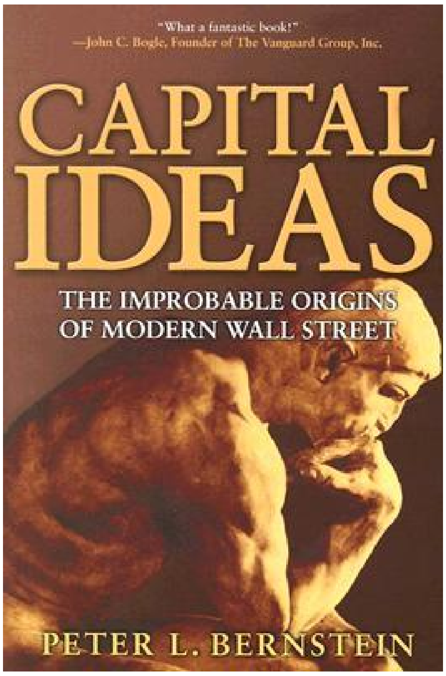

Capital Ideas: The Improbable Origins of Modern Wall Street

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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.

Capital Ideas: The Improbable Origins of Modern Wall Street Details

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From Reader Review Capital Ideas: The Improbable Origins of Modern Wall Street for online ebook

John says

The late Peter L. Bernstein's Against the Gods is the quintessential book on the phenomenon of risk. After several re-readings over the years it still stands up. That epic book prompted me to delve in another Bernstein opus, Capital Ideas. While this study of seminal ideas that shaped Wall Street has its merits, it is less likely to be re-read and referenced. Bernstein profiles the theoretical titans who came up with models, theorems and instruments like CAPM, the efficient market hypothesis, the random walk and portfolio insurance. The book has a biographical bent, focusing on the nuances, habits and oddities of philosophical titans like Harry Markowitzh, Myron Scholes, Paul Samuelson and Fisher Black. Sadly, instead of an illuminating provocative insight into the forces driving modern business (which you are likely to get from Against the Gods), I received a rather cursory, superficial history lesson that has become fairly outdated and irrelevant. Still, Bernstein has a flair for spinning stories and thankfully does not immerse himself in complex algorithms and hieroglyphics.

Justin Tapp says

Your investment manager or stock broker probably believes he can beat the market-- ie: do a better job investing your money than simply putting your money in an index fund. And he is wrong. Anyone who says "I can beat the market" is a liar. "Buy and hold" is a better strategy for the investor than actively trading. As Nobel laureate Eugene Fama recently pointed out (again) using data from 1984-2006:

Even before expenses, the overall portfolio of active mutual funds shows no evidence that active managers can enhance returns. After costs, fund investors in aggregate simply lose the fees and expenses imposed on them.

As more players enter the capital markets, the markets become more strongly efficient. This is why I have a problem teaching finance-- I see too many students graduate who think they are somehow smarter than the market. Granted, one aspect of Efficient Markets Hypothesis may not hold to be true -- the underlying price may not always be right (and see my review of Taleb's Fooled by Randomness or Mandelbrot's The (Mis)Behavior of Markets) and risk may be grossly misassessed due to false assumptions of normality.
But people who are able to see mispriced assets or missassessed risk either don't exist or are too far and between. Bill Miller became a legend for managing a fund that beat the S&P 500 for 15 consecutive years (the only one to do so). Now his fund is the worst performing of its class and he's lost tens of billions of dollars.
This is also why I don't want to be an investment manager or try to sell someone the idea that I could pick the best mutual funds for them, because the data say that active management is ludicrous. All I could do is match their risk tolerance to the stated risk of the fund, like selling them the color car they want to drive.

Capital Ideas: The Improbable Origins of Modern Wall Street by Peter L. Bernstein is a classic history of modern finance. How academic economists and mathematicians revolutionized finance, and how the investment services industry fiercely resists their ideas. From determining the fair price of an option to designing the optimally diversified portfolio, Bernstein tells the story of how it all took place from Bachelier to Rubinstein.

Last summer, I read Bernstein's Against the Gods (my review here), which told the history of risk and is a good prelude to this book. What Taleb and Mandelbrot argue is that the tools used in Bernstein's book are folly for risk management because of the models' underlying assumptions--the world is not normally distributed. 1987 is an "aberration" Bernstein glosses over, and 2008 made Taleb and Mandelbrot rock stars (Taleb calls for every Nobel economics winner in Capital Ideas to be stripped of their awards).

As far as comprehensive history, this book is tough to beat. It has been required for our Jan term class for the last several years, which is why I needed to read it (although I'm not requiring it). After the dot-com crash of the 1990s, Bernstein wrote a sequel "defense" of his "heroes" which I would like to read.

4 stars out of 5.

Max says

This was good. I think I would have enjoyed it more if I wasn't in the middle of law school. I had trouble devoting as much attention to it as I would have liked. Nevertheless, I felt that I learned a decent amount from it. I guess I was disappointed that the connections weren't made between the theories being explained and the effect on modern finance.

Steve says

While not what I would call exciting, this was interesting none the less.

"Capital Ideas" is a history of the people and papers which contributed to modern economic and financial theory. It's interesting to note that many things which everyone seems to accept as fact today with were unheard of 50 years ago. What will the next 50 years bring?

These few paragraphs summarize the tone and feel of the book nicely. While discussing the conflict which arose between the academics and the practitioners:

"Markowitz, for example, threatens the private preserve of portfolio managers by stressing the dominance of the portfolio over its individual components. That means that managers should not blithely stuff portfolios with their favorite picks, ignoring the overwhelming importance of diversification. In fact, the diversification Markowitz calls for often requires managers to hold stocks they do not like in order to balance out the ones the do like.

Tobin's Separation Theorem goes even further, by rejecting the conventional method of designing each portfolio specifically for each customer. Rather, Tobin prescribes identical equity portfolios for all accounts, regardless of objective or risk aversion. So who needs separate portfolio managers for each group of clients?

Security analysts are also vulnerable. Samuelson and Fama and their ilk argue that stock-picking is an activity doomed to fail and that technical analysis is a dangerous waste of time. If the stock market is efficient and stock prices are a random walk, who needs security analysts to make recommendations to portfolio managers?

The worst was yet to come. According to Sharpe, the market portfolio is the most efficient portfolio of all. If all you have to do is buy the market, or an index that replicates it, who needs anybody to cary on the traditional activities of a trust department?"

M. F. M. Osborne argues that, since stock transactions occur only when there is a difference in opinion on the value of the stock that, for the market as a whole, the expected price change is zero. Interesting way to look at things.

Mia says

A good -- if ideologically uncritical -- history of the theories and theoreticians of modern finance, including the influence of the Chicago school. This is a book written by someone who believes(d?) in the system, so one shouldn't expect questions of human impact or ideology. It's all about the numbers. But if you ever wanted to understand the previous century on Wall Street (up to the early 90s) from that perspective, this isn't a bad place to start. I'm curious how the current economic situation would be described/perceived by the author (the updated volume was released in 2007, so still wouldn't cover everything that has happened since.)

Ali says

I have read the book 5 months ago. So my review may seem a bit "shaky". However, I will do my best to give general idea without spoilers.

Capital Ideas is without doubt a must-read book for anyone who is interested in Finance as discipline and as part of Economics that is focused on the economics of markets in general. It is even a good book for those interested in Science.

The book explains the beginning of the financial markets more specifically the, as I call it, mother of markets which is the U.S market represented by Wall Street. Taking you through a historical journey into the minds and players who shaped Wall Street. Going into details about theories and tools most Finance professionals and Business Schools use Today!

As Finance student I learned a lot and I think it is an essential book to read. Its always better to know the roots of your major.

Quinton says

This book depicts the tales of the proponents of the Efficient Market Hypothesis, including the following: Fisher Black, Eugene Fama, William Fouse, Hyne Leland, Harry Markowitz, John McQuown, Robert C. Merton, Merton Miller, Franco Modigliani, Barr Rosenberg, Mark Rubinstein, Paul Samuelson, Myron Scholes, William Sharpe, James Tobin, Jack Treynor, and James Vertin. It discusses the origins of the dividend discount model, CAPM, the Black-Scholes option pricing model, and other models.
The book displays the weaknesses and strengths of the EMH, but urges you to follow the ways of the

theorists, to help make the market more efficient, and thus help make the world a better place.
It is obviously a few years old, and thus doesn't really grasp the idea that EMH may never work, because unlike the laws of physics and math, the laws of economics/finance are based on the will of humans, who are fallible. In other words, they aren't laws, more like guidelines, that can be followed, or ignored.

It was an interesting read, but somewhat dry. I can't recommend this for anyone but those interested in the history of finance, and EMH. Any others will likely get bored...

Ridzwan says

French mathematician Louis Bachelier proved decades ago that the vast majority of "investors" who trade actively do not beat market averages. The cornerstone concept has since become the foundation of many contemporary investment management concepts such as the Modern Portfolio Theory (MPT), the Modigliani-Miller theorem, and more relatively recent ideas such as "portfolio insurance" expounded by Leland and Rubinstein. Capital Ideas is a treatise on how these concepts were conceived and developed, and how these have shaped Wall Street as we know it today.

John says

A little dated in the face of advances in behavioral economics, but a great comprehensive history of the development of the modern financial theories that influenced the way finance was taught to my generation of professionals.

Frank Stein says

The ideas in Capital Ideas have been covered elsewhere, but probably never as well. Peter Bernstein looked into every old academic journal and interviewed every old economist to help him understand how new ideas about efficient markets and financial engineering penetrated Wall Street and reshaped American finance. It's a great story of abstract economic speculation having a profound effect on real lives and real money. Bernstein himself is in a perfect position to explain these conjoined developments, since he worked as an academic economist and also ran a brokerage shop on Wall Street for decades.

While early Wall Street Journal editors Charles Dow and William Peter Hamilton argued that smart forecasters could predict changing tides in the market (the "Dow Theory"), a tubercular man named Alfred Cowles who invested his family's Chicago Tribune money decided to find out if they were right. After the 1929 Crash proved most of them wrong (Hamilton predicted it, but he had also predicted a crash in 1927, and two in 1928), Cowles founded the Cowles Commission for Research in Economics. With the help of Irving Fisher of Yale, he also founded the Econmetrica journal and discovered that most stock-pickers lost relative to the market. When Henry Markowitz worked with the Cowles Commission as a graduate student (of Jacob Marshak) at the University of Chicago in the 1940s, he used this data and research to formulate his theory of Portfolio Selection, which argued that there was an inevitable, and constant, tradeoff between risk and reward, and that risk was actually just a measure of the variance in one stock portfolio and the rest of the market. When the Cowles Commission moved to Yale in 1956, its new director James Tobin used

Markowtiz’s insights to show there was in fact one perfect portfolio for all individuals, and that all variations in risk should be managed by the amount held of a “riskless asset,” namely cash. Later, William Sharpe, working with Markowitz while the later was at RAND near UCLA, developed the idea of a single “index” by which all stock returns could be measured, which also helped simplify computer calculations about successful stock picks.

Other research influenced the budding new theories. In 1934 Holbrook Working showed that wheat prices followed a “random walk,” and couldn’t be predicted from former price changes. He showed random number charts to commodities traders and proved they could not differentiate them from actual market price changes. Later, at Carnegie Tech, the old hyperkinetic Keynesian Franco Modigliani and the Boston-born Merton Miller, argued that stock values were entirely independent of the way a company was financed, and that the best way to evaluate a company's investments was to see its effect on stocks.

These ideas all cumulated in the Capital Asset Pricing Model (CAP-M), created independently by William Sharpe, Jack Treynor, and John Lintner around 1963, and the Black-Scholes Options pricing model of 1972. These revolutionized the way stock brokers traded through showing that the overall risk in the stock market was the crucial variable to know and that variance of that risk for stocks and options was the crucial determinant of value.

Bernstein shows how these ideas gradually penetrated markets. They led directly to Wells Fargo’s first “index fund,” the Stagecoach Fund, and then to portfolio insurance for stocks in the 1980s. Bernstein points out the growth of the computer was essential in this change, since it allowed traders to use the complicated math models of the economists on the trading spot. On the whole, despite wallowing in too many obscure characters, this is another great book showing how great ideas really matter.
