A speech by Dr Paul Woolley at The Prince's Charities Event 'Resilience and the Long-term: Rethinking Portfolios for Prosperity' on 27th June 2013

Your Royal Highness, Ladies and Gentlemen,

It is an honour to be invited to represent the dismal science of economics today - except I am not dismal. I am optimistic that I can explain the nub of the problems of finance and sustainability as well as point to the solution, all in 10 minutes.

First the problem

The finance industry has always been important to this country and we can do it quite well. But in recent decades global finance has gone off the rails.

Its role is to channel savings into productive investment

- as such, it is just a utility, like gas or water

Yet finance has become the world's largest and most highly paid industry.

It does not even perform its basic function well. It is obese, unnecessarily complex, opaque, exploitative and prone to crashes.

And the food chain of intermediaries leaves only scraps for the end-saver.

The finance sector is fuelled by capital provided by savers. Savings institutions such as pension funds are the collection point for savers' capital and set the terms for how it is allocated and used.

Immediately there is a problem. Astonishingly the bulk of investing by pension funds and other savings institutions is now conducted without reference to fundamental value.

Passive investing is supine by definition. But funds are also allowing, even requiring, the bulk of active investment to be conducted without reference to the earning power of the assets.

There are only two strategies for investing

- fundamental investing based on expected future earnings and dividends

- and momentum investing; or trend following, which considers only short-run price changes and disregards value

Momentum investing has come to dominate, both for short-term gain and for short-term risk reduction.

It is the main cause of bubbles and crashes. The choice between these two strategies rather than the length of holding period is the key to understanding short-termism.

In the context of today's meeting, the laudable aims of the sustainability movement cannot flourish when investors disregard fundamental value.

The Cause

How has this come about?

Academic finance teaches that competition among investors ensures that prices reflect fundamental value, that capital markets are self-stabilizing and that excess profits cannot persist.

But a theory that predicts perfection cannot explain departures from perfection. The natural sciences have similar such special and limiting cases - a vacuum, zero gravity or zero friction - but relax these assumptions to build general theories.

Bizarrely, the efficient market theory attempts single-handedly to inform the general understanding of how finance works. It also provides the instruction manual for how practitioners invest and policy-makers regulate.

Pension funds use this manual to select benchmarks, control risk, choose strategies, and write contracts with managers.

Yet the prevailing academic paradigm cannot even explain momentum, and is silent on choice of strategy and short-termism

No wonder the financial world is in the mess we find it

Now the Solution

Academic theory has assumed that investors invest directly in securities.

At my centre at the London School of Economics, directed by Dimitri Vayanos, we are developing an alternative model of finance by recognizing that individual savers delegate responsibility for investing to others.

Individual savers are the principals, while fund managers, banks and even pension trustees are the agents.

Delegation creates principal/agent problems: the agents have better information and different objectives, and the principals are uncertain of the competence and diligence of the agents.

The new theory explains mispricing, momentum, bubbles and crashes and other long-standing puzzles, such as value and growth, under- and over-reaction and why, perversely, high risk stocks offer a lower return than low risk stocks.

The new theory enables investors to compare the risk-adjusted returns to different strategies and implementations, something so far only possible empirically.

We show that momentum can be justified only for investors with short horizons, and that fundamental investing wins out in the medium and long run.

Put simply, trying to do the best each year is a recipe for doing badly in the long term.

Policy implications spill out of this work. It shows that almost everything practitioners and policy-makers are currently doing is diametrically wrong and both privately and socially damaging.

The new instruction manual for operating in inefficient markets indicates the appropriate benchmarks for active and passive investing, the best choice of strategy, the correct way to manage risk and diversification, and guidance on the optimal design of contracts between pension funds and their managers.

Here are a few examples:

- global GDP plus local inflation makes a sound overall benchmark, while risk should be specified in relation to cash flows rather than prices.

- the easiest way to reduce momentum investing is to cap turnover at around 30% p.a. and for the authorities to remove tax exemption for funds that fail to do so.

Funds adopting these strategies, through choice and without coercion, will be rewarded with higher medium- and long-run returns, irrespective of what other funds are doing. There is even an early-mover advantage

- and as the number of funds shift to the new guidelines, the finance sector will become more stable and less prone to crisis

- and sustainable policies will flourish

The obstacles to implementation of the new regime are formidable: vested interests, closed minds, timidity and the army of lobbyists for Wall Street and the City

There is a general recognition that finance needs to be more long-termist but so far there have only been platitudes and exhortation from the G30, G20, the European Commission and others.

What is needed is a code of best practice for sovereign wealth funds and public pension funds devised and overseen by the IMF

The code must have a theoretical foundation such as along the lines I have just described.

As public funds set the example, private funds will follow suit, keen not to miss the opportunities, content to follow a sensible herd or challenged by disgruntled beneficiaries.

There should be corresponding codes for corporations and regulators.

Corporate managers are guilty of pandering to the short-termism of investors, as well as their own short-term ends

- they too need a demonstration of the importance of long-termism in selecting projects, in the choice of funding and in their personal rewards

Regulators should encourage the adoption of the code of best practice by investors,

- and should end the inconsistency of preaching long term investing on the one hand and imposing short term mark-to-market valuations on the other.

To conclude

Principal/agent problems and a flawed theory and understanding of finance are bringing capitalism to its knees.

A new interpretation of finance points to the critical role played by those responsible for society's wealth - Ladies and Gentlemen, You!