

THE
MYTH
OF THE
RATIONAL
MARKET

*A History of Risk, Reward,
and Delusion on Wall Street*

JUSTIN FOX



HARPER
BUSINESS

An Imprint of HarperCollins Publishers

CONTENTS

INTRODUCTION: IT HAD BEEN WORKING
SO EXCEPTIONALLY WELL *xi*

EARLY DAYS

1. IRVING FISHER LOSES HIS BRIEFCASE,
AND THEN HIS FORTUNE 3

The first serious try to impose reason and science upon the market comes in the early decades of the twentieth century. It doesn't work out so well.

2. A RANDOM WALK FROM FRED MACAULAY
TO HOLBROOK WORKING 26

Statistics and mathematics begin to find their way into the economic mainstream in the 1930s, setting the stage for big changes to come.

THE RISE OF THE RATIONAL MARKET

3. HARRY MARKOWITZ BRINGS STATISTICAL
MAN TO THE STOCK MARKET 47

The modern quantitative approach to investing is assembled out of equal parts poker strategy and World War II gunnery experience.

4. A RANDOM WALK FROM PAUL SAMUELSON
TO PAUL SAMUELSON 60

The proposition that stock movements are mostly unpredictable goes from intellectual curiosity to centerpiece of an academic movement.

**5. MODIGLIANI AND MILLER ARRIVE AT A
SIMPLIFYING ASSUMPTION 75**

Finance, the business school version of economics, is transformed from a field of empirical research and rules of thumb to one ruled by theory.

**6. GENE FAMA MAKES THE BEST
PROPOSITION IN ECONOMICS 89**

At the University of Chicago's Business School in the 1960s, the argument that the market is hard to outsmart grows into a conviction that it is perfect.

THE CONQUEST OF WALL STREET

**7. JACK BOGLE TAKES ON THE PERFORMANCE
CULT (AND WINS) 111**

The lesson that maybe it's not even worth trying to beat the market makes its circuitous way into the investment business.

**8. FISCHER BLACK CHOOSES TO FOCUS
ON THE PROBABLE 132**

Finance scholars figure out some ways to measure and control risk. More important, they figure out how to get paid for doing so.

**9. MICHAEL JENSEN GETS CORPORATIONS
TO OBEY THE MARKET 153**

The efficient market meets corporate America. Hostile takeovers and lots of talk about shareholder value ensue.

THE CHALLENGE

**10. DICK THALER GIVES ECONOMIC
MAN A PERSONALITY 175**

Human nature begins to find its way back into economics in the 1970s, and economists begin to study how markets sometimes fail.

**11. BOB SHILLER POINTS OUT THE MOST
REMARKABLE ERROR 191**

Some troublemaking young economists demonstrate that convincing evidence for financial market rationality is sadly lacking.

**12. BEATING THE MARKET WITH WARREN
BUFFETT AND ED THORP 211**

Just because professional investors as a group can't reliably outperform the market doesn't mean that some professional investors can't.

13. ALAN GREENSPAN STOPS A RANDOM
PLUNGE DOWN WALL STREET 227

The crash of 1987 exposes big flaws in the rational finance view of risk. But a rescue by the Federal Reserve averts a full reexamination.

THE FALL

14. ANDREI SHLEIFER MOVES BEYOND
RABBI ECONOMICS 247

The efficient market's critics triumph by showing why irrational market forces can sometimes be just as pervasive as the rational ones.

15. MIKE JENSEN CHANGES HIS MIND
ABOUT THE CORPORATION 265

The argument that financial markets should always set the priorities—for corporations and for society—loses its most important champion.

16. GENE FAMA AND DICK THALER KNOCK
EACH OTHER OUT 287

Where has the debate over market rationality ended up? In something more than a draw and less than a resounding victory.

EPILOGUE: THE ANATOMY OF A FINANCIAL CRISIS 309

CAST OF CHARACTERS 321

ACKNOWLEDGMENTS 329

A NOTE ON SOURCES 331

NOTES 333

INDEX 371