Soros, George – The Alchemy of Finance

John Wiley & Sons, First edition 1987, [Finance] Grade ★★★★★

This book is by many famous traders quoted as the revelation that changed how they view markets. Not that the author needs the validation of others. "Four hundred seventy-three million to one. Those are the odds against George Soros compiling the investment record he did […]" as Paul Tudor Jones II states in his foreword. In The Alchemy of Finance Soros presents his theory of how markets work, a theory he has named reflexivity.

The philosopher, science theorist and originator of the black swan example, Karl Popper was also the teacher of George Soros. According to Poppers method of empirical falsification knowledge cannot be proven truths. What we call knowledge are theses that have been subject to critical examination and have not yet been proven false. It doesn't mean they are true but they are the closest we get. This view also forms the core of Soros theory of market functionality. The market also forms a hypothesis and puts it to the test during the actual course of events.

The first part of the book is a critique of the so called modern portfolio theory but also above all a presentation of the reflexivity theory. With market prices as the intermediate, the thinking actor's imperfect perception influences reality just as reality influences perceptions. There is a two way interaction, not only between market prices and investor perceptions, but also between market prices and fundamental economic developments. The feedback in these processes ensures that the system cannot be in equilibrium. For example, expectations on a situation simply cannot be stable if the expectations in themselves affect reality. Instead the interactions create loops that, at times, bring market prices far from rationality.

Human perception of a situation will according to Soros always be faulty. As no one can know how others view a situation and the collective view will affect the situation, everybody will have imperfect information. The errors will either be too optimistic or pessimistic, but the net balance will constitute what Soros calls the prevailing bias. Changes in prevailing bias change market prices. In extreme situations the loops between market prices, the reality and the prevailing bias will create booms and busts. Understand the process, spot the miss pricing plus the trigger that will break the feedback loop (plus preferably the timing of the trigger) and you will be able to act faster and invest with greater conviction than other market participants.

In the major part of the book Soros goes through a number of macroeconomic situations of the 1980's, using the reflexivity model as the analytical tool for these case studies. After this experiment is evaluated the author finally makes a number of prescriptions for how economic policy should be conducted. The combination of theory formulations, reviews of passed economic situations and a Hungarian born author with a language that is complex and a tone that is slightly overbearing, is sure to weed out those not truly interested in the topic.

This doesn't make the book less important. At the time overlaying Karl Poppers thinking on financial markets was a true revolution. However, few practitioners and academics understood the message and Soros never became the renowned philosopher of the markets that was so clearly his ambition. Many of those who took his theory to hart were neverthelsess immensely successful and today the influence that theories around complex adaptive system are starting to have suggests that Soros was simply way ahead of his time.

The book is in no way a pleasure to read but if you haven't read it you don't fully understand how markets work.

Mats Larsson, December 23, 2011