

Financial analysts, economic historians, and actuaries may find useful the book's numerous data series, but they may equally reproach the author for the book's editorial shortfalls. On page 103, for example, a quote from John Maynard Keynes' *The General Theory of Employment, Interest and Money* is fumbled, and the egregious muddling of words is plain sloppy. The book's layout also disappoints. Most pictures are grainy, and numerous text boxes and data tables run over onto successive pages; they thus hinder rather than help reading.

These cosmetic blunders, which a second edition ought to correct, might unfairly cast Poitras's research as amateurish rather than erudite. On balance however, the book fosters appreciation of our global profession's early beginnings and is well worth reading.

—D.E.M.

***Puzzles of Finance: Six Practical Problems and Their Remarkable Solutions.* By Mark P. Kritzman. John Wiley & Sons, 605 Third Avenue, New York, NY 10158-0012, 212-850-6336 or 800-225-5945. 187 pages, \$29.95.**

*Reviewed by Mark S. Rzepczynski, senior vice president, Research & Trading, John W. Henry & Company, Concord, Massachusetts.*

A disappearing cultural phenomenon is the nonacademic essayist who writes not because of a publishing requirement but out of a heartfelt need to address an issue. Contemporary finance debates are often mired in the stilted and arcane language of an elite who have a mastery of abstract concepts and statistics, but the debates have little appeal to most practitioners, who have less advanced training and must deal with reality. Mark Kritzman is, in

the finest sense, a popularizer who can describe complex questions and then answer them in clear and precise language. In *Puzzles of Finance: Six Practical Problems and Their Remarkable Solutions*, he teaches some key fundamentals of finance through intriguing paradoxes and anomalies.

*Puzzles of Finance* consists of a set of essays on problems that involve considerable complexity but are essential to a grasp of basic finance. The book's lessons are equally informative for a large pension plan sponsor, an individual investor, or an analyst. Of course, anomalies often yield to rational explanation upon careful examination. Thus, when dissected by a skilled writer, these initially vexing puzzles prove to be mere curiosities or obvious misunderstandings of fundamental concepts.

Kritzman describes six finance puzzles—the Siegel Paradox in foreign exchange, the definition of likelihood of loss, the time diversification problem, why the expected return is not always expected, the choice between all stocks half the time or half stocks all the time, and the irrelevance of expected return for options.

The Siegel Paradox is an interesting anomaly in which the expectation of the reciprocal of an exchange rate is greater than the reciprocal of the expectation of the exchange rate. Gains from knowing this fact have been illusory, but Kritzman uses it to set the tone for the book by showing that the obvious is not always so obvious and that there is relativity in finance. Although perceived gains and losses are clearly related to perspective and definition, this observation does not mean that finance contains no truth. The point is that sound financial thinking can be achieved only through precision in terms and agreement

of assumptions. The devil is always in the details.

The likelihood-of-loss problem is a better example of financial relativity or ambiguity than the Siegel Paradox because we all want to avoid loss but we may not agree on exactly what we fear losing. Substantial differences exist between the likelihood of a loss on average, a loss in at least one period over time, penetration of a loss threshold, a cumulative loss over time, and the loss during a single period. Any risk manager who has had to explain how to interpret value at risk to a board of directors will affirm that the meaning of loss changes with perspective and is a starting point of confusion. Indeed, there is risk in simply trying to understand exactly what you intend to protect.

The question of time diversification is another fundamental issue of investing that every practitioner should understand. Financial planners, based on the concept that likelihood of loss diminishes with time, commonly place younger investors—who have long horizons—in stocks. This strategy makes sense, however, only under a special set of assumptions. If stocks follow a random walk, a risk-averse investor may find it a false approach. An investor's utility function is relevant, but determining how to measure utility beyond simple questionnaires has not always been on the top of research agendas.

The power of compounding has customarily been viewed as an unalloyed benefit to investors. In the section "Why the Expected Return Is Not to Be Expected," Kritzman, however, gives us a flavor of the dark side of compounding and the true meaning of expected return. By definition, there is a 50 percent likelihood that our actual returns will be below their expected value. Thus,

reliance on a single expectation is clearly perilous. Investors must bear in mind that they can easily go broke in a long-term investment that has an expected return of 10 percent. Accordingly, one can make a strong case for the necessity of analyzing *distributions* of simulated future returns.

Placing too little emphasis on risk is another source of anomalies. Under the pithy heading of "Half Stocks All of the Time or All Stocks Half the Time," Kritzman shows that, although you may be indifferent about the expected return in a stylized example, your risk preferences in reality will clearly guide you to one solution. Through his simple illustrations, Kritzman argues persuasively for balanced investing. He extends the puzzle to more complex issues, such as market timing and switching between cash and stocks, in which he finds that bounds on the size of the switch allow for a reduction in required skill. In general, investors will be better off if they constrain their money managers' timing behavior.

Kritzman's final puzzle addresses the classic issue of the irrelevance of expected return for option valuation. Arbitrage arguments, the workhorse of modern finance, provide a clear framework for showing why expectations and risk preferences do not enter the valuation decision. Kritzman demonstrates the surprising simplicity, as well as the elegance, of this result, which is the culmination of years of arduous work.

What is the importance of the specific puzzles that Kritzman has chosen relative to all the issues in modern finance? It is hard to say. I take issue with some of his choices, such as the Siegel Paradox, and would include others that I believe have greater practical impacts on the professional lives of *Financial Analysts Journal*

readers. Here are a few that I would add:

- The equity premium. What asset allocator does not fret over the magnitude of expected excess returns from equity and whether the relationship between equity and fixed-income returns has changed over the last decade?
- The home bias associated with international diversification. Why don't investors hold more geographically diversified portfolios? (Incidentally, inadequate geographical diversification also plagues domestic-only investors who show a bias toward local or regional companies.)
- The persistence of active management, from both the supply and the demand side, in the face of empirical evidence detailing the inability of managers to create positive alpha.
- Any of the behavioral finance problems that have created a plethora of anomalies.
- The continued inability of many practitioners to grasp fully the wide-ranging implications of the arbitrage arguments underlying such theorems as Modigliani-Miller's irrelevance of capital structure.

Many of these issues represent, to be sure, potential books unto themselves, whereas Kritzman may have had more modest goals in selecting his puzzles. In any event, he expertly handles the puzzles he does explore.

A forceful unifying addition to Kritzman's book would have been a fuller development of the thread that weaves all of his puzzles together. Kritzman misses this opportunity to highlight the most significant problem of all finance: The inability of practitio-

ners to understand or quantify probability has created a world in which investors are victims, not controllers, of the risk versus return trade-off. Still, we would be in worse condition if Kritzman had not encouraged us to come to grips, at long last, with our limited understanding of the issues he does raise in *Puzzles of Finance*.

—M.S.R.

***The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic.* By James P. Hawley and Andrew T. Williams. University of Pennsylvania Press, P.O. Box 4836, Hampden Station, Baltimore, MD 21211-0836, 800-445-9880. 232 pages, \$47.50.**

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According to the authors of *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic*, by 1997, institutional investors owned almost 60 percent of the outstanding equity of the 1,000 largest U.S. corporations. The top 25 institutions alone owned 28 percent of the equity of the 25 largest corporations.

Most investment professionals are aware of the growing power of the managers of public and private pension funds, mutual funds, and other fiduciary accounts, but this useful book spells out the details through extensive tabulations of the institutions, the corporations they influence, their investment styles, and their proxy strategies. Most importantly, the authors show the impact of institutional investors on the equity markets, on corporate governance, and indeed on the national economy.

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