

Overview

A modern economy simply cannot work without a successful financial system, and the financial system has an enormous influence on every aspect of business management.

At its best, finance is essential for global wellbeing, especially as we contemplate the many issues facing the world in the 21st century: climate breakdown, poverty, and inequality. At its worst, finance is inefficient. It is believed by many to be overly focused on profit. As students will learn, there is (sometimes unexpected) evidence to support all these perspectives.

Anyone who wishes to pursue a career as a business decision-maker needs to understand how the financial system really works; what makes it function well, and what creates failure; and how will it affect the company for whom you work, and the world in which you live. Any business person who wants to understand how capitalism works needs an understanding of how the financial system works, and why it fails. Yet perhaps surprisingly these topics are often missing from business school curricula. This course aims to fill the gap.

The course will be of particular interest to those who have a wider world view and who wish to challenge convention, develop critical thinking skills, and respond constructively to the considerable criticism the industry currently faces. For those contemplating a career within finance it will address the essential question of “The Purpose” of the industry to which they intend to devote their professional life. For those outside finance, it will be informative as to how modern so-called ‘capitalist’ economies actually work. Those who have taken Simon Taylor’s course in Financial Institutions may find it a useful foundation, however it is not required for this class.

It is led by **David Pitt-Watson**, former Pembroke Professor. He has had a successful career in finance, which has included sitting on the board of some of its most notable institutions. He has also been critical of its workings, however. He works with **Ellen Quigley**, who is currently advising Cambridge University on the responsible management of its £3.4 billion endowment.

They will be assisted by senior guest speakers. For example, last year these included senior economists, investors, writers, advocates and practitioners such as **Andy Haldane**, chief economist at the Bank of England; **Tracy Blackwell**, CEO of Pensions Insurance Corporation and one of the City’s most successful entrepreneurs; **Philip Augar**, an ex-financier who has spent the last twenty years researching and writing about the development of financial markets; **Fiona Reynolds**, head of the \$100-trillion Principles for Responsible Investment; and **Tilly Franklin**, who runs the endowment for Cambridge University.

Teaching Method - TBC

If possible this course will be delivered face-to-face through five teaching sessions. They will include lectures, class discussion, games and exercises, and of course Q&A sessions with our guests. There

should be ample time for class engagement. Should face to face classes prove impossible, the course will be delivered over 5 online lectures plus Q&A sessions.

The course aims to be challenging, practical, informative, and fun. Some background reading is required, and other texts recommended, but these should not be unduly onerous; however, students will be encouraged to explore topics further should they wish to do so.

Sessions will involve a guest speaker with a successful career in the finance industry or influencing it, who will help reflect on the topics raised in the class.

Method of Assessment

The course will be assessed by means of an end of course essay.

- Individual end of course essay of 2,000 words max. 100%

Course Leaders

David Pitt-Watson is a former Pembroke Professor and now a Visiting Fellow at the Cambridge Judge Business School. He is a leading thinker and practitioner in the field of shareholder activism and responsible investment. Until the end of 2012, he was Chair of Hermes Focus Funds, and a former board member of Hermes Fund Managers. As co-founder and former Chief Executive Officer of the Focus Funds and Equity Ownership Service, he helped build Europe's first shareholder activist fund and led the largest responsible investment group of any institutional fund manager in the world.

He was independent non-executive at KPMG and an advisor to Aviva and other institutional investors. He has been deeply involved in policy development within the finance industry. He chaired the UN Environment Programme's Finance Initiative in the run-up to the Paris climate conference. He leads the RSA's Tomorrow's Investor Programme, which has successfully championed better pension arrangements in Britain.

He has written extensively. His first book, *The New Capitalists*, published by Harvard University Press, is influential around the world and has been translated into five languages. His most recent book, *What They Do with Your Money*, was published by the Yale University Press. https://en.wikipedia.org/wiki/David_Pitt-Watson

Dr Ellen Quigley holds a doctorate in economics education from the University of Cambridge, where she is also a postdoc and Advisor to the Chief Financial Officer on responsible investment. Her particular focus is on institutional investors such as pension funds, university endowments, and sovereign wealth funds. Ellen holds a B.A. in English and American Literature and Language from Harvard University and an MSc in Nature, Society, and Environmental Policy from the University of Oxford. Ellen frequently lectures on the topics of economics education and ethics, the transition to a low-carbon economy, and positive investment.

Course Readings

We recommend that students purchase a copy of Davis, Lukomnik, Pitt-Watson, "What They Do with Your Money". It contains a simple summary of many of the issues discussed on the course.

Course Structure

Session 1: The Purpose of Finance

By the conclusion of this first-class participants should understand, and feel comfortable to debate, the key purposes of the finance industry – both those things it does that are important, and those things for which it can be criticised for not being "socially useful". Students will learn and reflect not only on the economic approaches they have learned about at business school, but also how social and institutional forces combine to create successful financial organisations.

Discussion topic for further thought:

- What is the purpose of the finance industry? Today it consumes 8% of the GDP, up from 3% in the middle of last century. It pays much higher salaries than much of the rest of the economy. Why? What services does it provide that justify this success?

Students wishing to explore further may wish to address one or other of the following questions:

- a) Mohammed Yunus won the Nobel Prize because of the activities of the Grameen Bank lending money to poor people. Its principal claim to fame was that it removed thousands of people from poverty. This was done with innovation which allowed Grameen to charge 20-30% interest, when others charged many times that amount. What was so special about the Grameen Bank? Why had no-one done it before?
- b) Wallace and Webster created the first "funded pension" in the 18th Century. Today, in the UK, similar pensions provide two thirds of the savings that enter the financial system. Some feel that the design of Wallace and Webster's pension was better than that available to most employees today. What was special about Wallace and Webster's fund? What difficulties did they overcome to create it, and why had these not been addressed before? What relevance does it have for pensions today, particularly in those parts of the world where private pension provision is lacking?

Guest speaker lecture TBC.

Required readings:

Davis, S., Lukomnik, J. and Pitt-Watson, D. (2016)

What They Do with Your Money: How the Financial System Fails Us and How to Fix It. New Haven: Yale University Press
Chapter 1 What's the Financial System For?

E-book via [iDiscover](#)

Printed book at:
HG181.D38 2016

Session 2: How Well the Finance Industry Fulfils Its Function and How Finance Works

We will look at current research suggesting that the finance industry may not fulfil its purpose well. We will examine the work of Thomas Philippon and Guillaume Bazot on the long-term productivity of the finance industry. They both suggest that there has been little increase in efficiency over more than 100 years.

We will investigate where the problems may be, and examine the arguments that:

- Finance may not be structured to maximise benefits to its customers, and certain activities may be an expensive zero-sum game; we will examine the 'mis-selling' controversies and some critical evidence on performance in the hedge fund and private equity industries.
- Some needed financing may not be happening; we will examine the so-called 'equity gap' and the 'debt gap'.

Using a simple trading simulation, we will gain some insight into the institutional mechanisms that might encourage good and bad outcomes. We will also reflect on whether the way in which we make our choices may encourage us to turn a blind eye to catastrophic events, from financial crises to climate change.

Discussion topic for further thought:

- In the simulation the class will discover whether they are able to choose a good fund manager? What criteria did they use? If others do the same, will this lead to good outcomes? If not, what lessons does this have for the "real world", and for the actions of asset owners, fund managers, companies, regulators and others.

Guest speaker lecture TBC.

Required reading:

Philippon, T. (2015)	"Has the US Finance Industry Become Less Efficient? On the Theory and Measurement of Financial Intermediation." <i>American Economic Review</i> , 105(4): pp. 1408-1438 pp: 1-8	E-article via Business Source Ultimate
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Supplementary Reading

Davis, S., Lukomnik, J. and Pitt-Watson, D. (2016)	<i>What They Do with Your Money: How the Financial System Fails Us and How to Fix It</i> . New Haven: Yale University Press Chapter 2: Incentives Gone Wild	Ebook via iDiscover Printed book at: HG181.D38 2016
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Session 3: How Finance Really Works

In the class, we will consider how the techniques learned in studying finance can best be used in a well-functioning financial system. The aim will be to help students reflect upon, challenge, develop varying perspectives on, and make practical the insights they have learned throughout their studies. We will consider:

- How robust some of the techniques of financial analysis may be
- The importance of transaction costs in economics
- The social and institutional bases that keep transaction costs to a minimum
- What encourages responsible behaviour, in particular fiduciary duty, and how it can be undermined.

Discussion topic for further thought:

- Before the financial crisis the IMF believed that the financial system was “fundamentally sound”. That proved to be a terrible mistake. Yet some argue that the techniques they were using are still being taught and applied. Is that true? If so, where might we make mistakes in the future?

Students wishing to explore further may wish to address the following questions. They centre around the question of whether our current methods of economic analysis “assume away” many of the most interesting phenomena that make economic systems work or fail. For example:

- Many within the system were relying on “normal distributions” to predict risk. Might that have been a mistake? Do we still use normal distributions today? Why?
- Nobel Prize winner Ronald Coase believed that many of our economic models are “remote from the real world” and “incapable of handling” the problems they seek to answer. He believed we need to spend more time thinking about economic institutions. What are the institutions of finance, and why do they matter?
- Fukuyama and Landes are economic sociologists and historians. When they study what creates prosperity, they alight on very different considerations than might be found in an economics or a finance textbook. What sort of things do they identify? Are they that important?

Guest speaker lecture TBC.

Required reading:

Davis, S., Lukomnik, J. and Pitt-Watson, D. (2016)	<i>What They Do with Your Money: How the Financial System Fails Us and How to Fix It.</i> New Haven: Yale University Press Chapter 6 The Queen’s Question	Ebook via iDiscover Printed book at: HG181.D38 2016
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Supplementary reading:

Haldane, A.G. (2012)	“Tales of the Unexpected.” <i>The Credit Crisis Five Years On: Unpacking the Crisis conference.</i> University of Edinburgh Business School, 8-9 June	Conference paper via Bank of England
Lewis, M. (2014)	<i>Flash Boys: Cracking the Money Code.</i> London: Penguin	Printed book at: HG4928.5.L48 F5 2014
Coase, R.H. (1990)	<i>The Firm, the Market and the Law.</i> Chicago: University of Chicago Press, pp: 7-9	Printed book at: HD2326.C62
Augar, P. (2009)	<i>Chasing Alpha: How Reckless Growth and Unchecked Ambition Ruined the City’s Golden Decade.</i> London: Bodley Head Chapter 12 Our own position in time	Printed book at: HC256.7.A93 2009
Fukuyama, F. (1995)	<i>Trust: The Social Virtues and the Creation of Prosperity.</i> London: Hamish Hamilton Chapter 13 Friction-Free Economies	Printed book at: HB72.F84

Session 4: Keeping the System Working: Corporate Governance and the Climate Crisis

In this class we will explore how, as part of its asset management function, finance plays a pivotal role in *corporate governance*. The class will reflect upon the regulations, institutions, governance and market mechanisms through which the finance industry affects the rest of the economic system.

Corporate governance may be more important than ever in our current era. Finance is changing rapidly as the sector begins to recognise and respond to the threat of catastrophic climate change. How should this change the behaviours of asset owners, fund managers, regulators, service providers, and others in the financial industry? We will examine:

- Impactful asset allocation across asset classes
- Climate risk
- Universal ownership theory

Discussion topic for further thought:

- Two clients approach you. One is primarily concerned about climate risk to their portfolio; the other is primarily concerned about investment impact, with a focus on reducing company-level emissions. What advice would you give them, and would you say the same things to both clients? Universal ownership theory describes a paradigm in which long-term asset owners' interests align with those of the economy and society as a whole; they are, in finance terms, more dependent on beta than on alpha for their long-term returns. If you are an asset owner and you share this view, how would this affect the way you invest?

AND/OR

- Students and staff at the University of Cambridge are upset that their pensions and endowments seem to be invested in companies whose management are turning a blind eye to climate breakdown. Some suggest that securities in such companies should be divested. Others suggest that the powers of shareholders are such that they can influence the companies to decrease emissions. The Vice-Chancellor has asked for your advice on what influence shareholders can have, and how that influence should best be exercised by Cambridge. What would you say to him?

Guest speaker lecture TBC.

Required reading:

Davis, S., Lukomnik, J. and Pitt-Watson, D. (2006)	<i>The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda</i> . Boston, Mass.: Harvard Business School Press Chapter 1 The Civil Economy: The Democratization of Ownership	Printed book at: HG4521.D38
Quigley, E. (2019)	<i>Universal Ownership in the Anthropocene</i>	Paper via SSRN (sign in required)

Chambers, D., Dimson, E. and Quigley, E. (2020)	“To Divest or to Engage? A Case Study of Investor Responses to Climate Activism.” <i>The Journal of Investing</i> , 29(2, ESG Special Issue): pp. 10-20	E-article via SSRN (sign in required)
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Session 5: A Successful Career in Finance: Understanding the known unknowns

The class will reflect on what we have learned. How can the perspectives we have learned help achieve our goals? For some these may be career goals: getting a job that offers long-term progression. For others this may be about impact: how can they gain insight, and even influence the way the financial system works?

It will also reflect upon how personal and shared cultural ethics contribute to the success (or otherwise) of the finance industry. We will explore how psychology, social norms and behavioural economics contribute to understanding how the financial system works. We will be challenged by new research by Dr Ellen Quigley on how the disciplines you have learned on a business school course may influence your outlook on the world in ways that you might otherwise be unaware of.

Required reading:

Quigley, E.	<i>The Education of Economists (Forthcoming)</i>	Research review to be produced for this class
Ghoshal, S. (2005)	“Bad Management Theories are Destroying Good Management Practices.” <i>Academy of Management Learning & Education</i> , 4(1): pp. 75-91	E-article via Business Source Ultimate

Supplementary reading

Singer, P. (1997)	<i>How are we to live? Ethics in an Age of Self Interest</i> . New ed. Oxford: Oxford University Press Chapter 1 The Ultimate Choice	Printed book at: BJ1012.S56 H6 1997
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Teaching Staff

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