

Dear All,

I would like to take this opportunity to introduce myself and give a little background to my decision to fund a centre for research into the dysfunctionality of capital markets. My career over the past forty years has revolved around finance and has spanned the private sector, academia and policy-oriented institutions. I received my BA and Doctorate in Economics from the University of York and went on to lecture there in the early 1970s . I then moved to the International Monetary Fund, initially as an economist and latterly headed the division responsible for the Fund's borrowing and investment. Returning to the private sector, I was on the board of merchant bank Baring Brothers in the mid-1980s. For the past twenty years I have been a partner in GMO, the fund management group based in Boston, US, setting up and running its London affiliate, GMO Europe. The firm manages pension fund and college endowment assets and was an early pioneer in the development of the quantitative approach to asset management. I retired last year with the express intention of initiating research into the social efficiency of capital markets.



Throughout my career I have been intrigued by issues relating to the efficiency of the stock market in terms of pricing and resource allocation. I am fortunate in having observed capital markets as both practitioner and academic. I have been constantly aware of much in the real financial world that seemed at variance with academic wisdom and much that, despite its importance, seemed to attract at best limited attention..

My firm's experience in developing a quantitative approach to investing proved an important influence. Contrary to the predictions of the Efficient Market Hypothesis, we found it was possible to derive valuation models using publicly-available information to generate fairly consistent excess returns on a wide range of equity and bond products over many years. We eschewed brokers' reports and company visits, relying instead on analysis of a comprehensive database to gain some basic, but important, insights into the determinants of equity valuation. Our work over those twenty years gave results that were difficult to reconcile with the academic notions of efficiency.

Another key influence arose from the events surrounding the bubble in technology and telecom stocks at the turn of the millennium. Throughout the mid 1990s, we had taken this view that improvements in the quality of data and more widespread adoption of sophisticated investment strategies were likely to make stock prices more efficient. However the bubble involved market-wide distortions on a scale rarely matched before and threw into dramatic relief many of the issues and pressures that exist in capital markets. It resembled a laboratory experiment where all the interrelationships were magnified to an usual and illuminating degree. As a result I found myself transferring my interest from finding ways to take advantage of these distortions as an investor, to understanding their causes.

A large body of existing research investigates the behavioural biases of investors as the source of systematic mispricing. Yet the reality is that stock and bond prices are subject to periodic distortions that are far from systematic and often convulsive.

This suggests that we need a better understanding of the functioning of capital markets and, in particular, of the role played by financial intermediaries. It may be that some of the problems arise from the institutional framework and the delegation of investment responsibility to agents. There is also evidence for the widespread adoption, though choice or necessity, of momentum investing that disregards and distorts valuations. Market participants of all types may be acting rationally and optimally at the individual level, but collectively the outcome may be socially inefficient.

It is to explore the causes, consequences and mitigation of possible dysfunctionalities of capital markets that I have chosen to fund this centre at LSE. I expect the work to extend across a broad front from pure theory to policy and to span the full spectrum of finance. This may in the end lead to a better understanding of why it is that the financial markets have come to command such vast resources of capital and people, and to play such a dominant yet unsteady role in the modern economy,

Dr Paul Woolley