

The
WISDOM
of
FINANCE

DISCOVERING HUMANITY
in the WORLD OF RISK *and* RETURN

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AUTHOR'S NOTE

This book is not about the latest study that will help you make money in the stock market or that will nudge you into saving more. And it's not about the optimal allocation of your retirement assets.

This book is about humanizing finance by bridging the divide between finance and literature, history, philosophy, music, movies, and religion.

This book is about how the philosopher Charles Sanders Peirce and the poet Wallace Stevens are insightful guides to the ideas of risk and insurance, and how Lizzy Bennet of *Pride and Prejudice* and Violet Effingham of *Phineas Finn* are masterful risk managers. This book looks to the parable of the talents and John Milton for insight on value creation and valuation; to the financing of dowries in Renaissance Florence and the movie *Working Girl* for insight on mergers; to the epic downfall of the richest man in the American colonies and to the Greek tragedies for insight on bankruptcy and financial distress; and to Jeff Koons's career and Mr. Stevens of *Remains of the Day* for insight on the power and peril of leverage.

In short, this book is about how the humanities can illuminate the central ideas of finance. But this book is also about how the ideas of finance provide surprising insight on common aspects of our humanity.

So, this book is also about how understanding insurance can help us make sense of and confront the disorder of the world; how understanding the capital asset pricing model can allow us to real-

ize the value of relationships and the nature of unconditional love; how understanding value creation can help us live a meaningful life; how understanding bankruptcy can help us react to failure; and how appreciating theories of leverage can teach us about the value of commitments.

For readers unfamiliar with, but curious about, finance, this book attempts to outline the main ideas of finance without a single equation or graph—and only with stories. I'm always struck by how intimidating finance is to many of my students. There's a reason for this—some people in finance want to intimidate other people. By attaching stories to the ideas of finance, previously intimidating material will hopefully become accessible and fun. For concerned citizens or aspiring professionals, finance has never been more important—and ignorance of it has never been more costly. At a minimum, when someone you know starts going on about options, leverage, or alpha generation, you'll know what they're talking about.

For students or practitioners of finance, this book allows them to revisit the big ideas of finance in a fresh, different way. Many practitioners of finance I see in my classroom were taught finance in a mechanistic way that has led to a fragile understanding of the fundamental ideas. When I probe them for the underlying intuitions, their understanding of the formulae helps little, and they can struggle to relay the conceptual underpinnings of what they do. By seeing these same ideas in a completely different way than you're used to, you will deepen your understanding and, most importantly, your intuitions.

For those readers engaged in finance deeply, the book holds one final promise. Your endeavors are routinely maligned today, and it can be difficult to make sense of one's life when your work is characterized in such a negative way. But there is great value—and there are great values—in finance. By reconnecting to that value—and those values—perhaps you can understand your life's work

as a meaningful extension of the values you hold dear. At the end of his poem about a recreational woodchopper, “Two Tramps in Mud Time,” Robert Frost captures vividly how important it is for us to understand our work and our lives as an integrated whole.

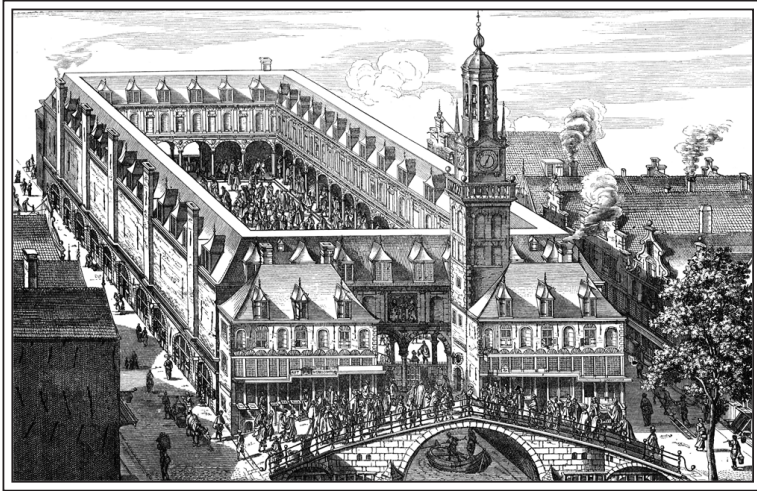
My object in living is to unite
My avocation and my vocation
As my two eyes make one in sight.
Only where love and need are one,
And the work is play for mortal stakes,
Is the deed ever really done
For Heaven and the future's sakes.

Most ambitiously, this book endeavors to improve the practice of finance by rediscovering the humanity of the core ideas of finance. The demonization of finance is counterproductive, and regulation, while helpful, holds only limited promise for addressing the transformation of finance into an extractive, rather than a value-creating, industry. Perhaps we can all find our way back to a more noble profession by enlivening the ideas of finance through stories that illuminate our lives and our work.

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INTRODUCTION

Finance and the Good Life



The “Wall Street vs. Main Street” rhetoric that has become so pervasive reflects a common view of finance as an industry that extracts more value from the economy than it creates. At the same time, there is a growing awareness of how central finance is to our economy and our lives. We see finance everywhere, from our retirement assets to our investments in housing and education. The combination of deep suspicion and curiosity is further complicated by the complexity in which finance shrouds itself—mind-numbing acronyms, formulae, and spreadsheets serve as barriers to understanding the world of finance.

For practitioners of finance, this creates several problems. They need to explain and justify what they do more clearly to win back

confidence. They need to ensure that their activities are truly value creating. More personally, working in an industry that is perceived negatively can take its toll. With expectations so low, finance professionals have little to aspire to, which creates a downward spiral of low expectations and poor behavior.

How do we open up the ideas of finance to everyone so they can access them in an affirmative way? How do we recover a sense of the virtues of finance so that the practice of finance can be improved?

This book takes the unorthodox position that viewing finance through the prism of the humanities will help us restore humanity to finance. The problems that finance addresses, and the beauty of the approach it adopts, are most easily understood by attaching finance to the stories of our lives. More than regulation or outrage, fixing finance requires practitioners to return to the core ideas, and ideals, of finance—which can help them ensure that they are creating value and not extracting it. By linking those core ideas to literature, history, and philosophy, we give them deeper resonance and make them more resistant to corruption.

I stumbled upon the idea of linking finance to stories. In the spring of 2015, I found myself in a position I often do—struggling at the last minute to make good on a commitment. I had agreed to give one of the “last lectures” to the graduating MBA class of Harvard Business School. The so-called last lecture is a tradition that allows professors to offer students, on the eve of their graduation, words of wisdom. At its best, it returns the university to a bygone era. Rather than the production and dissemination of specialized knowledge, for a moment we would all return to an antiquated notion of a university that acknowledged that, as John Henry Newman put it more than 150 years ago, “the general principles of any study you may learn by books at home; but the detail, the color, the tone, the air, the life which makes it live in us, you must catch all these from those in whom it lives already.”

Having procrastinated for a while, I initially retreated to familiar territory and decided to give a talk about recent financial developments in American corporations. It would be titled “The Slow-Motion LBO of America” and it would describe how the current share repurchase craze should be understood and reversed. I had something concrete to say, it would be provocative, and, to make myself feel even more superior, I rationalized that it was meatier than the puffery that is usually offered in these settings.

After I made this decision, I saw a dear friend and colleague. In the last year, he and I had engaged in a series of discussions about how to reinvent ourselves by forcing ourselves into new challenges. After I told him of my decision to talk about these developments, his reaction was muted. I had internalized his voice enough to hear him asking me: “Really? Do you think that’s what they need as they graduate? And is that what you need?”

His silence was enough to make me realize that I was missing an opportunity. And his friendship gave me the courage to think about doing something that was a challenge to me—a social scientist weaned on statistics and economic models. Instead of a safe topic, I would try to talk about the good life. But what did I, a man in my middle years, know about the good life?

I had long been bothered by the common presumption that markets, and finance in particular, were a crass domain that we had to shelter ourselves from in order to live a good life. It has become common to denigrate finance and to assume that finance has little of value to offer the world, and certainly has no wisdom behind it. Executives who make ham-fisted comparisons between finance and God’s work only make the case that finance has little wisdom in it.

But this common rejection of finance and markets is problematic. For starters, the rejection of markets and finance as a source of wisdom is deeply unhelpful. Many highly educated individuals are deeply engaged in markets and concern themselves with financial matters for most of their time on this earth. By suggesting

that finance has no positive values embedded in it, we encourage these individuals to live a professional life without values and to separate their personal, moral selves from their work. That compartmentalization is difficult and often untenable. Can you engage in a life's work that is bereft of wisdom and values and hope to live a good life?

Aside from being highly impractical, this rejection seems plain wrong. Many of my friends and former students love finance, markets, and business and find them life-affirming. They understand that finance is far from God's work, but they derive real joy from what they do. Could something so crass and devoid of moral value yield such joy and professional satisfaction? If the common presumption is unhelpful and incorrect, what might the opposing view be?

As is typical, I committed to a title—"The Wisdom of Finance"—but remained unsure about what it meant. In the subsequent weeks, I was surprised by how easily I could connect the lessons of finance to life, and how rich those linkages were. After the lecture was delivered, I was overwhelmed by the reaction of the MBA students, who were clearly hungry for wisdom that was not distilled from on high but from their own worlds and their own work. Mid-career executives were even more appreciative, as they understood better so many of the challenges that life presents. And, as has happened before in my life, I unwittingly stumbled into a commitment that provided returns that far exceeded the investment I had made.

While the lecture was successful as a means of mapping the core ideas of finance to the questions of a meaningful life, writing a book created a new problem. The correspondence between finance and life's problems could be easily sustained for an hour amongst people who appreciated business. But could I sustain and enliven that correspondence over the course of a book for many different types of people? Did I have a talk or a book?

As I struggled with these questions, I recalled that the best description of finance I had ever found came not from a textbook or a CNBC special but from a parable told by a Sephardic Jew writing in Spanish in Amsterdam in 1688.

In *Confusion de Confusiones*, Joseph de la Vega provides a vivid description of the nascent financial markets that were mesmerizing many observers at the time. Those vibrant markets featured the stock of only one company, the Dutch East India Company, which today would be analogous in its reach and dominance to some combination of Google, Alibaba, and General Electric.

Some of de la Vega's commentary seems remote. He explains, for example, that the dividends of the Dutch East India Company "are sometimes paid in cloves . . . just as the directors see fit." Other parts of his story are remarkably current, as when he provides an explanation of how frothy markets are driven by excessively low interest rates and how a bankrupt company is restructured.

Rather than dryly articulating the nature of those markets, he told a story—a conversation between a merchant, a philosopher, and a shareholder. The merchant and the philosopher are archetypes of the doer and the thinker. Puzzled by how financial markets work, they consult the shareholder for insight.

When the philosopher explains how little he understands about financial markets, the shareholder responds with my favorite description of finance: "I really must say that you are an ignorant person, friend Greybeard, if you know nothing of this enigmatic business which is at once the fairest and most deceitful in Europe, the noblest and the most infamous in the world, the finest and the most vulgar on earth. It is a quintessence of academic learning and a paragon of fraudulence; it is a touchstone for the intelligent and a tombstone for the audacious, a treasury of usefulness and a source of disaster, and finally a counterpart of Sisyphus who never rests as also Ixion who is chained to a wheel that turns perpetually."

De la Vega captured the best and worst of finance by relaying a story—and that story led me to see finance in many stories. I had always enjoyed stories, but becoming an economist made me distrust them. Now, I would return to them.

Soon I began to find finance in literature, in philosophy, in history, and even in popular culture. Once I began seeing the parallels, I couldn't stop. And I began to understand why finance and these fields were deeply connected. Many distrust markets, particularly financial markets, because they are thought to be hostile to humanity—but perhaps that has things completely upside down. Perhaps finance is deeply connected to our humanity.

As one example of the alternative view, the philosopher Friedrich Nietzsche notes that the whole idea of duty and personal obligation is rooted in “the oldest and most primitive personal relationship there is, in the relationship between seller and buyer, creditor and debtor. Here for the first time one person moved up against another person, here an individual *measured himself* against another individual. We have found no civilization still at such a low level that something of this relationship is not already perceptible. To set prices, to measure values, to think up equivalencies, to exchange things—that preoccupied man's very first thinking to such a degree that in a certain sense it's what thinking *itself* is. Here the oldest form of astuteness was bred: . . . the human being describes himself as a being which assesses values, which values and measures, as the ‘inherently calculating animal.’”

Released from the conventional wisdom of the opposition of finance and markets to humanity, I decided to write a book that tried to unify them. That unification is my effort to fix finance and to make it accessible.

The following chapters can be sampled in any order. But the book is organized purposefully. Ideally, the reader is unconsciously taking

a course in finance and emerging with the intuitions of finance, but only by enjoying stories.

While many analogize finance to physics, the better analogy is to biology. There is a branch that, like molecular biology, precisely focuses on the most essential building blocks of life. That branch is called “asset pricing.” And there is a branch called “corporate finance” that is akin to sociobiology, interested in all the contingencies and messiness of the world that we actually observe. The book follows a conceptual arc that is divided roughly between those two branches.

The first three chapters consider the foundational question of asset pricing—how does one deal with the omnipresence of risk in the world? As I conceived the book, I was reminded of how central insurance is to finance and to my way of understanding the world—so the first chapter lays down the foundations of risk and insurance, with the help of Francis Galton’s quincunx, the author Dashiell Hammett, the philosopher Charles Sanders Peirce, and the poet Wallace Stevens.

The next chapter extends the logic of insurance to two key risk management strategies—options and diversification—that correspond to strategies for dealing with uncertainty. In this chapter, authors Jane Austen and Anthony Trollope as well as the Greek philosopher Thales do most of the work. With the foundations of risk and insurance well laid, the next chapter addresses how risk corresponds to return and how that relationship dictates the conditions for creating value in the world. Here, John Milton, Samuel Johnson, and the parable of the talents serve as our guides.

The asset pricing branch of finance tries to establish the value of assets by thinking hard about the risks they present and the returns we demand for bearing those risks. There are many who dismiss markets as mechanisms for establishing true values. This first part of the book suggests that the question of value—how it arises and

how we should measure it—bridges finance to the humanities in rich ways.

Asset pricing provides a powerful perspective on risk and value—but does so by ignoring much of the messiness of life. Indeed, a founding myth of asset pricing is a story of individuals on islands who own trees that produce fruit and must exchange fruit with each other. Asset pricing focuses only on the relationship between owners and their disembodied assets, thereby shearing the world of complexities like companies, more complex individual motivations, and the uneven diffusion of resources and information. That messiness is what most of us experience every day, and that is the subject of corporate finance.

The next four chapters consider all this messiness. The fourth chapter considers what happens when the relationship between investors and the underlying productive assets they own is mediated by human beings with their own motivations. The resulting emphasis on the relationship between principals (shareholders) and agents (managers) is the problem of corporate governance—and arguably the central problem of modern capitalism. The principal-agent problem, as demonstrated by Mel Brooks's *The Producers* and E. M. Forster's *A Room with a View*, is also a powerful frame for situations in our life when we are, consciously or unconsciously, behaving on behalf of others.

Now that companies have been introduced, we can consider when and how they should combine with each other—an activity known as merging. In the fifth chapter, mergers are paralleled with romantic relationships by exploring how romance and finance have been intertwined from Renaissance Florence to the rise of the Rothschilds to the merger of AOL and Time Warner.

The next two chapters combine the lessons of risk from asset pricing with the messiness of corporate finance by exploring the idea of debt and what can result from excessive levels of debt—bankruptcy. The artist Jeff Koons and William Shakespeare's *The*

Merchant of Venice allow us to map the commitments of borrowing to a much more personal setting. And Kazuo Ishiguro's *The Remains of the Day*, the fall of the richest man in colonial America, and a case study of the American Airlines bankruptcy teach us about the risks of excessive borrowing and the rewards of conflicting obligations.

The final chapter attempts to synthesize much of the book by trying to make sense of the disjunction between the nobility of the ideas laid out in the preceding chapters with the reputation of finance today. The stories by authors Leo Tolstoy and Theodore Dreiser manifest the typical reputation of finance, and Willa Cather provides the recipe for living one's life in a manner that is consistent with the nobility of the financial ideas discussed in the preceding chapters. A brief afterword and detailed references (including suggestions for further reading) conclude the book.

With this tour of the molecular biology (asset pricing) and sociology (corporate finance) of finance complete, hopefully the field of finance will come alive for you—and will help you navigate the risks and returns of your life.