart, why aren’t you rich?” Why don’t the experts have an advantage in stock-picking? Or do they? Are markets so efficient that they incorporate all relevant information instantly and leave us nothing to trade on? Or, can some investors “beat the market” consistently?

Is it A Random Walk Down Wall Street, as posited by Burton Malkiel’s [book](#) of that title? Or, did my believing it, just lure me over the stock-market cliff? I’ll think twice before I drink that Kool-Aid again.

It sounds odd to say nobody can benefit from new information because somebody already has, but that’s the logic. It’s like nobody goes to that restaurant any more because it’s too crowded. Or, nobody can win the lottery, notwithstanding the fact that someone usually does.

I don’t have good answers yet, but I find the questions intriguing. When I find the answers, I’ll let you know — as soon as I’m rich.

When the Federal Reserve began its 401(k) program in 1970, most of the economists I knew were drawn to the safe, fixed-income alternative rather than one of the equity options. They really were economic experts, but they still doubted their ability to “beat the market.” To paraphrase Clint Eastwood, they knew their limitations.

I once served on the Fed’s Investment Performance Committee for its pension and 401(k) funds. We interviewed our investment managers periodically to see how they were doing. It wasn’t so much whether their picks were up or down, but how they were doing relative to their benchmark. It was a stroke of genius when professional money managers trained everyone to grade them on a curve, so to speak. Absolute results didn’t matter; it was all relevant. (See my poem, “[Beating the](#)

[Boogie.](#)”)

I never felt comfortable deciding whether to replace weak performers or give them more time. Since “past results are no guarantee of future performance,” and given my leanings toward the efficient market theory, I thought it just as likely that a weak performer last year would perform well the next year.

Does the recent stock-market crash make a stronger market next year more likely or less likely? Is it easier for the Dow to return to previous highs than it was to attain them in the first place?

I once appeared on a panel with a politician who began every answer with “I can argue it round; or I can argue it square.” That’s about how I feel on stock-market issues.

Obviously, fully half of stock investors fall below the median, and most fail to beat the broad averages. When some do, it doesn’t mean they can do it again next year.

Probability theory says that, if I flip a fair coin and get 10 heads in a row, the probability of the 11th being a head is still approximately 50 percent. Picking stocks is not flipping coins, but it’s close.

Close, but not identical. You can find evidence of inefficient markets. For example, economic circumstances and hints from Fed policymakers may create a virtual certainty about the Fed’s next policy move, but, when the expected happens, the market often treats it as a surprise. Not every time, but often.

[If You’re So Smart: The Narrative of Economic Expertise](#), by Donald McCloskey, is the best book I’ve read on this subject. If you are a professional stock picker, you may want to avoid this book to retain your confidence. Also too convincing for comfort for some is Steven Landsburg’s [The Armchair Economist](#), Chapters 19 and 20. They don’t provide reassurance for those of us with newly depleted 201(k)’s.

Particularly distressing to me is Landsburg’s contention that all losses (and gains) are permanent. Using the analogy of a roulette wheel with equal numbers of positive and negative changes of differing amounts, he leads into the following paragraph on Page 189:

With a random walk every change is permanent. Today’s price is the sum of all of the (positive and negative) changes that have come before, and each of those changes is determined by a separate spin of the wheel. If today’s spin yields you a -15, then all future prices will be \$15 lower than if today’s spin had yielded 0. The effect is entirely undiminished by the passage of time.

I find it hard to accept that recent declines won’t make future gains more likely. Surely 14,000 on the Dow Jones industrial average will be easier to attain the second time than it was the first time.

I plan to hedge my bets, however, by taking my vitamins to extend my investment life. But I’m afraid the stock market is no place for old men.