

Why are markets inefficient and what can be done about it?

By John Authers

‘Value’ momentum leads eventually to bubbles and mispricings

Markets are not perfectly efficient. More or less everyone agrees to this in the wake of the financial crisis. And while asset bubbles have recurred from time to time throughout history, bubble production has accelerated sharply.

So not only are markets inefficient, but they are more inefficient than they used to be. This is despite rapid technological improvement to make markets faster and more liquid. So *why* are markets inefficient, and what can be done about it?

The most popular answer is to blame human nature. Behavioural economists, applying experimental psychology, have explained many market anomalies. But human nature is constant. Greed and fear have been around forever. It is hard to blame an intensifying problem in the markets on any increased level of greed.

Paul Woolley of the London School of Economics thinks he is on his way to a new answer. On his reading, the problem is lodged in the division between principals and agents. Most money is placed in markets by agents acting for the owners, not by the owners themselves. Agents – fund managers of one kind or another – have their own incentives which can differ from those of their principals, and they also have more information. The interactions of principals with agents, in the form of fund flows in and out of the big institutions, drive markets.

Importantly, this is more the case than it used to be. The institutionalisation of investments is a relatively recent phenomenon, arguably dating back no earlier than the “Erisa” pension reforms in the US some four decades ago. Thus in investing, the principal-agent split is more pervasive than ever before.

Mr Woolley, formerly a fund manager at GMO, now believes that he can explain two of the principal anomalies which both academics and investors have found to persist over time: the “value” effect (that cheap stocks outperform in the long run), and the “momentum” effect (that winning stocks keep outperforming losing stocks).

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His intuition is as follows. Funds holding an asset suffer poor returns. This leads to outflows, which force them to sell that asset, creating momentum. It will also lead to “comovement”. As assets flow out of a fund, so all the assets it holds will tend to drop in price. This can extend effects across whole sectors. Eventually, this creates the cheapness that subsequently allows the value effect to prosper.

For an example, look at “value” funds during the tech bubble of the late-1990s. In absolute terms, they kept rising. In relative terms, they performed terribly compared to the booming tech sector, and so much money was pulled from them. This caused value’s underperformance to deepen, and also ensured that the “value effect”, once the inevitable reversal occurred, would be particularly strong.

After much mathematics, the momentum effect proves overwhelming for a matter of some years. And momentum, divorced from the real world fundamentals, leads eventually to bubbles and mispricings.

What can be done about this? Mr Woolley believes that the answer is education. If problems are understood, it will be easier to deal with them.

More specifically, the contracts written between ultimate investors and their fund managers are a critical point of friction. At present, fund managers are paid to beat a benchmark, using indices weighted according to stocks' market capitalisations. They are also compared against their peers. Fund managers low in the league tables are likely to suffer outflows. This encourages them to look for momentum.

So, benchmarks should not refer either to peers or to any market index. Mr Woolley suggests a target based on growth in nominal GDP; many pension funds are now moving towards a target based simply on meeting their liabilities to pensioners.

Other crude measures might thwart the momentum effect. The fund management industry is dominated by money managed on a tax-privileged basis. Pension money should be exempt from tax. But he suggests removing tax privileges if turnover exceeds 30 per cent per year.

Newspapers could desist from publishing league tables of managers' performance. The consultants who advise big pension funds should also ignore league tables.

Would such measures work? Competition is deep in our psyche. Rather than maximise some outcome, many of us tend merely to try to beat someone else. George Cooper points out in a fascinating new book that this might mean that classical economics itself is flawed, as classical economists assume that we are optimisers, not competitors with the Joneses.

The market flaws Mr Woolley has found may always be present. But we should at least try to damp their effects as much as possible. The alternative is ugly indeed.

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