

The Private and Social Benefits of Long-term Investing

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- Agenda
 - Why short-termism is costly to investors and society alike
 - How to implement a long-term strategy
 - Based on a theoretical framework

Evidence of growing short-termism

- Short holding periods/high turnover, High Frequency Trading
- Explosion in derivatives trading, hedge funds, manager turnover

Note or Source

Explanation for short-termism

- contracts and guidelines with delegated managers, fee structures - especially performance fees
- quarterly peer group comparisons, herding
- tight tracking to mispriced indices, widespread use of momentum trading
- mark-to-market valuations, commercial risk of managers

Note or Source

Private Costs of Short-termism

- Two basic strategies: Momentum, Fair Value
 - Momentum used for alpha and to reduce short-term risk (also default strategy for lazy investors)
 - Fair Value based on future cash flows
- Private costs
 - Momentum = buying after prices have risen, selling after prices have fallen
 - Momentum investors collectively lose to fair value investors in long run
 - Momentum risks constant over time
 - Fair value risks decline over time
 - Success of momentum strategy sensitive to periodicity

Note or Source

Social Costs of Short-termism

- Leading to mispricing, bubbles and crashes
 - Misallocates resources
 - Causes macro-economic turbulence, crises
 - Reduces GDP, equity returns and welfare

Note or Source

Private and Social Gains from Long-termism

- Long-term investors gain at expense of momentum investors in long run
- Fair value benefits from lower long-run risk
- Fair value more forgiving strategy than momentum
- Individual fund benefits regardless of what other funds do
- Private and social interests fully aligned
- Facilitates Sustainable, Responsible Investing

Implementing long-term strategy

- Curtail momentum, cap turnover
- No tight tracking, esp. of indices
- Use predominantly fair value as basis for investment
- No performance fees or only long-run performance basis
- Limit use of derivatives for short-term risk purposes
- Set real benchmark e.g. GDP
- No mark-to-market valuation constraints

Note or Source

A Theoretical Framework

- "An Institutional Theory of Momentum and Reversal" Vayanos, Woolley 2010
 - Asset pricing with delegation to agents (asymmetric information)
 - Explains mispricing bubbles and crashes in rational framework
 - Shows prices depend on fund flows, as well as cash flows
 - Explains momentum, reversal, comovement, under/over-reaction puzzle etc.
 - Shows that short-term risk reduction and commercial risk promote volatility

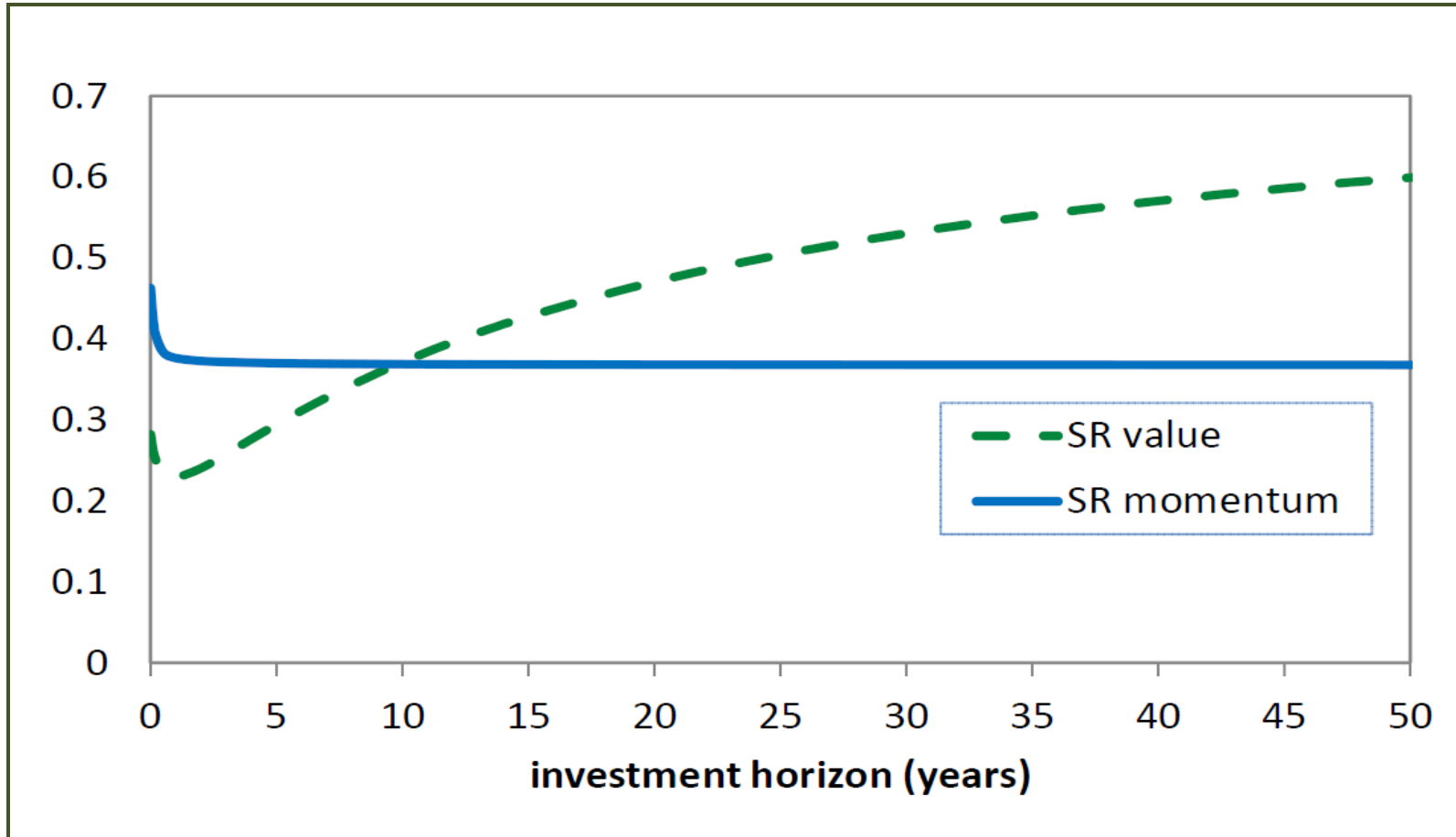
Note or Source

A Theoretical Framework

- "A Theoretical Analysis of Momentum and Value Strategies"
Vayanos, Woolley, 2011
 - Shows returns to momentum and fair value strategies over one period
 - Also over multiple periods with continuous rebalancing
 - Shows optimal mix of momentum and fair value for given horizon
 - The longer the investor's liabilities (horizon) the greater the allocation to fair value
 - For short horizons, more to momentum and less to fair value
 - Can show optimal implementation of all strategies: :mix, quality, turnover etc.

Note or Source

Sharpe Ratios of Fair Value and Momentum



Sharpe Ratios of Momentum with varying lookbacks

