

Bookstaber, Richard – A Demon of Our Own Design

John Wiley & Sons, 2007, [Finance] Grade ★★★★★

Why did I wait 10 years to read this book? It is a joy to read. Richard Bookstaber has had a long career in the financial markets. Today he is the Chief Risk Officer at the pension fund University of California Board of Regents and a senior advisor at the US Treasury's Financial Stability Oversight Council. When he wrote this book he was a hedge fund portfolio manager and prior to that he was in charge of risk management at both Morgan Stanley and Salomon that later turned into Citigroup. The reason for not picking the book out of the bookshelf was that the subtitle "*Markets, Hedge Funds, and the Perils of Financial Innovation*" gave me the impression that it was a sensationalist, hedge fund-bashing book written by an outsider. This is obviously completely wrong. Few are more qualified than the author to discuss financial risk.

There are three parts to this book although they aren't presented chronologically. There is one extremely interesting theoretical part comprising of chapter 1, 8 and the conclusion; there is a brilliant autobiographical part covering Bookstaber's Wall Street career (chapter 2-7) and then chapters 9 through 11 present a somewhat less vivid, semi-theoretical, discussion around hedge funds and much more. For me the chapter on the 1987 crisis was a revelation. Why are researchers still debating what triggered the downturn? Here it's written out in black and white from someone who had the benefit of both a front row seat and the oversight and understanding to make sense of the event. In short it was a combination of investor psychology, a mismatch in liquidity between the futures market and the cash equities market to act as a trigger and the widespread usage of portfolio insurance that created a self-enforcing negative loop of selling.

In the Wall Street section the author describes the full palette of financial mishaps that he experienced at the investment banks - including the debacle of LTCM, which was closely affiliated to Salomon. In general too many think that only what has recently happened is likely to happen next or that things that seldom happen, will not happen – at least not

on their watch. Combine this with the non-linear effects of a constant stream of newly invented derivatives plus complex organizations with plenty of politics and you have an accident waiting to happen. Time after time new financial products are launched without the understanding of unintended consequences. Sometimes the risks are even deliberately ignored as the gains will fall to the banks' personnel but they will not face the losses.

The theoretical part and especially the chapter "*Complexity, Tight Coupling, and Normal Accidents*" should be required reading to be eligible for employment at financial regulators. A combination of complexity and tight coupling creates unforeseen events that often cascade through the financial system as a crisis. The complexity arises as the agents in the system change their behavior depending on others behavior and events are often triggered by the use of derivatives – and this is written before the 2007/08 crash. Due to the constant need for liquidity when using derivatives - and the often high leverage - agents in the financial system are critically interdependent and the speed of the market gives little room for error or time for adjustment when things go wrong. That accidents occur in such a system is according to the author to be expected – they are so-called normal accidents that arise by the design. The need for liquidity, not new information, is the main driver of short-term price movements. Less leverage and an incubation period for financial innovation is suggested to tame the system.

The text is colorful, quick-witted and written with a self-irony that adds to the readability. Bookstaber is a quant with a splendid way with words! At this point the book merits a 5-star rating. Unfortunately the hedge fund part isn't fully up to par. It's untidy, a bit defensive about hedge funds, searching, and the author doesn't seem to have fully completed his thoughts. In contrast to earlier parts, no colorful interior from the hedge fund world is offered - pity. In all, if you are to understand financial calamities you should have read this book.

Mats Larsson, August 11, 2017