Book Reviews

Equity Markets. By ROBERT A. SCHWARTZ. New York: Harper & Row, 1988. Pp. xvi + 544.

Equity Markets. by Robert A. Schwartz is designed to serve as the textbook in a masters level course dealing with market microstructure issues. In the past, it is my guess that many masters degree programs without acknowledged experts on their faculty have decided that such a course is too focused to generate sufficient demand to cover the costs of instituting such a course. It is possible that recent events on Wall and State Streets, the subsequent reaction among politicians and the press, combined with an increase in interest among academics in theoretical and empirical microstructure issues, may change the balance. That is, there may now be sufficient interest on both the demand and supply sides to justify more courses in microstructure issues.

In my opinion, *Equity Markets* is the best available text for such a course. The analysis is on a level that is appropriate for sophisticated masters students—some discussions require calculus and involved algebraic manipulations. The book proposes a method of analysis and uses this methodology consistently to analyze questions having to do with the optimal behavior of investors facing a securities market with frictions. The intuition derived from this analysis is then used to examine regulatory issues and the architecture of markets.

The book is divided into three sections. The first section is institutional and provides a description of the rules of the game, the players, and the history of the game. The second section provides the formal methods of analysis (primarily those of consumer choice from microeconomics) and examines the empirical implications of the analysis. The final section discusses market architecture, including the design of trading mechanisms and the role of governmental regulation.

The first section's material is well chosen, but not unique, and the discussion fits well with the remainder of the book by providing enough institutional detail to motivate subsequent analysis. The institutional description is consistent with a theme that runs throughout the book that the purpose of a market is to provide liquidity and price discovery and that different institutions may be able to perform these functions with varying degrees of success.

The heart of the book lies in the second section. The best chapters here are Chapters 8, 10, and 11, for these provide the meat of the microstructure analysis. The discussion of trading strategies in Chapter 8 provides the intuition for an analysis of the relation between market design and performance. The most rigorous analysis is that of the optimal trading strategy when facing a call market (an uncommon securities market in the U.S.), but the issues associated with a continuous market are at least introduced. Curiously, I think, a discussion of the market order/limit order choice is deferred until Chapter 10.

Chapter 10 provides a discussion of the effect market microstructure considerations have on the statistical properties of returns. Except for minor quibbles (for example, it is stated that sequential information arrival contributes to positive serial correlation in returns, yet this statement is refuted back in Chapter 9), I think the discussion of statistical properties is good and provides a suitable introduction to the analysis of data discussed in Chapter 11, which is quite good analysis that most students will find useful.

While the second section deals with microstructure issues from the investor's point of view, the third section considers microstructure from the point of view of those providing the liquidity—market makers. Chapter 12 presents an accurate and up-to-date summary of the various theories of the spread. I would have liked to have seen more reporting of specific empirical work related to the determinants of the spread, but this is a small point since the broad conclusions of empirical research are reported.

Chapters 13 and 14 deal with (respectively) the design of markets and the governmental regulation of markets and market activity. The discussion of market architecture is centered around three topics: geographical consolidation (one versus many exchanges), temporal consolidation (call versus continuous markets), and price stabilization. The book provides a reasonable analysis of the pros and cons associated with the two forms of consolidation. Of particular interest is a specific example of an alternative form of market.

The data presented with the analysis of price stabilization are fascinating; Chapter 13 provides transaction-by-transaction data for one stock on March 1, 1987 (a presumably unremarkable day) as well as hour-by-hour data for October 19, 1987. The data, which indicate the volatility of stock prices, can form the basis for an extensive discussion of the definition of and the desirability of price stabilization. Price stabilization in this book is taken to mean smoothing the fluctuations about the equilibrium price, and, hence, stabilization is closely related to the "price discovery" purpose of markets (a topic considered in Chapter 15).

Different individuals will have different ideas about what should appear in a course devoted to market microstructure, and I suspect that no book will have exactly what any given professor will want. This book is no exception. Were I to teach such a course, I would use *Equity Markets*, but its use would be supplemented with other readings. For the purpose of choosing these supplementary readings, the quite extensive bibliography of *Equity Markets* will be quite helpful as it appears to be particularly strong in referencing papers that will be accessible by masters students.

I would not go so far as to say, however, that the publication of *Equity Markets* is sufficient to inspire me to design a course in market microstructure. Many of the chapters of *Equity Markets* discuss material that is discussed in other courses in the finance curriculum, and I do not believe that the uniquely microstructure material is sufficient to fill an entire course. I do not mean to suggest that *Equity Markets* misses a substantial amount of literature on market microstructure but rather that the literature itself is still somewhat limited. I should add that some of the material in this book could profitably be discussed in a portfolio management course. Unfortunately, the book is fairly expensive, and I would hesitate to recommend this as a supplementary text for a portfolio management course.

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Money and Capital Markets. By TIM S. CAMPBELL. Glenview, IL: Scott, Foresman and Company, 1988. Pp. xv + 606.

Advancements in financial theory such as option pricing and agency theory in the past fifteen years have provided insightful ways of understanding the claims of various parties on the firm and the potential for incentive problems in such an organization. These and other recent theories in finance are surprisingly absent from the majority of textbooks in the area of financial markets and institutions. Considering that these courses are normally offered in finance departments with a corporate finance course as a prerequisite, such a void is hardly justified. Tim Campbell's new book fills this gap. It builds upon theories of modern corporate finance and financial economics to discuss the organization and behavior of financial firms and markets.