the reading room

neoclassical finance

By Stephen A. Ross
Princeton University Press
102 pages

review rating

■■■■■■■■□□

Stephen Ross is the Franco Modigliani Professor of Finance and Economics at the Massachusetts Institute of Technology. Before this he taught at Yale and the Wharton School. He has worked with many of the titanic figures of classical finance: Bob Merton, Myron Scholes, Gene Fama and the late Fischer Black.

This monograph is based on the Princeton University Lectures in Finance that he gave in the spring of 2001 - sponsored by the Bendheim Centre for Finance at Princeton. Professor Ross speaks with great authority and an easy style on, what he considers to be, the elegance and the power of the pillars of neoclassical financial theory and analysis. This is intentionally not a textbook, and leaves whole areas untouched; for example there is nothing on corporate finance, options pricing or the binomial model (on which he has written extensively). Rather, he focuses on those areas now being challenged by behavioural finance and other theories that question the neoclassical model. Thus, he addresses: no arbitrage, being the fundamental theorem of finance; asset pricing (incl. CAPM) and complete markets; the efficient market hypothesis; and finally he takes a neoclassical look at behavioural finance in the closed-end fund puzzle.

Some readers, like me, might be daunted by the extensive use of algebraic formulae, and indeed by his theoretical/logical approach of adopting, sequentially under discrete headings: definition; then representation theorem; then proof - with threads drawn together under a conclusion. He acknowledges that the second chapter is more technically demanding than the rest of the book, but says it can be skipped without harm by the reader who is prepared to accept its results and application in subsequent material. Notwithstanding this pervasive recourse to technical theories and language ("stochastic diffusion", "concave utility functions" et seq), this book contains a readably pithy and convincing case of neoclassical finance. It overtly questions the departure to behavioural explanations for so-called anomalies in asset pricing, and on occasion these alternative explanations are treated with respectful derision. Professor Ross takes a clear position on such issues.

In Chapter 3, on efficient markets, his concluding observations are particularly apposite. Under the heading Testing the Pros he deals with "a particularly intriguing class of tests of efficiency … the direct tests of the ability of fund managers to outperform the market. These tests offer the possibility of being constructed so as not to depend on the choice of a particular asset-pricing model. Personally, I always found these to be among the most compelling since they don't rely on the econometrician's ability to find patters in the data, but, rather, on the actual results of professionals who are munificently rewarded if they do find patters. The first studies in the 1970s (see, eg, Jensen 1969) quite clearly show that funds tend to underperform rather than overperform, and did so by just about their costs." He continues on this theme with some numeric analysis of the impact of hedge funds, to find out how much "inefficiency" there is in the market. He takes as a rough guide hedge funds listed in the offshore US directory through to about 1996, and a generously estimated average alpha of 4% p/a - a very generous alpha attribution for today, in light of current data (eg, Tremont) through 2005 from the much larger current hedge fund universe. "With about $200 billion of funds, that means about $8 billion of alpha per year. Assuming this undercounts banks and others engaged in similar activity by the factor, say, 2, that brings the total to $16 billion, and doubling it again to account for all the other missing players takes the total to $32 billion, which we will round up to $40 billion just to be conservative. This is a tidy sum, but not when measured against a rough estimate of $50 trillion of market assets. This means that, on average, prices are "off" or inefficient to about $40 billion/$50 trillion, which is less than 0.1%. There should be no debate, then, over whether the efficiency glass is half full or half empty; it is simply quite full."

The final Chapter 4, being the neoclassical look at the closed-end fund puzzle, is particularly interesting and relevant for the light that he sheds on the recent Australian glut of listed investment companies (LICs) - which are the Australian equivalent to the US listed closed-end fund. A reader of this chapter would have paused and carefully considered the listing premium (post promoter and float fees/costs) and the likely trading discount of these funds - before investing in the IPO. Most recent offerings (esp. the cash-box IPOs of 2005) are now trading at a significant discount to NTA, which Professor Ross would not be surprised about. His analysis of the fee impact for LICs provides a neoclassical explanation for the discount for most US funds. He also deals with the information-based premiums and the dynamics of distribution policies and how these can impact discount/premium. As to the IPO premium he observes: "Aside from the gullible (of which I have no illusions), the fund will be purchased only by those who believe in the managers ability to add value (or in the beliefs of others that the manger is valuable), and they will pay a premium to do so. As the fund begins to trade, though, unless the performance validates the initial faithful, the fund must go to a discount to reflect the fees taken out by management. Since most mangers have no special abilities, this is the common case.

By By Stephen A. Ross
Princeton University Press
102 pages

review rating

Indeed, even if a manager is generally perceived as adding value, the discount from fees can be so large as to produce a net discount." Consider the 2005 LIC IPOs from Macquarie, Babcock & Brown and Allco.

In the conclusion to this final chapter he addresses certain of the arguments from the behavioural school, and particularly those linked to investor sentiment. He prefers to "first see what can be explained by purely neoclassical arguments and then move on if forced to do so." The appeal to investor sentiment "seems almost limitless in its ability to explain just about anything. Once we have jettisoned the discipline of a market in which arbitrage is eliminated, we can reverse-engineer any observed pattern of prices and deduce a demand structure that would support it. Further more, psychology is sufficiently imprecise in its predictions of human behaviour that it places no brake on this activity. There are studies that say people are over-confident and studies that say they are timid - for every zig there is a zag."

Over to the behavioural brigade!

For those interested in the fundamental pillars, and who wish to reassure themselves as to the absence of that free lunch, this is an encouraging and illuminating read. It also holds direct practical relevance to today, and is rated 8.

MARTIN EARP
Noosa, Christmas 2005