A Random Walk Down Wall Street Study Guide Questions

Chapter 1: Firm Foundation and Castles in the Air

1. What does Malkiel have to say about the apparent complexity of financial markets and the prospects for individuals who want to manage their own investments?

2. Describe the behavior of a financial or economic time series that displays the properties of a "random walk."

3. Why do Wall Street professionals take offense to the term "random walk?"

4. In your own words, describe the difference between investing and speculating.

5. Do you agree or disagree with the following statement by Malkiel: "The fascination of investing is that it is a gamble whose success depends on the ability to predict the future." (Hint: explicitly describe the expected return of an investment vs. the expected return of a “gamble.”)

6. Describe the firm-foundation theory of investment value.

7. Describe the castles-in-the-air theory of investment value.

Chapter 2: The Madness of Crowds

1. Describe the Tulip Bulb Craze.

2. Describe the South Sea Bubble and The Mississippi Company.

3. Describe the 1920s stock market bubble and crash, paying particular attention to similarities with the historical bubbles discussed earlier in the chapter.

Chapter 3: Stock Valuation from the Sixties Through the Nineties

1. In Malkiel's opinion, has the gradual evolution of trading volume from primarily individual (~ 90% individual in 1960) to primarily institutional (~ 90% institutional by the 1990s) resulted in more rational valuations of financial securities?

2. Should we have expected that putting the professionals in charge (pension funds, mutual funds, hedge funds, etc.) would have resulted in more rational valuation?

3. Describe the "tronics" boom.

4. Describe the conglomerate boom.

5. What does it mean to invest in "concept" stocks?

6. (This is a tough question to answer without conducting a little research, but do your best with it and be prepared to discuss.) Do you see any parallels between Malkiel’s description of how Harvard, Cornell and the University of Chicago bought blocks of stocks in National Student Marketing and how endowment and pension money is invested today – particularly with endowments’ and pensions’ fascination with hedge fund investing? (Feel free to think “Bernie Madoff” here.)

7. Why was the Nifty Fifty the next logical evolution in investing in the late 1960s?

8. What sector represented the "next great hype" of the 1980s?
9. Why should the lessons of Japan make American investors nervous?

10. Did Japan turn out to be "different" in terms of the valuations their stocks could fetch and the inflated value of Japanese real estate?

Chapter 4: The Biggest Bubble of Them All: Surfing on the Internet

1. What does the term "bubble" mean in an investments context?

2. What characteristics are common to the formation of bubbles?

3. Describe a "positive feedback loop" and how this can contribute to the formation of a bubble.

4. Explain why was it unrealistic for Cisco's stock (CSCO) to sell at a P/E ratio of more than 100 when it already had a market capitalization of $600 billion.

5. Did internet and technology companies use knowledge of the "tronics" boom to their advantage? Give some examples.

6. Briefly describe the behavior and subsequent career prospects of analysts like Mary Meeker, Henry Blodgett and Jack Grubman during and after the internet bubble.

7. Describe the results of studies of the profits earned by small-investor day-traders.

Chapter 5: Technical and Fundamental Analysis

1. What is technical analysis, and what are the core beliefs of the technician?

2. Critique the accuracy of the following statement by Malkiel: "The first principle of technical analysis is that all information about earnings, dividends and the future performance of a company is automatically reflected in the company's past market prices." Take a position on whether the statement is accurate or inaccurate, and support your position with reasoning.

3. Would it be possible to know with certainty if a technical trading rule worked because a.) technical analysis was effective vs. b.) the rule simply being a self-fulfilling prophecy (investors see a pattern forming, believe it will repeat, and then trade in a way that ensures that it does repeat)?

4. What is the primary job of the fundamental analyst, and why is this job so difficult?

5. What does Malkiel mean when he says that fundamental analysis might not work because the market fails to correct its mistake?

   In questions 6-9, describe Malkiel's four fundamentals that determine a security's value under the firm-foundation viewpoint.

6. The Expected Growth Rate.

7. The Expected Dividend Payout.

8. The Degree of Risk.

9. The Level of Market Interest Rates.
In questions 10-12, describe Malkiel's three rules for using technical and fundamental analysis together for individual stock selection.

10. Buy only companies that are expected to have above-average earnings growth for five or more years.

11. Never pay more for a stock than its firm foundation of value.

12. Look for stocks whose stories of anticipated growth are of the kind on which investors can build castles in the air.

Chapter 6: Technical Analysis and the Random Walk Theory

1. Do you agree with Malkiel's assertion that chartists (technical analysts) have to believe in momentum in the stock market? Explain thoroughly.

2. If stock prices follow a random walk, is that consistent or inconsistent with an efficient market? Explain thoroughly. (Hint: You're going to have to talk about information arrival into markets, and how that information gets reflected in securities prices.)

3. Malkiel dismisses all the major techniques of technical analysis, and implies that the uselessness of these techniques should be well-known to the general public. Yet, he acknowledges that people continue to devote an enormous amount of effort production of this type of "information." Identify the reason Malkiel cites for the public's continued devotion to technical analysis (it has to do with human nature). Can you think of any other reasons that explain why technical analysis continues to enjoy such popularity?

4. Another danger of technical analysis is that it lures investors into thinking they can "time the market," which can result in their being less than fully invested for considerable periods of time. Consider Professor Seyhun's (not Seybun, Malkiel misspells his name) study of the best market days from the mid 1960s to the mid 1990s. What would have happened to an investor's total long-run return if he/she had been out of the market for just these 90 days (out of 7500 total trading days).

Chapter 7: How Good is Fundamental Analysis?

1. Which type of analysis prevails on Wall Street, fundamental or technical?

2. What is the main priority of the fundamental analyst?

3. How useful is it to consider past earnings growth when forecasting future earnings?

4. If you forecast that every publicly-traded firm would have earnings growth equal to the long-term growth rate of the economy (7% nominal), would your forecasts be more or less accurate than those of the professional analysts?

5. What are the five reasons Malkiel cites that explain why security analysts have such a poor track record forecasting future earnings?

6. On average, do actively-managed mutual funds have higher or lower returns than passive stock indexes?
7. Agree or disagree with the following statement, and provide supportive reasoning:
The fact that many mutual funds beat their benchmark indexes every year contradicts Malkiel's assertion that mutual funds underperform on average.

8. Is the fact that some funds beat the indexes for several years in a row consistent with pure chance, or does this outperformance have to be due to skill?

9. What does mutual fund managers Cash/Total Assets ratio over time say about their skill as market timers?

10. At the end of his career, what were Benjamin Graham's views on the value-added of fundamental analysis?

11. Summarize Malkiel's personal viewpoint regarding the performance of professional analysts and the academic view that markets are highly efficient.

Chapter 8: A New Walking Shoe: Modern Portfolio Theory

1. If markets were perfectly efficient, would there be any way to consistently earn a return that was higher than the market average?

2. Would the method you described in Q1 above be considered "beating the market?"

3. What is the standard metric for total risk in finance?

4. Write out the formula for this metric and explain, in your own words, exactly what is being measured by the total risk statistic.

5. Are there any shortcomings associated with the metric? Explain why it is important to be aware of these shortcomings.

6. Examine the graph of the distribution of monthly stock returns to the S&P-500 Index. If Malkiel is correct and the distribution of monthly returns is approximately symmetric, explain why the distribution of returns is centered on 1% per month rather than zero.

7. Have there been any five-year periods when buy-and-hold investors failed to earn positive rates of return? (And you can extend your answer to this question by considering the 10-year period Mar-99 to Mar-09.)

8. Provide a general description of the major contribution of Markowitz to portfolio theory and, in particular, how we measure portfolio risk.

9. Describe the most important factor that determines whether or not diversification will reduce risk, and by how much.

10. In the real world, what is the major factor limiting how much risk can be reduced in any reasonably-sized portfolio of stocks (at least 8-10 different stocks)?

11. Why are the returns of most stocks positively correlated?

12. True or false (and explain why) — unless the returns of most of the stocks in a reasonably-sized portfolio (8-10 stocks) are negatively correlated, there are no significant benefits from diversification. Explain your answer thoroughly.
13. Research shows that risk is reduced as more securities are added to a portfolio, up to a certain point. What is the number of securities necessary to get the maximum benefits from diversification?

14. For an investor interested in maximum diversification, what security/asset classes should be included in his/her portfolio?

**Chapter 9: Reaping Reward by Increasing Risk**

1. What is the basic logic behind the capital asset pricing model?

2. Define and describe the two main subcomponents of total risk that emerge from the capital asset pricing model.

Regarding an error in the text: Between pages 201 and 211 Malkiel commits a common error in explaining beta, and then corrects the error (without realizing it). Here's the mistake: Beta does not make a statement about the overall volatility of an individual stock. Beta makes a statement about two things: one, how an individual stock is likely to affect the volatility of a diversified portfolio, and two, how the volatility of a diversified portfolio is a function of the portfolio's beta. In other words, there are very few stocks with return standard deviations (total risk) lower than the market — even low beta stocks have higher total volatility than the market (which is a big diversified portfolio). However, if you create a low beta portfolio, that portfolio is likely to have lower volatility than the S&P 500, and conversely, high beta portfolios are likely to have higher volatility. Notice that past the error at the top of page 224, Malkiel begins talking about diversified portfolios and beta, so he corrects his error in context. Again, to sum up: it will be rare to find a low beta stock that has lower standard deviation of returns than the market. Adequately diversified low beta portfolios, however, are much more likely to have lower standard deviations than the market.

3. Interpret the chart on page 200.

4. According to modern portfolio theory, how would you construct a portfolio so that there's a greater chance of earning a higher return than the S&P 500?

5. Is recent academic research (Fama and French 1992 in particular) supportive of the relation between beta and expected return?

6. What reasons does Malkiel provide for the failure of the CAPM?

7. Describe the main statement of the arbitrage pricing theory (APT).

8. Does Malkiel believe the CAPM and the APT are the last words in measuring risk and expected returns in finance?

**Chapter 10: Behavioral Finance**

1. The "economic theories" Malkiel refers to (really the modern portfolio theory tools from previous chapters), suffer from what MAJOR limitation?

2. What is the MAIN difference between the beliefs of the behaviorists and the beliefs of the efficient market proponents?
In questions 3-6, explain each of the four factors that contribute to irrational market behavior.

3. Overconfidence.
4. Biased judgment.
5. Herd mentality.

Chapter 11: Potshots at the Efficient Market Theory and Why They Miss

I have some small disagreements with Malkiel in this chapter, so I'm going to try and carefully delineate our differences. First of all, I believe that the market vacillates between efficiency and inefficiency, and it's vacillations in these cycles that are the major unpredictable element in financial markets. In other words, it's like Goldilocks and the Three Bears. Sometimes valuations are too high, sometimes too low, and sometimes they're just right. Periods of incorrect valuation can prevail for individual stocks, industries and sectors, or the entire market — the incorrect valuation is not spread homogenously across the market. And, when the valuation of certain stocks or sectors begins correcting itself, it doesn't mean that the degree of incorrect valuation in other stocks or sectors can't simultaneously be getting worse. For example, as valuations in tech stocks corrected from 2000-2003, other stocks stepped into the overvaluation spotlight, such as TASR, RIMM, and RHAT. It's often the same story for undervaluation — you could have bought AAPL for $12-$14/share in early 2003. Thanks to iTunes, the iPod and the iPhone, the share price just blew past $200, for the 2nd time. Almost the same story for GOOG, which you could have bought in the low $100s a few years ago (now worth $600, also for the 2nd time). I don't believe consistently beating the market is so difficult because it's almost always efficient, I believe consistently beating the market is so difficult because the deviations from efficiency are hard to forecast.

Another disagreement — when Malkiel says that no one has ever consistently beat the market, he's wrong. There are rare exceptions. Fidelity's Peter Lynch did it, and Legg Mason's Bill Miller did it for something like 14 years in a row (before having several cataclysmically bad years with his famed Value Fund). I cannot tell you if this is due to skill or luck — I don't know. But I can observe their remarkably successful records and report them to you, which is something Malkiel owes you as a scientist of finance.

One final disagreement — when academics talk about no single trading system or strategy consistently beating the market, they are technically correct, but they're invoking one of their childish technicalities to make a point. I believe there are a few Michael Jordans and Joe Montanas of stock picking — and they have absolutely no incentive to identify themselves to us. These people should trade for their own portfolios, keep a low profile and switch brokerages periodically. (Brokerages know everything about your portfolio performance and trades, and they're watching you all the time.) These super-traders do not employ the same system or strategy every day; they're constantly updating their knowledge and views, sometimes they're hot, sometimes they cool off. Because academics can't code these real-life intuitive skills
into formulas that lead to published research, they prefer to say it can't be done. Or, more accurately, they say "No one has proven it scientifically." Technically, they're correct (and BORING). With that being said, I think the best reason to play an active trading game (like Stock-Trak) is to find out for yourself how hard it is to trade actively, pay commissions, and beat the market. When you’re managing money for other people (professionally), you will also have to engage in a post-period analysis known as “performance attribution,” which means an analysis of HOW you earned your out-sized returns. Sophisticated professional clients, like endowments and pensions, are not just interested in the returns you earn for them, but also require detailed analyses of how those returns were earned (by following a predetermined strategy).

Okay, enough from me, now for the chapter questions.

1. How does the financial press treat the efficient markets hypothesis (EHM) after big downside market breaks such as October 1987 or July 2002?

2. When the market rises 30-40% in one year, as it did in 2003, does the financial press also ridicule the EMH? Why do you think their scorn is so one-sided?

3. Does the academic community still hold that markets are perfectly unpredictable?

4. Is Malkiel strictly correct when he says "No one person … has yet to produce a long-term, consistent record of finding money-making, risk-adjusted individual stock-trading opportunities."

5. What did Fama's 1998 study conclude regarding most of the anomalies (deviations from market efficiency) found by academics?

6. Explain whether the following two statements are contradictory or complementary (first is from Malkiel, second from Richard Roll later in the chapter):

   It is important to distinguish statistical significance from economic significance.

   A true market inefficiency ought to be an exploitable opportunity.