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BOOK REVIEWS

Mark Kritzman, Senior Editor

THE UNDERCOVER ECONOMIST

By Tim Harford
(Reviewed by Javier Estrada, IESE Business School, Barcelona, Spain)

Alfred Marshall, one of the founding fathers of Economics, used to suggest that one first work out results mathematically, and then put them into ordinary language. If the second step was not possible, he advised: Burn the math! I strongly believe that the beauty of economics lies in the intuition behind the math, that the economic approach has much to teach to non-economists, and that a course of essential economic thinking should be required either in high-school or in all college degrees. It is in this light that books like *The Undercover Economist*, by Tim Harford, are always welcome and useful.

Harford is one of several economists who over the last few years has made an effort to bring economics to the mainstream. This is not, to be sure, an easy task. Economic thinking often goes through the three stages of truth suggested by the German philosopher Arthur Schopenhauer: First it is ridiculed; then it is violently opposed; and finally is it is accepted as self-evident. Brilliant economists such as Gary Becker and Judge Richard Posner, who have pioneered the application of economic analysis to "non-economic" issues, have spent many long years on the first two stages before finally arriving at the third.

A good economist does not readily accept the idea that recycling paper increases the number of trees. If planting trees is made less attractive by the reduced demand for paper, the supply of trees will shrink, and whether the number of trees increases or decreases is an empirical question. Theory can go both ways. Similarly, an economist does not readily accept that a safer birth-control device will reduce the number of unwanted pregnancies; the reduced risk will lead to an increase in the number of sexual encounters, and whether unwanted pregnancies increase or decrease is an empirical question Theory, again, can go both ways. Economic reasoning can also be used to explain why individuals may rationally choose to get fatter or to have more accidents, however strange that may sound.

Harford's book consists of a selection of topics chosen to illustrate the economics hiding behind our everyday lives. He discusses, for example, the complex issue of price discrimination with simple examples such as the different prices Starbucks charges for different types of coffee, the different prices Disneyland offers to locals and tourists, and the different prices for the same items observed in two different Marks & Spencer stores just 1,500 feet away from each other.

Harford also discusses externalities, a core issue in economics, with stories about traffic jams in big cities, the recent congestion tax drivers must now pay in London, and the market for permits to emit sulfur dioxide in the US. He also deals with the economics of information, addressing issues such as moral hazard and adverse selection, and again brings them to the mainstream with several examples such as why health insurance rests on the existence of asymmetric information (or, as he calls it, mutual ignorance), why companies spend heavily on advertisement, and, of course, why it is difficult to buy a decent used car.

Game theory, which has become inevitably intertwined with economics (particularly after the Nobel prizes awarded to John Harsanyi, John Nash, and Reinhard Selten in 1994, and to Robert Aumann and Thomas Schelling in 2005), is not ignored in the book. In one of the chapters I found most interesting, Harford insightfully discusses the government auctions for third-generation (3G) cellphone services, carefully explaining why the auctions largely failed in New Zealand, why they were successful in the UK, and why they had mixed results in the US.

Perhaps in an effort to reach a wider audience, Harford steers away from microeconomic reasoning and tackles some hot macro issues, such as poverty, globalization, and China. In a nutshell (and oversimplifying), poverty is explained as stemming from corruption and weak institutions; globalization as the consequence of David Ricardo's theory of comparative advantage; and China's growth as the result of Deng Xiaoping's replacement of a socialist system that gave the wrong incentives with a market-oriented system that does the opposite. (I did say I was oversimplifying!)

Any downsides? Yes, most books have them and this one is no exception. I would have certainly liked to see the name and insight of Ronald Coase in the discussion of externalities. (The market for trading pollution permits was inspired by his theorem.) I would have liked to see a better and longer discussion of the economic approach to individual decision making. (Why people might have more accidents when seatbelts become mandatory? Why people might get fatter when low-fat foods become popular?) I could have lived without the chapters on poverty, globalization, and China. (They seem to be there to ride the wave of the current popularity of these topics.) And I would have replaced those three chapters with discussions on the economic approach to "non-economic" issues such as crime, education, discrimination, marriage, sex, and sports, to name but a few.

Readers who enjoy Harford's book may also want to consider *Freakonomics* by Steven Levitt and Stephen Dubner; *Sex, Drugs & Economics* by Diane Coyle; *Naked Economics* by Charles Wheelan; *Hidden Order* by David Friedman; *Free Lunch* by David Smith; and *Fair Play* by Steven Landsburg. A special mention goes to the book that, in my view, remains the benchmark and still the best of this type, *The Armchair Economist*, also by Steven Landsburg.

In short, Tim Harford should be congratulated for his effort to bring the essential economic approach into the mainstream. He is witty, entertaining, and above all, insightful. I have no doubt that you will both enjoy and learn from reading this book.

THE FUTURE FOR INVESTORS

By Jeremy Siegel
(Reviewed by Javier Estrada, IESE Business School, Barcelona, Spain)

Very few books achieve the honor of becoming instant classics, and

Jeremy Siegel's *Stocks for the Long Run*, now in its third edition, is most likely one of those. Siegel's new book, *The Future for Investors*, is plainly and simply a must-read follow-up. It is said that the sequel a movie is usually not as good as the first; when it comes down to Siegel's sequel, this commonly-held belief does not apply.

The fact that this book is a sequel of the first (Siegel calls it a "natural extension") is made clear in the preface, in which Siegel states that in the speaking engagements that followed the publication of his first book he was often asked two questions: (1) Which stocks should investors buy for the long run? and (2) What will happen to portfolios when baby boomers retire and start selling theirs? This book largely is an attempt to answer both questions.

The book is divided into five parts. In the first, "Uncovering the Growth Trap," Siegel takes one step further a message that comes out clear in his first book: Dividends are the main driver of stock returns. At the same time, he advises investors to stay clear from hot stocks and industries; it is when investors pay too much for glamour stocks that subsequent returns are poor. In fact, Siegel shows that the best returns are obtained in out-of-favor companies that manage to survive negative trends all the while paying high dividends. *It is precisely the reinvestment of these dividends at low stock prices that yields the highest returns*. (And it is for this reason that, despite all the bad news for tobacco companies over the last several years, Phillip Morris, now Altria Group, is the best performing of all the original components of the S&P500.)

In the second part, "Overvaluing the Very New," Siegel gives investors a few hints to help them spot bubbles (watch for intensive and increasing media coverage, watch for high valuations based on concepts and names instead of earnings) and renews his charges against growth stocks. Standing on the shoulders of Warren Buffett and Peter Lynch, he makes a convincing argument for avoiding hyped stocks in growth industries and focusing on the best stocks of struggling industries instead.

In the third part, "Sources of Shareholder Value," Siegel defines the concepts of bear market protector and return accelerator, and links both to dividends, the underlying theme of the book. Dividends provide protection against bear markets when reinvested at the low prices prevailing in these markets; they also enhance returns once the extra shares bought at depressed prices eventually go up in price.

The fourth part, "The Aging Crisis and the Coming Shift in Global Economic Power," is perhaps the one which readers of finance books will be most unfamiliar with. Siegel skillfully first scares investors with some demographic trends (the aging of the population, the retirement of baby boomers) and their implications (unfunded pension funds, declining stock prices), and then gives them hope with a "global solution" (the population in developing countries is much younger and will eventually buy the baby boomers' assets thus preventing a market slump).

Finally, in the last part, "Portfolio Strategies," Siegel tackles some well-known issues, such as international diversification, country versus industry diversification, the home bias, and the lack of a positive relationship between growth and returns (the fastest growing countries are not those that deliver the largest returns because growth tricks investors into overpaying for stocks). And showing a flair for marketing, he offers investors the D-I-V directive: Investors should focus on companies that have sustainable cash flows and return them as ***d****ividends*; should recognize the ***i****nternational* economic forces that are shifting power away from the US, Europe, and Japan toward China, India, and the developing world; and should buy stocks with reasonable v*aluations* relative to their expected growth.

I have a few quibbles with some issues but they haven't prevented me from largely agreeing with Siegel's views and recommendations. Just for the record, I would have liked to see a better treatment of transaction costs and taxes, both of which are particularly relevant when buying high-dividend stocks. I also have some reservations about the ability of small investors to reinvest their dividends, given that if their stake in a company is small so will be their dividends, and buying a few extra shares is always expensive once transaction costs are taken into account.

All in all, I found the book thoroughly enjoyable and instructive. I have been recommending it to practitioners and students, and certainly I recommend it to you.