## *Institutional Investors*

*By E. Philip Davis and Benn Steil. 2001. Cambridge MA and London, England: The MIT Press. Pp. 524. $47.95 hardcover.*

With the growth of pension funds, life insurance companies, and mutual funds, an increasing proportion of household saving is being institutionalized. A greater proportion of assets are now managed by professional portfolio managers instead of invested directly in the securities markets or held as bank deposits. This book provides a broad and thorough review of both institutional investors (specialized financial institutions that manage savings collectively) and asset management (the process by which assets collected by institutional investors are invested in the capital markets).

A substantial portion of the book focuses on the United Kingdom and the United States, which have experienced the greatest growth of institutional investing, where regulation has been less restrictive and where academic research has been most extensive. However, the book also covers institutional investing in Continental Europe, Japan, and emerging market economies, offering comparisons across a broad spectrum.

Both authors have excellent backgrounds to do the research for this book. E. Philip Davis is Professor of Economics and Finance at Brunel University in West London and a Research Associate of the LSE Financial Markets Group, an Associate Fellow of the Royal Institute of International Affairs, and Research Fellow at the Pensions Institute of Birbeck College in London. Benn Steil is Senior Fellow and holds the Linda J. Wachner Chair in Foreign Economic Policy at the Council of Foreign Relations in New York. Much of the research for this book was carried out while he was Director of the International Economics Program at the Royal Institute of International Affairs in London.

The early chapters of the book focus on the development of institutional investors, who have grown substantially in the past decades. Their claims are valued at 100 percent of gross domestic product of the G-7 nations (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States). This percentage is almost twice GDP in the United States and the United Kingdom. Movement of the rest of the G-7 countries to this level would cause massive expansion of institutional investment. Several factors account for this significant growth: ease of diversification, improved corporate control, deregulation, technological developments, enhanced competition, demographic shifts, growing wealth, and deficiencies in the social security systems.

A review of the performance of asset managers indicates that their most important tasks are asset allocation and security selection; the former is very important, but research in the United States and the United Kingdom suggests the latter is value deducting—index investing is more rewarding. As for the structure of the asset management industry, the Anglo-Saxon countries differ from Continental Europe because of greater competition, resulting in higher fees and less focus on performance in Europe. Another difference is that specialist managers dominate in the United States, while balanced managers tend to dominate in the United Kingdom.

As for the future of asset management, growth prospects are good. However, marked structural change is under way. For example, there is a trend to global management through mergers, reflecting the benefits of size; the European Monetary Union may break down barriers to entry; and a shift from defined benefit to defined contribution pension plans favors a different style of management. The next sections of the book examine the effects of the growth of institutional investors on the capital markets and on banks, followed by a discussion of the impact on the nonfinancial sectors.

One of the most interesting parts of the book is an extended discussion of the trading environment. Institutional trading is done in much larger blocks of securities and requires considerable skill and different techniques to minimize the market impact of transactions. Increasing automation permits the saving of significant trading costs, although a number of common market practices limit the incentive for cost minimization in fund management firms. Fiduciary problems and regulatory implications are additional influences on trading activity.

Measuring trading costs is difficult. Explicit costs, like brokerage commissions and taxes, frequently include payments unrelated to the actual buying and selling of securities, like payment for research and other services. Bid-offer spreads vary by transaction size and the relevant market. Market impact varies by size of transaction and market liquidity. Opportunity costs reflect incompletely filled or delayed trading orders. One study cited an institutional portfolio

that for a thirteen-year period had an annualized return of 26.2 percent on paper but had a return of 16.1 percent as implemented!

In summary, as a reference book, *Institutional Investors* is invaluable. It is not an easy read, but the material is well organized so that answers to particular questions or coverage of particular topics are easily available. The breadth of coverage is impressive, and the literature review provides an excellent source for further information. The discussions on institutional investing outside the United States are especially revealing, given the often parochial nature of the literature in the United States. Anyone in the financial services industry will find the book a valuable source of information. Anyone with an interest in corporate pension plans or in the services of the financial sector for personal investing will also find the book of interest. Moreover, no other source of such comprehensive information on institutional investing is currently available; the book is a significant contribution to the literature on the subject.

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## Great Bubbles

*Ross B. Emmett, ed. 2000. London, Pickering & Chatto Limited. Volume 1, pp. 271. Volume 2, pp. 252. Volume 3, pp. 426. $470 hardcover.*

In conventional usage, a bubble is a rise in the price of an asset that feeds on itself but is unrelated to any fundamental change in the value of the asset. Thus, an increase in the price causes further increases in price. At some point, asset holders become persuaded that the increases can't possibly continue and selling begins, which causes others to sell even faster because they are now persuaded the bubble has burst. It seems clear that policy makers want to understand what causes financial bubbles and what effects they have on the economy in order to make policy decisions about whether or not to inhibit them. Business economists want to understand bubbles so that they can make better personal and business financial decisions. We think that these volumes can help achieve both goals. Moreover, they will prove to be interesting to those who simply want to know about the events.

Focusing only on materials available in English, Emmett's purpose is ". . . to bring together a multidisciplinary set of writings on the three classic financial market events of the seventeenth and eighteenth centuries." The material includes poetry and prose, newspaper articles, pamphlets, official documents, sixteen prints contemporaneous with events, and research analyzing and interpreting the material. The material cuts across many disciplines including economic history, history of economic thought, other social sciences, and literary analysis. Having some background in the political history of early eighteenth century France and England is helpful.

The story itself is fascinating but takes considerable effort to understand from the original sources in these volumes. The language of the early eighteenth century can be torturous: words, spelling, capitalization, and sentence structure are different enough from the modern to present puzzles. Also puzzling can be the satirical and polemical nature of the original materials. However, the volumes also contain significant recent research on the subject that may give readers a more coherent perspective of the issues of that time. We recommend that readers begin with those articles if their background in history of the early eighteenth century is weak.

Volume 1 contains an introduction by Emmett, material on tulipmania in Holland, early writings of John Law on monetary theory and policy, and two selections from Charles Mackay that established the standard interpretation of bubbles as combinations of greed, group hysteria, and irrational behavior.

The tulipmania of 1636-7 involved a rapidly rising price for bulbs of unusual tulips as tulips became a popular flower. Investors expected the price to continue to rise, and a buying frenzy occurred. Eventually prices for rare bulbs collapsed, leaving the Dutch government and trade groups with financial and contractual problems not anticipated in law or custom.

In the writings by John Law, we can see his rudimentary version of what we know as the quantity theory of money. His concern was that a specie-based money is inefficient because it uses resources that could be put to a non-monetary use, subjects the country to outflows and inflows of specie that affect the money supply, and makes it difficult to control the money supply to achieve macroeconomic goals. Law proposed that a central bank be developed with a paper money system where the supply of money could be changed to match the demand for money. It is this scheme that has led many economists to praise Law as one of the outstanding monetary theorists, illustrated in the text by an excerpt from Joseph Schumpeter's *History of Economic Analysis* and material by Antoin Murphy.

Volume 2 contains eleven original materials and four analytical pieces focusing on the Mississippi Scheme and England's Exchange Alley. There are two aspects of the Mississippi Bubble in France. The first involved John Law's attempt to shift French money to bank notes from specie,

which met severe resistance from some French officials. Secondly, the bank notes were backed by shares in a French company whose major asset was the monopoly right to develop resources of French colonies, especially along the Mississippi River. Share prices rose on the promise of profits and then crashed. Law fled France, and France returned to specie.

The material on Exchange Alley includes Larry Neal's writing on the performance of early capital markets in London and Amsterdam, which may be of special interest to business economists. Neal provides time series showing the actual behavior of prices on the London Stock Exchange during the 1698 to 1734 period. He argues that the development of joint-stock companies allowed the holders of such assets to more easily sell them than if the company had been organized on a partnership basis. Neal concludes that for those companies whose returns are strongly correlated with the market rate of return, the evidence is consistent with the modern theory of the tradeoff between risk and rate of return.

Sandra Sherman's article on English society's confusion over changing meanings of contracts and credit well illustrates the difficulties eighteenth century people had finding words for the new phenomena of international capital markets.

Volume 3 includes twenty-two original sources and seven analytical/interpretative materials, all on the South Sea Bubble. In the South Sea Bubble, the South Sea Company assumed the national debt of England and gained a monopoly on British trade with the South Sea Islands and South America. Again, prices rose in anticipation of profits until many holders became uncomfortable and sold in a falling market.

Important analytical material includes two more selections from Larry Neal, and an article by Catherine Ingrassia. The first Neal selection uses data on the prices of Compagnie des Indes shares to assess whether the various fluctuations in the price of shares during 1719 were consistent with a rational or an irrational bubble. In the second selection, Neal develops his argument that the stock issued by the South Sea Company resulted in a substitution of the more liquid assets of South Sea shares for the less liquid asset of government debt, primarily annuities issued beginning in 1694, which only paid the registered owner. He concludes that his interpretation of the South Sea Bubble provides an argument that a large part of the bubble was not due to the irrationality of the participants and points out that stockholders at the beginning of the year of the bubble (1720) who held their shares would have still realized a 56 percent annual yield by December 1720, after the bubble had burst.

Catherine Ingrassia's article analyzes the language of commentary and the iconography of prints surrounding the South Sea Bubble. The analysis makes clear that the experience of the bubble was socially upsetting and dislocating on two grounds. First, the participants included women and persons of "lower" social classes. Second, the commentators on the bubble perceived there to be no object of "real" value connected to the prices of South Sea stock and therefore concluded participants were irrational.

Emmett's introductions to written materials are brief, cogent and relevant. However, the prints that are not included within articles are reproduced without introductions. Also, the material excerpted from books presents references without full citations or bibliography, which makes pursuing sources difficult. The lack of an apparatus to help readers understand satiric references also hinders modern readers. There is an excellent index to the set at the end of Volume 3.

This three-volume work provides an excellent compilation of original and analytical material on three classic examples of bubbles. For those wishing to explore the original documents on bubbles, these volumes provide an excellent entree to the literature available in the English language. For those with a limited budget or interested primarily in an analytical discussion of bubbles, we would recommend starting with Peter M. Garber's *Famous First Bubbles.* (The MIT Press, 2000) or Neal's *The Rise of Financial Capitalism: International Capital Markets in the Age of Reason* (Cambridge University Press, 1990).

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