INTERVIEW WITH BURTON MALKIEL

PAM
Counting down from 10 and the very first thing you're gonna say is hi P, hi J. I'm gonna ask the first question, give it ten seconds before you answer. Here's the very first question: Dr, we just saw a piece, a story, and we just heard from someone who manages, accounts that are only available to the really wealthy. And you just heard them say, that those managers, and their returns and results are not that much better than the avg, and yet the fees, etc etc. What do you think of that? Do you agree?

BURT
Hi Pam and Jack, glad to be with you. Let me tell you that I agree entirely. I think that individual that think only the wealthy, only those with country club connections can get into the really good investments, let me tell you a lot of people went to Bernie Madoff's country club would tell you, don't believe that for a second. In fact, I think individual should avoid these fancy investments like the plague. Now let me tell you that my university, Princeton, invests in hedge funds, but let me say 2 things about that: Number 1, Princeton University, and Yale, and Harvard can get into the few, really good hedge funds that exist. The man or woman on the street, will not get into the good ones. You're gonna get into the mediocre ones and the mediocre ones have perfectly terrible rates of return, secondly, when my university negotiates to get into a hedge fund, it doesn't pay 2 and 20, now that's the typical expense 2% of the amount of money that you give them, plus 20% of the total profits. They don't pay that, they negotiate a much lower fee. The individual can't do that, so my advice is avoid the kinds of fancy, exotic investments like the plague. For the typical hedge fund, the returns are in fact very poor, and you're not likely as an individual, to get into the few good ones, you're much more likely to get into a mediocre one or worse a failing one, and let me tell you that 10-20% of these hedge funds fail each yr, it is not for individual, forget it, don't do it!

PAM
Ok lets talk about that, take that apart a little bit, with respect to mediocre hedge funds. Lots and lots of hedge funds out there, how many approx these days exist, after what's happened these past yrs, how have you studied them to reach this conclusion?

BURT
Well, I've actually done a study of hedge funds and a study of the published results that seem very good. You know there are services that say, the average hedge fund made X% over the last 5 yrs, and the problem is, that all of those results have what's called survivorship bias in them, and by that I mean, normally when you read stats about hedge funds have done so well, it's only the hedge funds that survived, you don't typically have the hedge funds that didn't survive. Let me give you an example. There's a famous hedge fund, Longterm Capital Management, which was doing well for a while and then it collapsed. Well, during the period when it was doing well, it was in the database, it was in the avg suggesting that hedge funds did well, but for almost a yr before they collapsed, when the returns were terrible, they were not in the database. So you've

got to be very cautious about believing the stats that you read about hedge funds. All you're getting are the stats from the successful ones, not the unsuccessful ones. And there are thousands of them out there, the indeces that you see, and that get the publicity, are not representative of what the average investor gets from a hedge fund, and even worse, if you looked at the ones that individual can get into, they normally only get into the Madoff-type hedge funds of the world, the ones that do really poorly.

PAM
How does one even check to see, what the performance numbers are in a typical hedge fund. There are 100s out there, maybe you can start from that point of view that there are 1000s out there, I don't know if it's 1000, or 5000 at this point. Something like, here's where a typical investor, what they can and cannot know.

BURT
Well, I mean, you're absolutely right. This is not like a mutual fund, where the past results have to be reported to the SEC and have to be a matter of public record. A number of these are very secretive, in many cases, you can't know. And there's another interesting thing that happens: there is a, this gets a bit technical, but it shows you what some of the problems are as I said, the typical fee, that you pay, is a 2% management fee plus 20% of any profits. Now that is called 2 and 20, that's the typical fee arrangements. Now the 20% profits, are only the profits over what the hedge funds call the 'high water mark.' in other words, if you have a hedge fund, you put $100 in, it goes to $200. Well, the first thing that will happen is, that $20 of that $100 appreciation goes to the hedge fund manager, that's the 20% of the profits. But let's say next yr, the hedge fund goes down from $200 to $180, the hedge fund doesn't get the 20% then, and suppose in the next yr after that, the hedge fund goes from $180 back to $200, well the hedge fund manager doesn't get 20% of that difference between $180 and $200, b/c the hedge fund didn't get above the high water mark, which is the highest amount that was ever achieved. So what does a hedge fund manager do, the hedge fund manager, if all the hedge funds went down a certain amount, which all the hedge funds did during the terrible markets of 2008, you then close the hedge fund and start a new one that doesn't have that high water mark, the high water mark is just the initial price of the hedge fund, and so there isn't a long term record all you're relying on is that the hedge fund manager says well we've had 10-20 yrs of experience and we've done well. In general, this high water mark and the fact that so many of them close and reopen suggest that it's really very, very difficult for the individual to even get the right information.

PAM
So then Jack, my co-host, says to you, "so Dr. I want to be a hedge fund manager when I grow up."

BURT
What do I say to Jack? Absolutely!! Hedge fund are wonderful for the hedge fund manager, they're just not very good for the investor. That's one of the things, if there's a basic lesson about investing, it's there's such a conflict of interest between the purveyor of the service and what the

individual gets. The more the purveyor gets, the less there is for the individual. And that is true of hedge funds, it's true of very expensive mutual funds, it's even true of people who sell investment services they're wonderful businesses if you can get ppl to buy them. I always liked the quote of Steve Forbes, who said, "There's a lesson about this that I learned at my grandfather's knee: It is far better to earn money buy selling investment services, than by taking the advice of the investment service."

PAM
Bingo, times 10. I mean that is absolutely the whole message of this episode. But we also want to be the fly on the wall, and see what it's like to be really wealthy and see how they invest. Kinda like Oz behind the curtain, the all powerful Oz. Superior returns, superior service, no one else can have access to that, they sleep at night, knowing that that's the case, what do you say to that?

BURT
Well what's very interesting is, that if you look at how professional institutional investors invest. And by professional institutions, I mean looking at pension funds, looking at various endowment funds, looking at anybody who is considered a professional investor. What's interesting to me as an advocate of low expense index funds, which is something I believed from a time before index funds existed, when you look at how they invest, about a third of the common stock and bond portfolios of the most professional investors, are invested in these index funds, so don't kid yourself and think they have found the holy grail. They, more than individual, make use of the very low cost index funds, that I've always believed should be the core of every portfolio, and that I use myself in my own retirement accounts.

PAM
Yeah but what about Oz?

BURT
Uhh, Jack, let me tell you what the situation is, sure there are a few people who have hit it well, with a hedge fund, or with a private equity fund. But most of them don't, and in fact, the most professional investors, the institutional investors, those that run the pension funds, those that run the endowment funds those are the people who agree with something that I've suggested all of my life, even before the time when index funds existed, that the core of every portfolio ought to be invested in very low cost index funds. That goes for stocks, that goes for bonds, that goes for international, it even goes for emerging market equities. ⅓ of the stocks and bonds held, by institutional investors are index funds today. They're the ones that have access to the good hedge fund managers, so why not do what in fact those professionals are doing? They recognize just how hard it is to get to the very best of hedge funds, equity funds. I do this myself with my own retirement portfolio and I think individual should be doing exactly the same, invest in low cost index funds, and you won't get average performance, you will get well above average performance, b/c you're paying well below average fees!

PAM

Wonderful. Ok, who's arguing with your assertions? Who's out there that is in conflict with your info, anybody say to you, that's not true?

BURT
Sure, there are, and remember that's the kind of conflict of interest that you find in the investment business. Whenever there are averages, you will find somebody that does better than avg. And after my research on hedge funds, you can be sure there were a few hedge funds that said look, Malkiel's wrong, here's my results and for the last 5 yrs or 10 yrs, I've done better than his simple index funds. Well, they'll always be somebody who can say that, they'll always be some mutual funds who say look for the last 10 yrs I've beaten those index funds. Let me tell you what the problem is, I've looked at those arguments, and there have been some of them the problem is there seems to be no persistence in that above average performance. Those hedge fund managers who came out after me, when I published my hedge fund research, what we found was, a yr or so after they came out with their data they way underperformed the indeces. And let me give you a little factoid here. There were 10, excuse me 14 mutual funds that had beaten an S&P 500 index fund for 15 yrs thru 2007. So here's your answer, all of these guys beat the index fund yr after yr, and there were 15 of them who did it. Well, how many do you think beat the index in 2008? And the answer is there was just 1. And that's the problem, you will always find somebody who can report, hey I beat the index, you invest with me. They'll always want to say that, that's they're business. The more money they have, the more money they make. The problem is there's almost no persistence, and let me give you one other fact…

BURT
Net of fees, right. In other words there have been ones, net of fees that have beaten the index. But they're not the same ones, yr after y… (Pam speaks) … both it's exactly the same. There's no persistence in hedge fund returns there's no persistence in mutual fund returns, and probably the best investor in the US, Warren Buffett, has said, and I quote "We'd be much better off, just buying simple low cost index fund."

PAM
Uhh huh?

BURT
Well, let me give you another example, David Swenson, who's thought of as the best professional manager, he has said, he wrote a book, on how institutions might invest by doing a lot of private equity and things like that, and he then started to write a book for the individual investor, and his idea was gee let me write a book for the individual investor, how the individual investor could do it. And after he started to work on this, he came to the conclusion, that you know what, the individual investor ought to simply buy a low cost index fund, and so in some sense the best investors we've got in the country, are now telling you, hey you know what, this heretical idea, and it was that, I first published my book "A Random Walk Down Wall Street" in 1973, and I was thought of as being absolutely insane but that heretical idea is now, in my view, accepted by the best investors in the world.

PAM
Got it, ok I'm loving this. (BG voice). I'm curious to know, how many hedge funds do you reckon, do you suppose are out there right now, alive and kickin?

BURT
Uh, that's very hard to know b/c there was such a major attrition, I said there's usually 10-20% attrition, I say there was more than that over the last 12 months b/c of this high water mark, you don't get the incentive fee unless you go above the high water mark. But there's certainly well over 1000, and I don't think anybody knows, and the reason that people don't know is, that while there are services that publish the returns of hedge funds it isn't like mutual funds where everybody is required to report, it's voluntary reporting, and what we know about hedge funds is, they only report if they have pretty good returns and they want to advertise those returns. So the answer is, we really don't know, but it's fair to say that there are probably 1000s of them out there, they're very profitable for hedge fund managers, and particularly wealthy peopl, people in Wall Street will try to sell them a hedge fund and tell them that if you're wealthy, this is the thing you really need to have. Let me mention one other thing about hedge funds, that makes it even worse, what WS usually tries to sell ppl, is you don't want just one hedge fund, that's too risky, you want diversified hedge funds, and that is called 'fund to funds.' Well gee that sounds wonderful, I'm diversified too. I don't get just one hedge fund, I might get a fund of 10-15 hedge funds. Well the problem is you might pay 2 and 20 to the individual hedge funds as a fee, and then you pay an additional 1 and 10, an additional 1% plus 10% to the manager of the fund to funds, you've got fees on fees, and it's almost impossible for the individual investor to get ahead of the game. Let me tell you my friend Jack Bogle, has a quote that I use all the time, and I think it is just so important that individual investors always keep this in mind: In the investment business, you get what you don't pay for. The lower the fees, the more there will be for you, even for actively managed mutual funds, and I've done a lot of statistical work on this. If you want to be sure, you say no I don't want all index funds, I want some active funds, I believe this managers' gonna do well. Well, if you want to have a top cortile, actively managed fund then buy one that has bottom cortile expenses and bottom cortile portfolio turnover. You don't want ppl who are just buying and selling all the time, that creates all kinds of costs, and it's very inefficient from the standpoint of taxes…

PAM
(Sets up scenario about a super wealthy person and why do they believe that hedge fund is key)

BURT
Well, I think it's in part b/c one, as I said before, hedge funds are a great business, and the best hedge fund managers are very rich. And it's natural to think, hey if the manager's rich, maybe I'll be rich! You know there's an old story that came out of a book from the Great Depression, it was called *Where are the Customer's Yachts?* and the idea was this person was visiting New York for the first time, was taken downtown and he saw all of these wonderful yachts and said, 'well who's yachts are those?' well they're the yachts of the Wall Street brokers and the person thought

for a minute, well that's interesting. But, where are the customers yachts? I think its in part because the purveyors of these services are very wealthy and its very natural to think, well gee if they're wealthy then maybe they can make me wealthy too. And that's what's wrong. That's the fallacy. Just because they're wealthy, they're wealthy by earning fees from you. What's good for them, is not necessarily good for you.

PAM
Concept: a couple of very wealthy women, 60s, sharp and on top of it…'I have money in a hedge fund, and my portfolio didn't suffer one bit in '07, '08, '09 so…? My response was gonna be, 'yeah but how do you know?' because I almost wanna say, 'how do you know?!' how do you know what your performance was?

BURT
Well, Pam first of all the term 'hedge fund' is in some sense a misnomer. The only thing that's consistent about hedge funds is that they're normally very highly leveraged. That is to say they borrow a lot of money. And they do tend to roll the dice. And, ya know its like the person who's just been to Atlantic City and rolls the dice and happens to have bets on number six and sixteen and sure enough sixteen hits. He goes down and says, see I made a lot of money. Its possible that some of these people did make some money and some of the hedge funds that were literally on the short side, that is to say, instead of holding stocks long, that is I own Citi Group, I owned Bank of America, I owned General Motors, and of course I got killed in 2008. Suppose the hedge fund was short, had sold short, that is trying to profit on the fund going down. So Pam, its possible somebody owned that fund and did well in '08, if you were hedged although most hedge funds really aren't hedged, its quite the opposite, they're highly levered. But if you were hedged, you might've done well in 2008. But the markets been going up in 2009, I would say to this woman , if she really did do well in 2008, well what was your report for the first quarter and the second quarter of 2009 when the market was going up? And I'll bet you she says the answer was 'hey I really didn't do so well.' And again I want to go back to this Bernie Madoff example, I am sure Bernie Madoff's investors were as happy as clowns, they couldn't have been happier, he was reporting to them 12% a year returns. Boy, isn't this wonderful? The returns never go down. They're 12% all the time! Until, they were negative 100%. So I think that's the issue and that's why I think you wanna be very, very, very careful.

PAM
When you're talking to a wealthy person, and they'll wind up talking about money and the economy because its the cocktail chatter, and these people are very smart, very wealthy, very good at what they do and i'll ask them, what's your yearly performance? They'll say well, all i know is that we're doing really well and we didn't suffer! We did not suffer during the great recession of '08 because we had a superior investment manager because we had access to that particular club. And I just wanna say, 'how do you know?'

BURT

Well, Pam you're right, they don't know. I mean, the Madoff example is the perfect example. You might have thought you were making 12% a year, year in and year out, and that's what he was reporting. The whole thing was smoke in mirrors, until it completely collapsed and you realized you hadn't been making 12% a year, you lost 100%. Now its possible somebody made money in 2008 but particularly there are some hedge funds that just sell short. That just, instead of buying stocks, sold them short to profit on the stocks going down. But let me tell you, even the people who have been successful with hedge funds, the Harvard Universities, the Yale Universities the Pinceton Universities, they've lost 30% of their portfolios and they're invested in the very best hedge funds. So i would say be very, very cautious. Let me just tell you one other story, its actually one of the most wonderful investment stories that a broker tells you to buy this particular fund or this particular company and its selling at $.50 a share, and you buy it. And then the broker calls you and says, 'hey its now at a $1 a share.' So you buy more. And then the broker calls you and says, 'hey its at $2 a share.' You buy more. Then the broker calls you and says wonderful news, its at $4 a share! And the investor says, ' good, sell.' And the broker says, 'to whom?' and thats really, Pam, your question about how do you know. Until you get the cash out and normally with these things you can't just take the cash out, you're locked in for a certain amount of time, until you get the cash out, you really don't know.

PAM
Another rebuttle I hear is: yeah but that Madoff thing was such a huge exception to the rule...that was an anomoly, that was so strange....shades of grey.

BURT
Pam, Madoff's ponzi scheme may have been an extreme situation, but all i can tell you is there have often been years where 20% of the hedge funds go out of business, so while they may not all be ponzi schemes is that what we do know is the attrition rate for hedge funds is 7,8,10 times the attrition rate for mutual funds and the one mutual fund that keeps on going like the ever ready bunny is the index fund which year after year does better than 2/3 of the other funds that you can buy. And even if you disagree with me, 'that, gee i wanna go shot for the moon at least have the core of your portfolio invested in these low cost portfolio funds and you'll be really glad you did.'

PAM
You have to feed yourself for a lifetime, not for just a year. You have to invest over your lifetime, not just over the time they report good results...

BURT
Pam, you're absolutely right. There have been sometimes some wonderful but there isnt any persistence, the fact that you've had a wonderful year one year does not mean you're gonna have a wonderful year the next year, in fact quite the opposite. These hedge funds have these particular styles and the style might be in one year, but not in the next year. And secondly remember that there is… The other point thats so important is that there's voluntary reporting of hedge fund results. And if a hedge fund has a really lousy year, it often doesnt get reported, if a

hedge fund has a stellar year it always gets reported. So there's a real bias in this because there's voluntary reporting, that you tend to see the good results reported and not the bad results. And with respect to your talking to rich people at cocktail parties, my own experience is you'll always hear the rich people saying here was my successful investment, you almost never hear them say at cocktail parties gee this was one that wasn't terribly successful. So we have a little bias in our memory and particularly in the things we like to tell other people. We like to report the good things, we like to forget the bad ones.

PAM
Investing over a lifetime versus investing over a very short period of time. We need to face it, long term doesnt mean 10 years, it should mean like 40 years...that's a true investing career, wouldn't you say?

BURT
I would say, absolutely right. And one of the big lessons that I try to tell people is nobody is going to be able to time the market, but what you ought to do during the years you're putting money aside, when you're saving, just save a certain amount quarter after quarter your 401k or your 403b or however you're doing it. You'll put some money on top, but also if you do it regularly, you'll put some money in at the bottom. And fortunately if you believe as i do, that this country is a great country, its the most flexible country. Productivity is going to continue to grow. Doing that so called, dollar cost averaging, putting money in time after time will over a lifetime, i'm absolutely convinced, will produce excellent results and i say that the core of anyones portfolio ought to be in low cost index funds.

PAM
Do you have a definition of long term?

BURT
You're absolutely right about long term, I think that we are now in a situation where life expectancy has increased dramatically, i think you can see that most people now are gonna be living into their 80s, into their 90s, in fact i've seen statistics that thre will probably be over one million baby boomers who actually live to an age over 100.

PAM
So long term investing is how many years, would you say? How many decades?

BURT
Well, it isn't 10 years. But i would say it's at least twenty, and twenty, thirty and fourty which is the kind of definition you've given...is i think fine. And i think fine even for people in their middle age, you know people in their 40s and 50s ought to look for at least a 30 year investment horizon.

PAM

Anything else you want to say on this show?

BURT
Well first of all, Pam I want to say thank you for your very good questions. I really appreciate the opportunity to be on your show. Let me just say if there's kind of one hot button, for me, I'm not gonna mention anyone by name but there's a very popular show on CNBC and one segment of it is 'Are you Diversified?' And someone says, 'I have four or five stocks and their in different industries, am I diversified?' And the host of the show says, 'oh yes, you're diversified. That's fine.' The host of the show says, 'oh you've got five stocks in different industries, you're well diversified.' Well, for me diversification means you've got stocks over all industries, you don't want one, you want thousands of them. You want them not only in the United States but you want them all over the world, you want them in emerging markets, you want them in China and India and Brazil. The countries that are growing so rapidly, you want bonds as well as stocks. And thats one of the other advantages of index funds with one stop shopping, you can get the broadest diversification possible. And you're not diversified with just a few stocks or a few bonds.

PAM
Chloe appreciates you putting up with her

BURT
What kind of a dog is Chloe?

PAM
A labrodoodle

BURT
A labrodoodle, well we have a schnauzer… and I even dedicated the last edition of my book, "A Random Walk Down Wall Street" to my schnauzers, so I'm a lover of dogs too.

PAM
Thank you, yea! Ok, I think we've got eveything we need…