

The 1-2-3 of Investing

Part 9: the Origins of Finance

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For those readers who are interested in investing, finance would seem to be a good choice for a college major. Finance literally began as a dissertation about combining stocks in a portfolio. Harry Markowitz had argued that stocks that are not perfectly correlated with one another will reduce risk without sacrificing return. The doctoral student was earning a degree in economics from the University of Chicago when he developed what latter would be called the modern portfolio theory.

The actual date of birth for finance can be traced to noted American economist and University of Chicago professor Milton Friedman, who was present at Markowitz's dissertation defense in 1954 and surprisingly claimed that the thesis was not economics! Some would call Markowitz's theory "financial economics" but, for most, it's simply finance. The theory would later win the Nobel Prize in Economics in 1990.

Not surprisingly, the University of Chicago became the center for research in finance. The school attracted great thinkers like Eugene Fama, who has been called the "father of modern finance". His greatest contribution is the efficient-market hypothesis, which claims that stock prices incorporate all available information and that excessive returns from stocks are not possible.

Another academic giant from the University of Chicago was Myron Scholes, who with Fischer Black created a model that some have heralded as the most important financial model of

the 20th century. It is used to price market derivatives, such as options, and was used by the writer¹ of “The 1-2-3 of Investing” for his dissertation at the University of Kentucky. The model won the Nobel Prize in Economics in 1997.

Of course, not all contributions to finance in those early years were made by University of Chicago professors and students. KSU business students will see William Sharpe’s capital asset pricing model (CAPM) in Finance 3100, Finance 4360 and possibly others that determines assets’ required rates of return. Stocks with actual returns that are greater (less) than their respective required returns are regarded as above-average (below-average). The CAPM captured the Nobel Prize in Economics for Sharpe in 1990.² Sharpe taught mainly on the west coast and retired at Stanford.

Another model that KSU business majors will use is the Gordon model. It is intended to establish the price at which a stock should trade. Myron Gordon had Harvard and MIT connections with many of finance’s contributors. In a personal note, Gordon’s switch from journalism³ to economics is akin to your writer’s experience—journalism to finance.

¹ Not to be confused with the “Great Thinkers.”

² More than one model and more than one contributor can win the Nobel Prize in the same year. While Sharpe won in 1990 with the CAPM, Markowitz did likewise with his portfolio theory.

³ Ranked #1 among regretted college majors...seriously.