Bernstein, Peter L. – Against the Gods

Wiley, 1996 [Equity Investing] Grade ★★★★★

The sharpest minds of ancient times had a major advantage against modern thinkers. When faced with unexpected outcomes they could answer by reverting to faith or superstition. Greeks, Romans and Arabs came far in many other aspects but failed to develop the theory of probability. Instead, it was two Frenchmen, Blaise Pascal and Pierre Fermat, who made the breakthrough in the 17th century. The impact of the discovery has been massive, not only to mathematicians but also to all those who deal with matters with uncertain outcomes. In the best-selling *Against the Gods* the reader is taken on a remarkable journey through human history to clarify the subject of risk - which still can't be explained fully.

The author, Peter L. Bernstein was both an investor, a financial historian and prominent within academia. Having been an active investor and an economist is a feat he shares with John Maynard Keynes, an oft-cited character in *Against the Gods.* Bernstein published ten books and countless articles during his long career and is renowned for his supreme writing skills.

The main difficulty with investing originates from the notion that all the answers are in the past and all the questions are in the future. Many are those trying to predict the future - causing them to expose themselves to risk - or according to Bernstein *"the chance of losing money"*. The author's main idea with the book was to explore the lessons of history to judge the current methods of handling risk. He therefore portrays those who have contributed the most to form the modern theory. This includes ancient thinkers as Aristotle and Al-Khwarizmi, later intellectuals as Pascal, Thomas Bayes and Francis Galton and modern theorists as Keynes and Daniel Kahneman. It's a remarkable history lesson.

Galton's discovery of regression to the mean during the 19th century - covered in one chapter - may be the most important for investors. It can be summed up with these timeless words from the author: *"When investors overreact to new information and ignore long-term trends, regression to the mean turns the average winner into a loser and the average loser into a winner."* By being contrarians, value investors have used the idea successfully over the last century. Another enticing chapter covers Amos Tversky's and Kahneman's creation of Prospect Theory. They managed to disprove that humans are the rational beings as depicted by traditional economists, by showing that people occasionally make irrational decisions. Keynes was one of the few who had earlier criticized the view of the rational man, as he viewed humans as being driven by animal spirits. Benjamin Graham was definitely another - something he is not credited for in the book. Graham also emphasized diversification as a tool for managing risk, which is not mentioned either in the chapter dealing with Harry Markowitz and his mathematical model of diversification. Overall, I think Bernstein's coverage of the 20th century gives too much credit to academia and too little to practitioners.

The main takeaway from the book is that the lessons of history support today's preferred method of how to tackle problems involving both skill and luck. Using objective data from the past as the base rate and adjusting the probability by critical reasoning should lead to better decisions - and therefore lower risk. This is highlighted by current thought-leaders as Michael Mauboussin and Howard Marks. The best investors have a tendency to think probabilistically and relate declining prices (without impairments to the intrinsic value of the business) to improved odds. It should be a good way to approach investing for all.

The book is certainly no walk in the park as it takes a lot of effort to grasp the ideas. It is nonetheless a great start for those who want to join Mauboussin and Marks in making better decisions. Most of all it's a very interesting book - not only for investors but for all interested in acquiring timeless wisdom. The odds are favorable that you will enjoy it.

Niklas Sävås, October 25, 2018