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BOOK REVIEWS

Mark Kritzman, Senior Editor

BEYOND THE RANDOM WALK

By Vijay Singal
(Reviewed by Mark Kritzman)

Academic researchers and investment practitioners have long investigated whether investment markets are efficient and if not, how to exploit perceived inefficiencies. At one extreme, there are those (often from Chicago), who adopt a religious view toward market efficiency, denying both evidence and reason. At the opposite extreme are those, who armed with massive data files and computational power, discover significant t-statistics every other week (more about this later). Vijay Singal strikes just the right balance in presenting 10 anomalies that appear to offer legitimate opportunity for profits or at least sound advice for avoiding unnecessary losses.

Beyond the Random Walk distills the often technical jargon of academic research into accessible recipes for successful investing. Each chapter includes a detailed description of the anomaly, as well as a review of the supporting evidence, often supplemented by Singal's own research. But Singal does not stop with empirical evidence. He gives reasons for the anomaly as well as reasons to believe it will persist in the face of well-informed arbitrageurs. Perhaps of most interest to practitioners, Singal presents a step by step instruction manual for profiting from the anomaly, if possible, or at least preventing others from profiting at one's expense. These anomaly chapters are bracketed by an inaugural chapter on market efficiency and a penultimate chapter on behavioral finance.

Singal's first anomaly deals with the price performance of stocks around the turn of the year. Small stocks that have done poorly tend to rise in January because investors engage in tax loss selling in December. Similarly, stocks that have done well throughout the year are not sold in December because investors postpone capital gains taxes by selling in January.

Continuing with calendar effects, Singal next discusses the weekend effect. Evidence shows that, on average, stocks produce large returns on Fridays, while Monday's returns are flat or negative. He attributes this pattern to short sellers who choose to close speculative positions before the weekend. Singal points out that the best one can hope to gain from this anomaly, as well as from some of the others, is to trade more effectively. Owing to transaction costs, it is not always possible to arbitrage many of these anomalies.

Singal goes on to describe short-term price drift, in which prices continue to drift up or down after the release of high quality information, and then momentum in industry portfolios. With

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this latter anomaly, Singal adds the qualification that industries without a related futures market display greater momentum.

Chapter 6 is for those who have had trouble following the mutual fund scandal. No one should dispute the notion that it is wrong to trade after a fund has closed for the day in order to exploit late arriving information. This practice is larceny, plain and simple. However, many funds remain open even after component securities that trade in earlier time zones have ceased to trade. Singal describes how to exploit the mispricing that results from these stale prices. Although this practice is not necessarily illegal, some might question the ethics of such behavior. Singal rightly points out that, in order to protect themselves from exploitation, investors should at least avoid funds that allow others to trade on stale prices. I suspect that broader market awareness, together with regulatory intervention, will soon render the mutual fund mispricing anomaly obsolete.

Singal next reviews trading by insiders, which he is careful to distinguish from insider trading. He posits that corporate executives and directors have a better understanding of a company's prospects, and that investors may gain an edge by mimicking the trades of these insiders.

The S&P 500 anomaly allows investors to profit from the tendency of S&P additions to rise in price between the announcement and the effective date and the associated tendency of deletions to fall in price.

Merger arbitrage allows investors to profit by acquiring target companies because they do not immediately rise in price to the bidder's offer. Of course, this strategy is not without risk because the merger ultimately may not occur.

The home bias anomaly refers to the reluctance of investors to diversify adequately outside their home country. This anomaly does not offer an arbitrage opportunity. Singal's advice is for investors to avoid this bias in their own portfolios.

The greatest anomaly of all is the forward rate bias. This anomaly refers to the fact that forward prices on currency contracts over-predict subsequent changes in the spot rates. Singal takes care to explain the connection between interest rate differentials and forward discounts and premiums. He goes on to demonstrate that investors have profited by purchasing forward contracts that sell at discounts while selling forward contracts that are priced at a premium to the spot rate.

I was impressed throughout the book by Singal's ability to present complex notions in a lucid and accessible style without bending to over simplification. And, I was equally impressed by his objectivity and caution. Nonetheless, I would like to add a cautionary note of my own. Suppose you hypothesize that there is an anomalous return associated with a particular attribute. If the association is truly random there is a 5% chance that the association will appear significant given the usual 95% threshold. If you test a second uncorrelated attribute which is also truly unrelated, the likelihood that at least one of them will appear significant rises to 9.75% ($1 - 0.95^2$). If we extend this logic, you are more likely than not to discover a statistically significant anomaly after 14 attempts, even though none of the attributes is truly related with abnormal returns; hence, my earlier comment that researchers with sufficient data discover anomalies every other week. My advice, therefore, is to regard anomalies with suspicion, and to read carefully *Beyond the Random Walk*. It's a great book!

INVESTMENT MANAGEMENT PORTFOLIO DIVERSIFICATION, RISK, AND TIMING—FACT AND FICTION

By Robert L. Hagin
(Reviewed by Oliver Campbell)

Robert Hagin has had a remarkable career as an academic and

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then principal of Morgan Stanley Asset Management. Over the span of that career, Hagin uncovered many useful investment peculiarities for the benefit of his clients. This book divulges important truths about equity investment management, markets, and the often idiosyncratic behaviors of its participants. Hagin engages his reader by posing questions in every chapter related to the widely held perceptions regarding the chapter's topic. The answers often seem obvious but almost always are not so. Prepare to be humbled about your investment acumen! The mistakes that the reader makes in response to the queries posed drives home the fact that we live in a world in which a cacophony of data and information make focusing on the important aspects of investments a difficult task indeed. The real answers colorfully illustrate the many and costly mistakes individuals and professionals alike make with regard to investment decision making.

Investment Management relates important quantitative findings of academics and leading practitioners in a fashion that is understandable to a wide, non-quantitative audience. There are dozens of examples of behavioral and informational mistakes and misperceptions uncovered by many of the field's leading researchers, including Nobel Laureates. Hagin reacquaints investment professionals with and introduces laymen to the leading theories and tools offered by Sharpe, Markowitz, Tversky, Smith and Kahneman, and Merton, and describes and illustrates why their contributions were important. Topics addressed include investor overconfidence, fear and greed, style investing, information overload, and a noteworthy nod to Fisher Black and "Noise." Hagin also enlightens the reader to his own substantial contribution to the field which he calls the "Torpedo Effect." This analysis reveals that the best (worst) returns come from buying equities which have the worst (best) *forecast* earnings changes but subsequently have some of the best (worst) *actual* earnings changes. The import is that for most investors, intuition would predispose them to getting enchanted with (owning) high expectation stocks when the greatest rewards come from the low expectation stocks as regards forecasted earnings.

Perhaps the most fascinating examination Hagin shares is in regard to market timing and asset allocation. He constructs a historical graphic of optimal and worst returns over time of perfect foresight in allocating between stocks and cash. The graphic takes the form of a "football" and the insights garnered expose the wishful and misplaced hope for market timing ability to the cold light of day. The cost of engaging in market timing and imprudent tactical asset allocation is clearly illustrated and the historical record is amazing.

This book is a goldmine—not because it points the reader to the mother lode but because of the many sizable nuggets of wisdom imparted by Hagin. There are so many mistakes that can be made by an investor and this text is all about mistake avoidance! Simply avoiding most long-term mistakes by many investors will help them to realize their long-term goals. An easy and straightforward solution to missing most of the landmines, which is a recurrent recommendation, is to index. Hagin does, however, allude to the "free rider" status of indexers and notes that indexers need active participants to result in indexing being a worthwhile strategy.

This is an important read for investment professionals who want to sharpen their abilities and is a challenging, but doable read for motivated non-professional investors.

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