

**Investing for your own and the greater good**

Paul Woolley

**Most of us have been brought up to believe that free markets combined with healthy competition deliver good outcomes. We also presume that what holds true in goods markets also applies in financial markets. The reality has made a mockery of this belief. Capital markets have come to resemble less the embodiment of efficiency, more a war zone. If foundations adopted investment policies more in line with this reality, they could secure better long-term returns on their own investments. At the same time, as large institutional investors, they could play a significant role in shaping the future of long-term investing and helping to bring stability to financial markets.**

The standard paradigm for how financial markets work comes from the work of a group of Chicago economists who formalized the 'efficient markets hypothesis' in the 1970s. According to this theory, competition means prices are always 'right', capital markets are self-stabilizing, and no one can consistently earn excessive profits.

Everything we have observed in recent years has been the antithesis of the world described by this theory. Equity returns have been wretchedly low and volatile; bubbles, crashes and crises abound; and the return on fixed income has collapsed with no early prospect of improvement. Bankers have alternately made billions in profits and bonuses or come cap in hand to be rescued with bail-outs of even greater magnitude.

Because there has been no accepted alternative to the received wisdom, most of the policy actions and decisions of asset owners such as pension funds and charitable foundations are still based on the presumption of market efficiency. Sadly, new research shows that investing on the basis of a misunderstanding of how finance works leads to low and volatile returns and leaves asset owners vulnerable to exploitation by intermediaries.

The flaw in the efficient markets hypothesis is its failure to recognize that the bulk of asset owners (call them the principals) do not invest directly but delegate the task to agents, such as fund managers, banks and brokers. Delegation creates problems because agents have better information and different objectives from the principals, and the principals have difficulty learning whether agents are competent and diligent. In the case of foundations, the trustees are responsible for fulfilling the mission of the foundation while investment of assets is usually delegated to professional investment managers.

**A new theory of finance**

Five years ago my colleagues and I at the London School of Economics, the University of Toulouse and UTS in Sydney set about rewriting asset pricing theory by acknowledging the principal/agent problems that plague finance. We show the two fundamental consequences of this. First, stocks, bonds, sectors, even entire asset classes can become seriously mispriced in an apparently competitive market even

though all market participants are acting rationally in their individual self-interest. Second, agents are able to extract in fees and expenses a large chunk of the returns rightfully belonging to their clients' capital.

Mispricing can be traced to the simple fact that asset owners hire and fire fund managers on the basis of recent performance. Underperforming managers are assumed to be incompetent and replaced by those who have been lately successful. This process contributes to the amplification of price shocks: in effect, the overshooting of fair value (based on a security's future dividend stream) that creates momentum (trending) and subsequent reversal in prices. Think of what happened when value managers were being replaced by growth managers as the Tech bubble inflated in 1999-2000.

Once mispricing gets into the system, investors are tempted to ride the trends instead of investing on the basis of underlying worth. The new theory shows that asset prices respond to the short-term fund flows moving across markets. The efficient market hypothesis denies the importance of such flows, believing instead that prices depend solely on the expected future earnings from each asset.

The capture of excess profits, or 'rents', by agents is a separate and insidious consequence of delegation. Buying a washing machine, you can judge its quality based on the reputation of the maker and the look, feel and action of the product; and you can take it back if it fails. In fund management you cannot tell whether the product you commit to buying is any good until it is too late. The asset owner, ie the foundation, bears all the risk, whereas the agent receives his fees and bears no risk.

For 25 years a wide range of empirical work has been revealing the various distortions and inefficiencies displayed by financial markets, but with no theory to explain them. The new body of theory we are developing does a good job of explaining features of market performance hitherto unexplained or unaddressed, including momentum and reversal, value and growth, under- and over-reaction, and short-termism.

### **Remedies for asset owners**

Being able to explain where the finance sector is going wrong also points to the remedies. We show that the act of delegation to agents lies at the heart of mispricing and rent capture. If asset owners can be made aware of the situation and learn how to mitigate the worst of the problems, they can gain a significant private benefit in the form of higher risk-adjusted returns. Foundations are under fewer constraints to follow the herd than pension funds, which are more subject to regulatory and actuarial supervision, the present and future holders of pensions – so they are more likely to be early movers. Once a significant body of giant funds follows suit, social advantages will follow in the form of a more stable and less exploitative financial sector.

Here are the main actions that big funds can take:

*1 Adopt a long-term approach to investing based mainly on long-term dividend flows rather than momentum-based strategies that rely on short-term price changes.*

The entire edifice of the fund management industry is built on two mutually inconsistent strategies: 'fair value investing', based on a security's future dividend stream, and 'momentum investing', which means riding the latest trend. Both can be effective if executed well and there is merit in combining them for diversification. For

investors with early liabilities and therefore ultra-short horizons, the quick pay-off of momentum makes it the strategy of choice.

For those with longer horizons, like most foundations, fair value investing is the better choice for three reasons. First, success with momentum is sensitive to timing, not buying too early nor selling too late. By comparison, value strategies are less sensitive and can work using quite basic techniques. Second, momentum investors are always buying after prices have started to rise and selling after they have started to fall. Collectively, therefore, momentum investors lose out to fair value investors. Third, when a momentum bet fails the investor moves on to the next stock. Momentum is thus a succession of independent bets, making its long-run risk equal to the sum of the short-run risks. If a fair value investment fails in the short run, it is likely that the stock has got cheaper and will be retained. For the fair value investor, long-run risk therefore declines over time as the ups and downs tend to even out.

### *2 Cap annual turnover of portfolios at 30 per cent per annum.*

Asset owners can set guidelines that either explicitly limit momentum or give the delegated managers less cause to use it. Momentum is used by hedge funds to gain quick short-term gains and long-only managers use it to reduce short-term divergence against peer group or benchmark. Momentum is a high turnover strategy whereas fair value investing requires patience and has much lower turnover. It follows that the easiest way to ensure compliance is to limit turnover to around 30 per cent per annum.

### *3 Adopt stable benchmarks for fund performance.*

Using stock and bond indices as benchmarks is tying your fund's performance to a relic of the efficient markets hypothesis. The ideal benchmark is one that follows a relatively stable path over time, reflects the characteristics of the liabilities, and is grounded in real cash flows. Foundations seek a stable, and hopefully steadily growing, real income over time. They have less concern about short-term fluctuations in market values than pension funds, with their 'mark-to-market' constraints, which means they are obliged to provide annual appraisals of their current financial situation. Annual growth in GDP, whether national or global, represents the ideal benchmark for overall performance.

### *4 Understand that all the tools currently used to reduce risk and diversify are based on the discredited efficient markets hypothesis.*

Investors should base their risk and diversification decisions on the underlying cash flows of securities and asset classes, not on market prices. Market values are subject to big swings and give misleading signals, whereas dividend streams are more stable. Efforts by long-horizon investors to reduce short-term price volatility against a mispriced index come at the expense of long-term returns. Moreover, once a new asset class becomes popular, all the price correlations change and the hoped-for diversification gains mostly disappear.

### *5 Be wary of any form of 'alternative investing'*

Over recent years it has been increasingly fashionable for pension and other funds to invest in alternative asset classes – hedge funds, commodities and private equity. Advisers point to the advantages of diversification and the greater opportunities open to the supposedly more talented management these asset classes attract.

It is not surprising that these innovations have enriched the managers rather than their clients. Principal/agents problems are greatest in new and complex financial products. High leverage and performance-related fee structures encourage risk-taking and therefore moral hazard. Agents can hide behind the opacity and lower reporting standards. Recent evidence shows that 85 per cent of the returns on all the capital ever invested through hedge funds has disappeared in fees.

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By pursuing strategies based on the defunct efficient markets hypothesis, foundation trustees are both damaging their own funds and contributing to the wider destruction of social utility. Each foundation that adopts these policies will benefit, whether or not other funds follow suit. As more and more funds adopt them, the social gains will come through more stable financial markets. Foundations that recognize the problems set out here and begin to act along the lines suggested will thus be aligning their own incentives with those of society at large.

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