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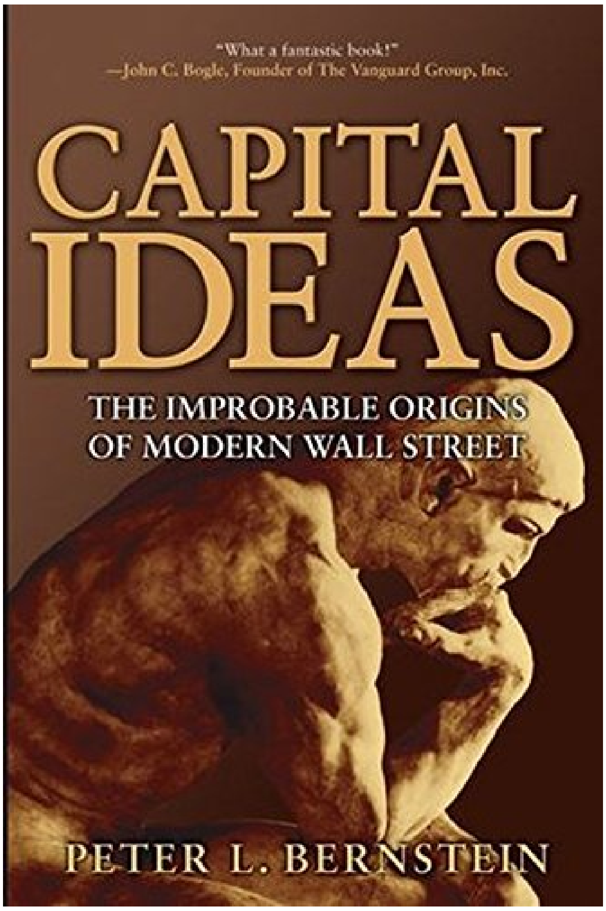

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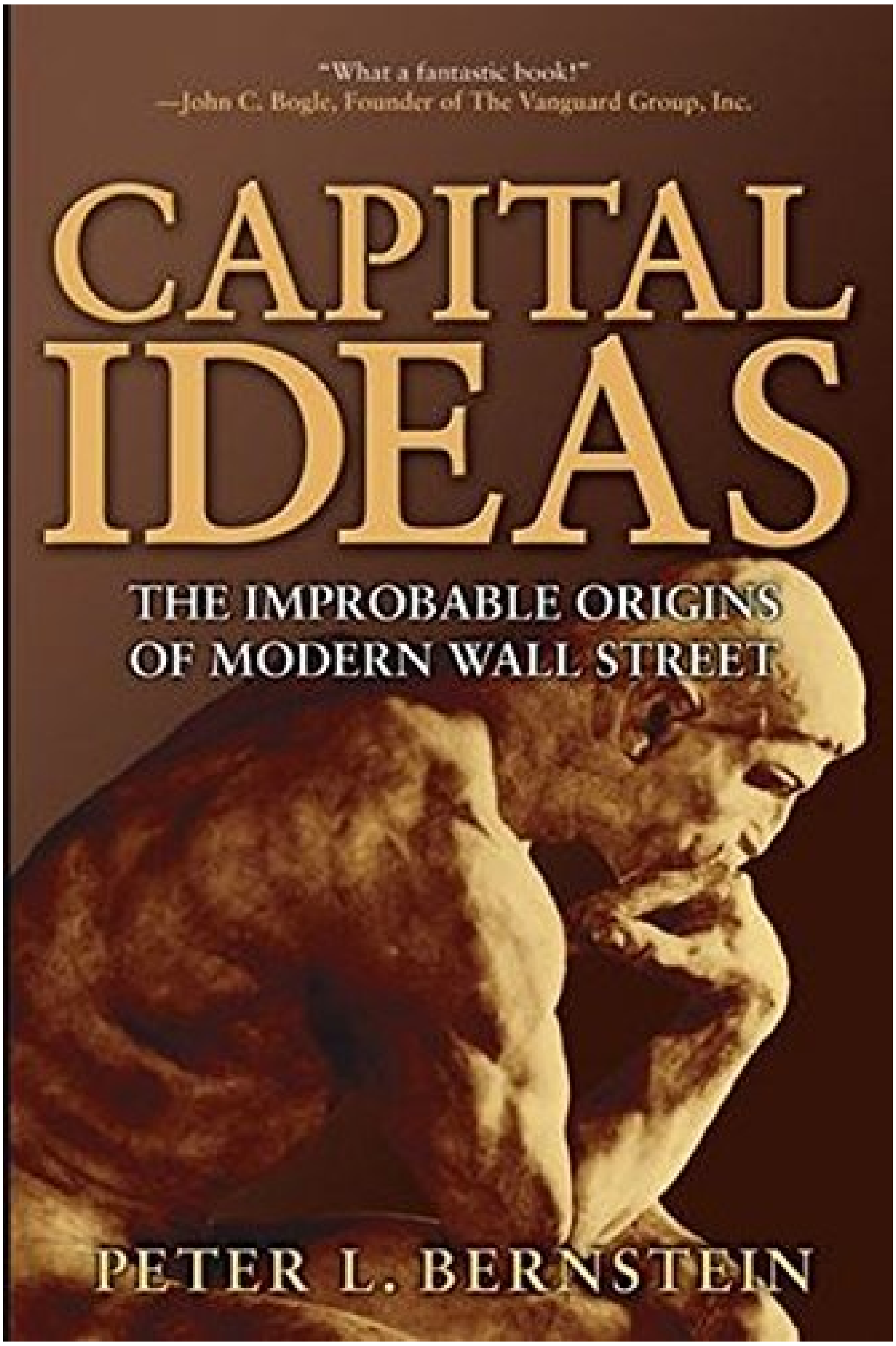

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In a thorough, well-written work on the modern financial marketplace, Bernstein traces the merging of academic research with the curbstone techniques of Wall Street. Previously considered impractical pursuits, the concepts developed in "ivory towers" by various scholars and economists forced the marketplace to rethink its methods in light of events of this century. From early attempts at predicting market behavior and developing the concept of risk and portfolio management theories, these thinkers contributed a theoretical basis to capital markets, bridging the gap in understanding between insiders and outsiders. The text presupposes a knowledge of market and economic theory, but a well-informed reader will find this an interesting summary of the development of modern finance.
- Kenneth J. Cook, Melbourne, Fla.
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controlling risk in the competition for above- average investment returns. At any rate, less than two decades later (with a big assist from powerful numbers-crunching computers), asset allocation, diversification, hedging, performance measurement, portfolio insurance, and allied techniques are norms, not novelties, in the management of large pools of money. While his text may prove a bit difficult for market tyros, Bernstein makes a fine job of tracing the town/gown links that are restructuring big-time investment strategy and practice. -- Copyright ©1991, Kirkus Associates, LP. All rights reserved.

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Capital Ideas traces the origins of modern Wall Street, from the pioneering work of early scholars and the development of new theories in risk, valuation, and investment returns, to the actual implementation of these theories in the real world of investment management. Bernstein brings to life a variety of brilliant academics who have contributed to modern investment theory over the years: Louis Bachelier, Harry Markowitz, William Sharpe, Fischer Black, Myron Scholes, Robert Merton, Franco Modigliani, and Merton Miller. Filled with in-depth insights and timeless advice, Capital Ideas reveals how the unique contributions of these talented individuals profoundly changed the practice of investment management as we know it today.

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Review
Richard Brealey London Business School This is a great book...captures marvelously the excitement of the search for new ideas.

Most helpful customer reviews

78 of 94 people found the following review helpful.
Interesting even if cheerleading
By Professor Joseph L. McCauley
"Poets are the unacknowledged legislators of the world....Let those who will, write the nation's laws, if I can write it's textbooks." (P. Samuelson, quoted by Berstein)
Bernstein has written a fascinating pre-LTCM (pre 8/98) book on the history of econometrics and finance, beginning with the origins of the Cowles foundation as the consequence of Cowles' personal interest in the question: Are stock prices predictable? This book is all about heroes and heroic ideas, and Bernstein's heroes are Adam Smith, Batchelier, Cowles, Markowitz (and Roy), Sharpe, Arrow and Debreu, Samuelson, Fama, Tobin, Samuelson, Markowitz, Miller and Modigliani, Treynor, Samuelson, Osborne, Wells-Fargo Bank (McQuown, Vertin, Fouse and the origin of index funds), Ross, Black, Scholes, and Merton. The final heroes (see ch. 14, The Ultimate Invention) are the inventors of (synthetic) portfolio insurance (replication/synthetic options).
This book consists largely of a pre-LTCM (pre-10/98) cheerleading for option-pricing mathematics based on lognormality, and corresponding synthetic portfolio insurance. Osborne and Mandelbrot are mentioned. The book is not error-free: e.g., Mandelbrot's ideas on stock prices are stated as being the origin of chaos theory (!), and Mandelbrot (of random fractals fame) is misportrayed as an `articulate proponent' of chaos theory! Another error (page 182): "..persistent forces are constantly driving the market toward (Modigliani-Miller) equilibrium." The evidence for the EMH is supposed to constitute the `proof' for this nonsense. So much for `proofs' in economics. So ingrained is the false, misleading and inapplicable notion of "equilibrium" in the minds of economists that it is hopeless to expect to educate them out of their own morass. Even Black, who was educated as a physicist as an undergrad, did no better:
"When people are seeking profits, equilibrium will prevail." (F. Black, quoted by Bernstein)
Among the interesting and entertaining stories that are told are: the displacement of Graham and Dodd's `value theory' by the EMH, the revolutionary role played by Wells Fargo Bank in using the `new finance math', and in creating index funds. The importance of the Miller-Modigliani `theorem, which `proved' that the (not-uniquely-defined) `value' of a corporation is independent of it's debt. Then, there is the wild-haired idea of `portfolio insurance', how to eat your cake and have it too (a free lunch, derived from the assumption that free lunches don't exist). No portfolio can be insured against extreme deviations, especially those that occurred in 10/87 and wiped out confidence in LOR (Leland-O'Brien-Rubinstein Associates). But this failure of finance theory produces no crisis for Bernstein, whose book is the history of heroes, not villains. His last chapter, which can be ignored by the reader without loss, is states his ideology: free market ueber Alles. Or: equilibrium will prevail, even without restoring forces (I like to put it this way: there are no "springs" in the

market). I did get something important from this book: the origin of America's spend-spend-spend ideology in the Modigliani-Miller `theorem'.
If the optimal portfolio is not risky enough, borrow to finance it's purchase. (Wells Fargo's application of Tobin's idea, quoted by Bernstein)
(This is a shorter version of a longer review that appeared in fall(...).

4 of 4 people found the following review helpful.
The Power of Ideas
By Etienne RP
The popular literature about the world of investment in the 1980s carries titles that reflect those events: Bonfire of the Vanities, Barbarians at the Gates, The Predators' Ball, and Liars' Poker. The main characters are arrogant, greedy, cynical, and shady. The movie Wall Street summed it all up: "greed is good", the address by corporate raider Gordon Gekko to a crowd of investors, is the claim that came to epitomize the zeitgeist.

But what if the real heroes of the stock market frenzy were not those pathetic figures that generations of MBA students tried to emulate? What if the unsung heroes of the times were instead the professors and ivory tower academics who wrote those students' textbooks? Finance professors are usually not held in very high esteem: their economics colleagues won't share office space with them, their practically-minded students deride them for not practicing what they are teaching, and the general public considers any accident on the stock market as proof of the flaws in their theories.

Peter Bernstein's book pays due respect to their profession. It focusses on a small group of innovators who created finance as an academic discipline, and transformed Wall Street and the world along the way. Published in 1992, Capital Ideas starts and ends with two turning points in the history of modern finance: the crisis of October 1974, which saw the culmination of the worst bear market in common stocks since the Great Crash of 1929, and the stock market crash of October 1987, in which hundreds of billions of dollars were wiped out in a few hours.

Financial innovation was blamed on those two occasions, and finance specialists were castigated as sorcerer's apprentices. But for Bernstein, finance is more a solution than a problem, and the answer to the risk of innovation getting out of control is still more innovation. Had it not been for the crisis of 1974, few financial practitioners would have paid attention to the ideas on portfolio selection and risk management that had been stirring in the ivory towers for some twenty years. And putting the blame of the 1987 crash on portfolio insurance, as the commission chaired by Nicholas Brady did, is compared by the author to a proposal to slow down the train, when efforts should focus on improving the quality of the roadbed.

Finance had difficulty establishing itself as an academic discipline. It was taught mostly in business administration departments, not in economics faculties. Even in business schools such as Harvard, the investment course in the 1950s attracted so few students that it was taught at noontime so that it would not take up precious classroom space at prime time. Finance attracted marginal individuals, the kind of persons that would be described nowadays as nerds, with a taste for crunching numbers and dabbling with computer mainframes. Only a few of them had formal training in economics. The discipline flourished in only a handful of US universities where the talent of a few individuals made a difference and where business school professors did talk to their colleagues in the economics department: Chicago, MIT, and a few other places.

The body of knowledge that forms the core of the discipline-what Bernstein refers to as Capital Ideas- was conceived in the space of only twenty-one years, from 1952 to 1973. In short, it is contained in Harry Markowitz's work on portfolio selection, Franco Modigliani's and Merton Miller's revolutionary views about corporate finance and the behavior of markets, the Capital Asset Pricing Model developed by Sharpe, Treynor and a few others, Eugene Fama's explication of the Efficient Market Hypothesis, and the option pricing model of Fischer Black, Myron Scholes, and Robert C. Merton.

When the discipline was developed, many economists regarded the stock market as a side-show in the economic system, not worthy of serious attention. Even Milton Friedman, who sat on Markowitz's dissertation committee, reflected the prejudices of the profession when he declared: "Harry, I don't see anything wrong with the math here, but I have a problem. This isn't a dissertation about economics. It's not math, it's not economics, it's not even business administration." And it was something completely new and unrelated to previous work: Markowitz's seminal paper on Portfolio Selection, that brought him fame and a Nobel Prize, lists only three references to other works in its bibliography. One of the most fundamental paper by Jack Treynor, that laid the groundwork for the CAPM, wasn't even published.

There were some exceptions. The most famous was Paul Samuelson, known for his textbook first published in 1948 and who made so many contributions to the economics discipline that the Nobel jury had trouble highlighting only a few when they awarded him the prize in 1970. Although Samuelson was Keynes' most distinguished disciple, he rejected Keynes' own view of the market as little more than a casino, and he saw the stock market as a central institution as well as a source of fascinating intellectual puzzles. Another economist with a keen interest for financial markets was James Tobin, who spent most of his career at Yale except for a brief stint at he Council of Economic Advisers that began with the following dialogue when President Kennedy offered him the job:
- I'm afraid you got the wrong guy, Mr. President. I'm an ivory-tower economist.
- That's the best kind. I'll be an ivory-tower president.
- That's the best kind, Mr. President.

The book is very rich in anecdotes and personal details on the academic founders of modern finance, most of whom were interviewed at length by the author. It requires no prior knowledge of the field, although knowing one's betas from one's alphas will help the reader go through the material. My own exposure to theoretical finance has been very limited, but having done the maths once on the CAPM or the Modigliani-Miller theorem helped me get through the relevant chapters, whereas the last chapters on option pricing theory or continuous time finance are way beyond my grasp and could only be understood metaphorically. But the Capital Ideas and the difference that they made are just too important to be left ignored, and Peter Bernstein has made a great job of explaining them to the general public.

9 of 13 people found the following review helpful.
Good introduction to difficult topic
By houseofcommerce@ibm.net
Capital Ideas can be a nice introduction to a difficult topic and one should read it before starting to get involved in the more profound literature of financing scholar books.
The only two blames I have to make is 1. that the personal side of the stories is expanded too far - it would be enough to state that some teacher is considered a workaholic, the description of his calling at sunday night gets you out of the more important context of what he rally prooved and claimed for the new theory of financing. and 2. that the differences in the beta and CAPM theories is not so clearly described - although it is a major topic in the book - that the book alone leaves you with a precise idea of the differences. So this must be left for other books.
The book is nonetheless highly recommendable, since it has the advantage that sine ira et studio all theories find their way into the book, so you will not run into the danger that you loose one financial problem just because the scholarly author of a financing manual forgets to tellabout it, which is often the case.
So get this book soon, it is easy to read, and a friend of mine - a Dr of Medicine who would for the first time

read about this topic - was much impressed by it and liked it immediately; and I can add, he even understood it.
Dr. Rudolf C. King CEO, princeandprince.com

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