Frydman, Roman and Goldberg, Michael D. – Beyond Mechanical Markets

Princeton University Press, 2011, [Economics] Grade ★★★★★

Beyond Mechanical Markets is among the best and most rewarding books I have read for a long time. Two renowned professors at NYU and UNH, present an economic theory—Contingent Market Hypothesis—that explains how the financial markets really work. I believe most seasoned investors will agree, and even applaud the reasoning, though a naïve practitioner might say there is nothing new here. In reality it is actually a forceful attack on contemporary economic and finance theory. I have never read a more elegant explanation on why the Efficient Market Theory (EMT) has such empirical failings, nor have I genuinely understood the epistemological flaws with Behavioural Finance (BFT) before. Financial markets are neither predictably "rational" nor irrational. Both fundamental and psychological factors matter, but not in a way that can be pre-specified with mechanical rules.

The book's main purpose is to bring back the notion of imperfect knowledge and non-routine change in fundamentals into economics and finance. There are many well-grounded statements in the book that contrast current mainstream theory, e.g.: Outcomes of financial markets are not predetermined with a minor random error component (EMT); We are not think-alike robots in a mechanical system (Rational Expectations Hypothesis, REH); Sustained larger swings—bubbles—in asset prices are not due to irrationality (BFT). It is understandable why most academics prefer a deductive approach—with rigor and consistency in focus. But knowledge in social sciences evolves over time and when facts change, we change our minds and therefore our forecasting and forecasting strategies.

The book consists of two parts: The Critique and The Alternative. Both are intriguing readings. The Critique is very educational. Even true believers in efficient markets will get some musings. It's also fascinating—and scary—to witness how some descriptive theories from doubting professors can develop into a decisive dogma. Anyone reading the original works of John Muth (REH), Paul Samuelson (Martingale Property Model) and Eugene Fama (EMT) will be surprised how this fusing could turn out into strong beliefs that the outcomes of financial markets are predetermined. Why are we not more sceptical to today's mantra with index funds? Actually, some of the assumptions behind these theories are so absurd it is almost funny.

In the Alternative, the authors reintroduce some of Keynes' thoughts with a slightly new interpretation which is probably the most interesting part of the book. Keynes' segmentation of market participants into short–term and value speculators and their dynamic interactions, is one of the foundations in their theory. Non-routine changes in the currently important fundamentals, occasionally reflexive forces, moderate guarded revisions due to uncertainly, the speculators' different investment horizons and risk perceptions are key variables to explain swings in asset prices and their boundaries although not their magnitude and duration. And risk is not volatility—it is the gap between price and value. The Contingent Market Hypothesis, although not perfected yet, is appealing in many ways. Even some of the "puzzles" are no longer anomalies with their theory.

But the book has some minor flaws too. The final chapter on policy feels a bit sketchy. The target audience is slightly unclear. It is written in a non-specialist language but without good insights in economics and finance it is a difficult read. The sentences sometimes even complicate an already complex subject. Moreover, the basic conclusions are repeated too often in my opinion. Better if the book had been shorter and more concise.

All in all, it's a great thought-provoking book. A measured economic theory that acknowledges the workings of portfolio managers and financial analysts… *"The fact that it is possible, and that some individuals do succeed, provides powerful incentives to look for signs of change and attempt to speculate on them."*

Michael Persson, September 6, 2014