Mansharamani, Vikram – Boombustology

John Wiley & Sons, 2011, [Finance] Grade ★★★★

One of the holy grails of investing would be to spot financial bubbles before they burst. Hedge fund manager Vikram Mansharamani who teaches a class at Yale called Financial Booms and Busts, has written a book on this very subject. With the notion that while asset markets most of the time are efficient they now and then stray to extremes, the author aims to provide a framework for understanding the likelihood of a bubble – a seismograph to identify the trembles before the rupture.

In a complex world the author argues that a multidisciplinary analysis is essential to be able to spot a potential bubble. The book is divided in three parts. In the first part the author presents a number of intellectual tools aimed at understanding the workings of a bubble. In the second the framework is applied to a number of historical bubbles and in the final part the author focuses in on a potential present day bubble.

The tools presented include George Soros Reflexivity Theory to spot how prices through feedback loops move into disequilibrium; The Austrian business cycle and Hyman Minsky's Financial Instability Theory where stability produces instability through the accumulation of increasingly speculative debt until the process breaks in a so called Minsky Moment and thirdly the many biases brought forward by behavioural finance. Moving on, the author discusses political aspects such as moral hazard and manipulation of market prices and the last prism in this multifaceted lens is the biological models of epidemiology where studies of infection rates and removal rates give clues to disease transmission but could equally be used for the understanding of transmission of ideas plus models of animal herd behaviour and what those have to say about human groupthink.

This very loose framework is laid upon historical events such as the Dutch tulipomania, the equity bubble of 1929, the Japanese real estate bubble, the Asian crisis of the 90's and the subprime crisis. Not surprisingly many of the features in the above models were indeed present. Most important and always included in the previous bubbles was reflexive dynamics between collateral values and access to credit, cheap money, overconfidence and beliefs that there would be a policy response if prices fell, i.e. moral hazard. The present day bubble that the author zeroes in on is China and he concludes that many of the same issues that caused previous bubbles are very much active in this moment. I will not go deeply into the Chinese bear case but regulated interest rates, indebted and speculative local governments, stage owned banks lending with the historic knowledge that credit losses will be dealt with by the state and runaway property prices in larger cities are parts of the plot.

At first I was a bit sceptical to the text, any one model is rather shortly described and the framework in itself and the way it was used on historical bubbles felt a bit forced. Of course the author already knew the tools he picked would show up in the historical bubbles, that is why he had chosen them. And why leave out the TMT-crash? Because it didn't fit the model? Still, the more I read the more I came to like the book. Spotting bubbles is important. These are some of the best tools available for the purpose. They should be part of any investors' arsenal.

Unfortunately for all of us and as Mansharamani would agree on, this book doesn't answer the most important question regarding bubbles – when they will burst. With or without that knowledge, being able so sense a bubble building up is still immensely valuable.

Mats Larsson, November 14, 2011