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Book reviews

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Capital Ideas Evolving. Peter L. Bernstein. John Wiley and Sons, 2007, ISBN 978-0-471-73173-3, 304 pages. doi:10.1017/S1474747207003277

I rarely accept the opportunity to review a book, but I make a rare exception for a simple reason: I am a Peter Bernstein fan. I have thoroughly enjoyed many of his articles and prior books, particularly his *Against the Gods: The Remarkable Story of Risk*. Thus it was easy to say yes to the opportunity to review Bernstein's latest effort, which is a sequel to his 1992 book *Capital Ideas*. This new work is an excellent introduction to, and history of, modern portfolio theory that will appeal to academics, practitioners, and others who study financial markets.

In the 1992 volume, Bernstein laid out the foundation of modern portfolio theory. That book was a great introduction to many of the ideas and men that have shaped the financial markets of the 21st century. Practitioners have often been skeptical of the dense work of academic scholars: too many equations, too many simplifying assumptions, and too opaque. Early on, Bernstein was no exception to this general rule. But he came to realize the import of many of the insights of financial economists. As he wrote there (*Capital Ideas*, p. 76):

> … [A]cademics were converting the heart of portfolio management into an array of incomprehensible equations. Perhaps those mysterious mathematical symbols did mean something after all. I began to worry, and then to learn, and finally to change my ways.

Many have changed their ways in the ensuing years. The ideas of modern portfolio theory have transformed Wall Street and the new book, *Capital Ideas Evolving*, describes this transformation. In particular, this volume is an updated and improved version of the earlier effort. Written in clear, accessible prose, the book's main protagonists are not the intellectual giants that lend their names to chapter titles, but the insights about financial markets that these men generated. (Unfortunately, financial economics remains a largely male domain.) Following a format similar to the original but with a more liberal sprinkling of war stories from the front line of investment management, Bernstein explores (many of the same) men and ideas covered before. Chapters are devoted to Paul Samuelson, Robert Merton, Andrew Lo, Robert Shiller, Bill Sharpe, Harry Markowitz, and Myron Scholes. Though the chapters are organized around the scholars, the focus is always on the ideas; there is only passing discussion of the formative experiences of the men behind the ideas.

A central theoretical theme in the book is the paradox of neoclassical market efficiency. In an efficient market, prices fully reflect all available information. But if prices fully reflect all available information, there are no gains to information collection; therefore, no one will collect information. How, then, can markets reflect all available information? Of course, the resolution to this paradox – insightfully laid out in the classic work of Sanford Grossman and Joseph Stiglitz – is that there must be gains to information collection that are sufficient to compensate those who spend their days collecting information. Bernstein refers to

this pursuit of valuable information as the "Theory of Sharks" and rightfully points out that each anomalous return pattern that lacks an equilibrium explanation is doomed to be consumed by the Wall Street sharks. Investors ignore equilibrium concepts such as this, which are at the heart of modern portfolio theory, at their own peril; unfortunately, many investors *do* ignore these core insights.

All good protagonists require a formidable foe, and the foe of modern portfolio theory is behavioral finance. In 1992, many of the ideas of behavioral finance were heretical in mainstream finance. Since then, behavioral finance has blossomed into a respectable subfield of financial economics, and Bernstein describes the work of many in this area including the influential work of Daniel Kahnemann, Richard Thaler, and Robert Shiller. While acknowledging the contributions of behavioral finance, Bernstein clearly professes his love of the simple, elegant, and insightful contributions of mean-variance optimization and the Capital Asset Pricing Model (CAPM). However, Bernstein acknowledges that investors make mistakes, which (in my view) may have important policy and welfare implications that are absent from traditional theory.

Another way this volume extends the 1992 book is that he includes more "war stories" from the frontlines of investment management. These stories are more plentiful for a very simple reason – the ideas of modern portfolio theory have now permeated and blossomed in the investment management business. Bernstein describes the success and evolution of Goldman Sachs Asset Management (GSAM), Barclays Global Investors (BGI), the Yale Endowment, and PIMCO. All of these giants of the investment management business are built on foundations created in the work of capital ideas. In all, this new effort represents a worthy addition to the Bernstein collection. I recommend the book to all serious students of financial markets.

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Competitive Equity: A Better Way to Organize Mutual Funds. Peter J. Wallison and Robert E. Litan. The AEI Press, 2007, ISBN: 978-0-8447-4252-6, 154 pages. doi:10.1017/S1474747207003289

US mutual funds are structured as corporations or equivalent business/statutory trusts with their own boards of directors or trustees. Mutual fund boards, which are largely comprised of individuals who are independent of the fund's sponsor/manager, owe fiduciary duties to fund shareholders, just like directors of any publicly owned company. Among their most important responsibilities is the duty to review, evaluate and approve the fund's service contracts with investment advisers and other service providers. They are specifically charged by statute, regulation and court rulings with assessing the reasonableness of the advisory fees charged to the funds on an annual basis. Under the current regulatory overlay, investment advisers also owe fiduciary duties to fund shareholders, including a duty to refrain from charging unreasonable fee levels.

Co-authors Peter Wallison and Robert Litan are sharply critical of this current system. Essentially, their position is that having an intermediary board actually impairs competition and keeps costs for investors higher than they should be. They propose establishing an alternative structure that would eliminate the independent board, transfer many of its non-fee responsibilities to professional trust companies, and allow the competitive marketplace to control fee levels. They stop short of suggesting that the current structure be eliminated. Rather, they propose that the law be amended to authorize sponsors to establish managed investment trusts (MITs) that could be offered as an alternative to funds structured in the traditional way.

The fundamental premise of their book is that the current structure is akin to rate-making authorities setting public utility fees on a "cost-plus" basis. In the words of the authors,

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