Merton H. Miller

448th Convocation Address: “The Chicago Financial Economics Tradition: Some Practical Lessons,”

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“The Chicago Financial Economics Tradition: Some Practical Lessons”
by Merton H. Miller

I am honored indeed that our students have elected me their designated faculty speaker for today’s Convocation. “Just keep it short,” they told me. “Ten minutes max! And do try to make it meaningful to our parents. Give them some flavor of the GSB market-centered approach to life. And help them understand better what they can and cannot reasonably expect from their investment in our graduate education.”

What you parents are expecting from your investment, I can’t say, of course. But if you hope to acquire a lifetime supply of valuable, free investment advice, forget it. Your newly minted M.B.A.’s will not be offering you a steady stream of sure-fire hot stock picks. And don’t think they’re simply being stuck-up or ungrateful in refusing to share with you the secrets of the craft. They’ve learned from me and some of their other professors in the Chicago financial economics tradition that an M.B.A. degree conveys no advantage in stock picking or market timing.

I know that will be hard for some of you parents to accept. It certainly was hard for my father to understand when I got my degree, which was not an M.B.A., but an even loftier Ph.D. in economics. Then, as now, many wondered what professional economists were good for, after all, if they couldn’t forecast stock prices. My father never gave up hope that some day I would come up with valuable nuggets of economic wisdom for him. He’d say: “Amalgamated Widgits sure has some great new products on its drawing boards. I’m thinking of buying in now and riding the stock up before these new products actually hit the stores. What do you think?”

“Sounds exciting, Dad,” I’d say. “But where did you learn about all these great new products?”

“Oh, I read about them in the Wall Street Journal,” he’d say. “Or perhaps Barron’s or Fortune. What do you think?”

Then I would put on a look of mock disappointment and say, “Oh, sorry Dad, it was a great idea, but you are too late. If you read it in the Wall Street Journal (or Barron’s or Fortune), everybody else has read it, too. The information about those new products is already built in to the prices you will have to pay for the stock."

And, putting aside technical jargon, that's really the essence of what has come to be called the "efficient markets" doctrine - a doctrine long identified with the Chicago financial economics tradition. In an efficient market all publicly available information is quickly incorporated into prices. Information is a valuable commodity after all, and like any other valuable commodity, society won't waste it. So an investor, like my father - and like some other fathers here today - whose investment ideas come only from the daily press or from listening to Wall Street Week can't beat the market that way. They're always going to be too late.

That does not mean, I hasten to add, that those of you with only publicly available information might just as well pick investments by throwing darts at a dart board. The dart-board story is often used to caricature the Chicago-style efficient markets crowd, but you can safely mark down anyone who brings it up as an amateur, an outsider with tin ears, like someone who refers to San Francisco as Frisco.

Don't buy a dart board to pick stocks. Don't even think about which ones to buy. Buy them all! Buy the whole market. That's not as hard to do as it sounds thanks, in part, to after-hours efforts by some of the Chicago efficient markets crowd who dreamed up the idea of no-load, index mutual funds some twenty-five years ago. True, you'll wind up with some terrible turkeys in your portfolio that way, but you'll also get your share of the big winners. The losers and winners will cancel out and you'll end with just the average rate of return on the market. You'll never do better than the market, but you'll have the satisfaction of knowing you'll never do worse either. And you won't be sending your broker's kids through college with all your trading commission dollars.

A purely passive equity investment strategy of this kind has benefits for me as well as for you. If you follow my advice, I will never have to remember exactly what I told you and whether it turned out to be a bum steer. Buying the market is in that sense a "golden rule" policy that I can always safely offer to any of my students or their parents. In fact it can be shown to be the only such policy I can confidently recommend to those relying only on public information, because it's independent of their life circumstances and their tastes, beyond just their general aversion to taking unnecessary risks. Holding the market is really nothing but the sensible principle of diversification carried to its logical limit.

Buying and holding the whole market will not, of course, solve all your investment problems. You still must decide how much of your wealth to keep in equities and how much in those lower-risk but also lower-return assets going under the heading of fixed-income securities. And here, alas, neither I nor your M.B.A.'s can give you definitive advice because the asset allocation choice, unlike the choice of which equities to hold, is not a matter of portfolio efficiency but a matter of taste - the taste for risk.

Because tastes for risk vary between individuals - and even for the same individual at different stages of the life cycle - I can't give golden rule advice on asset allocation that everybody can always follow. But if I can't tell you what to do, I can at least warn you about what not to do. First, don't adjust your risk posture over time by playing with the mix in your equity portfolio - by shifting to less volatile, supposedly safer stocks as you grow older. Keep fully diversified at all times, which is to say keep passively invested in the whole market and make your risk adjustments by changing the fixed-income proportions. In your prime working years, for example, you may want to be mostly in equities. As you get older and approach retirement, you may feel more comfortable with a larger fixed-income proportion. And when you're just starting out, of course, you may even want to hold negative amounts of fixed income securities by becoming a net borrower. That, after all, is what tuition loans are all about.

Second, don't try to guess the tops and bottoms of the stock market. You're going to be no better at market timing than you are at stock picking. Worse actually, because you may from time to time be able to pick up some inside, company-specific information. But nobody has inside information about the level of stock prices, except possibly Alan Greenspan, who can always produce at least a short-term drop in stock prices, if he and his colleagues are so inclined. Certainly economists don't have any special advantages in this respect, no matter how many Nobel Prizes they may have won. I know one famous economist, whose name I won't mention, who was advising everyone that the stock market was irrationally overvalued and that it was time to get out. That was in 1992, however! Anyone who followed his advice thus lost out on five of the highest years of stock market returns ever.

The notion of passively investing the entire equity proportion of a portfolio often strikes some as a cop-out, not as cheating, perhaps, but as free riding or some equivalent lapse in social responsibility. What if, in despair of beating the market averages, everyone behaved passively by assuming that prices already reflected all value-relevant information? How would that information ever get impounded into prices in the first place?

The answer, of course, is that while everyone can't hope to beat the market average by superior stock picking, some people still may. The efficient markets view says only that you can't count on beating it if all you have is publicly available information. But you can do better if you can get hold of some non-public information before everyone else does. And it's the people with more than just the already published, stale information that keep the prices honest for us passive types.

"And how," you'll ask, "do these 'lead steers,' as they're sometimes called, get the as-yet-unpublished information?" Actually, in any of a number of ways, some of which I prefer not to dwell on lest some parents or in-laws here today happen to work for the S.E.C. I don't want to be accused of corrupting the young. Remember what happened to Socrates. The main legal way of acquiring valuable, non-public information is to produce it, as it were, by investing shoe leather and other valuable resources to dig it up, to get to it before everybody else catches wise. So if you're willing to invest the time and the resources, you can hope to achieve a rate of return higher than that market average return earned by the typical uninformed, passive investor. "How much higher?" you'll ask. And now comes a typical GSB Chicago, catch-22 answer. Just enough higher on average to compensate for the extra costs you have incurred. On average, you can expect to be equally well-off whether you elect the passive track or the active track.

Note that I emphasize on average because some people by luck, or by superior skill and cunning as they prefer to believe, will indeed strike it rich - will hit the Comstock Lode, so to speak, and wind up in the upper right-hand tail of the probability distribution of outcomes. If so, they are soon fabulously wealthy, and they become philosophers as well, whose views not only on investments but on the future of Western Civilization and other big-think topics will routinely be sought by the press and the talk show hosts. While some especially lucky or skillful may thus exceed the return on the informationless, passive strategy, some other active investors must be earning below-normal returns. That's the way it is with averages.

Let me add one final warning on the subject of beating the market by superior stock picking. It can be done, as I say, if you dig for new information and happen to find it. Some people think you can also do it by what has been called "tape spinning," that is by using the computer to sift through the reams of past data available on stock prices looking for "patterns" in those prices that seem to have forecasted well in the past. A mutual fund I know, for example, claims to beat the market by finding what are called "momentum stocks." The trouble with these gimmick funds - and there will always be plenty such given the rich cloud-patterns you can always find even in absolutely random data - is that they mostly seem to involve small companies with infrequently traded and highly illiquid stocks. When you try to exploit your gimmick, high transaction costs will thus eat up your potential profits. And even if the profits don't disappear immediately, word of your success will quickly attract imitators and again the profits will vanish. After all, everybody can spin the tapes and pick out your hot patterns and, in the process, effectively pick your pockets.

Among other things, that helps explain why the efficient market hypothesis is still going strong despite thirty years of efforts by graduate students and assistant professors to find exploitable “anomalies” as they are called, that is, opportunities to pick up free lunches. The efficient markets hypothesis tells us, however, that there are no free lunches and that the very act of reaching for what seem to be free lunches will cause them to go away. It’s terribly frustrating and reminds one of the case of poor Tantalus in the ancient Greek legend. As he bent over to drink from the spring, the water always receded. And as he reached for the grapes, the wind always blew them just out of reach.

At this point, some of you may be thinking you have figured out where I am heading in this talk. You think I’m now going to tell you that getting an M.B.A. degree is like any other information-production activity from which you may well hope to derive above average returns. But then will come the catch-22. I’ll say you can’t really expect more than a normal risk-adjusted net return on your investment of tuition and lost earning opportunities - the same risk-adjusted net return you could expect from a purely passive investment of those same funds.

That’s almost, but not quite the point I was about to make. My news is actually a bit more encouraging. The education market, after all, has both a supply side and a demand side. And when the supply and demand are in long-run equilibrium, you couldn’t expect anything but normal returns on your investment. The evidence suggests, however, that the ultimate equilibrium in the market for quality M.B.A. education has not yet been reached. Otherwise so many people wouldn’t be clamoring to get in to quality M.B.A. programs like ours. Which implies, dear graduates and parents, that you probably can reasonably expect returns on your graduate education to be better than just average passive returns on the investment. And who knows? If you are skilled enough or lucky enough, you may even wind up as a philosopher in the extreme upper right-hand tail of the distribution.

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