Is non-fundamental, second-hand investing killing capitalism?

By Editor Test *Mon, Jul 8, 2013*

"Principal-agent problems and a flawed theory and understanding of finance are bringing capitalism to its knees," says Paul Wooley of the Paul Wooley Centre for the Study of Capital Market Dysfuntionality at the London School of Economics.

Momentum investing had become dominant over fundamental investing, both for short-term gain and short-term risk reduction, and it is the main cause of bubbles and crashes, according to Paul Wooley, chairman of the Paul Wooley Centre for the Study of Capital Market Dysfunctionality at the London School of Economics.

"The choice between these two strategies, rather than the length of holding period, is the key to understanding short-termism," he said at an event at St. James Palace in London. "Principal-agent problems and a flawed theory and understanding of finance are bringing capitalism to its knees," he added. His comments were reported in a recent issue of *IPE.com*.

A team at the Wooley Centre has developed a model of finance that tries to explain mispricing, momentum, bubbles and crashes. While savers fuel the finance sector, institutions such as pension funds determine how that capital is allocated, Wooley said.

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

Pension funds use academic finance theory to select benchmarks, control risk, choose strategies and write contracts with managers, Wooley said, but that theory assumes investors invested directly in securities. Instead, they delegate. But delegation creates principal-agent problems, he said, with the agents having better information and different objectives, and the principals being unsure about 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," he said.

The model showed that momentum could only be justified for investors with short horizons, and that fundamental investing won out in both the medium and long run.

"It shows that almost everything practitioners and policymakers are currently doing is diametrically wrong and both privately and socially damaging," he said. Funds adopting these strategies will be rewarded with higher medium- and long-run returns, irrespective of what other funds are doing, he claimed.