



Alice in Financeland

At first glance, there is little about the current financial system that makes sense. The more one looks, the less sense it makes. In theory the financial sector is supposed to support the long-term growth of the real economy. In practice, it has become so detached from the real world that it is more akin to a fantasy land, inhabited by a growing number of peculiar characters undertaking nonsensical tasks. Lewis Carroll's Alice would be very much at home.

When Alice falls down the rabbit hole into Wonderland she embarks on a series of bizarre encounters, from the white rabbit with his pocket watch, the hookah-smoking caterpillar and the Mad Hatter stuck in time at 6pm to a Cheshire Cat whose head merrily takes leave from its body, a Mock Turtle and the gleeful Queen of Hearts herself.

In between these bizarre encounters Alice shrinks and falls into her own pool of tears, takes part in a circular running race with no winner and gives witness at a trial where all persons more than a mile high are ordered to leave the court.

Today's Financeland is in danger of making all this seem very ordinary. When Mum's hard-earned Pound heads down the hole into today's Financeland, it is likely to go on a similar journey to Alice, encountering strange financial beasts and involuntarily taking part in circular nonsense. Mum's proverbial Pound has every chance of drowning in dark pools, being pounced upon by ultra-low latency traders and falling prey to Alligator Swaps, Canary Calls and Iron Butterflies.

In Financeland, there are ABCDs (Asset Backed Credit Default Swaps), COCOcds (Credit Default Swaps on Contingent Convertible Notes), Airbag Swaps (interest rate swap whose value adjusts according to rising interest rates by indexing the floating portion of a constant maturity swap), Christmas Trees (three different call options at strike prices resembling a Christmas Tree), DECS (Dividend Enhanced Convertible Stock – preferred stock with extra dividends plus an embedded short put option and a long call on the issuing company's shares),

FLEXs (Flexible Exchange Options), Index Rolls (combination of index funds and LEAPS – long-term equity anticipation securities), PERCS (Preference Equity Redemption Cumulative Stock – convertible shares with extra dividends limited in term and participation), Quadruple Witches (the third Friday of March, June, September and December when stock index futures, stock index options, stock options and single stock options all expire on the same day), and Zebras (Zero Basis Risk Swaps).

Not to mention Delta (sensitivity to an underlying instrument), Gamma (sensitivity of Delta), Vega (sensitivity to underlying volatility), Vomma (sensitivity to Vega) and Zomma (the change in Gamma!). Lewis Carroll would have been particularly proud of these!

There is one key difference between Wonderland and Financeland. While Alice returns to the real world unscathed, the same cannot be said for Mum's Pound.

Blindfold capital allocation

Financeland's absurdity has three main underpinning features. The first is the blindfold nature with which Mum's Pound is handled. As it enters Financeland, the chances are high that it will be simply allocated to an index or exchange traded fund (ETF). Society's savings are being increasingly allocated with eyes wide shut.

The long-term, active fund manager is fast becoming an endangered species. In many ways, they have been responsible for their own downfall. Short-term incentives, product proliferation and closet index hugging have all driven clients towards blindfold investment.

Most index and ETF funds make no attempt to work out whether the companies receiving this scarce capital are intending to use it productively. Thus, very poor quality companies, whose activities are counter to the long-term benefit of societies, are the easy recipients of society's capital. This can't be a good outcome for Mum's Pound or society more broadly.

Surely the point of a financial industry is to strive to allocate capital productively, not to shut its eyes and pass it on indiscriminately. 'Smart beta' products are an attempt to address this problem by using computers to pick certain companies based on quantifiable characteristics. The problem is that any assessment of business fundamentals and long-term company potential requires a healthy dose of qualitative analysis and judgment. The feeling that management may be misleading investors or that a company may lean too heavily on unhealthy political connections cannot be captured by a spreadsheet.

Short-termism

The second absurdity of Financeland is its short-termism. This is well documented. Time horizons have collapsed. Based on NYSE (The New York Stock Exchange) index data, in 1940 the mean duration of holding period by US investors was seven years. This stayed the same for the next 35 years. By the 1987 crash the average holding period had fallen to under two years. By the turn of the century it had fallen to below one year. It was around seven months by the beginning of the global financial crisis in 2007.

If the trend continues, time horizons will reach some kind of perpetual motion, where capital is instantly and constantly recycled around the financial system, without pause. Arguably we are there already, given the prevalence of high frequency trading.

As Michael Lewis' excellent and frightening book 'Flash Boys' highlights so clearly, financial markets today are dominated by speculation, not investment.

It is tempting to place responsibility for this at the door of the stock exchanges themselves. In theory the stock exchange has a role to play as the guardian of financial markets and the mechanism by which companies can use society's savings to expand their businesses. Instead, stock exchanges have become the heart of the problem. They have allowed and encouraged financial engineering on a scale that has completely overshadowed the original purpose of the stock exchange.

To compound the problem, many stock exchanges have taken the decision to list upon themselves. They have become both the casino and the house. To use another analogy, the gamekeeper has turned poacher. Alice would approve.

Unfortunately, short-termism and speculation are bad for Mum's Pound for two reasons. First, they have created too many agents whose purpose is to grab as much as possible of Mum's Pound, rather than productively put it to good use. High frequency trading is a case in point. Its sole purpose is to take some of Mum's Pound away from her by getting a millisecond ahead of her order. That they are willing to pay millions of pounds for the privilege of that

millisecond is testament to the amount of damage they are doing to Mum's Pound. There are no 'liquidity' benefits to society that occur from high frequency trading. As Michael Lewis puts it, liquidity is;

“one of those words Wall Street people threw around when they wanted the conversation to end, and for brains to go dead, and for all questioning to cease”!

Michael Lewis

Secondly, the damage wrought by short-termism reaches far back into the real world again, and this is well documented. Given their dependence on such short-term, transient, unreliable capital, many listed companies are under pressure to run their businesses simply for the next three months, rather than the next ten to twenty years. This is not good for society or Mum's Pound.

The wrong kind of alignment

The third aspect of absurdity in Financeland is the obsession with financial alignment. Just as the Queen of Hearts could only think about chopping off heads, so are today's Financelanders obsessed with financial alignment.

“At the end of the day, the most important thing for you to know is that I have skin in the game” declared a new CEO to us recently. The longer this sentence hangs in the air, the less reassuring it becomes. Is skin in the game a good thing? Even if it is, is it really the most important thing? And what 'game' are we supposed to be playing? 'Skin in the game' is perhaps the most commonly used method today to try and address the principal-agent problem in shareholder capitalism. It applies not just to company managers but to fund managers as well.

A recent Financial Times headline announced “Fund Managers urged to put more skin in the game”. Your managers will care a lot more about looking after your money if they have their own money alongside, went the subtext. Again, this is a much less reassuring statement than it first appears. Does Mum really want to hand over her hard-earned savings to investors who are only going to try their best because they are looking after their own money at the same time?

In Financeland it is assumed that humans perform better the more they are paid. In the Real World this has been proven not to be true as highlighted by Dan Pink's excellent [Ted talk](#). With the exception of simple, repetitive tasks, financial incentivisation can often lead to poorer outcomes including diminished intrinsic motivation, lower performance, the crowding out of good behaviour, unethical behaviour, addictions and short-term thinking. All these are easily recognisable traits within Financeland. None of them are good for Mum's Pound.

Solutions

If blindness, short-termism and misplaced alignment are the ailments of Financeland, what are their cures? A large number of ideas have been suggested over recent years. Three in particular stand out as worthy of immediate consideration.

Long-term stock exchanges

Most compelling is the creation of a series of new electronic long-term stock exchanges designed to replace the void left when the old stock exchanges metamorphosed into today's financial casinos. What should such a stock exchange look like? Buyers and sellers would exchange real shares in real companies. There would be no short-selling or financial derivatives and a minimum holding period of a day. These features would go a long way to ensuring investment drowned out speculation. At present it is the other way around. Brad Katsuyama's IEX is an important step in the right direction, although it still permits too much financial engineering. Does Mum's Pound really benefit from the existence of preference equity redemption cumulative stock?

Investment notice periods

The second compelling idea is around the restriction of liquidity. The majority of equity investment has no notice period. Introducing a simple notice period of a week or month on all regulated investments would deal a significant blow to short-termism. Listed equities are in theory a way of reallocating society's savings for the long-term. Why then do investors in equities need to be able to buy or sell instantly? We are used to time deposits when we entrust our savings to the bank. Why not time investments too?

Redefining alignment

The third group of ideas worth consideration are around alignment. Rather than focus on the financial alignment between managers and shareholders, emphasis should be placed instead on real alignment with the broader society from which real companies and financial companies both derive their license to operate.

The greatest weakness of most remuneration schemes is that they end up crowding out much more important non-financial motivators for performance around the

intrinsic quality of the job itself. This is not a new idea, and dates back at least two thousand years to the Indian epic Bhagavad Gita, in which Lord Krishna admonishes Prince Arjuna never to undertake work for the sake of reward, but rather for the work itself. This theme is repeated in the wonderful chapter four of Schumacher's 'Small is Beautiful' which covers Buddhist economics and was written after the author's trip to Burma in the 1950s. According to Schumacher, the "Buddhist point of view takes the function of work to be at least threefold: to give a man a chance to utilize and develop his faculties; to enable him to overcome his egocentredness by joining with other people in a common task; and to bring forth the goods and services needed for a becoming existence."

Dan Pink converts this into today's language, arguing that the motivation of employees should revolve around three elements:

“Autonomy: the urge to direct our own lives. Mastery: the desire to get better and better at something that matters. Purpose: the yearning to do what we do in the service of something larger than ourselves.”

Dan Pink

In other words, jobs are not a means to an end but an end in themselves. Very few companies think this way, particularly in Financeland.

All of these ideas appear at first glance peculiar. It is only when we are able to stand back from Financeland and recognise the absurdity of what it has become that ideas such as long-only stock exchanges, time investments and the importance of purpose appear eminently sensible suggestions for reconnecting Financeland to the Real World. Alice finally woke up. It is time we did too.

Investment terms

View our list of [investment terms](#) to help you understand the terminology within this document

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