



The Myth of the Rational Market: A History of Risk, Reward, and Delusion on Wall Street

By Justin Fox, HarperBusiness, 2009; 382 pages; ISBN 978 0 06 059899 0
Reviewed by John Brock

Abstract

Justin Fox, a former *Time* magazine business journalist and current Editorial Editor for the Harvard Business Review Group, started *The Myth* well before the current financial crisis erupted, but its release in 2009 could hardly have been better timed. The book is a masterfully documented and engaging history of the rise and the fall of the efficient market hypothesis (EMH). The history spans from the early 20th Century insights of mathematician Louis Bachelier and economist Irving Fisher to the recent sparring among economists – notably the University of Chicago’s Eugene Fama and Dick Thaler.

The book explains the evolution of EMH from the early attempts to clarify the apparently random movements in the stock market, to Fama’s EMH formulation in the 1960s (the price of a financial asset reflects all publicly-available information that is relevant to its value) to Michael Jensen’s bold 1978 declaration that ‘there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis’ (p. 107). From its earliest characterisation, the powerful and mathematically eloquent theory of EMH has developed into a broader set of conclusions. Fox describes how EMH progressed from the observation that stock price movements were random, to the claim that it was impossible to predict stock prices and, finally, to the conviction that ‘stock prices were in some fundamental sense *right*’ (p. xiv). The author also keeps an eye on the skeptics, from Herbert Simon in the 1950s and psychologists Daniel Kahneman and Amos Tversky in the 1960s, to present-day behavioral economists such as Richard Thaler. The final chapter, ‘The Anatomy of a Financial Crisis’, provides an interesting account of the genesis of the crisis, concluding with Alan Greenspan’s admission in Congressional testimony that he used to think that he was not smarter than the market, but then ‘the whole intellectual edifice [of rational market theory] collapsed’ (p. xii). While EMH may have spawned overconfidence in markets and paved the way for deregulation and *laissez-faire* policy, the recession of 2007–09 will probably inspire a pendulum swing in the other direction.

Economists as well as professional investors will find the *Myth of the Rational Market* an enjoyable, stimulating and worthwhile read. Undergraduate or graduate students, particularly business and economics majors enrolled in a History of Economic Thought or Personal Finance course, will take pleasure in reading this fascinating and very thoroughly documented story (particularly after the first half, which could be a little slow for the uninitiated). The beauty of the book is that Fox has integrated a great deal of economic and finance theory into a summary of the contributions by many of the key contributors of the past century. He not only discusses their academic contributions, he cleverly infuses interesting personal anecdotes along the way. For example, he begins the book with the story of Irving Fisher, who had already overcome many personal tragedies, suffering the theft of the only copy of his

manuscript of *The Nature of Capital and Income* (stolen in 1905 while he was talking in a phone booth). Thankfully, Fisher was not one to quit, and he entirely rewrote 'one of the principal building blocks of all present-day economic theory' (p. 4). Another story is of Alan Greenspan's classic trademark phrase 'irrational exuberance', which Greenspan thought of while taking a bath. Readers will discover that prominent economists are people, too!

In addition to the enjoyable narrative, *The Myth* provides some worthwhile insights for students of economics. Beyond learning about the historical chronology and interconnections that form the basis of our current economic and financial theories, readers will discover an important message about the methodology of the discipline. While mathematics provides a very useful tool, it is no more powerful than the assumptions that form the basis for its application. In classroom instruction, economists use assumptions not because they are always accurate representations of reality, but because they help students grasp the underlying logic of a situation. However, in the real world of financial markets, invalid assumptions sometimes generate dramatic failures. The author's discussion of the 1998 Long Term Capital Management (LTCM) debacle is not only captivating, but will serve as an eye opener for students. As Robert Merton, LTCM partner and 1997 Nobel Prize winning economist, so aptly acknowledged: 'The mathematics of financial models can be applied precisely, but the models are not at all precise in their application to the complicated real world' (p. 236).

From the first chapter to the last, readers will learn about how theories evolve – a continuous battle of ideas between academic leaders at the forefront of the discipline. The author discusses Thomas Kuhn's introduction of paradigm shifts in his classic, *The Structure of Scientific Revolutions*. Without realising it, students will be immersed in a story that generates an appreciation and better understanding of the scientific method – another reason to adopt this book in a college economics or finance course. Mr. Fox goes beyond merely discussing the basic logic of the models by addressing the personal attachment that many of those involved (understandably) acquire toward the theories they were instrumental in developing. It is hard to change one's position once a reputation and career have been built upon it. As John Maynard Keynes so appropriately stated: 'The difficulty lies, not in the new ideas, but in escaping from the old ones' (Keynes, viii). One such example Fox cites is how University of Chicago Merton Miller began his finance class one day in the early 1960s: 'He drew a vertical line on the blackboard, wrote "M&M" [for Modigliani-Miller] as a heading to the left of the line and "T" to the right. A student raised his hand and asked what the T stood for. "Them", Miller responded' (p. 95–6). Throughout the book Fox provides interesting anecdotes that help elucidate how fervently the players in the efficient markets evolution fought for their ideas. (By the way, for those who have an aversion to mathematics, the book has no graphs or equations.)

Fox ends his story with a prognosis from Robert Shiller, the Yale University economist well known for predicting both the stock market crash in 2000 and the recent housing bubble. Replying to Fox's question about the future of finance, Shiller replies: 'I think we're less than halfway through the development of financial markets. Maybe there's no end to it' (p. 321). It may be entirely coincidental that until the University of Chicago Booth School of Business moved to a new building in 2004, Fama occupied the office directly above Thaler's. A quick directory search shows that their offices are now both on the 4th floor of the new building. Is this a portent of the future of economics and finance theory? Could it be that future models will balance Eugene Fama's views of the rational and efficient market with the behaviouralist theories of Dick Thaler? Now that Fama and Thaler are on equal footing – as it were – will economics continue its movement from *homo economicus* to *homo sapiens*? The *Myth of the Rational Market* does not explore these questions, but instead focuses on Edmund Burke's sage advice: 'Those who don't know history are destined to repeat it.'

References

Keynes, John Maynard (1935). *The General Theory of Employment, Interest, and Money*, New York: Harcourt, Brace & World, Inc. (reprint 1965).

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A History of Risk, Reward, and Delusion on Wall Street. Justin Fox. To Allison. But rational market finance was not at heart a political movement. It was a scientific one, an imposing of the midcentury fervor for rational, mathematical, statistical decision making upon financial markets. This endeavor was far from an unmitigated disaster. It represented, in many ways, the forward march of progress. The Myth of the Rational Market: A History of Risk, Reward, and Delusion on Wall Street. By Justin Fox. It's also a tale of Wall Street's evolution, the power of the market to generate wealth and wreak havoc, and free market capitalism's war with itself. The efficient market hypothesis - long part of academic folklore but codified in the 1960s at the University of Chicago - has evolved into a powerful myth. That myth is crumbling. Celebrated journalist and columnist Fox introduces a new wave of economists and scholars who no longer teach that investors are rational or that the markets are always right. Many of them now agree with Yale professor Robert Shiller that the efficient markets theory "represents one of the most remarkable errors in the history of economic thought." No, I just let other events that life creates bump it off my priority list. This book (The Myth Of The Rational Market: A History of Risk, Reward, and Delusion on Wall Street) primarily deals with two things: people and an idea. The people are thinkers, students, doctors of economics, mathematics, physics, finance, and business, and professors of those same disciplines. Many began as academics, but consulted for think-tanks or businesses, or created companies to exploit their own theories and work product. The idea, at its most basic, is that the "market" (e.g. bond market, stock market, commodities market) is efficient. The myth of the rational market: a history of risk, reward, and delusion on Wall Street. HarperCollins, 2009. 382p index ISBN 9780060598990, \$27.99 In Myth, respected editor and columnist Fox pits two heavyweight adversaries against each other: creators and adherents of the rational market versus their skeptical behavioral finance opponents. But Fox's volume, with its tantalizing chronological exploration of the eggheads and practitioners (from Irving Fisher and Paul Samuelson to Gene Fama, Fisher Black, Robert Shiller, Warren Buffett, and Alan Greenspan) and ideas (random walks, the efficient market hypothesis, portfolio and option pricing) will bring smiles and tears to readers' faces and should be a required complement for anyone interested in these debates. To read the full version of this content please select one of the options below. You may be able to access this content by logging in via Shibboleth, Open Athens or with your Emerald account. Login. To rent this content from Deepdyve, please click the button. Rent from Deepdyve. If you think you should have access to this content, click the button to contact our support team.