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BOOK REVIEWS

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FREAKONOMICS

By Steven D. Levitt and Stephen J. Dubner
(Reviewed by Tim Adler)

"Freakonomics" is a lively excursion through a collection of research by economist Steven Levitt, winner of the John Bates Clark medal. With coauthor Stephen Dubner, the book encompasses an eclectic range of topics: sumo wrestling, drug dealing, the Ku Klux Klan, crime prevention, dating, and parenting to name a few.

While the list of topics covered may suggest the subject matter would be of more interest to sociologists than finance practitioners, the broad range of relevance becomes apparent early on. Arguably, in this book there is as much value in the discussion *of* the issues, as the methods used by Levitt and Dubner *to* discuss the issues.

In Chapter 1 we learn the answer to the question "What do schoolteachers and sumo wrestlers have in common?" As we are lead to the answer of the question posed, we are introduced to a core principle used throughout the book; the notion that incentives determine the actions of rational human beings. Levitt frequently uses this premise to structure the relevant questions to ask of the supporting data. The supposition in this example is that teachers cheat to falsely claim performance bonuses. Levitt considers how teachers would cheat given the significant disincentives to not be caught cheating. In a conversational manner, Levitt employs his evidently fertile imagination to consider a number of alternative cheating methods and the pros and cons of each. Next, algorithms are developed to identify the occurrence of each effective cheating method. The results of the data mining exercise that follows are astounding.

The procedure developed in Chapter 1 to determine the honesty of teachers is later applied to examine the behavior of participants in other environments. The procedure is first analyze the respective incentive structures to speculate the probable behavior of participants. Second, conduct a data mining exercise to determine the true behavior of participants. Using this methodology intriguing conclusions are drawn about the worth of real estate agents, the true meaning of real estate advertising verbiage, the forthrightness of members of internet dating agencies, and the prejudice of New York City voters and competitors on the television game show "The Weakest Link."

The chapter titled "Why do drug dealers still live with their

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mums?" suggests great potential for an interesting discussion—and it certainly fulfills its promise. At the outset of the chapter, readers may be tempted to concoct a few hypothesis in advance of the content. It is unlikely that many readers would realize that drug dealers make below minimum wage and thus face a curtailed set of possible living arrangements. These types of incorrect assumptions—that drug dealers are wealthy—are termed "conventional wisdom—simple, convenient, comfortable, and comforting—though not necessarily true." Levitt's disdain for "conventional wisdom" is plainly obvious.

In the second half of the book Levitt continues his attack on conventional wisdom to determine the causes of declining crime rates and the components of good parenting. The analysis is confronting, controversial, and most assuredly not politically correct. The structure for dissecting both topics is similar. Step one—identify the societal beliefs of the causal factors. Step two—construct questions that if answered would prove or disprove the efficacy of each factor. Step three—interrogate the available data to answer the questions posed. Step four—draw conclusions from the surviving factors. Levitt's skill to decompose these complex issues into a series of relevant, tractable questions is illuminating in itself.

Readers of the book gain an insight into Levitt's offbeat personality. One suspects the quote by John Kenneth Galbraith, included in the discussion of "conventional wisdom," is pinned somewhere on the wall of Levitt's study: "We associate truth with convenience, with what most closely accords with self-interest and personal well-being or promises best to avoid awkward effort or unwelcome dislocation of life."

Readers of *Freakonomics* will find it a worthwhile investment of time. The book addresses each topic in a concise, easy to consume manner. We are left inspired and better equipped to look beyond the stereotypes and ask the right questions of the world around us.

THE FUTURE FOR INVESTORS: WHY THE TRIED AND TRUE TRIUMPH OVER THE BOLD AND THE NEW

By Jeremy J. Siegel
(Reviewed by Bruce Grantier)

Jeremy Siegel's very successful "Stocks for the Long Run"[1] made the case for stocks over bonds. His new book addresses an equally important question: which stocks? This review briefly summarizes the book, comments on Siegel and Schwartz' original paper on performance of the S&P 500,[2] and relates the book to value investing and behavioral finance by reference to two recent surveys of literature.

The book contains three main themes: (1) the superior performance from 1957 to 2003 of the so-called "tried and true"—the value stocks of the S&P 500; (2) the implications for investment returns of potential dis-saving by aging baby-boomers; and (3) the advantages of global investing.

The dominant theme of the book is that valuation is more important than growth in determining investment returns. The empirical basis for this is a detailed study of the S&P 500 from its modern inception in 1957 through 2003. The study tracks the returns of three portfolios over this 47-year period, during which 917 new stocks were added. It concludes that the "tried and true" outperformed the "bold and new," because the latter were often over-priced.

Siegel's example of IBM vs. Standard Oil of New Jersey (Exxon) eloquently illustrates this finding. Over 1950–2003, IBM had better per share growth in revenue, dividends, and earnings. Also, IBM's stock had greater price appreciation than Exxon's, and the technology

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sector experienced much higher growth than energy. However, due to Exxon's higher dividend yield and reinvestment thereof, Exxon had a superior total return. In summary, dividends provided steady growth and downside protection, and avoid the "growth trap" of overvaluation of new additions to the S&P 500. Value provided better returns than the S&P 500 overall.

Siegel quotes Warren Buffet throughout the book, and it is obvious that Siegel is a Buffet disciple. Siegel begins with Buffet comments as a guest lecturer at a Wharton class and ends quoting Buffet: "I have seen no trend toward value investing in the 35 years I have practiced it. There seems to be some perverse human characteristic that likes to make easy things difficult."

A second theme (well known to Siegel)[3] is that the aging babyboomers need not worry about the potentially depressing effect of selling stocks in retirement. The emerging wealth of Brazil, Russia, India, and China will finance the aging boomers' stock sales (at the same time, easing retirement costs by selling cheap goods). This theme is based on economic modeling and not the value precepts of the first part. In a recent review in the *Wall Street Journal*,[4] Dr Robin Brooks of the IMF challenges the conclusions. He argues that since the richest 10% of the US population own about 88% of individually owned stocks, it is not likely they will have to sell holdings to maintain living standards. Milton Friedman, a friend and former colleague of Siegel's at the University of Chicago, shares the view that the aging boomers will not face this problem—they can live off dividend income, and forced selling of assets will be only marginally.

A third theme is global investing. Siegel summarizes the issues surrounding home country bias and advocates a 40% international weight. This is below the weight of non-US equities in the MSCI World Index, but well above the weight of the average pension fund asset mix. He notes that, as with the earlier IBM/Exxon example, growth does not equate to returns; China has had much greater growth than Brazil but lower investment returns.

A *Wharton Journal*[5] interview notes Siegel's extraordinary indebtedness to a number of former students, in particular Jeremy Schwartz (also noted in book) whose research with Jeremy Siegel inspired the book.

"The Long-term Returns on the Original S&P 500 Firms" by Siegel and Schwartz[6] goes into much greater detail on the study of the survivors and descendent stocks of the 1957 S&P 500. It details the assumptions as to treatment of changes in stocks, such as mergers, acquisitions, privatizations, spin offs, distributions, bankruptcies, and nationalizations. The findings are consistent in direction with other literature on value vs. growth investing although not necessarily the same in magnitude.

A recent review of the literature was written by Louis Chan and Josef Lakonishok.[7] Lakonishok, Schleifer, and Vishny[8] are among the first citations in value investment literature, generally preceded only by Fama and French.[9]

In academic studies of the differences in returns from style investing, the results are fairly consistent although the explanations are quite different. The studies typically divide stocks into deciles by some value metric such as the book to market ratio, and measure differences over long periods. The authors point out: "A large body of empirical research indicates that value stocks, on average, earn higher returns than growth stocks. The reward to value investing is more pronounced for small-cap stocks … The value premium exists also in equity markets outside the United States." Interestingly, the difference between value and

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growth investing reported in the literature is in the order of hundreds of basis points, much larger than Siegel's reported differences.

Behavioral finance has attempted to provide as an explanation for the value premium. Andrew Lo recently reviewed behavioral literature and put forward a hypothesis that attempts to explain investor behavior.[10]

According to Lo: "…Underlying the EMH are the assumptions that market participants are rational economic beings, always acting in their best interests and making decisions in an optimal fashion … These assumptions of rationality … have come under attack from a number of quarters … in particular by psychologists and experimental economists (who) have documented a number of departures from market rationality in the form of behavioural biases. Apparently ubiquitous to human decision-making under uncertainty…"

Lo notes the differences between economics and psychology: psychology has its roots in empirical observation, controlled experimentation, only later do they attempt to make inferences about the origin of such behavior. Economists typically derive behavior axiomatically from simple principles, resulting in economic behavior that is refuted routinely. Lo's Adaptive Markets Hypothesis (AMH) attempts to reconcile behavioralists and efficient markets believers. The AMH holds that investors, while they act in self-interest, make mistakes and learn and adapt from them; natural selections lead to evolution in markets.

Overall, Jeremy Siegel's *The Future for Investors* is an important sequel to *Stocks for the Long Run* and a valuable extension of his quest for higher investment returns. His conclusions are consistent with the existing literature on value investing and his explanations for the value premium are probably a significant contribution to this field. These explanations are supported by both the philosophy of the Warren Buffet value-school and the behavioralists. Siegel's findings support a notion that value investors are much more like behaviorlists than economists, and that field is a prospective place to look in explaining style-based investment returns.

Notes

1. Jeremy J. Siegel, *Stocks for the Long Run* McGraw Hill, 1994, 2002.
2. Jeremy J. Siegel and Jeremy D. Schwartz, "The Long-term Returns of the Original S&P 500." December 2004, The Wharton School, to be published in the *Financial Analysts Journal*, draft available on Jeremy Siegel's website.
3. Jonathon Burton, *The Investment Titans: Investment Insights from the Minds that Move Wall Street*. McGraw Hill, 2001. The book outlines Jeremy Siegel's views on demographics/investing, but also has chapters on Josef Lakonishok and Richard Thaler.
4. E.S. Browning, "Future Shock—As Boomers Retire, a Debate: Will Stock Prices Get Crushed?" May 5, 2005.
5. Tim Viles and Matt Addison, "Siegel on *The Future for Investors*." March 2005.
6. Ibid.
7. Louis Chan and Josef Lakonishok, "Value and Growth Investing: Review and Update." *Financial Analysts Journal*, January 2004.
8. Josef Lakonishok, Andrei Schleifer, and Robert Visnhy, "Contrarian Investment, Extrapolation, and Risk." *Journal of Finance*, December 1994.
9. Eugene Fama and Kenneth French, "The Cross-Section of Expected Stock Returns." *Journal of Finance*, June 1992.
10. Andrew Lo, "Reconciling Efficient markets with Behavioural Finance: The Adaptive Markets Hypothesis." March 2005, unpublished.

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