

Preface

This book approaches personal finance from an investments perspective, and investments from a personal finance perspective. Texts in the area of finance tend to be either on corporate finance or investments. However the appropriate dichotomy may be between corporate finance and personal finance. Texts on personal finance would cover investments, as the current one does. In the future texts may emerge covering other aspects of personal finance such as saving and debt. The present text pays some attention to saving and debt, but the emphasis is on investments. This emphasis stems largely from the fact that there is far more academic literature on investing than on saving and borrowing. There are a few texts available specifically on personal finance with coverage of savings and debt, but unfortunately they tend to be at a relatively elementary level of analysis with little reference to the academic literature.

The current text differs from other texts on investments in a number of ways:

1. It recognises that investing is a behaviour, which can be analysed from the perspectives of a number of disciplines. Many investment texts are based solely on financial economics. When they allow another discipline into the analysis it is typically by means of a separate chapter, or section of a chapter, on behavioural finance. This entails a consideration of the implications of cognitive psychology. The present text does not separate behavioural finance into a separate chapter, but integrates it into many aspects of investing. It also goes beyond cognitive psychology and introduces the significance of a number of other disciplines such as social psychology, sociology, accounting, macroeconomics, politics, demography, gerontology, media studies, and marketing.
2. It uses less mathematics than most other texts. Although mathematics can provide rigour, it can also be a barrier to communication. Many readers find mathematics impenetrable, and can lose sight of the fundamental principles by being distracted by mathematical methodology. Furthermore mathematics can limit discussion to the measurable dimensions, whereas many important aspects of personal finance and investing are not measurable.
3. There has been an attempt to integrate the most recent (at the time of writing) literature into the discussion so that readers become acquainted with the most recent ideas and evidence.

4. The text recognises that personal finance is about money management. Correspondingly the concepts and principles covered are related to the money management problems of individual investors.
5. Many of the investment theories are illustrated by numerical examples.
6. The text has a UK orientation. Whilst non-UK residents can use the text to learn about the principles and processes of personal finance and investments, the institutional examples (e.g. savings schemes, pension schemes, and the regulatory framework) are UK-based. However about 95% of the text has universal relevance.
7. There are chapters dealing with issues, which are important but are rarely given emphasis in other texts. Examples include the psychology of financial decision-making, stock market bubbles and crashes, the significance of institutional investors, the purposes and processes of regulation, property investment and finance, and alternative investments such as structured products and hedge funds.
8. The text recognises that most investment at the personal level is carried out through institutional investors. Consequently there is much more emphasis on institutional investors than is typically the case with other texts.

Theory and Practice

This book should be useful to practitioners in the fields of personal finance and investments as well as to students. Sometimes practitioners dismiss theory as irrelevant to their needs. However an understanding of relevant theory can be of great assistance to practitioners. It is worth quoting from Cordell, Langdon and Lemoine (2006):

“Although academic research is often obtuse and unrealistic, many articles have implications that have relevance to the real world inhabited by practitioners. Plowing through the mathematics and statistics of some articles may be a stretch for most practitioners, but the inferences drawn from articles are often worthy of the financial service professional’s time and effort. Indeed, many of the financial concepts used daily by practitioners.....were born in academic articles.” (Page 78)

This book incorporates the contributions of more than 800 recent articles, which are of relevance to both practitioners and academics. The intention has been to make the concepts and implications of those articles readily accessible to those who lack the time to devote to reading the articles themselves. However, since the articles are referenced, the reader is able to refer to the articles where this is desired.

The only thing that is certain is uncertainty

The reader should not expect to find unambiguous answers to all the many questions concerning personal finance and investments. One of the reasons for ambiguity is the existence of differences in opinion. There is, in particular, a dichotomy between two schools of thought. One school is known as the traditional or neoclassical tradition (but which could be referred to as the arbitrage-optimisation tradition). According to this school of thought most people act rationally (or nearly so) and financial markets allow them to do so. Markets are expected to be accessible and investors should have equal access to information. Arbitrage and optimisation are important concepts in this tradition. The returns from investments are expected to be no more, nor less, than fair compensation for delaying expenditure and accepting risk. This is probably the dominant school of thought amongst academics.

The main alternative school of thought is referred to as behavioural. According to this approach people are frequently irrational and financial markets do not always provide conditions that permit rational investors to fully achieve their objectives. Sentiment plays a large part in this tradition. Practitioners are often more comfortable with this school of thought.

The reader may find that there are different answers to the same questions. This is to be expected, particularly when there are radically different ways of thinking about problems. The debates continue. It should not be assumed that one perspective is correct for all times and in all markets.

According to the Efficient Market Hypothesis all investments are correctly priced since they reflect all relevant information (or are sufficiently accurately priced to preclude the possibility of profiting from mispricing). The debate about the Efficient Market Hypothesis may seem arcane but it is central to the debate between the two main schools of thought. Traditional finance theory is largely premised on

market efficiency. If financial markets were not efficient, the case for traditional finance theory would be weakened. It may be expected that degrees of efficiency vary from time to time and from market to market.

There are many financial market adages. One is: “The only thing that is certain is uncertainty”. This applies not only to financial markets but also to the analysis and understanding of those markets.