



Robo-Investors Beware: What You Don't Know Can Kill You: Books

By James Pressley - May 3, 2011

The world is ruled, for good or evil, by little more than ideas, as [John Maynard Keynes](#) observed.

One particularly fatal assumption is that markets follow mechanical rules, argue Roman Frydman and Michael D. Goldberg in "Beyond Mechanical Markets," a groundbreaking look at how to tame asset booms and busts.

Frydman is a professor at [New York University](#), Goldberg at the University of [New Hampshire](#). Together, they set out to expose most economic models, rational and behavioral alike, as misguided and downright dangerous.

Financial markets aren't utterly rational, almost perfect allocators of capital, they say. Nor are they mere casinos stampeded by herds of irrational gamblers. Yet these are the concepts that first led lawmakers to ignore the grotesquely swollen U.S. housing bubble and then, after the fizz went pop, left them trying to stamp out speculation altogether.

For all their differences, these two models share an "irreparable flaw," the authors say: They presume that individuals behave like robots in a world where the future unfolds mechanically from the past. In reality, of course, the future is unknowable and change unpredictable.

Serious investors, however rational, must base their decisions on incomplete information and watch out for technological innovations and other "non-routine changes." Do we know how many iPads [Apple Inc. \(AAPL\)](#) will produce next quarter? Does Federal Reserve Chairman [Ben Bernanke](#) have an exit plan? What you don't know can kill your portfolio.

Swinging Ever Higher

Confronted with imperfect knowledge and non-routine change, investors may revise their forecasts bit by bit for long stretches, tending to assume, as Keynes put it, "that the existing state of affairs will continue indefinitely." This is a reasonable thing to do.

Corporate earnings and other economic indicators can, after all, trend upward for years. As expectations rise, asset prices swing ever higher and overshoot -- until the inevitable moment when

enough investors decide valuations are unsustainable and, balking, pull back. Then the cycle slips into reverse.

Consider the U.S. in the 1990s. During much of the decade, indicators ranging from gross domestic product to productivity rose strongly, the authors say. This boosted optimism that a technology revolution was afoot, prompting analysts to raise forecasts and investors to bid up prices.

Speculative Excess

The boom was more than a phantasm. Though psychology was in play, it was tethered to real trends. Companies old and new in the early '90s were busy using novel [information technology](#) to lower their costs and improve their products.

Later on, of course, the market went mad. One [Internet company](#), [Theglobe.com Inc. \(TGLO\)](#), surged 606 percent on its first day of trading. By then, speculative excess had pushed the upswing way past its due date.

Thus asset price swings both allocate capital and, all too often, misallocate it, as the U.S. housing debacle showed. Until we understand what drives price swings, we can't hope to avert another crisis.

For Frydman and Goldberg, the answer lies in that cocktail of imperfect knowledge, non-routine change and psychological influences such as confidence. To illustrate their argument, they cite U.S. stock-market reports published by Bloomberg News. These market wraps "provide a window into the decision-making of the professional players whose trading determines prices," they write.

'Strong Conclusion'

Drilling into the reports, a doctoral student advised by Goldberg, [Nicholas Mangee](#), extracted data showing what factors influenced daily prices from Jan. 4, 1993, through Dec. 31, 2009. On virtually every day of the sample, Bloomberg journalists (and the fund managers they quoted) cited fundamental factors such as earnings and interest rates as a driver of prices. On 55 percent of the days, at least one psychological factor -- think fear and greed -- cropped up.

"Bloomberg's market-wrap stories yield an exceptionally strong conclusion," the authors write. "In virtually no cases do psychological or technical considerations alone move the market."

If the fund managers quoted in these news reports are right, prices feed on non-routine changes in such things as earnings and [oil prices](#). Contrary to mechanistic models, investors aren't robots; they are humans making decisions about the future and choosing, as Keynes said, "between alternatives as best as we are able."

The challenge in this world of imperfect knowledge is to keep asset prices from swinging so far out of whack that they grossly misallocate capital and devastate society. That's where the state comes in.

Damping Swings

Governments could post guidance ranges for reasonable values in various sectors and indexes, the authors say. These ranges would draw on historical benchmarks, which show that markets do correct themselves once price-earnings ratios cross certain thresholds.

The state also could back up its guidance with actions designed to damp the frequency and magnitude of excessive swings. If prices soar above or swoon below the range, investors might face higher [interest rates](#) or greater margin and collateral requirements. A sensible approach, assuming regulators have the guts to hit the brakes.

Though "Beyond Mechanical Markets" spares us equations, it isn't for anyone who suffers from attention-deficit disorder. Readers must digest sentences stretching beyond 40 words and exegeses on the Rational Expectations Hypothesis. They also must bear with an account that says surprisingly little about the role of credit growth in asset bubbles.

Yet of all the books I've read on the crisis that began in 2007, this one comes closest to laying a foundation for a more pragmatic and genuinely useful school of economics.

"Beyond Mechanical Markets: Asset Price Swings, Risk and the Role of the State" is from [Princeton](#) (285 pages, \$35, 24.95 pounds). To buy this book in [North America](#), click [here](#).

(James Pressley is a book critic for Muse, the arts and leisure section of Bloomberg News. The opinions expressed are his own.)

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