London Business School

50 Celebrating our past Inspiring our future

# 1970 How we made the City slicker

In 1970, when London Business School started its one-week course in investment management aimed at finance practitioners, it was teaching things that few people in Britain had heard before. Ideas about efficient markets and portfolio theory that had started circulating in the US in the early 1960s, hadn't made it across the Atlantic. British undergraduate courses didn't cover anything about finance.

"There was an obvious gulf between the thinking of people who studied this stuff and the thinking of people who did it," says Finance Professor Stephen Schaefer who joined the School as a research assistant in 1970. "Education – at least education about finance – wasn't highly prized in the City for a long time; a lot of the people we taught were thoughtful, charming and interested, but most of them didn't believe a word of what we were telling them."

## Big claims

At that time in the City few people realised there were ways of measuring their performance and they got away with extreme claims. Schaefer remembers an investment manager standing up indignantly on one of his courses and saying: "If I couldn't make 25 per cent more than the market year in, year out, I wouldn't be in this game." He'd clearly never once properly measured his performance.

It's hard to imagine today but this was before computing power had taken off and the data just wasn't available. When Schaefer looked for information on the government bond market for his PhD he discovered a brokerage firm with a data tape about all the bonds. But he was dismayed to find that whenever a bond matured, the firm wiped all the past data about it in order to save money on the magnetic tape that the information was stored on.

The gulf in thinking between academics and practitioners wasn't helped by the fact that much of the research was too complicated for practitioners and not many academics were interested in explaining their ideas. Richard Brealey found himself in the middle of the two worlds. After six years in the City with Sun Life of Canada, he became Head of Quantitative Research at a Boston mutual fund. It was one of the first US companies to try to measure the risk of individual stocks and individual portfolios. Brealey was aware of all the evidence coming out of places like MIT and the University of Chicago but he still had trouble convincing his colleagues.

## The real deal

"If a guy was buying high risk stocks in a bull market and doing marvellously then there was no point trying to tell him anything," says Brealey. "But then the bubble burst and he was unemployed. I was just trying to make people see risk and understand performance measurement."

Brealey was also up against the "chartists": "There was a whole department of people who would look at charts of stock prices and look for patterns. They would say that a certain stock had gone up and now it was down, so it was going to go up again (or down). It was all nonsense."

His exasperation with the mutual fund industry led him to write a slim volume called *An Introduction to Risk and Return from Common Stocks*. Published in 1969, it was designed to be accessible to practitioners. "It was a brilliant book," says Schaefer. "It took all the stuff most people would find impenetrable and made it understandable."

## A hive of financial thinking

Brealey headed back to England and joined London Business School as a Research Fellow, later becoming a senior lecturer and Professor. He brought the big American thinkers over to England. Jim Lorie, the head of the finance department at Chicago who developed the first major historical database of stock prices at the Center for Research in Security Prices, CRSP, came for a year. As did the financial economist Paul Cootner of MIT and Stanford, known for his book *The Random Character of Stock Market Prices*. Others like Bill Sharpe, the Nobel Prize-winning professor behind the capital asset pricing model, came for two weeks. "It was great fun," says Brealey. "I was just interested in all these new ideas. One had lots of arguments and debates."

In 1973 the Institute of Finance and Accounting was set up, led by the School's first Professor of Finance, Harold Rose. It was funded by City institutions including Prudential, Warburg, Barclays, Tokai Bank and NatWest. The money let the School put together a team of people that became one of the strongest finance groups in Europe. Brealey set new PhD recruits on the first systematic studies of different aspects of the UK's capital markets – Schaefer on government bonds, Paul Marsh on rights issues, Julian Franks on takeovers, Elroy Dimson on initial public offerings and Stuart Hodges on portfolio theory. And inspired by the CRSP database, Brealey set up the first unbiased database on UK share prices.

By 1976 faculty members like Marsh and Dimson were looking for new ways to spread finance ideas to people who were working, and started evening programmes of one night a week. There was a course in corporate finance and one in investment management. For the latter, people could do a term of accounting, equity management or bond management – or all three. More than 150 people a year attended the courses.

## Goodbye to the old ways

The new ideas were spreading, boosted by the supply of recent MBA students who had also learnt about finance, and the vestiges of the City's old, closed-club way of doing things were about to be blown away forever. In the mid-1980s the 'Big Bang' led to the opening up of the stock market to competition and American firms started to arrive in London in a big way, bringing their financial theories with them. The new thinking was to change the structure of the City – and the way it behaved.

"For one thing the amount of alcohol went down," says Schaefer. "I remember in the late 1980s, at a time when the world had obviously got much tougher, I went to lunch at one of the clearing banks and it was the works – butlers, three kinds of wine, port and cigars, and finishing at four o'clock. But they couldn't afford it and they didn't understand that they couldn't afford it."

One of the consequences of efficient market theory was the rise of passive investment strategies that replicated major indices such as the S&P 500 and FTSE 100, which is the way more than half of investment managers work today. These passive strategies bring better returns if they're done on a large scale – in came large firms like BlackRock and out went some of the smaller, more traditional financial firms.

## The City thrives

City firms started to put more emphasis on education and in the early 1990s the School started its only specialist degree programme, the Masters in Finance, which was aimed at London's financiers and companies' corporate finance people. "We thought it was to deepen people's knowledge but people actually came to broaden their knowledge," says Brealey. "You'd find someone who'd spent five years trading Japanese yen warrants and didn't want to do that all their lives."

In 1991 the School won a pitch for a research project for the Corporation of London, the local authority that covers the City. With the creation of the European Union's Single Market looming, business people were worrying that Paris and Frankfurt could rival London as a financial centre. The Corporation wanted an assessment of the City's competitive position in financial services. As project director Brealey commissioned 26 reports into all aspects of the City's activity, such as regulation, tax, security, transport, legal services, accountancy, telecommunications, property, the labour market, the stock exchange and financial activities.

The City Research Project's final report made the right call. It said London looked secure in its competitive advantage while suggesting that better data could be helpful. It also predicted that advances in technology and communication were unlikely to lead to the decentralisation of the City.

## Sound financial advice

The School's finance faculty became a source of financial advice for practitioners, governments and regulators. Dimson currently chairs the strategy council of the Norwegian Government Pension Fund, one of the world's largest sovereign wealth funds. Schaefer recently wrote a report for the same Norwegian fund on how it had been affected by the financial crisis. He's also advised the European Commission on bank bailouts and been on the board of the Securities and Futures Authority. Franks has long been an advisor to regulatory authorities including Ofcom and Ofwat and provided advice to Treasury committees. From 1998 to 2001, Brealey was a special advisor to the Governor of the Bank of England on issues of financial stability. And Marsh was a director of the big M&G asset management and unit trust group.

During all this time the finance department was steadily developing, with more recent recruits such as Professors Ian Cooper, Francesca Cornelli, James Dow and Narayan Naik leading the latest financial research.

Today several thousand people have been through the department's finance programmes, in addition to MBA students, and the ideas of finance are substantially more accepted. City firms have people with skills and qualifications they wouldn't have considered important 40 or 50 years ago.

Schaefer thinks both sides have moved closer together. "Academics have become more nuanced in the way they interpret the research. And most practitioners accept a good chunk of it," he says, "and that's partly because of the impact of business school education. Ideas that were revolutionary in the 1970s, everybody knows. People have grown up with them and have a view about them now."