“A Random Walk Down Wall Street” book report

Student’s Name

Institution of Learning
In the book “A Random Walk Down Wall Street” by Burton G. Malkiel (Malkiel, 2007), the theme of wise personal investment is a key component of the entire story. First published in 1973, subsequently edited and republished for 8 times, the book has become a classic in the modern investment theory. The ninth edition of the book contains 15 chapters that are incorporated under the roofs of four book’s parts. This review will summarize the main ideas of the chapters to give the idea on style, structure and relevance of information, and conclude with an overall view of the reviewer on the book’s usefulness and adequacy to current financial world. The most influential idea of the book is that stock markets are efficient that leaves no chance to beat the market on a long-term, consistent basis. However, history shows that from time to time markets are beset by panics, manias and others bubbles based on people’s madness, which gives opportunities for extreme speculations rather than wise investment. This story is not about making money hand over fist, but rather about earning a long-term return.

The first chapter of the book “Firm Foundations and Castles in the Air” starts with defining the two basic investment theories that lay behind the investment decisions. The first, the firm foundation theory suggests that the valuation of an asset is based on the intrinsic value, and the investors could win on the fluctuations around this intrinsic or real value. The second, castles in the air theory argues that investors should act in response to crowd’s expectations. The idea is explained by Keynes’ example of picking the six prettiest faces out of a hundred that are going to win the price. Here, the investor does not have to calculate the real value of the corporation; he has to predict what the average opinion is likely to be. What is more, the author of the book suggests that both theories work in practice, but in different time frames.
The second, third and fourth chapters show the historical examples of market price overvaluation (Tulip-Bulb Craze, the South Sea Bubble, and the Wall Street Crash of 1929), speculative Movements from the 1960s through the 1990s (the “Tronics” boom, the conglomerate boom, the Bubble in Concept stocks, Nifty Fifty, the biotechnology and property bubbles) and finally the largest bubble of all – overvaluation due to dot-com boom. The examples are discussed in order to point out that well often the valuation of assets is defined by the psychological factors, such as madness of people, which leads to overvaluation and subsequent price-drops. The dozen examples confirm that market efficiency is not a coincidence.

The author’s main idea through the whole book is that markets are efficient, and when the inefficiencies (all mentioned above crazes) occur, it will not take a long time for the market to go back to its natural stage of efficiency. Thus, he goes to explanation of the commonly accepted investment models and techniques, pointing out their limited ability to predict something in terms of market’s “random walk”.

The next three chapters are concerned with technical and fundamental analyses for prediction of the future value of stocks. The author gives explanation to two most used on Wall Street techniques. Technical analysis studies the performance of the market prices based on the historical data. The investors use complex charts and forecasting models based on trends to speculate on predicted performance. Contrary to technical analysis, a fundamental study evaluates the health of the business by careful examination of financial statements, market performance and competitiveness of the financial entity. The author gives a favor to the second option for predictions of the assets’ prices as far as the technical analysis cannot make reasonable predictions in frames of the random-walk theory. On the other hand, the fundamental analysis looks at a broader range of data, which allows formulating a complex view on the company as a
market-player. However, even the most sophisticated approach may have serious flaws, such as unpredictable events (like 9/11 tragedy), unreliable financial data (like Enron’s bankruptcy), human failings and more. In reality, financial analysts may have a minimal advantage due to advanced and regular access to valuable information and materials.

Chapters 8 and 9 discuss the modern portfolio theory. The basic idea is that people should diversify their portfolios of assets using the findings of Harry Markowitz. The economist discovered that portfolios with risky stocks could be organized in such a way that the portfolio as a whole could have less risk than the individual assets in it. The author argues in favor of this approach providing the practical examples of the reduced risk in well-diversified portfolios (the portfolio of 50 equal-sized US stocks, the international diversified portfolio, including the stocks of emerging markets or even the portfolio with various classes of assets). However, in chapter 9 Malkiel introduces the capital asset pricing model as a framework to explain the fact that diversification cannot eliminate all risk. Therefore, the associated with the portfolio or asset risk can be divided into systematic and non-systematic risk. Whereas non-systematic risk can be diversified by wise portfolio management, systematic (or so-called beta) risk cannot be diversified. It is used as a tool to evaluate the return. The only way to expect the higher long-run investment returns is to bear the greater beta-risk. Chapter 10 provides an outlook to behavioral finance that applies emotional and cognitive biases of people to their investment decisions. From the behavioral point of view, Malkiel learns that long term investing in hot-assets does not make any sense. In addition, careful investor should not over trade by selling promising stocks. Thus, Malkiel advises to sell only losers-stocks.

The next three chapters give the author’s practical advice on investment decisions. Specifically, the author encourages ensuring that the investor is properly insured. Then, he offers
investing mostly into tax-sheltered accounts. Regarding the investment instruments, Malkiel believes that in the long run, it is evident, that stocks will produce more return, than bonds yield, and beat the level of inflation. However, for the any shorter than a decade period, the expected returns are random and depend mostly on the risk taken by investors. Therefore, for the short goals, the investor should tend to a diversified portfolio with investments in risk-free assets, like bonds and cash. This is the main conclusion of the previous practical and theoretical analysis of the financial markets. Finally, the last chapter “Three Giant Steps Down Wall Street” gives a summary on the whole book and suggests the concrete steps to investors. For those investors who lack analyzing skills, Malkiel suggests investing in an index fund. Otherwise, for do-it-yourself investors, he offers to look at companies with consistent growth, pay for stock no more than firm foundation value, guess the future trends and trade as little as possible.

To sum up, the book “A Random Walk Down Wall Street” is a useful guide for both students, who study Finance, and professional investors and analysts. In my view, the book does not contain the innovative ideas or theories in investing; however, it explains the existing approaches and views on investment opportunities in an easy and comprehensive way. The prompt examples and investment history overview give a complex view on investing as a science and a real life activity at the same time. Besides the summary of the world’s most popular investment theories and practices, the author gives precious advice for individual investors that sound convincing from the mouth of a successful investor and economist. Finding the book gripping and useful, though I suggest taking it as a relevant advice in combination with the ideas of the “Rule # 1” book by Phill Town (Town, 2006). The simplified philosophy of Benjamin Graham and Warren Buffett is a perfect complement to a “Random Walk Down Wall Street” for those investors, who take advantage in learning successful investment experiences.
References

