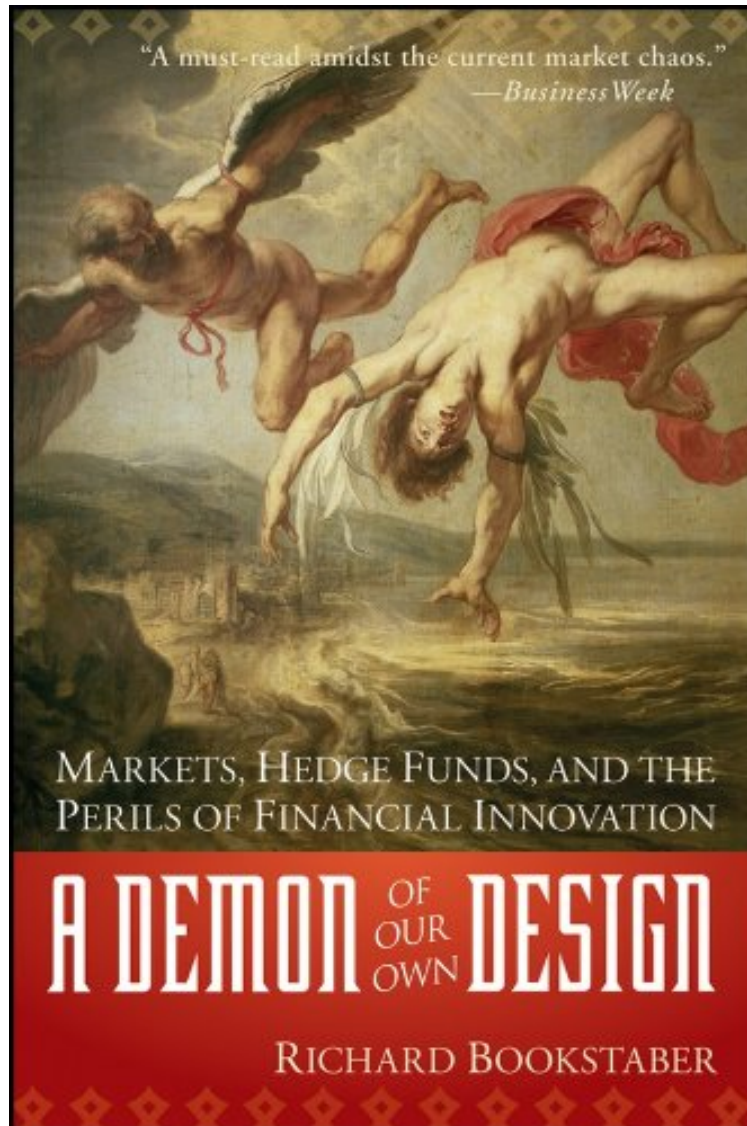


(Free pdf) A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation

A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation

Richard Bookstaber

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Richard Bookstaber : A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation before purchasing it in order to gauge whether or not it would be worth my time, and all praised A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation:

2 of 2 people found the following review helpful. Undoubtedly, one of the best books in my financial markets collection By Santiago Herrera Loved this book. I cannot explain how much I've learned and how much I have highlighted and commented on this book. The main topic of the book is complexity (as bred by a constant urge to

innovate in financial products) and how it related to financial crises. The author asks a fundamental question that not many have asked (unless asked trivially): Do we need to further innovate in financial markets? Is it beneficial that we have squared-CDOs and credit default swaps linking areas of the financial markets and the economy that were not linked before? It also addresses the topic of financial regulation and explains how more regulation might lead in fact to the next crisis. A great read, highly enjoyable. Plus, the book is filled with anecdotes, I'd go further and say it is anecdote-based, which makes the reading a lot more interesting and helps better understand tight coupling, normal accidents, systemic risk, etc. An amazing book, I've recommended it to other finance attorneys (like myself) and to anyone interested in understand the inner workings of investments banks, financial firms, hedge funds... I could ramble on for a while, I'll just say, an amazing book.

2 of 2 people found the following review helpful. The man that got it right

By Steve Klein

Richard Bookstaber published this book in 2007 indicated he wrote it well over a year before the crisis. The book articulates the primary concerns of the financial innovation unleashed in the last 30 years on the system that are the roots of the 2008 meltdown. The combination of excessive leverage and "tightly coupled systems" like the interconnectedness of the institutions that make up the financial system due to counter party risk and liquidity feedback loops, will mean that fairly small, unexpected events can cause system wide disaster. Bookstaber learned these lessons first hand from his perch at bulge bracket banks during the 87 crash and the LTCM debacle. Of course about a year after his book came out the financial system collapsed. In the years since, the "too big too fail" explanation hasn't rang true as more people come to the realization that excessive leverage and tight coupling are the culprits which lead to institutions that are too interconnected to fail. This is the most credible book pre-crises that's out there warning of the larger risks to the system that our financial innovation has produced.

7 of 8 people found the following review helpful. Great book just released before the financial crisis

By Abacus

Reading this book five years after its release, one has to admire how prescient the author was. He gives you a brilliant insider account of all the ways our financial system has faltered and will falter. Less than a year after the book release the financial system crashed for reasons detailed in the book including leverage, liquidity, regulatory, and complexity issues. This book is superior to Taleb's just released *Antifragile: Things That Gain from Disorder* that covers the same subject. The author explains numerous financial crises that occurred since the early eighties in technical details. However, on pg. 241, he synthesizes his analysis in just a few concise sentences. The 1987 crash was a vicious downward spiral caused by hedging actions (selling futures short associated with portfolio insurance) that reinforced the decline in stock values causing further hedging actions. The LTCM meltdown was caused by the forced asset sales at liquidation price triggered by creditors that resulted in further asset price decline. The dot.com bubble was due to the majority of traders being on the buy side of a very limited supply of hi-tech stocks that created a feedback loop of self-fulfilling prophecy. When dot.com IPOs met and exceeded investor demand, the market collapsed. In other parts of the book, he spends tens of pages on each of those crises. But, in a nutshell that is pretty much what they were about. The key explanatory chapter is chapter 8 titled "Complexity, Tight Coupling, and Normal Accidents." Here the author explains how systems that are complex with many interconnected variables with unpredictable, nonlinear effects, that in turn are associated with tight coupling (denotes a chain-like reaction without much time to react or adapt to the consequence) are recipes for disasters. Those are called "normal accidents" meaning they are to be expected; but, you can't expect what they will be. So, you can't prevent them. "The more complex and tightly coupled the system, the greater the frequency of normal accidents." The author depicts numerous failures of complex systems with various levels of tight coupling including nuclear plants disasters (Three Mile Island, Chernobyl) and aerospace disasters (Challenger and Columbia missions that both killed seven crew members). Financial derivatives make for perfect complex systems with tight coupling. They have numerous unpredictable nonlinear outcomes, high leverage, and lightning quick trading. Those characteristics make for what Warren Buffet called "financial weapons of mass destruction." Adding to the vulnerability of financial complex systems is the "Butterfly Effect" (reference to Chaos theory). As financial models make even fractionally small errors, those tiny errors over multiple iterations compound and generate huge intractable outcome errors. Another cause of complex vulnerability is scale. The business world has focused on economies of scale to extract a cost competitive edge. But, beyond a certain point scale does not contribute to economies but instead to complexities. In chapter 7 titled "Colossus" Bookstaber describes the forming of a financial conglomerate monster: Citigroup. He headed a market risk management group at Salomon that got acquired by Citi. And, he describes how the risk management function became unmanageable. Externally, tracking risk exposures globally in so many instruments, businesses, and geographies became impossible. Internally, the change in corporate scale expanded his risk management group to a dysfunctionally large level. Bookstaber indicates that regulations does not work in reducing the risk within financial complex systems. By forcing banks to reduce existing risk exposures, they are forced to sell assets. Those forced sales cause asset values to drop further forcing further asset sales. This relates to Fisher's The Debt-Deflation Theory of Great Depressions. "Trying to control the risk ends up creating a liquidity crisis." Forcing hedge funds towards increasing transparency is a self-defeating proposition. Hedge funds competitive edge are proprietary strategies. If their accounts become transparent, they pretty much go out of business. Bookstaber makes an interesting connection between Heisenberg's Uncertainty Principle and finance (pg. 223). In the quantum world, you can't improve the measurement of an electron's speed without impairing the measurement of its location. In

the finance world, you can't increase transparency without decreasing liquidity. As mentioned, transparency would impair the hedge fund sector. And, the latter is the major liquidity provider for illiquid assets. Without hedge funds many such markets would not be viable. If upcoming regulatory constraints do not impair the hedge fund sector, Bookstaber anticipates it could become a dominant force within the institutional investment world. His take is that if you take two equally brilliant investors, and the first one is limited to "long" strategies only and the other one is not and can avail himself to all sorts of other investment strategies, the latter one should prevail. And, that describes the difference between a traditional mutual fund and a hedge fund. However, that is one instance where I may question Bookstaber's opinion. The hedge fund has to deliver gross returns that are so much higher than the mutual fund because it charges so much more (1% operating expense and 20% of profits vs only the 1% for the regular mutual fund). Bookstaber suggests the hedge fund compensates for that because of the inherent leverage in hedge fund strategies. But, by doing so a hedge fund takes on risk that renders it much more fragile than a regular fund. Earlier, Bookstaber states that many hedge funds "win a little, win a little, than lose a lot." Thus, hedge funds blow ups are more frequent than mutual fund ones. Additionally, there is already too much money in hedge funds to chase too few market inefficiencies. This ultimately makes a case for neither hedge funds or regular mutual funds but index funds instead. Bookstaber addresses the Efficient Market Hypothesis (EMH) in a most interesting way. He understands the subject better than most as he wrote his economics PhD thesis on the transmission of information through the markets. Bookstaber states that stock prices are driven by two components: one is information, and the other is liquidity factors. The EMH covers only partly the information component. That's because it makes some liberal assumptions such as that traders are perfectly rational, and that their actions do not affect the markets. But, the EMH does not cover the liquidity factors. Those include the actual float or supply of each stocks, transaction costs, and leverage constraints. And, often liquidity factors are the predominant drivers of investment prices. Bookstaber states on pg 213 "[liquidity] is the primary driver of crashes and bubbles as well." This makes sense. The information component is disseminated instantly and should be fully reflected in stock prices at all times (the EMH take). But, liquidity factors can get markets out of whack. As Bookstaber explained, the dot.com bubble was mainly fueled by a very small float (short supply) of hi-tech stock at the onset. Bookstaber describes interesting statistical arbitrage strategies (paired stock trading) devised to differentiate between the information component of a stock price, that typically does not mean revert in the short term, vs the liquidity component that does. He indicates that this is easier said than done. As usual, the early traders who devised those strategies made a lot of money. But, the market is a rapidly learning machine and those Alpha returns were pretty much arbitrated out a long time ago. So, that's the puzzling thing about the EMH. The theory is far from perfect. Yet the markets are brutally efficient. Alpha returns depend on traders coming out with new investment strategies until they are replicated. At such point, they are forced to uncover Alpha returns some place else. So, efficiency is a moving target. In the conclusion, Bookstaber makes recommendations on how to reduce the fragility of our financial system. We should reduce the tight coupling within the system. He proposes to do that by reducing leverage which in turn reduces liquidity and the speed of market activity (tight coupling). He also recommends selective evaluation of financial innovations to prevent dangerous complexities. Insiders will not like Bookstaber's recommendations and will argue that financial innovation has greatly improved wealth creation worldwide. But, you have to distinguish between benign vs complex financial innovations. It is easy to argue in favor of ATMs, debit cards, new mobile payment mechanisms, and online banking innovations. But, did we benefit from MBS, CDOs, and SIVs? Certainly not lately!

Inside markets, innovation, and risk Why do markets keep crashing and why are financial crises greater than ever before? As the risk manager to some of the leading firms on Wall Street— from Morgan Stanley to Salomon and Citigroup— and a member of some of the world's largest hedge funds, from Moore Capital to Ziff Brothers and FrontPoint Partners, Rick Bookstaber has seen the ghost inside the machine and vividly shows us a world that is even riskier than we think. The very things done to make markets safer, have, in fact, created a world that is far more dangerous. From the 1987 crash to Citigroup closing the Salomon Arb unit, from staggering losses at UBS to the demise of Long-Term Capital Management, Bookstaber gives readers a front row seat to the management decisions made by some of the most powerful financial figures in the world that led to catastrophe, and describes the impact of his own activities on markets and market crashes. Much of the innovation of the last 30 years has wreaked havoc on the markets and cost trillions of dollars. A Demon of Our Own Design tells the story of man's attempt to manage market risk and what it has wrought. In the process of showing what we have done, Bookstaber shines a light on what the future holds for a world where capital and power have moved from Wall Street institutions to elite and highly leveraged hedge funds.