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BOOK REVIEWS

Review of *Traders: Risks, Decisions and Management in Financial Markets*

Robert A. Olsen

Traders: Risks, Decisions and Management in Financial Markets, Mark Fenton- O'Creevy, Nigel Nicholson, Emma Soane and Paul Willman, 2005, Oxford, UK: Oxford University Press, 244 pp.

Most academic economists know virtually nothing about the decision behavior of professional securities traders. This is because they usually assume that axiomatic rationality and optimization must dominate the decision process and that real world issues, such as personal goals and motivations are irrelevantly exogenous and thus outside the purview of their discipline. Unfortunately, the empirical evidence is now overwhelming that most decision makers don't behave in such a simple fashion and financial models based on these assumptions yield poor practical results. Good behavioral research must begin with more realistic assumptions about market makers decision behaviors and motivations. If you feel a personal need to learn more about the decision making behavior of honest to goodness securities traders, this well structured academic study would be a fine place to start.

To begin it should be noted that there are very few other texts (maybe three or four at most) that present the results of comprehensive, well structured, research designed to examine the decision environment and processes of securities traders. Most books on the subject tend to be either, anecdotal and focused on the personalities and behaviors of a few financial celebrities, or fatuously "How To". This book is neither.

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The data and conclusions presented in this book are based on a three year study of 118 experienced securities traders and trader managers in four London firms. The primary information on trading behavior was gathered by personal interview, survey, and experimental manipulation. The subjects traded various products such as stocks, bonds, and financial derivatives. The approach of the study is multidisciplinary and considerable emphasis is given to the work environment and social milieu as determinants of trader belief and practice. In addition extensive discussion is presented about trader risk preference and the influence of management practice on trader goals and operational behavior. Among the more interesting conclusions are the following.

1. Traders are not the super rational beings that most economic models assume them to be. They appear to rely on many of the same heuristics and rules of thumb that most people use to navigate the uncertainty of daily life.
2. Traders can often amplify rather than damp market price fluctuations in the normal course of their trading activity and can be a dominant source of "noise trading".
3. Traders exhibit a normal range of risk aversion in their private lives and tend to be conservative and risk averse as professionals. In fact, they often must be schooled to become more risk accepting and less emotional as traders.
4. Traders primarily learn their trade thru apprenticeship and mentoring by experienced traders. They rely heavily on intuition and the application of tacit knowledge and exhibit a type of decision making that can best be described as "naturalistic"(see the following review of "How Professionals make Decisions").

A major strength of the book is that it attempts to analyze trader behavior by framing the inquiry in terms of accepted psychological and sociological paradigms. The downside of the book is that it must be carefully reread in many places in order to identify many subtle market implications of the trader workplace and mentality. In particular, the book makes extensive use of "representative" trader comments to emphasize important points. In conclusion, the book is not a simple set of tables and graphs summarizing trader behavior but a more subtle and nuanced treatment of trading as a professional career.

Review of *How Professionals Make Decisions*

Robert A. Olsen

How Professionals Make Decisions, Henry Montgomery, Raanan Lipshitz and Berndt Brehmer, eds., 2005, Mahwah, NJ: Lawrence Erlbaum and Associates, 423 pp.

This book is a good companion to the previous book "Trading" because it contains 28 research studies investigating the nature and application of what has come to be called Naturalistic decision making. Naturalistic decision making refers to a type of decision practice that has been identified as the method of choice under the following circumstances.

1. The problem is ill-structured
2. The environment is uncertain and dynamic
3. There are shifting and competing goals
4. Positive feedback loops abound
5. High stakes and high stress are present
6. There are well recognized norms of behavior

Common examples of Naturalistic decision making environments include fire fighting, military combat, airplane piloting, emergency medical care, disaster relief, etc. Recent evidence also suggests that securities trading appears to be defined by recognized Naturalistic decision attributes as well.

The research papers in this book are from the 2000 Naturalistic Decision Conference held in Stockholm and are authored by recognized experts in the field. The book is divided into three sections; Individual Decision Making, Social Decision Making, and Advances in Naturalistic Decision Making Methodology, with each section consisting of nine separate research papers The individual papers run the gamut from conceptual to experimental to case studies. Since the first Naturalistic Decision Conference in 1993 the discipline has gained widespread interest and acceptance. This book presents an up to date summary of important developments the field. However, those who would appreciate a more basic and integrated discussion of the principles of Naturalistic Decision Making might first read "Sources of Power" by Gary Klein, MIT Press, 1998.

Review of *Happiness: Lessons from a New Science*

Robert A. Olsen

Happiness: Lessons From a New Science, Richard Layard, 2005, New York, NY: Penguin Press, 310 pp.

No, this is not a new self-help book, although that is what I also thought when I first picked it up. It is also not a book devoted to descriptions of investor behavior. However, it is an excellent synopsis of specific types of consumer thinking and behavior that is directly applicable to investment practice and partially responsible for such documented financial missteps overconfidence, herding, market bubbles, etc.

As some you may know, Professor Layard is one of Britain's most well known labor economists and a principal researcher with the London School of Economics. In this book Professor Layard systematically reveals what economists have wrongly assumed about human motivation and decision making by addressing the question, "why it is that happiness cannot be satisfactorily explained by relying on traditional economic models of rational thought and personal optimization"? After initially presenting evidence that happiness can be meaningfully measured and presenting data showing that, beyond some minimal level, increases in material wealth have little effect on personal happiness, the author delves into the topics of invidious comparison, the hedonic treadmill and the idea of a common social good. In summary, Professor Layard presents a picture of human beings who are innately focused upon cooperative behavior and social acceptance, primarily relying on heuristics and measures of relative worth, but who are driven to extreme acquisitive behavior and unhappiness by a surfeit of material goods, unhealthy social distractions, and erroneous social and material reference points. Along the way we are treated to examples of the misperception and mismanagement of risk, insufficient personal diversification, the misallocation of time, money and resources, and the erroneous deification of personal and economic flexibility. In the end it is human capital (healthy personal relationships), not economic capital that make for a happy life. Unfortunately "the dismal science" has ignored many of the most important motivations and decision processes underlying individual behavior and market dynamics.

The book is scholarly, well written and edited, with a surfeit of footnotes and references for those who wish to examine individual topics in more depth. Because many finance professionals continue to be stressed, anxious and defensive in spite of "having it all" this book provides the added bonus of suggesting how they might to improve their lives by not allowing their natural instincts to be hijacked by the neoclassical economic thinking.