Pedersen, Lasse Heje – Efficiently Inefficient

Princeton University Press, 2015, [Finance] Grade ★★★★

This text is an unusual hybrid of a description of hedge fund investment styles, investor interviews and a finance textbook. The book's promise is to be a mix of Antti Ilmanen's *Expected Returns* (an AQR colleague) and Jack Swager's "wizard-series". *Efficiently Inefficient* doesn't fully live up to this standard but I still like it.

This hybrid approach isn't surprising given the author's parallel and impressive career path. Pedersen is a finance professor at both NYU and Copenhagen Business School and has written several important papers earning him the title of best European economist under 40. Further he's on the editorial board of The Journal of Finance and a research associate at NBER. For most of us this would be more than enough but this is only half the story. The author is also a principal on AQR's asset management team and as such an important part of one of the world's largest hedge funds. This has no doubt given him easier access to the many investors to interview in this book. At least Pedersen has turned 43 by now so even he can't have it all…

The introductory section on the nuts and bolts of hedge funds (called *Active Investment* in the typical modest hedge fund style) discusses topics like risk management, back testing, trading, performance measurement etc. I found the notion of several different types of liquidity premiums very interesting and now and then the author presented a nugget I hadn't thought of but mostly this section gives the foundation for the rest of the book by describing the general character of "smart money" and the activities that hedge funds perform.

The remainder of the book analyzes eight common hedge fund investment strategies: long-short equities, short-selling, quantitative equities, global macro, managed futures, fixed-income arbitrage, convertible bond arbitrage and event-driven investments. Initially the strategy is described from a textbook type of angle and then Pedersen continues to show how they are practiced. The text on each strategy is finally ended with interviews with rock star practitioners like James Chanos, Cliff Asness, George Soros, Ken Griffin, John Paulson and many more.

Despite the author's high level of understanding he manages to deliver a high quality but also easily understandable guide to the strategies. Pedersen's theoretical background is in mathematical economics but save one chapter the number of equations is kept fairly low. With a whole spectrum of investment strategies some will surely interest certain readers more and some less. Due to the number of equations in the text and my low interest of investment strategies trying to find arbitrage opportunities among bonds and bills I largely skipped the text on fixed-income arbitrage.

A positive surprise to me was the interview with John Paulson who I've seen as a bit reckless going all in on the "greatest trade" in mortgage backed securities and then losing most of the gains on gold. Instead, in the interview on event-driven investment, I found Paulson both reasoning, intelligent and ready to learn from others. I'm further struck by how many of the strategies used and also the language used by hedge funds that has become an integral part of the everyday life of pension funds – no doubt wanting to become a bit more "smart money" themselves.

My main quarrel with the book is that it overpromises to some extent. The main title *Efficiently Inefficient* and the subtitle *How Smart Money Invests & Market Prices are Determined* implies a focus on pricing theory where markets are "*inefficient but to an efficient extent*" so that professional investors are compensated for their work. Well, if you don't count simply showing how a number of hedge fund investment strategies earn money there is disappointingly little of general discussion on this topic in the book.

Competent, high quality but a little overreaching.

Mats Larsson, January 6, 2016