

## Something Big In The City

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Published: November 15 2008 02:00 | Last updated: November 15 2008 02:00

The enormous growth of the financial sector is one of the wonders of our age. In the 1960s the business of banking, broking and insuring accounted for just 10 per cent of corporate profits in most developed economies. By 2005, this had swelled to nearly 35 per cent in the US and roughly the same in Britain, the two countries that host the world's largest financial centres.

Of course, the profitability of the financial sector is declining on account of the credit crisis. But politicians and financial authorities have felt obliged to plug the holes in a deflating system with vast public support, and even direct capital injections. Finance is now not only big, but worryingly unstable. Moreover, embedded in this growth is a mystery. Whereas companies such as Microsoft have risen by devising products that have added to the productive capacity of the economy, finance provides no such final good or product - it is a utilitarian mechanism for bringing together savers and borrowers. So what explains its relentless expansion?

This question is far from idle. It perplexes even those who have benefited mightily from finance's advance. George Soros recently observed: "The size of the financial sector is out of proportion to the rest of the economy. It has been growing excessively... ending in this super-bubble of the last 25 years."

Various attempts have been made to explain the mushrooming of finance. In the 1970s and 1980s, as the sector started its relentless climb, economists and others rationalised it by applying to finance the conventional wisdom that views competition as a guarantor of efficiency, and profits as a reward for doing a useful job well.

This was not unreasonable. Moreover, this view had a theoretical underpinning in the form of the so-called "efficient market" hypothesis, an attempt that emerged in the 1960s to apply the classical theories of competition to finance. In an efficient market, it was argued, competition among rational investors (or the financial intermediaries who do the actual investing) ensures that asset prices reflect the consensus estimate of their fair value in light of all available information. Efficient pricing then guides capital to its most productive use. It was a small step from this to arguing that financial companies were useful because they helped channel capital to the most productive places. And it was then the tiniest skip to suggest that more finance was a good thing.

Academics flocked to the efficient market banner and few, therefore, questioned the rapid growth of the sector. Governments smiled on finance too. This was after all a lucrative international industry which, directly and indirectly, threw off dizzying amounts of tax revenue. Britain's financial industries contributed about a third of corporation tax in 2000 - up from 15 per cent in the early 1980s. True, that in itself was not a colossal sum, amounting to some £15bn. But this ignored the much more significant personal and consumption taxes being paid by the bankers and financiers who flocked to the City honey pot.

There were, however, problems with the efficient market hypothesis. While it sounded great in theory, it never quite worked in practice. The expansion of finance (which should have led to ever greater efficiency) did not seem to slow the tempo, or moderate the severity, of speculative crises. Investors had to endure the emerging market debt crunch of 1982, the stock market crash of 1987, the US savings and loan debacle, the Asian crisis, the implosion of the US hedge fund Long-Term Capital Management, all the way on to the technology bubble that burst in 2000. These events all suggested that investors did not, in fact, discount information in the rational manner suggested by theory. It was quite possible for the stock market to remain for long periods at levels far removed from intrinsic value.

Critics of efficient market theory emerged. George Soros was an early opponent when he expounded his idea of "reflexivity" in the late 1980s. He suggested that the behaviour of markets was shaped by two influences: a "cognitive function", meaning the attempts investors make to understand market fundamentals and to predict outcomes based on this analysis, and a "participating function". The speculator both thinks and acts. His belief about the future drives his actions, and those actions influence the outcome, which in turn affects further thoughts - the "reflexivity" feedback loop. Moreover, Soros believed our knowledge of the world to be incomplete. And as actions are consequently based on flawed analysis, this generates unexpected results which then determine future analysis. This is a chaotic world of booms and busts.

Soros's critique never really took off. It did not help that one of his sons said that half his father's ideas

were "bullshit". But other "behaviouralist" critiques of efficient markets also appeared. Some economists wondered what would happen if investors couldn't be bothered to track down all the relevant information to price stocks, but became lazy. Could efficient markets still function then? This was the Grossman-Stiglitz paradox. But all such theories forced one to move away from mainstream economics and assume that financial markets somehow obeyed different laws.

Now a new challenge to the efficient market hypothesis is emerging which seems to explain more clearly why booms and crashes occur and, more importantly, why finance has grown so obese.

Paul Woolley, a former academic, policymaker, International Monetary Fund economist and asset manager, argues that efficient market theory falls down because of the "asymmetric information" problem. This, simply put, is the difference in the quality of information enjoyed by agents - the banks, fund managers, brokers and so forth - and the principals, or end investors. The agents know more than the principals and exploit this to maximise their own wealth. While this worry isn't new, critics have in the past focused on banking and corporate finance and on abuses such as insider trading. Woolley, however, applies it to investment management, arguing that asymmetric information, especially in this area, has far graver consequences for the functioning of finance.

This "agency" problem leads to two bleak conclusions. First, that capital markets do not necessarily price assets efficiently and capital can be misallocated. When the misallocation grows big enough, as it has now, it can lead to substantial macro-economic dislocation. Second, it allows banks and financial intermediaries to capture too big a share of the economic gains from capital investment, and thus from growth itself. And this share - the "croupier's take" in the celebrated phrase of Warren Buffett's partner, Charlie Munger - has been going up as financiers have become ever more cunning. Woolley argues that big and unstable capital markets make it likely that we will suffer more and potentially bigger upsets in future.

Woolley's analysis differs from that of Soros or the behaviouralists in that it does not require one to depart from mainstream economics. In his vision, the participants in financial markets are all acting optimally and rationally in their own self-interest, while generating outcomes that are less than optimal in terms of growth and welfare. Modern financial markets thus tend, Woolley believes, towards dysfunction. This flies in the face of the inherited wisdom that has prevailed since Adam Smith, and his belief in the power of the "invisible hand".

let's look more closely at the croupier's take - the amount raked off by intermediaries as investors' money is shuffled. The starting point is the real returns earned on stock market investments. Of course, those are a bit sick right now, but over the long term they are between 5 and 6 per cent a year.

The first croupier to appear on the scene is not a financier but a corporate executive. In 2002, for instance, the compensation of US executives in the form of share options was equivalent to 20 per cent of reported profits, according to Standard & Poor's. Bang goes one percentage point of the stock market return, even before the financiers arrive at the table.

Dock another half a percentage point for the fees paid by companies to investment banks for mergers and acquisitions and other services. Then one must not forget the costs of trading. These include commissions to brokers and stock exchanges, and the "spread" between the bid and offer prices of shares. Take these to be roughly 1 per cent of transaction value in aggregate. Thus, a fund manager with an average holding period of one year (meaning 100 per cent turnover of holdings each year) accrues annual costs of 1 per cent to clients. After this, real returns fall to a mere 2.5-3.5 per cent.

But things get even worse for retail investors. They must pay up-front charges when buying mutual funds of up to 7 per cent and higher fees of about 2 per cent. In addition there is taxation to consider: in Britain stock purchases attract 0.5 per cent stamp duty and in US mutual funds pay capital gains on their trading profits. Once that lot is taken into account, returns can shrivel to less than 1 per cent.

And the croupier's take has been growing. Company bosses were barely paid in stock-based incentives until the early 1990s. In 1990, equity-based pay for chief executives of US companies was about 5 per cent of their total remuneration. By 1999, the proportion had risen to around 60 per cent. At the same time their total pay rocketed. M&A volumes also soared. In 1980, the total value of mergers and takeovers involving US companies was equivalent to less than 2 per cent of gross domestic product, while by 2000, it was 21 per cent.

But the biggest contributor to the croupier's take has been the dramatic increase in secondary trading. Think of our fund manager as a tuxedo-clad croupier at the roulette wheel. Given fixed returns for the house each time the wheel spins, how can he increase its cash takings? Easy. So long as he knows the same amount will be staked each time, he spins the wheel more frequently. This is what fund managers have done. Take the equity market as an example. In 1965, the annual turnover of British equities was worth 10 per cent of nominal GDP. In 2007, turnover had risen to almost 300 per cent.

The growth of secondary trading has turned fund management into an extremely lucrative activity - at least for the agents. If one takes the global value of equities to be about \$40 trillion, the aggregate expenditure on active management fees and trading costs is about \$500bn a year. Woolley has translated this to show what it means for the typical member of an actively managed pension fund with the usual 100 per cent turnover of holdings per annum. Over a 25-year period, the managers will exchange the same equities continuously with other managers for no collective gain, but at a cost that reduces the end-value of the fund by more than 25 per cent. In effect, the managers' prosperity depends upon a highly lucrative tax that they levy on savers.

The rapid growth of trading began in the 1970s, when pension funds took off and the insurance industry reinvented itself as an investment medium. Individual savers were eclipsed by large institutions. In 1963, British pension funds, unit trusts and insurance companies owned just 19 per cent of British shares by value (excluding foreign-owned shares). By 1998 that total had risen to 65 per cent.

With these large institutions came new ways of measuring performance designed to help insurance bosses and pension fund trustees incentivise the fund managers to whom they delegated investment decisions. These managers would be pitted against a benchmark return, such as that on the FT All-share index. Those who "outperformed" would be given more money to run; underperformers would face the chop. But this had a perverse effect. It encouraged fund managers to take a shorter-term view. Given the requirement to deliver quarterly results, they increasingly invested with the trend - or used "momentum".

Investing based on fair value - where you purchase stocks that are mispriced and wait for their true worth to emerge - requires patience and is ill-fitted for a quarterly performance regime. But if one discards fair value, the only alternative is momentum investing.

In an influential book published in 1996, *What Works on Wall Street*, James O'Shaughnessy identified momentum trading as one of the most successful investment strategies. Over 50 years, he showed that stocks with the largest price gains from the previous year produced annual compound returns of nearly 15 per cent - double that of the market.

Momentum causes volatility. It contributed, for example, to the tech boom, which got going because investors came to the conclusion that technology would transform economic life and bring great rewards to the innovators. This in turn led to price rises in internet and technology stocks, which became self-fulfilling. Even when prices of stocks rose above what fund managers felt to be their fair value, the fund managers kept buying because they feared they would be left behind in the performance stakes. The few who held out were fired by their clients and replaced by managers who followed the herd. Fair value was simply thrown out of the window. Capital was misallocated on a grand scale.

Momentum is no friend to the end-investor. As Woolley points out, the volatility of the main British and US equity indices is 15 to 20 times greater than the variability of the dividend stream on which prices ultimately depend. For financiers, on the other hand, it is a blessing. Without it, share prices would be more stable and would better reflect fair value. In such a world investors would be less inclined to employ fund managers. Woolley's insight is that fund managers have institutionalised momentum investing precisely for this reason - it both brings them customers and allows them to extract more in fees.

Oddly, the croupier's growing wealth has not deterred investors from buying financial products and advice. One of the surprises over the past 20 years is that investors have shifted money from funds with low, fixed fees to the high, performance-based structures. One explanation of this is that investors react to volatility by seeking to pick winners in the form of fund managers and they accept that these winners should charge more.

Moreover these high fees provide a curious perverse incentive, as a contemporary fable about hedge funds shows. Let us imagine that two hedge fund managers each raise equally sized funds of \$500m. But instead of investing in stocks or bonds, they agree with one another to determine their investment outcome for the year on a single flip of the coin. The loser gives the winner 50 per cent of his fund. So at the end of the year, whatever the outcome, one of the hedge funds will have \$750m and the other \$250m. The overall return to investors before fees will be zero. But then look at how these fictitious managers are remunerated. First they both collect what is known in the industry as the "2 and 20". That means they get 2 per cent of the value of the assets just for managing them - that's \$10m each - and the winner pockets a further 20 per cent on the \$250m profit he has made: another \$50m. So our hedge fund managers have collected \$70m between them. Dock that from the combined \$1bn pot and the average return to their investors is a negative 7 per cent.

Of course this is a *reductio ad absurdum*. No hedge fund that advertised such a strategy would (one hopes) take in a cent. But it shows why these high fees encourage hedge funds to expand their businesses as fast as possible - whatever the outcome for the clients.

The modern finance industry is dauntingly opaque, and has become incomprehensible to many end investors. This opacity has helped bankers to increase returns and bolster margins. Just look at how US residential mortgages came to be packaged into collateralised debt obligations (CDOs) - the fons et origo of the debt crisis. These so-called structured loans were sold to banks, insurance companies and other investors throughout the world without it being properly explained what proportion of the total amount in each CDO was represented by sub-prime loans, and without anyone understanding what would happen to their value if property prices fell.

A last factor that fed the growth of finance was the much remarked-upon problem of "moral hazard". At the macro level, the policies of Fed chairman Alan Greenspan fostered an appetite for risk-taking in the financial markets that was ultimately unsustainable. This started in the autumn of 1998 when Greenspan orchestrated the rescue of Long-Term Capital Management, and then twice cut interest rates. The stock market quickly recovered and the so-called "Greenspan put" was born. Wall Street's bankers learned that financial panics were likely to be short and painless. Whenever the markets got in a mess, Greenspan would bail them out.

But moral hazard was not just a problem created by the Fed. It also lay in the reward structures offered to hedge funds and private equity firms, and the skewed performance fees that ensured while the bankers pocketed a big chunk of any gains from successful investments, the end investors ate any losses.

What had been created by the middle years of this decade was an excessively big and unstable system. Its chief growth engine was the seemingly endless expansion of secondary trading. This spread way beyond the equity market into the financial stratosphere of swaps and options. Moreover, with the harnessing of computing power to finance, the expansion of the secondary market had in theory become limitless. There was no end to the instruments and derivatives that could be devised and sold. As at September, the value of outstanding equities was around \$40 trillion globally, the bulk of which is actively managed and traded in the secondary markets. Then, beyond that is the \$1,000 trillion of derivatives mostly relating to these underlying securities and necessarily under active management.

While the efficient market idea held sway, academics viewed the expansion of finance with equanimity, even enthusiasm. Financial instruments always existed for a purpose - such as to pass on risk cheaply and efficiently to the investor best placed or most willing to bear it. If that were not the case, these products simply would not exist. More trading was beneficial because it enhanced liquidity, and liquidity lowers costs and promotes efficient pricing. In reality, these instruments are simply the offspring of an excessively volatile, momentum-driven system.

It is hard to see how the public benefits from a super-sized financial sector, although some of the symptoms of it will be alleviated by the correction now taking place. More financial institutions will probably be swept away. The use of leverage - borrowing to speculate in financial assets - will decline simply because debt will not, for a time, be so cheap. This healthy process, however, might not eradicate the cause of the problem. If we continue as we have done, finance might simply recover and again become overblown - leading to another, perhaps bigger, crash. Tackling the fundamental causes of super-size is, however, not so simple. If finance has grown disproportionately, this is partly because financial services is one of the things we demand more of as we get richer. So the answer must be to take the free markets that we have and make them work more effectively.

Indeed we should be trying to create a more free market. True, the rules need strengthening to stop distortions. But we shouldn't try to regulate away the profits of the City and Wall Street. Making money is fine - so long as the bankers also take the consequences when they mess up. This possibility should deter them from taking the foolish risks that have contributed to the crazy expansion of finance. Of course the authorities would still have to step in. Even in a world of less leverage, there would still be failures and - sometimes - the necessity for bailouts when there was a threat to the whole system. But the banks should be subject to much tighter regulation. Their capacity to raise huge sums in the wholesale markets (where banks and other financial institutions lend to one another) should be curbed. They should be obliged to move back to a deposit-based model of a sort still common in Asia. These utility-style banks should be firewalled from more speculative activities. Investment banks would be free to speculate using wholesale funds, but on the understanding that they would be on their own if things went wrong. In this respect, the US government's decision to allow two huge investment banks, Goldman Sachs and Morgan Stanley, to become banks is a profound misstep.

But how to curb the harmful activities of the other agents? Just as with banks, they should not be allowed to enjoy one-way bets. The Financial Services Authority is right to look at regulating the bonuses that bankers receive. Woolley has suggested the simple expedient of lengthening the period over which performance is assessed. "Momentum rarely carries bubbles in securities markets or commercial strategies beyond three years, so extending the performance period from the present one year to three would lower fees and help lengthen the policy horizon."

But there is also the bigger question of customer protection: how to prevent the end investor being

bamboozled by self-interested agents. This is harder to crack. The initiative will probably have to come from the end investors themselves, not individual investors but the stewards of the great collective schemes: the pension and endowment funds, as well as industry bodies and public sector agencies.

Woolley suggests that they should monitor fund managers for use of momentum, and set limits on turnover to encourage fair value investing. The state could chip in by encouraging the pension funds to pursue fair value trades, perhaps by withholding tax exemption privileges from funds deemed to be trading rather than investing in securities. It could also force banks and financial institutions to provide more comprehensive information to customers explaining and reporting strategies, execution and fees. Finally, companies should refocus on dividends as the main source of return to shareholders. Over the long term, the correlation between dividend and GDP growth has been very close. "Historically three quarters of the total return on equities has come from dividends," Woolley writes, "and they help concentrate investors' attention on the long-run prospects for companies rather than short-run changes in market value."

George Soros has suggested that the current crisis is so severe that it might lead to the end of the current era of financial capitalism. He suggests that we are moving away from "market fundamentalism", towards greater regulation of the financial system. He may be right. But it is too soon to write off the market. If this financial crisis causes a deep global recession, then investors will demand a higher risk premium for holding financial assets - as they did between the 1930s and the 1970s. In that event, the size of the cake available for the money men to carve up will itself shrink. n

Jonathan Ford is deputy editor of Prospect and a contributor to FT Weekend Magazine. A longer version of this article appears in the November edition of Prospect.

1965

Equity market turnover: £3.48bn.

Value of equities traded on UK markets equals 9.7% of gross domestic product

UK GDP

£35.89bn

1985

Equity market turnover: £101.26bn.

Value of equities traded on UK markets equals 28% of gross domestic product

UK GDP

£361.76bn

1995

Equity market turnover: £646.33bn.

Value of equities traded on UK markets equals 88.1% of gross domestic product

UK GDP

£733.27bn

2007

Equity market turnover: £4,142bn.

Value of equities traded on UK markets equals 295.6% of gross domestic product

UK GDP

£1,401bn

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