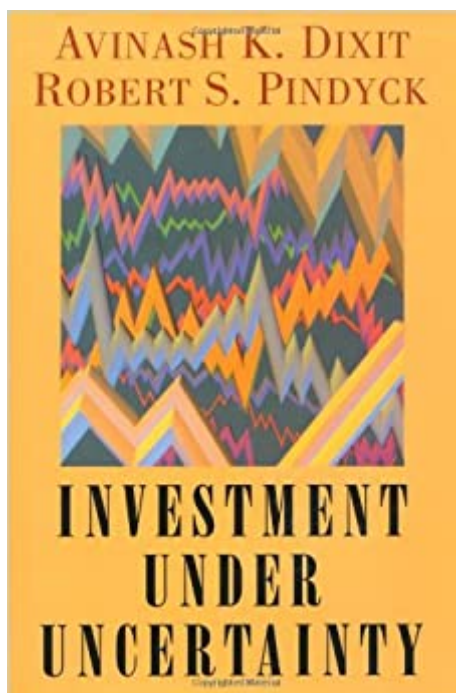


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# Investment Under Uncertainty



## Synopsis

How should firms decide whether and when to invest in new capital equipment, additions to their workforce, or the development of new products? Why have traditional economic models of investment failed to explain the behavior of investment spending in the United States and other countries? In this book, Avinash Dixit and Robert Pindyck provide the first detailed exposition of a new theoretical approach to the capital investment decisions of firms, stressing the irreversibility of most investment decisions, and the ongoing uncertainty of the economic environment in which these decisions are made. In so doing, they answer important questions about investment decisions and the behavior of investment spending. This new approach to investment recognizes the option value of waiting for better (but never complete) information. It exploits an analogy with the theory of options in financial markets, which permits a much richer dynamic framework than was possible with the traditional theory of investment. The authors present the new theory in a clear and systematic way, and consolidate, synthesize, and extend the various strands of research that have come out of the theory. Their book shows the importance of the theory for understanding investment behavior of firms; develops the implications of this theory for industry dynamics and for government policy concerning investment; and shows how the theory can be applied to specific industries and to a wide variety of business problems.

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"[The authors'] approach has powerful implications for investors in marketable assets as well. No investment professional or CFO can afford to ignore this brilliant new book."--Peter L. Bernstein,

author of Capital Ideas: The Improbable Origins of Modern Wall Street "Avinash Dixit and Robert Pindyck have successfully applied to capital budgeting the ideas and techniques of option pricing that have so enriched our understanding of financial markets."--Merton H. Miller, Nobel Laureate in Economics

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Let me start off by saying that this is an excellent book. The authors are very clear writers and the text is easy to follow. I think there are two types of readers that can benefit from reading this book. First, anyone that wants to learn about real options, especially the theory behind it should read this book. Dixit and Pindyck do a wonderful job explaining the different options embedded in real projects. Second, anyone that wants to learn how to use dynamic programming or contingent claims analysis to solve real options problems should read this book. In my opinion, Dixit and Pindyck have the best explanation of what to expect and how to solve the common specifications found in real options problems. They show problems that make use of different stochastic processes, such as geometric Brownian motions, mean reverting processes, or Poisson jump processes, and show how some of these can be solved analytically. Other books do not delve into a lot of detail on finding analytical solutions to the problems and merely assume that readers would be able to figure out their calculations. In addition, there is a short section (might even have been an appendix) that briefly discusses how numerical solutions work. After reading a number of real options texts available in the market, I am glad that I still took the time to read this book. This is probably the most important real options book out there. Although I think every one interested in real options should read this, I think the ones that are particularly interested in more applied real options are better served by a book like Copeland and Antikarov's Real Options book and Copeland's Valuation book. These books are more geared towards solving valuation problems using binomial trees, which for practical purposes would most likely be the approach used (as most real world problems would probably need numerical solutions anyway).

This book is a great introduction to real options and optimization with Brownian motion constraints. The book is well written. I started reading this as a senior in undergrad, and its almost self-contained. Great textbook -I highly recommend it. I wish Dixit and Pindyck wrote more textbooks in economics.

Must-read for anyone investing in anything!

This is probably the most useless book on real options which I own. The book is extremely difficult to follow and uses academic mathematical notation which is difficult for practitioners to follow. In addition, the authors have largely ignored both the underlying business operations which create real options and the existing operations literature on project management, operations research, petroleum engineering, manufacturing systems engineering, etc. which provide many of the tools necessary for practical evaluation of real options. The bottom line is don't waste your money on this book.

For anyone interested (seriously) in investment under uncertainty (aren't most of the investments such) this is a must have. But a few words of caution though. The book is not easy to read and follow if you don't have working knowledge of calculus, differential equations, numerical analysis (finite differences) and probability theory to a lesser degree. The book actually summarizes the field of investment under uncertainty up to the point when it was written (early 90s): basically it collects journal articles published in this area and organizes them in logical manner. But it also does more than just collecting articles: it emphasizes important points in each of them and omits irrelevant ones. It also adds important segments to bridge the gap between the articles. In the first few chapters authors give mathematical preliminaries (in my opinion you should look elsewhere if the maths is unknown to you but once you get the hold of it, you will appreciate their exposition as it is very concise and relevant to the issues in the book). In the rest of the chapters authors build the idea of investment under uncertainty starting with simple and moving on to more complicated examples. So who could use this book? Besides academics, people working on investment analysis in capital intensive industries (energy, RnD, real estate, etc - engineers might find this book very useful: Pindyck by the way has a degree in electrical engineering and Dixit in math). Coming from the energy sector I always felt something was wrong with traditional NPV analysis. Now I know what the solution is: use real options. Overall, the book is worth every second you invest in it.

A lifetime book, a must for people interested in the modern "real options approach". Thorough and very didactic book, the maths level is far easier than Duffie's books, for instance. Requires differential calculus but at undergraduated engineering level. Previous knowledge of stochastic calculus and optimization under uncertainty are not required because there are two excellent chapters where the authors explain these tools in a concise format. For serious students, researchers and practitioners in capital budgeting, financial economics and investment theory. Comprehensive industrial applications models of practical importance, with several numerical results throughout charts and tables, makes this book valuable for capital budgeting consultants. In textbook format, for people interested in a deep understanding of the models, not only in rules of the thumb or ease advices. The best choice for graduated level courses, but some chapters also can be used for MBA courses, at least as complementary text. A born classic book!

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