Abstract

Risk may be bad, but sometimes risk could also open up opportunities. But we must know how to measure it and weigh its consequences. Scholars come up with more and more sophisticated strategies to predict capital market behavior. Investors have more comprehensive understanding about market behavior than in the past. In my research, I want to compare the differences between risk managing methods in the past and present times. I aim to learn how risk managing strategies change with the constantly developing global capital market and how this market behaves under the influence of factors, such as the development of accounting information, improvement in information technology, and increasing risk awareness. The more we know about risk, the better we can understand and manage our future.

Literature Review

Starting in the nineteenth century, the finance industry experienced rapid change. In order to better understand the behavior of current financial markets, we should go back to where it all began.

Development of Risk Management

Like most other great revolutions, it originated in the mind. The revolutionary idea that defines the boundary between modern times and the past is the mastery of risk (Bernstein, Against the God, p. 1). A group of thinkers' remarkable vision revealed how to put the future at the service of the present. It showed the world how to understand risk, measure it, and weigh its consequences. In ancient times, most decisions were based on past experience or religion-based guesses. In the mid-seventeenth century, Blaise Pascal, a famed French mathematician, and Pierre de Fermat, a lawyer, developed a new version of the theory of probability. It had significant impact on human history. It was the first time people developed a rational approach to risk-taking. It inspired many to extend and broaden their work. In the eighteenth-century, Jacob Bernoulli, a Swiss scientist and mathematician, invented the law of large numbers and the methods of statistical sampling that are the inspiration for modern opinion polling and stock-picking. Thomas Bayes, an English minister, built on it to demonstrate the practical usefulness of statistics. In the twentieth-century, Nobel Laureate Harry Markowitz demonstrated why putting all of one's eggs in one basket is too risky. His risk diversification method revolutionized Wall Street, corporate finance, and business decision-making.

Revolution of the New Era

Furthermore, innovation is the sign of a new era (Bernstein, Capital Ideas, p. 1). Innovations that have emerged since the mid-1970s have totally transformed the financial industry. Everything had to be revised: investment objectives, diversification patterns, trading strategy, and the clientele. The complexity and speed of financial innovation have reached a point where it is hard to grasp what is happening from moment to moment.

The Power of Gold

The glitter of gold dazzled human eyes for centuries. Gold has motivated entire societies, shaped economies, inspired the most beautiful works of art, and provoked horrible acts by one people against another (Bernstein, The Power of Gold, p. 1). The reasons we are fascinated by this special metal is because gold symbolizes eternity, royalty, wealth, and formality. Gold is the medium and the store of another (Bernstein, p. 1). Innovations that have emerged since the mid-1970s have totally transformed the financial industry. Everything had to be revised: investment objectives, diversification patterns, trading strategy, and the clientele. The complexity and speed of financial innovation have reached a point where it is hard to grasp what is happening from moment to moment.

Risk is a choice rather than a fate. The actions we dare to take, depend on, how free we are to make choices, are what the story of risk is all about.—Peter Beren'estein

Methodology

Historical Landmarks

- Development of the theory of probability in the 17th century, which is the mathematical heart of the concept of risk
- The evolution of econometrics in the early to mid-20th century, as a science to analyze and test economic theories with statistical models
- The recent growth of computing and information technology which allows high-scale and high-speed analysis of financial data
- Nobel Prize in economics awarded to scholars for their contributions to the understanding of financial risk: James Tobin (1981), Harry Markowitz, William Sharpe and Merton Miller (1990), Robert Merton and Myron Scholes (1997)
- Constant innovation and flow of new financial products (futures, options, interest rate, and currency swaps, junk bonds, collateralized debt obligations, credit default swaps) that transform the capital market
- Major global economic crises that have caused scholars, practitioners, and policy makers to reexamine the way we think about and deal with capital market risk: The great economic depression of 1929; the stock market crash of October 19, 1987; the collapse of the South East Asian capital markets in 1998; loan defaults by the Mexican and the Russian governments; and the more recent economic crisis, which started with big financial institution defaults in late 2007

BIBLIOGRAPHY


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