The Liquidity Theory of Asset Prices

Gordon Pepper
with Michael J. Oliver

John Wiley & Sons, Ltd

The following are quotes about the course 'The Monetary Theory of Asset Prices', Module 3, Practical History of Financial Markets, Edinburgh Business School; run by the Stewart Ivory Education Company (SIFECO) and taught jointly by Gordon Pepper and Michael Oliver.

'An excellent series of lectures'.

'Quite inspirational'.

'Very interesting course making me more aware of monetary influences – very worthwhile'.

'I shall look forward to reading more if not all of the book'.

'Excellent, stimulating and in my view very important subject'.

'Very insightful. My eagerness to learn more has increased'.

'The back to basics. Clear, pithy and informative'.

'Good double act of academic/professional'.

'A very interesting course which I plan to follow up with further reading'.

'Michael Oliver: Highly enthusiastic, very thorough; Gordon Pepper: Very practical – steeped in the real world. An authority on money supply'.

'Excellent topics and materials. This is cutting edge work'.

'Excellent combination of presenters – academic background combined with practical examples'.

'My objective was to make some sense of my experiences over the past thirty years and gain some framework for assessing the future by listening to some of the finest minds in the City and the academic input – I HAVE NOT BEEN DISAPPOINTED'.

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Foreword

For at least the last decade, there has been a growing sense of frustration among market professionals with the attempts by academics to account for the behaviour of financial markets. Practitioners do not dispute the value of academic analysis, but assert that academic theories do not adequately explain the behaviour of financial markets. The result is that many very experienced practical people have become highly critical of traditional teaching in universities. This book, which represents the culmination of a lifetime's experience, is written by a practitioner who, over his long and distinguished career, has often worked with academics. This is no indigestible academic tome, however, it has been written for practical men and women; indeed it is a cornerstone of a new course in financial education established by The Stewart Ivory Foundation.

The Stewart Ivory Foundation is a charity founded in 2001 to further the development of financial education in Scotland. To cover omissions from conventional teaching, the Trustees, who represent the major investment management companies in Edinburgh, decided to sponsor the new course, which is entitled, 'A Practical History of Financial Markets', as one of the elective units within the Edinburgh Business School's (EBS) MBA programme. EBS currently operates the second largest distance learning MBA programme in the world, and in 1994 and 1999 was awarded a Queen's Award for Export for its MBA product. As well as the endorsement of a UK chartered university, the course is also offered as part of the 'Approved Provider Program' of the CFA Institute.

What is missing from the traditional approach to financial education? When asked about key omissions, investment managers normally reply: 'psychology and liquidity'. In recent years, the former has been partially codified in the field of Behavioural Finance and has been endorsed by the granting of the Nobel Prize for Economics to Daniel Kahneman in 2002. As this field of study is now well developed, it is not too difficult to find authors and teachers for a new course. However, finding authors and teachers with experience of the world of practical investment, rather than the halls of academe, proved a more difficult hurdle. Fortunately though, the problem was not insurmountable, and Behavioural Finance now forms a core unit of the course.

Matters were significantly more complicated in developing a unit of the course that deals with the issue of 'liquidity'. Liquidity can mean all things to all men. At its core is a belief that sometimes there is a force which exerts individuals to effect a financial transaction when they would not otherwise do so. Such a compelled action can be at odds with the voluntary actions taken by the rational man and normally assumed to result in efficiency. Most investment managers believe that understanding this force of compulsion is a key to understanding a financial market when it appears to be behaving irrationally. The bad news is that the only way in which fund managers have, in the past, come to understand the Liquidity Theory of Asset Prices is through experience. While experience may be the best teacher, the lessons, especially for an investment practitioner, can prove to be very costly. It seems truly remarkable that, despite investment managers proclaiming that liquidity has a crucial role in financial markets, no formal educational course on the Liquidity Theory of Asset Prices exists. It is difficult to explain this lacuna in investor education. One excuse often given is that the subject is so complex that it has proven too difficult to be explained and taught in an understandable format to practical men of finance. There might well be some truth in this, and thus, finding an author and teacher who not only was a master of the brief, but could also make his subject understandable to practitioners, could not be guaranteed. From the outset, the trustees of the Foundation considered that Gordon Pepper was the individual most likely to be able to provide this breakthrough.

Gordon's mastery of the 'liquidity' brief has been recognised for decades, not only by his peers in the industry, but in academia and by politicians in search of policy advice. Crucially, Gordon's understanding of this subject owes everything to his practical experience in the financial markets, rather than to any textbook or university lecturer. In Gordon's 1994 publication, *Money, Credit and Asset Prices*, there was clear evidence that, almost for the first time, here was an author who could make the subject largely understandable to all (that of course is not the same as saying that it made the subject easy to understand). *The Liquidity Theory of Asset Prices* is a significant advance on *Money, Credit and Asset Prices*. First, the analysis has become tighter since the earlier work was published. Second, it has gone through a series of filters to enhance further the intelligibility of the subject matter.

A major refinement to Gordon's approach came when he was faced with the difficult task of updating and turning his 1994 publication into distance learning materials for students of the 'Practical History of Financial Markets' course. Creating materials which can form the basis of a distance learning course is difficult enough in even the simplest of disciplines. Significant modifications for this particularly difficult subject were required. Even more distillation of the materials was needed to convert these distance learning materials into a series of lectures lasting not more than ten hours. It was at this stage that Gordon sought the assistance of Michael Oliver. Not only is Michael a professional lecturer, but he is also a leading economic historian, whose expertise on monetary policy is well recognised. Michael's input thus further increased the intelligibility of the subject matter, adding the voice of a professional economic historian in those sections of the book which seek to show liquidity in action by examining historical precedent. This was not the end of the distillation process, however. It is a military truism that 'no plan survives contact with the enemy', and a similar comment can be made with regard to educational courses and students. Thus, the final improvement in the materials has been made following the feedback from the students, primarily professional investors, who have taken the course. Student feedback, which has been very favourable – 'inspirational', 'cutting edge work', 'excellent', 'stimulating', 'steeped in the real world', 'insightful' – has also led to further fine-tuning.

The combined impact of these numerous processes has been to produce a book which is the best practical explanation of the Liquidity Theory of Asset Prices currently available for investment managers. For those more interested in theoretical issues, it also explains how the Liquidity Theory of Asset Prices interacts with, and complements, the Efficient Markets Hypothesis. Professional investors are bombarded on a day-to-day basis with assertions about the role liquidity is playing, and will play, in determining prices in the financial markets. Few, if any, of the providers or recipients of such advice can truly claim to understand the well-springs of such liquidity and the transmission mechanisms through which it impacts asset prices. This is a book guaranteed to go a long way to remedying that embarrassing lack of understanding of an economic force which will increasingly move to the centre stage of financial market understanding.

Russell Napier
Course Director
A Practical History of Financial Markets

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