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Long-term battle to expel short-term risk

By Paul Woolley

Risk metrics should be based on asset cash flows

Hardly a day passes without some high-profile call for long-term investment to be encouraged. A Green Paper is due from the European Commission, UK parliamentarians are probing the subject in the wake of the Kay review and the G30 last month published an authoritative paper, "Long-term finance and economic growth".

The most striking proposal so far comes from the G30: national regulators and international bodies, such as the International Monetary Fund and Financial Stability Board, should draw up best-practice guidelines for investors with long-term liabilities or horizons. The proposal is directed at public pension plans and sovereign wealth funds, and aims to influence private funds. If acted upon, this would have profound implications for the asset management industry and investment returns worldwide.

The main obstacle to change seems to be one of definition and terminology. Short-termism is not just about a holding period and long-termism does not equate to buy-and-hold. The distinction that matters lies in the investor's choice between the two basic investment strategies of momentum trading and fundamental investing.

Momentum involves riding trends and ignoring the underlying worth of assets. Momentum investors buy when prices are rising and sell when they are falling. They do this for short-term gain or to reduce short-term risk of poor performance.

In contrast, fundamental investors purchase assets based only on the expected future cash flows. This calls for patience as they wait for prices to recover from undershooting generated by momentum.

Momentum is the embodiment of short-termism and has become the dominant strategy. Asset owners have not only allowed this to occur but encourage it through the terms on which they delegate to fund managers. The use of market capitalisation-based indices as benchmarks, the specification of risk as divergence from such benchmarks, and the targeting of short-term performance objectives, including in fee structures, all lead inevitably to its use.

Nobody has explained to the asset owners quite how damaging this is to their returns.

One reason is that there is no place for a distinction between momentum and fundamental investing in the standard theory of efficient, or nearly efficient, markets. Surprisingly, this theory still informs our understanding of how finance works and provides the basis for setting benchmarks and analysing risk.

A second is that even those wishing to concentrate on fundamental value are prevented by the career risk of short-term underperformance against their peers.

A code of best practice should make clear that funds focusing on getting the best return each year are unlikely to achieve the best risk-adjusted return over the long-run. Momentum is a succession of independent bets, whereas long-term investing benefits from prices reverting to the mean, reducing risk over time.

The code should also spell out the need to adopt fundamental benchmarks, such as real global GDP growth plus local inflation. Risk metrics should be based on the cash flows of assets, not on their market prices. Derivatives are short-term instruments mostly used to implement momentum-type strategies, so their use should be limited. The easiest way to ensure managers are taking a long-term view is to cap turnover at around 30 per cent per annum. Contracts with agents should avoid performance fees based on short-term results.

The G30's call to action should influence policy makers and regulators, but a key incentive for long-term funds to change lies in the interests of the asset owners. They would achieve higher returns if their funds were released from the inhibitions of momentum-skewed benchmarks and short-term measures of relative performance.

As large funds adopt the new practices, a new comparator universe of long-termist funds will be created. This will do much to ease the concerns of those who fear short-term underperformance in the event of a new momentum-fuelled bubble.

The other side of the coin is that members of pension schemes will be able to challenge trustees who fail to comply with the new code and suffer underperformance as a result.

Writing the heads of a new code will be relatively straightforward. The complications come in the detail, especially in the recommendations on benchmarks and the development of new risk metrics. Then there is the need to establish a new monitoring process. But this proposal marks a huge step towards improving the functioning of capital markets and the returns to savers.

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