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In Defense of the History of Ideas

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Mark Blaug, historian of economic thought, recently put forth a challenging notion: Economic knowledge is path-dependent (Blaug [2001]). "What we know about the economic system is not something we have just discovered," he points out, "but it is the sum of all discoveries, insights and false starts in the past. Without Hayek and Robbins and Pigou, no Keynes; without Keynes, no Friedman; without Friedman, no Lucas; without Lucas...."

Blaug's hypothesis is equally relevant to finance theory. Suppose Harry Markowitz had never encountered that stockbroker in the dean's office in 1952, and turned instead to an entirely unrelated field for his exploration into the wonders of operations research. Or suppose Markowitz had let himself be seduced by John Burr Williams's seductive assertion—right at the top of the first paragraph of his masterwork—that the investor seeks "the best at the price" (Williams [1938]; see also Bernstein [1992]).

Without Markowitz's analytical structure based upon the *portfolio* and the necessity to give risk management as much consideration as calculations of expected return, would we have had Modigliani-Miller? I refer not only to their theory of corporate finance but also to their emphasis on the role of risk in corporate valuation and the critically important role of arbitrage in market behavior. Or would we have had Tobin and his focus on a single optimal combination of risky assets, which led in turn to his disdain of "interior decorating" as an approach to portfolio selection?

And without Markowitz, M&M, and Tobin, would Sharpe have come up with his proposition that the market is the most powerful factor influencing individual asset returns? Without the insight of systematic and specific risk, would we have had the Sharpe-Treynor-Lintner-Mossin capital asset pricing model itself? Or Eugene Fama and the efficient markets hypothesis?

And if none of this had happened, would indexing ever have gained popularity? How would we calculate manager performance? Even more important, would Black-Scholes-Merton have been able to figure out a systematic method for valuing options? And without indexing, performance measurement, and Black-Scholes-Merton....

I recently put this sequence of questions to a high-powered European audience of finance academics and practitioners. My own view, I suggested, was that the essences of these ideas, one way or another, would have emerged over time anyway, even without the signal contributions from this list of distinguished people, in view of the institutionalization of markets and the irrational exuberance of the late 1960s, the crashes of the 1970s, the tumult in corporate governance in the 1980s, and the information revolution of the 1990s.

The audience was silent for a moment, and then one man raised his hand. "Where would finance theory be today," he asked, "if Bob Shiller had been born in 1939 and Eugene Fama had been born in 1948, instead of the other way around?" Indeed! One could play with this question endlessly. For example, how would economic theory and public policy have developed if Milton Friedman had been born in 1883 and Keynes in 1912, instead of the other way around? What if Karl Marx and Adam Smith had switched birthdays?

Blaug has it right. Theories are as path-dependent as events. Athena may have emerged fully developed from the head of Zeus, but the wisdom she bestows upon us is accretive, not randomly developed. The history of ideas, therefore, is not a sideshow we can choose to ignore. Rather, it plays an integral role in our understanding of the tools and concepts handed down to us.

We would do well to keep Blaug's words before us: "There is nothing predetermined about our current theories and if years ago, economics [or finance] had taken another turn at a critical nodal point, we would today be advocating a different theory." Amen.

Bernstein, Peter L. *Capital Ideas: The Improbable Origins of Modern Wall Street*. New York: The Free Press, 1992, pp. 46-47.

Blaug, Mark. "No History of Ideas, Please, We're Economists." *Journal of Economic Perspectives*, Vol. 15, No. 1 (Winter 2001), pp. 145-164.

Williams, John Burr. *The Theory of Investment Value*. Cambridge: Harvard University Press, 1938.