



Capital Ideas Evolving

By Peter L. Bernstein

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—**John C. Bogle**, founder of The Vanguard Group and author, *The Little Book of Common Sense Investing*

"Just as Dante could not have understood or survived the perils of the *Inferno* without Virgil to guide him, investors today need Peter Bernstein to help find their way across dark and shifting ground. No one alive understands Wall Street's intellectual history better, and that makes Bernstein our best and wisest guide to the future. He is the only person who could have written this book; thank goodness he did."

—**Jason Zweig**, Investing Columnist, *Money* magazine

"Another must-read from Peter Bernstein! This well-written and thought-provoking book provides valuable insights on how key finance theories have evolved from their ivory tower formulation to profitable application by portfolio managers. This book will certainly be read with keen interest by, and undoubtedly influence, a wide range of participants in international finance."

—**Dr. Mohamed A. El-Erian**, President and CEO of Harvard Management Company, Deputy Treasurer of Harvard University, and member of the faculty of the Harvard Business School

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Editorial Review

Review

FIFTY years ago, the business of managing other people's money was very much an art not a science, and was largely a matter of finding someone who was privy to inside information. But during the 1950s, 1960s and 1970s, academics changed the study of what became known as portfolio management. They did so in the face of much initial resistance and scepticism from the industry.

In his 1992 book, "Capital Ideas," Peter Bernstein gave a magisterial account of the academics' thinking. The likes of Harry Markowitz, Bill Sharpe and Myron Scholes developed theories to explain the link between risk and reward, the gains to be made through diversification and the framework for valuing financial options.

In recent years, however, some of these concepts have come under attack. Critics have argued that the academics used too many simplifying assumptions, such as ignoring trading costs. A school of thought, known as behavioural finance, has proposed that investors are not as rational as the models assume and are subject to psychological biases, such as a reluctance to cut their losses.

Now Mr Bernstein has returned to the fray with a new volume in defence of his academic heroes. Although he accepts some of the theories' limitations, he argues that the professors built the structure for today's capital markets. Modern investors are much more sophisticated in the way they think about risk, in particular separating the returns available from market movements (beta in the jargon) and managerial skill (alpha).

The academic concept of efficient market theory--that prices already reflect all available information--has led to the creation of index-tracking funds that allow investors to own a diversified portfolio at very low cost.

Although behavioural financiers have spotted market anomalies, they have not shown that these can be systematically exploited: the average fund manager still struggles to produce a return that matches the index.

Indeed, Mr Bernstein seeks to show how financial giants such as Barclays Global Investors and Goldman Sachs Asset Management have built on the insights developed by the academics. If there are ways systematically to beat the markets these days, they probably require men with physics doctorates and massive computer power rather than a smooth manner and the right contact book.

There is the equivalent of a technological arms race as modern fund managers vie to find the best computer models and to trade quickly before their competitors spot the same opportunities. This race is making the markets more efficient, and so making the academics' models look more realistic than before.

As Mr Bernstein recognises, this frantic activity is something of a paradox. The academics have taught us to be suspicious of the claims of the investment industry. But if the fund managers were not beavering away trying to pick stocks, prices would not be set efficiently and the academics would be proved wrong.

Lacking its predecessor's historical sweep, this book is not quite as impressive a feat of scholarship. But Mr Bernstein has yet again produced a book that is insightful and thought-provoking. ("The Economist," June 15, 2007)

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"In both its sweeping account of investment ideas and the depth of the author's insights, "Capital Ideas Evolving" is unmatched." ("Financial Analysts Journal," July/August 2008)

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From the Inside Flap

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Praise For

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From the Back Cover

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