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Scott T. Young, *Essentials of Operations Management*. New Delhi: Sage Publications India Pvt. Ltd, 2009, 433 pp. Rs. 495 (ISBN: 978-81-321-0243-4 [Pb]).

The book *Essentials of Operations Management* by Scott T. Young represents a somewhat different approach to the subject of Operations Management. Most other books on the subject follow a conventional approach covering similar topics. This book attempts to discuss the subject of Operations Management more holistically as a part of a larger picture of overall management in an organization. Moreover, most books on the subject focus on production operations. The book gives sufficient treatment to service operations also. The book has been divided into three sections: 'Management and Strategy' (seven chapters), 'Planning' (four chapters) and 'Inventory, Logistics and Supply Chain Management' (four chapters).

The first chapter is a short introduction to the subject of Operations Management. Apart from illustrating the concept in manufacturing organizations like Boeing, it also looks at operations in service organizations like luxury hotels and universities.

The second chapter is on 'Productivity and Process Analysis'. Measures of productivity in a variety of organizations, mostly from the service sector are provided in this chapter. It covers organizations like call centres, publishers and movie theatres and even sports. A short discussion on Wiki productivity is quite a novel one. Process analysis has been

introduced as a DMAIC (Define-Measure-Analyze-Improve-Control) technique. However, the chapter focuses only on the first two steps, i.e., defining and measuring.

The third chapter focuses on the operations strategy. The treatment of this topic is quite different from the conventional one found in books on Operations Management. The discussion is more towards an overall business strategy rather than an operations strategy. In this context, Michael Porter's Five Forces of Competition and Value Chain are introduced. The discussion in 'Nine questions for formulating a strategy' tries to bring in some practical hints for formulating the strategy of a firm.

The fourth chapter on 'Managing Workforce' is normally not found in textbooks on Operations Management. Undoubtedly, workforce management is an essential part of operations of any firm and this is a welcome addition to the usual topics discussed by other authors. It covers various aspects including team building, retention, training and development and performance reviews. The discussions on Toyota and South-West Airlines are interesting and are good illustrations of how workforce is managed in successful organizations.

The fifth chapter is on 'Balanced Scorecard' and is again an absolutely new addition to the usual topics found in textbooks. Balanced Scorecard is increasingly being used by firms to review performance and thus, inclusion of this chapter is quite relevant. As mentioned earlier, this book is not restricted to a narrow view of Operations Management

and discusses topics as part of the larger issues of management in a firm. Application of Balanced Scorecard is discussed with respect to operations management.

The next chapter is on 'Total Quality Management'. The definition of quality is discussed with respect to eight different factors. Deming's 14 points are discussed in fair detail and some reference has been provided to service quality and lean operations. The DMAIC technique is discussed though not entirely under the heading of 'Six Sigma'. However, a brief reference to the concept of Six Sigma has been provided.

Chapter seven is on 'Sustainable Operations' which brings in a very relevant aspect of business management to the contents of this book. The issue of sustainable development is gaining importance each day as organizations compete for scarce resources and increasing energy consumption is considered a necessary part of development. The chapter covers aspects of global warming, pollution, recycling and green buildings.

'Forecasting and Aggregate Planning' is the topic of chapter eight. Both qualitative and quantitative techniques for forecasting are covered in this chapter. Aggregate planning techniques are covered but solved problems on these techniques are missing. An illustration has, however, been given for aggregate planning in services.

Chapter nine deals with the topic of 'Scheduling' in operations. Job shop scheduling is discussed including Johnson's Rule and its extension to three processes. Master production scheduling is discussed along with a detailed illustration on labour scheduling. Scheduling operations in a variety of service organizations including hospitals, airports

and sports are discussed. However, a discussion on scheduling of batch operations is missing from this chapter.

The next chapter discusses the issue of 'Facility Location'. It discusses the global location of firm operations and the application of the Geographical Information Systems (GIS) in deciding the right location for an organization. However, the techniques discussed are limited to the Factor Rating Method and Center of Gravity Method only.

Chapter eleven is on 'Facility Layout and Waiting Lines'. This chapter discusses process layout, product layout and cellular layout. The discussions on different layouts are too concise and it would have been better if the author had discussed these in more detail. Application of simulation to waiting lines is well-illustrated with the help of an example.

Supply Chain Management (SCM) is discussed in the twelfth chapter. The chapter gives an introduction to various aspects of SCM including transportation, outsourcing, warehousing, postponement and mass customization.

Chapter thirteen covers 'Inventory Management and Purchasing'. Though the chapter does cover the Economic Order Quantity Model and Purchasing at Fixed Intervals, the Reorder Point Model and a discussion on quantity discounts are completely missing. The discussions are too concise with no graphical representations and the treatment of this topic is absolutely inadequate.

'Resource Planning' has been covered in chapter fourteen. This mainly covers material requirement planning and an example has been provided. The MRP sheets provided in a tabular form have the grid lines missing. Without proper rows and columns marked with lines, it becomes a little difficult to read

the entries in the material requirement plan. A discussion on batch sizing rules is missing from the chapter.

The last chapter deals with 'Project Management'. The chapter covers the Critical Path Method (CPM), Program Evaluation and Review Technique (PERT) and Work Break-down Structure (WBS). Earned Value Analysis has also been included and success factors for projects are discussed. However, the Critical Chain Approach which is an improvisation of the conventional network planning tools has not been discussed at all.

At the end of the book a few case studies are provided. Each chapter has unsolved problems at the end and short cases also. However, solved examples within some of the chapters are not enough. At times, a mathematical treatment of topics also seems to be inadequate. The book, however, does include in its contents new and relevant topics like sustainable operations, balanced scorecard and workforce management which most other books do not discuss. The book could be a welcome addition to the library but is probably not exhaustive enough to be considered as a textbook.

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Devendra Agochiya, *Every Trainer's Handbook* (2nd edition). New Delhi: Sage Publications India Pvt. Ltd. 2009, 409 pp. Rs. 495 (ISBN: 978-81-321-0081-2 [Pb]).

In a fiercely competitive environment, organizational learning as well as employee

learning are the key drivers of competitive advantage. Continuous learning and development of people hones and develops the requisite competencies among them and prepares them to face the challenges posed by the turbulent and dynamic business scenario. More and more organizations are investing in the learning and development of their employees. Moreover, newer forms and modes of learning are emerging. Consequently, a large pool of internal and external trainers is being formed. However, there is a serious dearth of well-trained and competent trainers to meet the ever-spreading demand of training from the corporate world. The profession of training and development is still in a nascent stage in India and it has a long way to go. A large number of young men and women are entering the profession and they need help and professional guidance to grow and to contribute to the development of people.

The book under review by Devendra Agochiya is quite a handy and insightful volume for both new and seasoned trainers. The author traverses through the different facets of training and development ranging from the conceptualization of learning and training to the roles and functions of a trainer to an analysis of stakeholders of training to training design to the conduct of training and evaluation of training. The present book is different from the other books in the field of training and development in the sense that it is very practical and applied in its approach. While it deals with the why and the what of the training process, its main focus is how. It addresses the real issues that a characteristic trainer faces in his day-to-day professional life. The book treats a trainer as a facilitator of adult learning and emphasizes the primacy

of participatory learning and treats the learner as an active participant in the training learning process. The author stresses that the participant must own the training intervention and see himself as the key stakeholder in the learning process. The participant must understand that he is the main beneficiary of the training programme and his commitment to learning is crucial for the achievement of learning outcomes. A trainer is indeed an inseparable partner in the learning process and a catalyst who unobtrusively galvanizes the learning of participants.

The book has nine chapters. The first two chapters focus on training and learning processes. Training is conceptualized as not only acquiring required knowledge and competencies but also as changing one's behaviour. In fact, change in behaviour is the essence of learning. Adults are willing to change when they are convinced about the purpose of learning and its utility for their personal or professional lives. Thus they cannot be taught like children. They set their own agendas and learning goals. They should be exposed to participatory training where they actively participate and contribute to one another's learning. They decide what they wish to learn and how they intend to transfer learning on the job.

Today training can be class training, distance training or e-training. The role of a trainer as a facilitator is to encourage the participants to partake in learning activities, to raise questions concerning them and to think critically. It is also important for a trainer to help the learner unlearn his past perceptions, behaviour and styles as unlearning and learning go hand in hand.

Mobilizing and managing the key stakeholders of training is a *sine qua non* for any

trainer. The four major stakeholders in a training intervention are—the organization, the training agency, the trainer and the learner. All of them have to play their roles effectively to make a training programme successful. They have to develop clarity about one another's roles and responsibilities. They also need to have contracts—written or otherwise—with one another. Such contracts will be conducive to greater commitment and high performance from them.

The design and delivery of a training programme are the themes of chapters four and five respectively. The design of the training programme begins with a training needs analysis which is translated into the programme objectives. Contents, training methods, time allocation and faculty resources are then determined by the programme objectives. However, there are some basic principles of programme design that a trainer should keep in mind while designing it. During the delivery of the programme, learning occurs; thus, it is the most important phase of the training process.

The first contact between a trainer and the participants is significant. The participants need to realize that they are at the training venue for learning and they must take the training programme seriously. A trainer needs to establish the participants' ownership of the programme at the beginning of the programme itself. He should also establish norms and standards for conduct during the training so that optimal learning takes place. In other words, a learning climate should be created that is characterized by participation, asking questions, positive energy, mutual support, fun, hard work and sincerity. The author has devoted a section on asking questions. This is

important for trainers interested in participant-centred learning. Chapter seven is concerned with training methods and techniques. This is a comprehensive treatise but it covers the usual information. Nonetheless it can be useful for a new trainer.

Chapter eight is related to the dynamics of a training group. The norms and values of the training group affect training effectiveness. The diversity and interaction among the participants has an impact on learning. Hence, the dynamics of a training group have to be managed. The trainer needs to closely watch the behaviour of the participants and measure the level of learning. He needs to initiate a host of interventions during the different stages of the life of the training group. The last chapter deals with the evaluation of training. As the adage goes, if there is no measurement, there cannot be any management. The evaluation of a training programme can be either reactive or summative. The purpose of reactive evaluation is improvement, while the purpose of summative evaluation is validation. A mid-course evaluation of the programme is also desirable to introduce necessary modifications to facilitate the learning of participants.

In a nutshell, this book is a lucidly written, practical manual for a learning and development professional. It is especially written from the vantage point of view of a trainer. The roles and functions of a trainer are elaborated upon during the different stages of a training intervention. It uses a series of boxes illustrating a trainer's roles. There are valuable tips as well. The summary of the chapter acts as good *aide memoir*.

The author has done an extremely good job in presenting the contents in a readable and comprehensible fashion. The book does not

use jargon; at the same time, it includes all vital topics presented in a straightforward and clear language that an archetypal trainer needs to know and apply in his professional practice. It is not just recommended for a new trainer, but also for a veteran to re-visit and refresh the fundamental principles and processes of training and development.

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Mohamed A. El-Erian, *When Markets Collide: Investment Strategies for the Age of Global Economic Change*. New York: McGraw Hill, 2008, 304 pp. US\$ 27.95 (ISBN 978-0071592819, [Hb]).

Introduction

What should the financial community and policy makers do when markets collide? How should they handle the situation given that the notion of markets colliding is exacerbated by not only events in the developed world, but with those in the emerging economies as well? El-Erian is uniquely equipped to formulate and think through these developments because his work represents a unique point of convergence; he is both a policy maker and an investor by temperament. El-Erian is, therefore, convinced that it does not make sense to think about these recent developments without taking into consideration their implications for those who are working in the finance-based sectors of the international

economy, *and* for those who are interested in formulating an adequate policy response 'when markets collide' in the context of the international economy. The complexity inherent in this collision between markets is also interesting because it has evolved into a problem that does not respect national boundaries, but has become an international epidemic that requires us to summon not only our skills as crisis managers, but also as academics, policy makers and intellectuals. The theory of markets collision also includes accounts of the contributions made by central bankers, especially the US Federal Reserve under the leadership of Ben Bernanke and the Federal Open Market Committee (FOMC), to manage what might have otherwise become a major crisis of liquidity in the United States. The scope of the financial crisis can be understood by the fact that the Fed was forced to draw upon its institutional powers in a way that it has never had to in the past. While the time frame in this study is till January 2008, El-Erian is convinced that the disruptive events that happened after this period are only further socio-economic confirmations of his thesis.

The findings of the book, El-Erian argues, are important for those who not only want to have an understanding of the contemporary financial crisis but also to work out the modalities necessary to navigate it for the international community as a whole. This book can also be read in the context of the theoretical genealogy to which El-Erian and his peer group of scholars are intellectually related. The primary theoretical influence on El-Erian's work is that of the economist John Maynard Keynes and the training that he received in economics at the University of

Cambridge, where the focus was on approaching economics as a 'method of discovery' rather than as a settled doctrine in the social sciences. In this model of education, students were actively encouraged to think in terms of the strengths and weaknesses of the different schools of economic thought. An economic model, in their understanding, is not meant to be applied in a cookie-cutter fashion to solve a socio-economic problem or to formulate a policy. It is this *eclecticism in method* that has served El-Erian so well as a policy maker at the International Monetary Fund (IMF) and subsequently as an investor at Salomon Smith Barney, the Harvard Management Company (HMC), and currently with the bond-trader Bill Gross at Pimco. The economists that he is interested in are those with an innovative bent of mind, and who work at the intersection of economics and finance. They include Nassim Taleb, Peter Bernstein and Richard Peterson. All these leading thinkers are preoccupied with the possibility of generating intellectual synergy through inter-disciplinary work in the financial sciences.

Signals within the Noise

What exactly is going on in the financial markets? Why should those outside the realm of technical expertise in finance care? What are the special challenges and problems for policy makers? These then are some of the important but not the only questions addressed in this book. The key modalities involved in thinking about the problem of the financial crisis include not only the need to differentiate between signals and noise in the markets; but

more importantly, the ability to spot the signals *within* the noise. It was the inability to pick up early signals in the financial markets that set up the ground conditions for the crisis; this is not admittedly an easy thing to do. This is particularly the case with those who under-estimated the difficulties of financial globalization. El-Erian illustrates this phenomenon with the example of young kids playing soccer without a proper understanding of the game. Kids who play soccer begin to follow the ball throughout the play ground, but the more experienced players try to anticipate *where* the ball will be at a particular point in time. The moral here is that it is not analytically wise to be too data-dependent. The next task though is to work out the analytic modality that is necessary to handle 'aberrations, conundrums, and puzzles,' which have characterized the behaviour of the financial markets in recent years prompting the Federal Reserve, the US Treasury, and central bankers around the world to wonder what exactly is going on, given that these developments violate the standard expectations in models of the international economy that are usually invoked in the context of the balance of payments, the role of currency reserves, international capital flows, the US current account deficit, the yield curve, etc.

Aftermath of Summer 2007

El-Erian sets out a description of the financial markets in which such phenomena made their initial appearance starting with the crisis in the summer of 2007, and the changes that came about in the relationship between the so called 'debtor countries' and 'creditor

countries' as illustrated by the rising importance of the Sovereign Wealth Funds (SWFs) and their willingness to recapitalize leading Wall Street firms. The US Federal Reserve also had to cut the federal fund rates aggressively between September 2007 and January 2008 and encourage banks to increase the amount of liquidity in the system. What makes these phenomena interesting, in addition to their intensity, is that they did not occur sequentially but emerged simultaneously; hence, the need to examine the enormous 'collateral damage' that has affected both the industrialized world and the emerging economies during the financial crisis. It was the inability to understand the systemic implications of not sufficiently differentiating the signals from *within* the noise, and making a timely policy and/or regulatory intervention, that, according to El-Erian, is at the root of this financial crisis. What is needed then is a theoretical framework that can rigorously differentiate signals from noise, and then identify the signals within the noise, as set out in this book.

The Great Moderation

How, for instance, are we to explain the resilience of the emerging economies in the context of these developments? El-Erian hopes that the attempt to understand the underlying global transformations beneath the signals will make it possible for him to 'shed light on the future evolution' of the international economy, especially in terms of its fundamental notions. But, in order to do so, he finds it necessary to spell-out why the traditional surveillance modalities in place to monitor the

international financial system failed. El-Erian also includes memoirs of his time at the IMF and HMC to examine the nature of these challenges when they first emerged from the loci in which he found himself as an employee in these organizations. The traditional role of the IMF, needless to say, has to be re-thought in a situation where international reserves in emerging economies has increased to a point where the amounts being lent by the IMF have constantly gone down, given especially the onerous problem of conditionalities in lending to developing countries under the aegis of structural re-adjustment. What then should the IMF do to re-invent itself? These and other such considerations will also clear the theoretical ground necessary for El-Erian to examine the different economic frameworks generated by his peer group in an attempt to find better explanations for the aforesaid phenomena, including the end of an important period in economic history that is known as 'the great moderation'. The period after the summer of 2007 however marked the return of volatility in the financial markets, making it therefore necessary for financial analysts to seek greater recourse to monitoring mechanisms such as VIX to measure volatility, and VAR to measure risk.

The New Framework

What must the analyst know to read market signals correctly? This is the theoretical task that El-Erian sets out for himself. He starts off with the assumption that all systems are characterized by noise to some extent, and that the 'signal-noise ratio' must be determined as accurately as possible in any given analytic or decision-making situation. His

advice is that the analyst must neither ignore noise nor allow himself to be overwhelmed by it, but understand instead how the signal-noise ratio relates to the larger patterns of communication in a given system. This problem is also exacerbated by the fact that in the 'efficient-market hypothesis' there is a tendency to assume that whatever does not make sense from an efficiency point of view must be noise of some sort or the other and can therefore be ignored. The breakthroughs in behavioural economics, however, became possible precisely because it turned out that what was thought to be noise in the efficient-market hypothesis was not always noise from a behavioural point of view. There are a number of reasons for this. However much economic and financial analysts prize efficiency, market participants have to battle information asymmetry, and often misunderstand the nature and scope of signaling. Furthermore, they prefer to 'satisfice' rather than 'optimize' through forms of 'bounded rationality', and often encounter uncertainty, rather than certainty, as they go about their day-to-day transactions in the market. In these circumstances, the number and scope of market transactions will reduce or even stop since market participants will try to temper risk with prudence rather than act in the absence of necessary information.

The Black Swan Phenomenon

There are a number of other constraining factors as well in the context of developing countries, where capitalism has not yet matured as stable forms of socio-economic arrangements. In these markets, it is even more difficult for an analyst to push the efficient-market

hypothesis as an instantiation of economic rationality. Hence, it becomes necessary to turn to behavioural economics and neuroscience to understand how market participants actually behave irrespective of how rationalist theories expect them to behave. It is again the inability to differentiate between signals and noise that is analogously linked to the relationship between the 'mean' and 'deviations from the mean' in the language of statistics. The so called 'black swan phenomenon' is an interesting case in point. Black swans are statistically low-probability events; but that does not prevent them from occurring, despite their 'rarity, extreme impact, and retrospective predictability'. The tendency to think or normalize phenomena along the mean makes it difficult to both anticipate and recognize such phenomena when they occur. The cost-factor in not being able to spot a black swan winner can be quite high as recent historical phenomena demonstrate not only in the financial markets but in other spheres of life as well. El-Erian's framework hopes to provide the necessary correctives to make it not only possible to navigate change successfully, but to get ahead of the change curve when necessary by understanding the important role played by institutions of higher learning in this process. Education, as he reminds us, is the privileged locus from which analysts and policy-makers can further the cause of socio-economic change since as President Drew Gilpin Faust of Harvard University, his former employer, is fond of pointing out, 'change has no constituency' per se.¹ In a cynical world, where fundamental research is increasingly losing its constituency, academics must press on with the compulsion to bring about change through

the advancement of knowledge. This notion of change has to do with the fact that new knowledge always makes new demands on society to change its traditional ways of doing things. Universities must therefore not only focus relentlessly on the demands of higher learning, but must do so despite the pressures to compromise in the short term. Bringing about structural change depends then on the ability to understand the relationship between signals and noise, and the framework in which they can be differentiated effectively.

Multiple Equilibria

Financial analysts who are informed by academic research can help to work out the relationship between the emergence of anomalies and the underlying equilibrium in an economic model. If, however, the economic model in place is static, it means that it works with a deterministic or simplistic notion of static equilibrium. The changes that the author hopes to capture in the analytic process must therefore be able to invoke multiple equilibria in order to handle complex situations. These are situations that require corrective action despite the risk of 'moral hazard'. The notion of moral hazard that is invoked in the context of a financial crisis is fundamentally different from the one that is used in the case of the failure of individual firms when the economy is doing well. The nationalization of Northern Rock in the United Kingdom, and the attempt to rescue Bear Sterns by the US Federal Reserve through the offices of J.P. Morgan, are relevant examples in this context. Much of the populist indignation generated by these rescue attempts then is related to the inability to differentiate clearly between the

failure of firms and the *failure of markets*, since the danger that is being addressed by the authorities is related to the problem of ‘contagion’ that results when an economic situation cascades quickly out of control. That is why Fed Chairman, Ben Bernanke, argues in Congressional testimonies on the need for the Fed to be ‘alert and flexible’, and thereby ensure that there is sufficient liquidity in the system.

Capital Flows to the West

El-Erian is anxious to include the role of emerging economies in his framework because they force us to re-think the basic modalities of growth, especially if their economies were to be situated under the aegis of the purchasing power parity model rather than that of national income. He also reviews studies by scholars such as Michael Spence, Dani Rodrik and Antoine van Agtmael to argue that emerging economies like India and China are working with indigenous models of growth. Furthermore, the role that SWFs have played in re-capitalizing firms means that economists are forced to re-think how the developed and emerging economies should relate to each other in terms of international capital flows. It is this phenomenon that Larry Summers, former Secretary of the Treasury in the Clinton administration, referred to as

the ‘irony of our time’, since these capital flows have taken the world by surprise. They were not initially thought to be possible within developmental economics and the long-term implications of such flows is yet to be understood by economists and financial analysts given that the commonplace scenario is generally one of developing countries shopping for capital in the west with a promise of higher returns to foreign investors through FDI schemes. While such capital flows from SWFs have found a number of takers in Wall Street because of the recessionary environment in the US, they were, until recently, met with ambivalence (especially in sectors with implications for national security). This, however, is an opportune moment to re-think the fundamental questions in terms of the ‘regulatory and supervisory’ environments that would be necessary if the international economy is to persist with financial globalization during these recessionary times without seeking recourse to ‘beggar-thy-neighbour’ policies, that will merely deepen macroeconomic problems and erode asset values in economies across the world.

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NOTE

1. See Drew Gilpin Faust ‘Installation Address: Unleashing Our Most Ambitious Imaginings’, dated

12 October 2007 at http://www.president.harvard.edu/speeches/faust/071012_installation.php

Michael J. Mauboussin, *More Than You Know: Finding Financial Wisdom in Unconventional Places*. New York: Columbia University Press, 2008, (Indian Reprint, Collins Business, 2009), 328 pp. Rs. 1,190 (ISBN 978-81-7223-802-5 [Pb]).

Introduction

The role played by 'cognitive diversity' in thinking about and thinking through complex problems is an important element in understanding how firms and markets work. Is cognitive diversity desirable in solving complex problems? Is cognitive diversity essential in solving complex problems? These are the key questions that Mauboussin addresses in this collection of essays on 'finding financial wisdom,' as he puts it in his subtitle, 'in unconventional places'. Mauboussin not only makes an effective case for cognitive diversity, but also for 'multidisciplinary perspectives' in the process of problem solving. Mauboussin sources his fascination with the modalities of problem solving in complex situations and complex systems to the intellectual influence of Charlie Munger of Berkshire Hathaway, and the theoretical work of the Santa Fe Institute, which routinely brings together people working in different areas to generate new solutions and theories. This book is divided into four parts and covers areas such as 'investment philosophy', 'psychology of investing', 'innovation and competitive strategy', and 'science and complexity theory'. These essays were originally written when Mauboussin was with Credit Suisse First Boston. He is currently at Legg Mason Capital Management, where he

advices on investment strategy; he also teaches security analysis at the Columbia Business School in New York City. The animating philosophy in this book is inspired by the notion of 'consilience' that is associated with the work of the famous Harvard biologist Edward O. Wilson, who argues that 'a balanced perspective cannot be acquired by studying disciplines in pieces but through pursuit of the consilience among them' (p. v). It is only through the notion of consilience that it will become possible to narrow the differences between different approaches to knowledge. Why is this important? It is important because if 'the gaps between the great branches of learning can be narrowed, diversity and depth of knowledge will increase' (p. v). These lines from Wilson serve not only as the epigraph of this book, but also as its animating spirit. It is emotional intelligence (EQ) that matters even more than IQ in Mauboussin's notion of 'financial wisdom'. The themes that matter the most in an investment philosophy then pertain to the perennial conflicts inherent in the following binaries: 'process' versus 'outcome', 'long-term' versus 'short-term', and the importance of 'internalizing a probabilistic approach'.

Robert Rubin on Decision-Making

Mauboussin makes a compelling case for a process-based approach to decision making which works on the calculation of probabilities of a given outcome rather than depend on a model that is oriented only to 'actual' outcomes. The intellectual sources for this model are Robert Rubin's important commencement addresses at the University of

Pennsylvania (1999) and at Harvard University (2001). In these commencement addresses, Bob Rubin, who had earlier served as Secretary of the Treasury in the Clinton administration, emphasizes the role played by ‘probability’ in decision-making since, as Mauboussin reminds us, we ‘often make the critical mistake of assuming that good outcomes are the result of a good process and that bad outcomes imply a bad process’ (p. 10). Rubin, therefore, offers a set of guidelines on decision making which are characterized by the following four principles: Rubin’s first principle simply states that ‘the only certainty is that there is no certainty’ (p. 11). This is not only a problem that is endemic in finance-based industries, but must be understood in the context of ‘risk’ given that the terms ‘uncertainty’ and ‘risk’ are often conflated. Rubin differentiates between these terms by arguing that while outcomes cannot be predicted with either uncertainty or risk, we can at least differentiate between these terms since ‘with uncertainty, the underlying distribution of outcomes is undefined, while with risk we know what that distribution looks like’ (p. 11). The second principle states that decision making is related to ‘weighing probabilities’ carefully given that ‘probabilities alone are insufficient when payoffs are skewed’ (p. 12). It is necessary then to understand the relationship between the ‘frequencies’ of an outcome with the ‘magnitude’ of the payoff, if any. This is often forgotten because of the ‘loss aversion’ that characterizes not only the average investor, but also the average individual as demonstrated in 1979 by Daniel Kahneman and Amos Tversky in the context of prospect theory. The third principle is that uncertainty is not an excuse to procrastinate; Rubin

argues that ‘we must still make decisions based on an intelligent appraisal of available information’, given that, in practice, ‘additional information often only confuses the decision-making process’ (p. 13). And, finally, the ‘process’ of decision making is as important as the ‘outcome’ since no process of decision making can guarantee success for the firm. It is, therefore, important to work with recommendations that acknowledge the role of probability in matching the relationship between ‘price’ and ‘value’, and the gap that often emerges between these notions. ‘This prior acknowledgement,’ argues Rubin, ‘if shared by the organization, allows analysts to be wrong periodically without the stigma of failure’ (p. 14).

Philosophies of Investment

The preoccupation with incentives, however, can distort the process of rational decision making since it fails to adequately differentiate between investment philosophies that focus on ‘the profession’ as opposed to that of ‘the business’. It is much more likely, therefore, that an investment manager will beat the market with a focus on the profession and not get taken in foolishly by the short-term needs of the business. It is, therefore, important to learn to think in terms of ‘expected-value’, which focuses not so much on the ‘frequency of correctness’, but, instead, on the ‘magnitude of correctness’ (p. 24). Furthermore, investment strategies tend to work with a model of ‘attributes’ rather than with ‘circumstances’. This fails to recognize the importance of effective ‘valuation’, which requires sensitivity to the financial context in which

decisions are made. Fund managers ignore the financial context at their peril, especially when the markets demand to be understood in terms of complex dynamics rather than in terms of linear dynamics. This is also the problem that arises with expert opinion on the behaviour of stock markets and macro-economic forecasting in general. The constraints imposed by 'functional fixedness' and the problem of 'reductive bias' make it highly likely that the process of forecasting will go wrong because of the inherent propensity to reduce complex dynamics to linear dynamics and the residual fascination with the physicalist notion of equilibrium systems in the areas of finance and economics. Hence, expert systems built into computer programmes have started to pose a major challenge to human expertise as demonstrated by the superiority of Deep Blue over the legendary chess player, Garry Kasparov. It is therefore important to develop the skill sets inherent to cognitive diversity in professional training, which Isaiah Berlin identified as the difference between the approaches of the 'fox' and the 'hedgehog' in problem solving situations, especially when they are 'continuous' and 'dynamic' rather than 'discrete' and 'static'.

Consilience among Disciplines

It is also important to differentiate between two forms of decision making: 'individual' and 'collective' since both affect the dynamics of the market place (p. 69). This is because when the individual is rational the markets may not be rational and vice versa; but this, in itself, is not a cause for concern since even though individuals make irrational decisions, they do not all make irrational decisions

in the same way and at the same time. It is, therefore, important to differentiate between individual behaviour and collective behaviour. In order to outperform the market, it is necessary to come to terms with the 'dynamics of the collective', since it is quite difficult for individuals to outperform the collective. Diversity then becomes not only a necessary condition to ensure efficiency in the markets; a breakdown in diversity may even lead to a decrease in efficiency. The classic symptom of such a breakdown is 'herding', where the investor will suspend his better judgement and merely do whatever other investors are doing leading thereby to behavioural oscillations between the so called 'bullish' and 'bearish' phases. While objective measures of 'investor diversity' are not available in the markets, the success of 'contrarian investment' as a philosophy demands that they do not get carried away by the demands of either the short term or the long term, but understand the implications of different time-frames in determining their philosophy of investment. The approach that Mauboussin recommends from the literature on strategic management is called 'strategy as simple rules'. These rules that were developed by Kathy Eisenhardt and Don Sull spell-out how companies can resolve the short-term/long-term conflict by managing 'both for the next quarter and the next quarter century' (pp. 151–52). And, finally, new breakthroughs in neuroscience, rigorous applications of power laws to describe stock prices, network theory, and a more rigorous theory of information flows will help us to understand the structure and function of companies and capital markets in the future. While financial theorists have not been traditionally interested in the work done by those

outside their discipline, Mauboussin argues that 'consilience among disciplines will play a crucial role in advancing our investing knowledge' (p. 225). This book then is an attempt to make the biological notion of consilience

more acceptable in the theory and practice of finance.

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