

The 1-2-3 of Investing

Part 3: Efficient Markets

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New investors can learn much from Burton Malkiel's best-seller [A Random Walk Down Wall Street](#).¹ The book makes a strong case for mutual funds discussed in the last part of this series. It would be a mistake to say that the author writes from the sidelines. He worked as a professional investment analyst and as a director of one of the world's largest investment companies. Trading practice for academia, Malkiel later became an economics professor at Princeton University.

In a nutshell, the book offers suggestions on what investors should do as well as what they should avoid. Malkiel introduced readers to the “efficient market hypothesis”—or the belief that numerous, knowledgeable, and profit-maximizing participants in the stock market make it impossible to regularly find opportunities for above-average returns.² Prices of stocks, which are simply the present value of future cash flows, are said to reflect all available information. Attempts to “beat the market” should hinge on new information which has not yet been acted upon.

The idea of efficient markets has been applied to that for sports-betting. In a later piece in this series, investors who assign a portion of their investable funds to betting on the outcome of sporting events will be reminded that the market for sports-betting attracts participants no less

¹ Wall Street is a street in the financial district of New York City. There once was a wall that was built by the Dutch in the 17th century to protect colonists from Native Americans and English invaders.

² The hypothesis was actually created by Eugene Fama, an economics professor at the University of Chicago.

numerous, knowledgeable, and profit-maximizing than investors and that picking winning teams consistently is no more successful than picking winning stocks consistently.

Best quotes from A Random Walk Down Wall Street that underscore the meaning of an efficient market include *A blindfolded monkey throwing darts at the stock listings can select a portfolio that performs as well as those managed by the experts* and *Investors would be far better off buying and holding an index fund than attempting to buy and sell individual securities*. The reference to index funds means that those portfolios that track the performance of market averages such as the Standard & Poor 500—a collection of equities that includes major stocks like Apple and those in financials, healthcare, and consumer discretionary—can reward investors with a relatively good performance at a relatively low cost.

No, the average student will probably not read the 500-page book. It is enough for students to know from this piece in the investing series that funds which follow market indices such as the S&P 500 are a better way to invest in equities. Missteps to avoid include trying to time the market, following crowd-driven fads, and submitting to behavioral biases such as overconfidence, herding, and loss aversion. The subject of behavioral finance will be explored in the next segment.