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BOOK REVIEWS

Capital Ideas and Market Realities: Option Replication, Investor Behavior, and Stock Market Crashes. By JACOBS (BRUCE I.). (Oxford and Cambridge, MA: Blackwell, 1999. Pp. xx+399. £55.00 hardback, £19.99 paperback. ISBN 0 631 21554 9, 0 631 21555 7.)

Bruce Jacobs' *Capital Ideas and Market Realities* is an important contribution to a fundamental debate concerning the workings of financial markets. Jacobs' polemical but scholarly critique of orthodoxy is endorsed enthusiastically by Markowitz, no less, in a powerful foreword so it has to be taken seriously. Jacobs himself is an erstwhile academic who has become an important market player. Orthodoxy is taken by Jacobs and Markowitz to be the view that the efficient market hypothesis is a good guide to the workings of financial markets, and that in consequence they are benign in their impact on society. In particular financial innovation is likely to generate both private gains and social benefits through improving informational efficiency. The alternative is that markets over-react and may be better characterised by bubble models. Markowitz focusses on the basic point that instability (in the Micro 2 sense) can result if market participants buy when prices rise, and sell when prices fall. Hence any financial technique is to be viewed with suspicion if it induces such behaviour. Various portfolio replication *modus operandi* inspired by Black-Scholes do this and are prone to destabilise market strategies, whereas strategies inspired by Markowitz' own work stabilise markets. Markowitz' brief piece is extremely useful in putting Jacobs' work into context. Jacobs' main proposition is that unlike portfolio, insurance was a major cause of black Monday in 1987 when stock market prices fell by over 20% in single day. Jacobs devotes 25% of his book to an exposition of portfolio replication in general, and portfolio insurance in particular.

Over half of the book examines 1987 and the rest of the book – called an epiloque by the author – to what Jacobs terms 'sons of portfolio insurance'. As the latter included the collapse of *Long-term Capital Management*, I think this balance of the book is disappointing. I do not wish to decry the importance of debates about the nature of Black Monday; classic bubble or efficient reaction to news. Jacobs' collates an extremely lucid and useful survey of the literature on the topic. He presents it in an exceptionally non-partisan manner given the strength of his own opinions. However, Jacobs adds little fresh to this debate. On the other hand the implications of the collapse of *Long-term capital management* are still an open question. There is much written about it ranging from a Presidential task force through Dunbar's up-market journalism to Edwards' *Journal of Economic Perspectives* and Mckenzie's pioneering synthesis of economics and sociology. A survey and critique of this would have been both useful and telling. There is a danger that Jacobs' work will be viewed as dated or at best history. This is a shame as his insights are still crucial and relevant.

DAVID GOWLAND

University of Derby

  Published by Blackwell Publishers, 108 Cowley Road, Oxford OX4 1JF, UK and 350 Main Street, Malden, MA 02148, USA.