Interview by Kevin Press

A RANDOM TALK

with BURTON MALKIEL

Burton Malkiel

BURTON MALKIEL, BEST-SELLING AUTHOR AND PRINCETON ECONOMICS PROFESSOR, HAS HARSH WORDS FOR INSTITUTIONAL INVESTORS AND A WARNING ABOUT INTERNATIONAL DIVERSIFICATION.

How will the technology bubble be remembered?

Historians will record the Internet bubble of the late 1990s as one of the greatest bubbles of all time. Valuations became truly unbelievable. During the Nifty Fifty craze, the well-known growth stocks may have sold at 60-, 70- or even 80-times earnings. During the Internet bubble, stocks would sell at 60-, 70- or 80-times sales. Priceline.com, one of the Internet companies that sold discounted airline tickets, was valued at one time with a market capitalization that was larger than the combined market capitalizations of Delta Airlines, American Airlines and United Airlines. At its low, Priceline sold for about a dollar a share. You even had enormous multi-billion dollar capitalizations from companies that had essentially no sales at all. They were just selling on a promise.

People confused the correct idea that the Internet was real, that it was going to mean some profound changes in the way we live and shop and get information, to saying that the ordinary rules of valuation didn't apply. Whatever business you are in, an asset can only be worth the present value of the cash flows that are going to be generated in the future.

Look at reports that were issued by Wall Street firms. You find statements such as 'the old metrics are different this time.' That has certainly proved to be wrong. Most of these Internet stocks today are selling at a tiny fraction of their high market valuations. It is not clear that any of them have a business model that is going to allow them to make money. In one sense, Amazon.com is a very successful company. But they have yet to show that they are able to make any money.

To be sure, the same thing happened in our past histo-

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ry. There were many people who laid railroad tracks during the railroad-ization of North America. There was overbuilding and most of them collapsed. We had hundreds of automobile manufacturers at one time.

But what didn't happen in the past were the market valuations assigned to these companies. Why did firms like Morgan Stanley and Merrill Lynch put out buy recommendations on all of these stocks when they were at or near their peaks? The real problem is that their well-known analysts were paid a lot of money, not necessarily to make correct judgments about whether stocks were good buys or not, but rather based on their success in bringing investment banking clients into the firm. Who knows whether they knew better or not? But there was a clear conflict of interest.

Here's another thing—the CNBC effect. You had people talking about these extraordinary gains, and [producers] didn't want a fuddy duddy value manager being interviewed on CNBC. [They] wanted the person who said Amazon.com has a price target of $500 a share. Those were the people who got on those shows. That fed the public enthusiasm. There were some people who got it right. They were generally the value managers who actually underperformed the market as a whole very badly during that period.

How did institutional investors compare to retail investors?

The retail investors probably did a bit worse. Some of the institutional investors were sucked up in the enthusiasm and probably did overweight some of these stocks. But I think the real damage occurred with individual investors. It really worries me how sensitive the public money flows are to recent performance.

Having said that, everyone is ranked each quarter in the institutional business versus everyone else. The institutions—not quite to the extent that the public is—are not immune at all. Presumably the savvy institutions should be precisely the ones who lean against the wind. But if you look at the cash balances of mutual fund managers and institutional money managers, you find almost invariably their lowest cash balances are just at the peak of the market. They're almost perfect contrarian indicators.

I can remember arguments that I had with institutional investors in 1999, when I'd talk about the Pricelines of the world. People would say 'You don't understand the value of the first mover. What a brilliant idea Priceline has. Don't worry that they're losing money now.' Very clearly, there is soul searching to be done by the institutions.

INTERNATIONAL DIVERSIFICATION

I'm a big believer in globalization. Particularly for U.S. investors—more than for Canadian investors for the following reasons. I have some concern that the U.S. dollar may be an overpriced currency. If anything I would like to see U.S. institutions have a more global focus. Valuations in the rest of the world may be a little bit more reasonable than in the U.S.

I actually believe right now that, after a decade of disastrous economic performance, Japan seems to be getting close to the point where they're likely to get it right. I'm a little more optimistic about Japan.

Having said that, let me give you the downside. The theoretical argument for international diversification is that markets don't all go in lockstep. You get some risk reduction. The evidence that I've seen suggests that our global markets are much more closely tied, and the correlations among markets are much higher than they have been in the past. That in turn means that the diversification benefits are likely to be a little less. That is my worry.

[Still], I'm positive about international diversification despite the fact that the correlations have gone up.

What's your advice to a Canadian investor?

There are three asset classes where correlations have not increased. One is real estate—global real estate as well. The second is bonds. I consider high yield bonds to be an equity-type of asset. You're really

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getting paid to take those risks in the bond market, and the correlations don't seem to have gone up. Third, I think the risk of inflation is going to be a worldwide phenomenon.

One asset class that is uncorrelated with both equities and real estate are inflation-protection securities such as are issued by the U.S. and Canadian federal governments. I think that as a diversifier, those are absolutely great things to do.

I want to emphasize that while I think the correlations have gone up, and this dampens the benefits of diversification, they haven't eliminated them. I would still say that even with the higher correlations, there's some advantage for Canadian institutions to think of equities around the world.

Will we see an improvement in the Canadian dollar?

It wouldn't surprise me to see the Canadian dollar appreciate against the U.S. dollar. I think eventually the U.S. dollar will weaken, and it could be soon. What's been propping it up is the voracious appetite of world investors for U.S. assets. We've been running a bigger and bigger trade deficit. It's not on the trade side; it's been the voracious appetite for U.S. assets. To the extent that that wanes, you will see the U.S. dollar weaken. On a purchasing power basis, the U.S. dollar is overpriced.

What happens next?

Clearly you're in a much safer position if you're an equity buyer now than you were a couple of months ago. But I am still concerned, taking a longer historical view. I don't see equities as particularly cheap. And I don't see the 18% returns that we earned in the U.S. from 1982 through March of 2000, as being anything that is at all realistic for the future.

A realistic expectation for equities over the next decade is single-digit returns rather than double-digit returns. Therefore, some equities in real estate and some equity-type securities in high yield debt are going to be very attractive diversifiers for both individual and institutional investors over the next decade. ❖

Burton Malkiel is the Chemical Bank Chairman's Professor of Economics at Princeton University, and the author of A Random Walk Down Wall Street. *He spoke with* Canadian Investment Review *in Toronto at the beginning of April.*