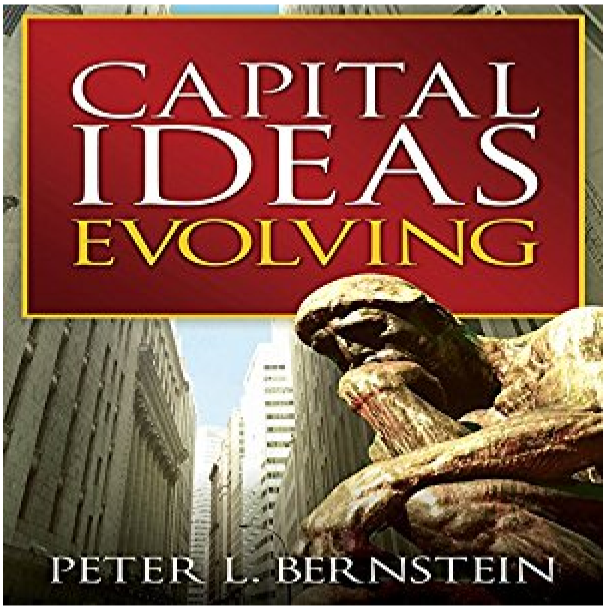
Capital Ideas Evolving



Synopsis

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Customer Reviews

For those interested in the Financial Crisis of 2008 Peter Bernstein’s "Capital Ideas" and "Capital Ideas Evolving" should be required reading. They describe the transformation, i.e. mathematicization, of financial economics over the 2nd half of the 20th century, frequently described as Financialization, generally recognized as a central feature in the evolution of the economy.That all economic systems evolve, for better or for worse, is an indisputable fact of economic life. Whether such evolution is stable or inherently unstable and whether governmental attempts to successfully manage economic evolution have desirable outcomes are questions whose answers are only tentative and fraught with political and technical ambiguity. Advocates for and against governmental intervention are agreed on at least one point: "One of the [competing narratives] will eventually be [publically] accepted, and will determine how the great financial crisis of 2008 is interpreted, and thus how it affects public policy in the future."Financialization and Globalization are the two structural changes in the economy that capture the essential features of the evolution of capitalist economies over the past half century.Bernstein's books, while suitable for academic purposes, are not beyond lay readers comprehension. Both books make an important contribution to informing the citizenry that an effective democracy must rely on.Donald MacKenzie's "An Engine Not a Camera" compliments Berstein's books. MacKenzie argues that in the hands of market participants the technical innovations described by Berstein became more than realistic models of Capital Markets, they actually caused the shaping of the markets they describe.For those interested in a popular and shorter exposition I would recomend Yeves Smith's "Econed."

Mr. Berstein's Capital Ideas Evolving is the first and the formost book everyone in the field of finance should read carefully. Inside the yeild book is the other one people in the field of finance should read thoroughly.

Good Concepts, a good explanation of History. But like most of his books he can get a little long-winded and belabor certain points and stories

Need to finish it to give a better review.

This was not an easy read, but it was worth it. I received my MBA in 1976. Much of this book was an explanation of the effects of the Capital Asset Pricing Model (CAPM) on current investment practices. He assumes that the reader is well versed with the intricacies of CAPM. I had to go back to other sources to review CAPM, but once I did, the book was a great explanation of how CAPM and other academic innovations have had a practical effect on portfolio management. When I finished the book, I had to admit that I was not able to apply much to my personal portfolio management, but I have a much better understanding of what my pension plan administrator is thinking about as well as what certain mutual funds managers are doing. The book is more beneficial for the professional investor than the individual investor.

I have a lot of respect for finance professors. To quote a felicitous expression, they perform "mathematics in flesh and blood". They are the surgeons of the modern economy, cutting through inefficiencies and making sure the blood of capital flows into the arteries of corporate accounts or personal savings. And like surgeons, society gratifies them with generous pay and social prestige:

the time is over when finance specialists were snubbed by their economist colleagues and kept on the margins of the discipline. Some may even get a Nobel prize in economics, while many may complement their academic salary with management consulting or hands-on investment.All these pursuits are perfectly legitimate, and finance professors are usually nice individuals endowed with a sharp mind. But Bernstein overemphasizes their worth and gets way too far in praising their accomplishments. The chronicler turns into a sycophant when he writes that "the vigor, the freshness, and the extraordinary clarity of Samuelson's mind would be stunning to encounter in a man of any age". Or that Robert Shiller's "ingenious and restless mind seems never to come to sleep".But leaving excessive praise aside, the book makes several strong claims that I found worth considering. The first is that the era of financial theory is over. Finance as an academic discipline is based on theories--the Capital Ideas of the title, described in the prequel volume-- that were developed from 1954 to 1972, starting from Markowitz's essay on portfolio selection ("Markowitz came along, and there was light"). The consequence is that most finance academics have now left theory behind, either to launch attacks on neoclassical assumptions based on behavioral observations, or to adopt an institutional perspective on how markets work in order to design better rules and instruments for managing risk. Others have left academia altogether and have moved to the dark side of portfolio investing, where they have created structures surprisingly close to the university setting: "we conduct research; we discuss it and improve it; and we build models and empirically test them. And in some sense we publish them and verify them when we test them in the market", says Myron Scholes, a Nobel prize laureate turned investor.The concentration of discoveries in a short time span and among a small group of innovators is by no means unique in the history of science. But past experience also shows us that well-established paradigms can be radically challenged and overcome by new ideas coming from the fringe of the discipline that put past theories into oblivion. Nothing stands still. The Capital Ideas are nor written in stone. And a new theory of finance may very well emerge that will match Markowitz's approach to portfolio selection, Modigliani and Miller's insights into corporate finance, the Efficient Market Hypothesis, the Capital Asset Pricing Model, and options pricing theory.The second claim made by the author is that the Capital Ideas are not vulnerable to empirical challenge. Behavioral Finance has pointed out many situations in which the axioms of neoclassical theory do not apply, but as Andrew Lo notes, these findings are only "a collection of anomalies, not a real theory. You need a theory to beat a theory". The same applies to statistical tests, which have repeatedly failed to confirm the validity of theoretical models. For Fisher Black, another Nobel prize laureate, you should put your trust only in logic and theory, and forget about statistical empirical results.But aren't the financial models designed by theorists repeatedly proven wrong by market crashes and financial crisis, at the cost of staggering financial loss and dire economic consequences? What worth is a theory that fails to foresee those crises, or worse seems to contribute to their occurence through unfettered innovation and mismanagement of risk? Bernstein responds that the creators of modern finance were not taken by surprise by difficulties in the implementation of their models. The academics knew as well as anyone that the real world was different from what they were defining, and that the models were an approximation to reality and a guide to strategy rather than a precise replication of the world. Perhaps, but the technicians of finance went way beyond their academic masters and really believed in their models, without the necessary dose of skepticism that only a familiarity with academic research can cultivate.The third idea that I would like to comment upon is what social scientists call the performativity of economics: the idea that reality looks increasingly like the theory, that "powerful forces are constantly at work in the markets to bring the resemblance between theory and reality closer with the passage of time." The real world itself is on a path toward an increasing resemblance to the theoretical world described in Capital Ideas. Even research that focusses on the distance between theory and reality actually contribute to the convergence between the two. Behavioral Finance, Bernstein notes, is by nature self-disfulfilling, and it has become the driving force toward the Efficient Market Hypothesis that it so vigorously attacks. The CAPM may be outdated as a theoretical model, but its influence has never been so great, as it has been transformed into a powerful real-world tool for managing money and for calibrating investors' performance. Theory creates a world of our own making.But here we should stop and ask ourselves whether we really want a world shaped by financial theory. A world that has gone quant is a world unintelligible to most mortals, a world without moral compass and where things regularly get out of control. Bernstein was right in pointing toward the world-making quality of financial theory; but he fails to consider the moral and political implications of this basic intuition.

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