Book Reviews by Ian Robertson

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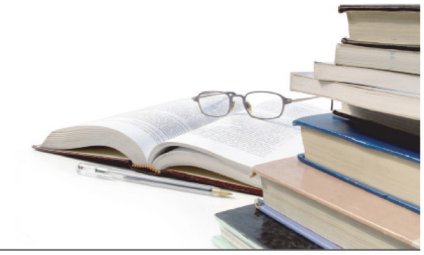
Ian Robertson, CFA, MBA, MA – Vice President, Director, Portfolio Manager | T 604 844 5424 | Toll Free 1 888 886 3586 | irobertson@odlumbrown.com
Odlum Brown Limited | Suite 1100 – 250 Howe Street | Vancouver, BC V6C 3S9 | Member-Canadian Investor Protection Fund

Title: ***A Demon of Our Own Design***

Author: **Richard Bookstaber**

First Edition: **Wiley (2008)**

Reviewed: **February 2013**



A look at "the perils of financial innovation."

Rating:
★★★★★
Out of 5 Stars

With its publication predating the financial meltdown of 2008 by a year, this well-written book about "the perils of financial innovation" promises an insider's view of what ailed the system; neither a postmortem nor a prediction, but rather a detailed diagnosis of the *corpus financius*. For the most part, Bookstaber, a former trader and head of risk management at several major Wall Street firms, delivers a very entertaining thirty year history of financial innovation and folly. Over time, risk is sliced or packaged in ever more innovative ways, leading to profits for traders and firms, and ultimately and inevitably outsized losses for shareholders when a bet turns bad.

Bookstaber writes about the stock market crash of 1987 (outlining both the cause and his role), the rise and fall of bond giant Solomon Brothers, the financial colossus that was Citigroup, and the rise of hedge funds. He includes many interesting anecdotes, at one point describing an innovative product developed by UBS which readers will recognize as index-linked CDs (in Canada GICs) offered a few years later by many retail bank branches, as well as some historical detours that provide context or an introduction to the issue at hand.

Readers shouldn't worry about the seeming complexity of the subject matter, as Bookstaber explains complex ideas and market mechanics very well, without jargon or condescension. Along the way, he takes the accounting profession to task (echoing former SEC chair Arthur Levitt's critique of a few years earlier), provides an explanation of efficient markets and the mathematical underpinnings of economics, and offers an excellent introduction to hedge funds by outlining different trading strategies and the importance of liquidity.

Bookstaber writes with wonderful turns of phrase, and more than once I found myself smiling at his witty but understated delivery. Describing the new market hotshots called risk arbitrageurs, he writes, "During the takeover boom of the 1980s, they were voracious, sharks that preyed on other sharks. They bet on who would take over whom. The most prominent names in this business included Ivan Boesky, who would later be arrested, and Robert Rubin, who would later be Secretary of the Treasury." As we know now, Rubin would later preside over Citigroup's risk mismanagement and its financial collapse. It seems the only shark with its reputation unsullied is the Long Island resident introduced to us a few years earlier by Peter Benchley.

Despite the excellent content and storytelling, I have a few small quibbles. First, and an issue which applies equally to the stock market reports on our daily news as it does to Bookstaber's book; references to stock market point drops are meaningless unless readers know the starting index level (and it's different for each of the Dow Jones, S&P 500 and NASDAQ). All market movements should be reported in percentages. Second, history has proved some comments inaccurate. For example, Bookstaber's comment that "mortgages have little in the way of default risk" may have been true historically, but of course has been proved disastrously wrong since. Third, his defense of hedge funds and their beneficial role in markets seems too biased, perhaps owing to his previous employment at a hedge fund. Hedge funds may well provide market liquidity, but their benefits and costs to the financial system are much more complex than Bookstaber pretends. Read for example the ongoing debate about today's high frequency trading and its impact on the transparency and stability of markets; liquidity runs amok, and to whose benefit?

Two larger issues, unfortunately, prevent the book from being truly outstanding: its divergent focus and its weak conclusion. Bookstaber may have been aiming to demonstrate our financial demon by recounting his involvement in various events, but unfortunately the high level of detail about the people involved gives it the feel at times of a memoir rather than a book with important lessons. Readers can skim much of the personal detail without losing any of the terrific content, but the lack of focus does detract from the overall effect. Bookstaber could have taken a lesson from Peter Bernstein's landmark book *Against the Gods: The Remarkable Story of Risk* in how to retain only the important details and remain both engaging and on message.

Curiously, despite his chronicles of others' bets gone bad, he remains confident that his own trades - shut down by senior management - would have paid off handsomely. Bookstaber's hubris ultimately limits the book's full potential, and after an excellent description of the symptoms, he unfortunately concludes with an unreflective diagnosis and an uncritical prescription. His prescription is for simpler financial products and less leverage. Prescient, given the incredibly leveraged financial system and undecipherable mortgage-based securities at the root of the following year's crisis, but vague and unhelpful. He is on firmer ground in his caution to regulators (is he talking directly to Alan Greenspan here?) that "it may be dangerous to assume that institutions behave rationally," and more solid ground still when, after introducing the notion of uncertainty and the impact of observation on the outcome (Heisenberg's Uncertainty Principle), he cautions that increased regulation may be counterproductive as it could have large, unforeseen and unintended consequences on the market.

Bookstaber is an expert on risk, an insightful and edifying guide, and a first-rate storyteller who has delivered an entertaining and educational tour of the risk of markets. Despite the criticism noted above, *A Demon of our Own Design* is a worthwhile read and a welcome addition to our understanding of risk in capital markets.