



CONTENTS

Research Workshops:
A list of workshops
conducted during
2007-2008.

5

*Current Activities of
Center Faculty:* A
listing of research
endeavors by
the faculty.

6

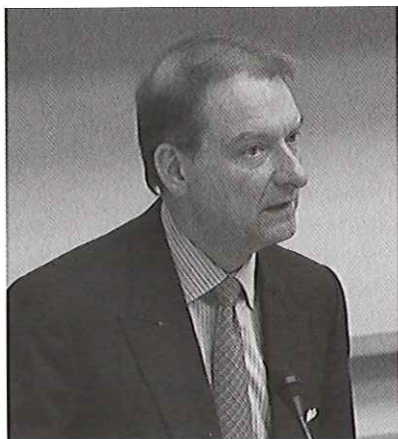
*Faculty Research
Papers:* Current
working papers since
January
2007

10

FINANCIAL MARKETS RESEARCH CENTER • 2008

Conference on
Securitization

Securitization, the packaging and repackaging of bundles of securities or financial contracts, is pervasive in today's marketplace. Mortgages, for example, are packaged into pools against which collateralized mortgage obligations are issued. Similarly, other types of debt claims such as car loans and credit card receivables are packaged



SEC commissioner Paul Atkins speaking on improving financial markets.

into debt securities. Securitization is also common in equity markets as stocks are bought and packaged into pools and resold as investment companies or hedge funds. While securitization creates liquidity and

diversification, the process of securitization also raises a number of important issues. Do the ultimate owners of assets know the quality of the underlying assets? Is there sufficient transparency? What is the role of credit rating agencies and credit insurers in assessing the risk of the underlying assets? What mechanism exists for maintaining the link between the price of the final securitized assets and the underlying claims? The recent asset-backed credit crisis and the associated write-downs by major financial firms have heightened concern about some of these issues.

The 21st conference of the Financial Markets Research Center held at Vanderbilt on April 17 – 18, 2008 examined some of the issues raised by securitization as well as other developments in financial markets.

Jim Bradford, Dean of the Owen School, welcomed conference participants. Then **Hans Stoll**, director of the Center, introduced the chair of the first session, **Neil Ramsey**, Chairman of Ramsey Quantitative Systems Inc. and an Owen School graduate. The first speaker, **Rich Lindsey**, President of Callcott Group LLC, gave a comprehensive overview of the credit crunch that began in the summer of 2007 and its broad-based effect on all corners of the financial system. After tracing the changes in interest rates, bank loans, and the mortgage market, Lindsey concluded that changes in the financial system including the

development of structured finance and securitization of financial claims provided important benefits but also had their faults. In particular, imperfections in these developments led to failures in delegated monitoring and worsening of information asymmetries. The next speaker, **Roy Henriksson**, Chief Investment Officer of Advanced Portfolio Management, discussed the similarities and differences between the stock market crash of 1987 and the credit crunch of 2007. One important similarity was that no event since 1987 has so threatened the integrity of the financial system as the 2007 credit crisis which continues to linger in its effects today.

The conference continued after a coffee break with a session on Asset Securitization chaired by **Bob Davis**, Executive V.P. of the American Bankers Association with responsibility for housing finance and risk management. The first speaker, **Adam Ashcraft**, Senior Economist at the Federal Reserve Bank of NY, described the "seven deadly frictions" associated with the origination and securitization of subprime mortgages. The frictions arise from asymmetric information and principal-agent conflicts affecting the various participants in the securitization process. These include the homeowner who takes out a mortgage loan, the originator of the loan, the arranger to whom the loan is sold, the investor who buys claims on the packaged loans, the investment manager who oversees the investor's portfolio, the credit rating agency that evaluates the credit risk of claims on the package of mortgage loans, and the mortgage servicer who collects loan payments from the mortgagor. He proposed a variety of methods to reduce the frictions. The next speaker, **Richard Herring**, Professor of International Banking at the Wharton School, described the securitization process and the growth in securities backed by subprime mortgages in a talk entitled "The Darker Side of Securitization: How Subprime Lending Led to a Systemic Crisis." He discussed the policy issues raised by the role of ratings agencies, the difficulty of valuing positions (i.e. what is fair value), the adequacy of disclosure, the requirements of Basel I and II, and the size of the subprime crisis and the problems its potential systemic effects pose for regulators. **Oliver Jakob**, Managing Director at Jeffries & Co and formerly a risk manager at Bear Sterns, spoke on the topic, "Risk Management: What Went Wrong?" Jakob put up an interesting slide showing the EPS of two financial concerns – one going sharply negative in 2007, and the other declining in 2007 but staying positive. The company that went bankrupt was the one with declining but positive earnings. This led to the question, "Does market risk matter or can panics upset apparently viable firms?" He concluded his

Securitization *(continued)*



Neil Ramsey introducing the first speaker.

remarks by noting the importance of giving risk management a prominent role within the firm including reporting directly to top management.

SEC Commissioner **Paul Atkins** gave the post-luncheon keynote talk on "Improving Financial Markets." He noted



Lively discussion.

the SEC responsibility in the area of capital requirements for broker-dealer firms and in the area of credit rating agencies (Nationally Recognized Statistical Rating Organizations – NRSROs). He summarized the recent recommendations of the Treasury for a new regulatory structure which would divide regulation into functional categories – financial stability, prudential financial regulation, and business conduct. He emphasized the need for efficient and competitive financial markets that are not hampered by unnecessary regulation. The talk was followed by a lively question and answer session.

Rick Kilcollin, partner in Sanborn Kilcollin and former president of the

Chicago Mercantile Exchange, chaired the session on credit risk transfer and assessment. Securitization, structured products, and derivative contracts are ways by which different types of risk are transferred from one investor to another. The process of transferring credit risk and the potential flaws in that process were discussed by **Michael Gibson**, Associate Director of the Division of Research and Statistics at the Federal Reserve Board and a member of the Bank for International Settlement's joint forum team to analyze risk transfer. He noted that failures in the management of the risk transfer process included managing the risk of super-senior tranches, managing off-balance sheet exposures, dealing with complexity and valuation of certain instruments, and accounting properly for counterparty risk.

Tom Ho, President of Thomas Ho and Co, spoke on the importance of integrating the assessment and management of credit risk and market risk. He noted these risks are not simply additive, and he presented a model for managing the risks jointly.

Comments by **Mike Edleson**, Morgan Stanley's Managing Director responsible for equity risk management, concluded this session. Edleson discussed the difficulty of anticipating what could go wrong and the importance of keeping the risk management staff attuned to the unknown.

The last session of the day, chaired by **Scott Morris**, CEO of the Boston Options Exchange, dealt with a number of dimensions of the credit crunch. **Andreas Preuss**, CEO of the Eurex, noted that Eurex performed well in the face of the disruptions caused by the subprime crisis. The increased volume of trading was effectively handled, and market quality, as reflected in the bid-ask spread, was

continued on page 4



VANDERBILT UNIVERSITY
OWEN GRADUATE SCHOOL OF MANAGEMENT

Financial Markets Research Center
401 Twenty-first Avenue South • Nashville, TN 37203-2422
615-322-3671 • www.owen.vanderbilt.edu/fmrc/

Hans R. Stoll, Director
Robert E. Whaley, Co-Director
J. Dewey Daane, Senior Advisor
Paul Chaney, Data Coordinator
Christoph Schenzler, Research Associate and Data Base Manager
Pat Scott, Administrator

FUNDING

The Center, founded in 1987, is funded by its members and by an endowment. Members sit on the advisory board, participate in all activities of the Center, receive research reports, and give advice on the activities and research direction of the Center.

Members over the past 21 years include the following:

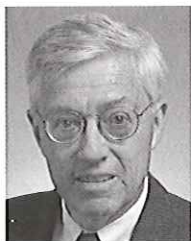
- Aeltus Investment Management, Inc.
- Archipelago, LLC
- America's Community Bankers
- Bank Administration Institute
- Bankers Trust Company
- Bear, Stearns & Company, Inc.
- * Boston Options Exchange Group, LLC
- Caterpillar Financial Services Corp.
- * Chicago Board Options Exchange
- Chicago Mercantile Exchange
- ** CME Group Inc.
- CTS Strategic Investments
- * Eclipse Capital Management, Inc.
- Equitable Securities Corporation
- ** Eurex Frankfurt AG
- Hirtle, Callaghan & Co.
- Hull Group LLC
- ** Interactive Brokers Group
- * International Securities Exchange, Inc.
- J. C. Bradford & Company
- Lavery Consulting Group, LLC
- Matlock Capital LLC
- Merrill Lynch & Company, Inc.
- Morgan Stanley Group, Inc.
- ** NASDAQ Educational Foundation, Inc.
- National Association of Securities Dealers, Inc.
- Nelson Capital Corp.
- New York Mercantile Exchange
- New York Stock Exchange, Inc.
- NYSE Euronext
- ** Options Industry Council
- Pacific Exchange
- ** Ramsey Quantitative Systems, Inc.
- Refco Group, Ltd.
- Ronin Capital, LLC
- Shayne & Co. LLC
- State Street Global Advisors
- Susquehanna International Group, LLP
- Thales Fund Management, LLC
- Timber Hill Incorporated
- Tudor Investment Corporation
- Van Hedge Fund Advisors International, Inc.
- White Cap Trading LLC
- Willis Corroon

* indicates current member

** indicates current lead member

FROM THE DIRECTOR

As I write this in July 2008, it has been a year since the credit crunch of 2007-2008 began with the collapse of two highly levered but relatively inconsequential structured debt funds at Bear Stearns and three months since



Hans R. Stoll

Bear Stearns itself went under. Still, the credit crunch seems to continue and spread to other parts of the economy. By contrast, the Crash of 1987 was concentrated in two days in October. That blow to the financial system was more severe and affected primarily equity markets, but the resilience of the financial markets and the economy was greater. Similarly, the Long Term Capital crisis of 1998 dramatically raised credit spreads, yet the crisis did not spread as it has today and credit markets soon righted themselves. The credit crunch of 2007-2008, while starting with the subprime market, has spread a malaise over all asset-backed markets and has spread to bank lending and to the stock market. The sentiment of participants at this year's conference, described elsewhere in the Newsletter, was surprise at the extent and continuation of the credit crisis. Unlike previous crises, the current one seems to be the result of weaknesses in the financial system itself. These include weak lending standards, lack of transparency in the securitization process and in the OTC derivative markets, lack of secondary markets, failure of effective monitoring and credit rating of asset-backed loans, and weaknesses in the functioning of the short term debt markets and in the implementation of monetary policy. One can only hope that the credit crisis will have passed by this time next year and that the weaknesses in our financial system will have been corrected.

The Financial Markets Research Center, founded 21 years ago, contributes to understanding and improvement of financial markets through its conferences and through support of faculty research. The more than 40 Center members that have helped to fund the Center in the last 21 years are listed elsewhere in this newsletter. Faculty affiliated with the Center currently number 19.

The FMRC is planning something special in the fall. The CONFERENCE ON FINANCIAL INNOVATION: 35 YEARS OF BLACK/SCHOLES AND MERTON will bring together the very best academics/practitioners to talk about the latest developments in financial product/market innovation. The conference, being organized by Bob Whaley to be held at Vanderbilt on October 16-17, 2008, will include five three-paper research sessions plus a panel discussion over two days. Each session will focus on an area of recent financial innovation. While we have not firmed up the program, we anticipate

having sessions on volatility, credit, real estate product markets, index options, and employee compensation contracts. Myron Scholes and Bob Merton will be in attendance. Leading scholars (including Rob Engle, Andy Lo, Francis Longstaff, John Cox, Steve Figlewski, Richard Stanton, Emanuel Derman) will participate, as will leading industry innovators including Leo Melamed. This promises to be a major event. Attendance at the conference will be by invitation. Business school deans from across the country will be able to nominate one of their faculty members to attend.

As is typical, several faculty visited during the past year. **Christian Schlag**, Professor of Finance, Goethe University, Frankfurt, who is in charge of the derivatives research and teaching program at Goethe University, visited in Mod 4 and taught Advanced Derivatives. Schlag has been a regular visitor every other year since 1995. **Kathryn Barraclough** received her PhD from the Australian National University in December 2007 and is Instructor for two years 2007-08 and 2008-09. She teaches courses in Derivatives and Bond Markets. **Gary Twite**, Visiting Associate Professor of Finance from the Australian National University, taught Corporate Financial Policy. Two distinguished scholars gave one-week courses between mods: **William Megginson**, Rainbolt Chair in Finance at the University of Oklahoma, lectured on Venture Capital and Private Equity in the fall; **James Seward**, Associate Professor of Finance at the University of Wisconsin, lectured on Corporate Restructuring in the spring.

Leaving the Center and the faculty of the Owen School is **Mark Cohen**, who has accepted the position of Vice President for Research at the Resources for the Future. Mark has been at the Owen School for 22 years and during that period has completed many research papers on topics such as environmental policy, the economics of crime, and the implication of environmental regulation for firm values. We wish him continued success.

Another noteworthy event that should not go unrecognized is the 90th birthday of **Dewey Daane** on July 6. Dewey, Senior Advisor to the Center and host of the Dewey Daane Invitational Tennis Tournament is a former Governor of the Federal Reserve System. Long term members of the Center will remember that the 1989 Center conference on International Finance and Financial Policy was billed as Dewey's retirement party. The fact of the matter is that Dewey never has retired. He continues to bring leading Federal Reserve officials to his Seminar on Monetary and Fiscal Policy, and he regularly provides economic forecasts for the Wall Street Journal. We wish him good health and look forward to his 100th. ■

GOALS OF THE CENTER

The Financial Markets Research Center at Vanderbilt University fosters scholarly research in financial markets, financial instruments, and financial institutions. The Center:

- 1 Provides a mechanism for interaction among industry practitioners, academic researchers, and regulators.
- 2 Identifies critical research issues in financial markets.

- 3 Supports research by faculty members and Ph.D. students at Vanderbilt.
- 4 Maintains data bases.
- 5 Funds research projects.
- 6 Disseminates research about financial markets. ■

Securitization *(continued)*



Bjorn Flesaker and Scott Morris contemplating the speaker.

maintained. Preuss expressed the view that a significant demand exists for exchange-traded credit derivatives, but that the major banks are opposed. **Bjorn Flesaker**, senior quant at Bloomberg and formerly at MBIA, the leading monoline credit insurer, discussed the economics of the monoline bond insurance business. **Jim Overdahl**, Chief

Economist at the SEC, noted some of the areas in which SEC regulation is related to the credit crunch; for example, accounting policy, issuer disclosure, and the SEC's membership in the President's Working Group and in IOSCO. He spent most of his discussion on the SEC's authority over credit rating agencies given to the Commission by the Credit Rating Agency Reform Act of 2006. Proposed rules for the rating agencies, which reflect a response to the credit crisis, are to be issued in June 2008.

The conference next broke for cocktails and dinner. While there is a tradition of no after-dinner speeches, the participants did take a moment to celebrate the upcoming 90th birthday (July 6) of **Dewey Daane**, Senior Advisor to the Center. Hans Stoll noted Daane's penchant for telling stories about his many small adventures of which there seem to be an ever growing number and thanked him for his contributions to the Center.

Friday morning's first session was chaired by **Jim Cochrane**, formerly Senior Vice President of the NYSE and currently an independent consultant. **John Damgard**, President of the Futures Industry Association, spoke on the current regulatory issues facing the derivatives industry, including the recent Justice Department paper calling for separation of futures clearing from futures trading. Damgard agreed that a captive clearing house makes it difficult and costly for new futures exchanges to compete since positions established in the new exchange would not be fungible in the established exchange. The next speaker, **John Labuszewski**, Managing Director at the CME Group, described the tremendous growth of index trading at the CME and discussed how index futures can be used to "transport alpha." A portfolio

manager, for example, can match his benchmark with the appropriate index futures contract and generate alpha by effectively investing the funds not needed to margin the index futures position. **Brian Reid**, Chief Economist of the Investment Company Institute, discussed the effect of the credit crisis for money funds. Money funds may only invest in asset-backed securities rated in the two highest credit categories. Downgrades and defaults may cause significant problems for money funds and potentially cause them to "break the buck." The final speaker in this session, **Jeff Smith**, Director of Research at the Nasdaq Stock Market, discussed recent developments such as Reg NMS, the merger with the OMX, and the acquisition of the Philadelphia and Boston stock exchanges. He emphasized the competitive nature of equities and options markets.

Bob Whaley, Professor of Finance and Co-director of the Center, chaired the last session of the day on the topic, "Hedge Funds." **Nick Bollen**,

Associate Professor of Finance at Owen, presented his latest research (joint with Veronika Pool) on hedge funds, "Do Hedge Fund Managers Misreport Returns? Evidence from the Pooled Distribution." Bollen and Pool conclude that some hedge funds avoid reporting losses because losses tend to lead to fund withdrawals. **Barry Schachter**, Director of Quantitative Resources at Moore Capital, in a philosophical commentary, argued that the empirical regularities identified by Bollen and Pool do not prove that returns are misreported to the exclusion of other possible explanations. In the ensuing audience discussion a number of interesting examples were offered that are consistent with the patterns documented in the paper. ■



Chuck and Pat Scott keeping things organized.

Dewey Daane Invitational Tennis Tournament

On a beautiful day, a record turnout battled for the contents of the Daane Cup. The event was marred when Bjorn Flesaker snapped his Achilles tendon. Not since Dewey Daane was hit in the nose by an erratic partner several years ago has an injury of any type occurred, much less one as serious as Bjorn's. We wish Bjorn a speedy recovery. The winner of the somewhat deflated group was **Craig Lewis** with **Christoph Schenzler** runner-up. ■



Tennis players before the battle.

Research Workshops

Workshops conducted at the Owen School throughout the year provide a forum for the exchange and testing of new ideas in areas of current research. During 2007-2008 the following researchers presented work on finance topics:

8/17/07 – **Ronald W. Masulis**, *Vanderbilt University*: “Corporate Venture Capital, Strategic Alliances, and the Governance of Newly Public Firms”

8/31/07 – **Nicolas P.B. Bollen**, *Vanderbilt University*: “Do Hedge Fund Managers Misreport Returns? Evidence from the Pooled Distribution”

9/7/07 – **Simon Gervais**, *Duke University*: “Overconfidence, Investment Policy, and Manager Welfare”

9/21/07 – **Jaime F. Zender**, *University of Colorado*: “A Simple-But-Powerful Test for Long-Run Event Studies”

9/28/07 – **Shawn Mobbs**, *Vanderbilt University*: “Tournaments, Heirs, and Organizational Structure”

10/5/07 – **Luke Froeb**, *Vanderbilt University*: “Evaluating Mergers among Firms that Manage Revenue”

10/10/07 – **William Megginson**, *University of Oklahoma*: “Dividends and Share Repurchases in the European Union”

10/12/07 – **Ayako Yasuda**, *University of Pennsylvania*: “The Economics of Private Equity Funds”

10/26/07 – **Timothy C. Johnson**, *London Business School & University of Illinois*: “Liquid Capital and Market Liquidity”

11/9/07 – **Itay Goldstein**, *University of Pennsylvania*: “Payoff Complementarities and Financial Fragility: Evidence from Mutual Fund Outflows”

12/7/07 – **Andrea L. Eisfeldt**, *Northwestern University*: “Financing Shortfalls and the Value of Aggregate Liquidity”

12/14/07 – **Manju Puri**, *Duke University*: “Who Runs? The Importance of Relationships in Bank Runs”

1/18/08 – **Lars-Alexander Kuehn**, *University of British Columbia*: “Asset Pricing with Real Investment Commitment”

1/22/08 – **Amir Barnea**, *University of Texas at Austin*: “Director Networks and Firm Governance”

2/1/08 – **Karthik Krishnan**, *Boston College*: “Universal Banking, Private Information, and Incentive Problems: What Do Ex-Post Lending Patterns Tell Us?”

2/8/08 – **Ilya Strebulaev**, *Stanford University*: “The Evolution of Aggregate Stock Ownership: A Unified Explanation”

2/12/08 – **Ran Duchin**, *University of Southern California*: “Cash Holdings and Corporate Diversification”

2/14/08 – **Shang-Jin Wei**, *Columbia University*: “Growth Potential and Corporate Disclosure: The Case of Foreign Trade Liberalization”

2/15/08 – **Toni M. Whited**, *University of Wisconsin*: “Which Firms Follow the Market? An Analysis of Corporate Investment Decisions”

2/19/08 – **Paige Parker Ouimet**, *University of Michigan*: “Control and Target Managerial Incentives in Acquisition Decisions”

2/22/08 – **Kathleen Weiss Hanley**, *Securities and Exchange Commission*: “Strategic Disclosure and the Pricing of Initial Public Offerings”

2/29/08 – **Murillo Campello**, *University of Illinois & NBER*: “Do Stock Prices Influence Corporate Decisions? Evidence from the Technology Bubble”

3/14/08 – **Mohan Venkatachalam**, *Duke University*: “The Power of Voice: Managerial Affective States and Future Firm Performance”

3/25/08 – **Evgeny Lyandres**, *Rice University*: “Real Options, Volatility, and Stock Returns”

4/4/08 – **Steven Swidler**, *Auburn University*: “Hedging House Price Risk with CME Futures Contracts: The Case of Las Vegas Residential Real Estate”

4/22/08 – **Lakshmanan Shivakumar**, *London Business School*: “Targets’ Earnings Quality and Bidders’ Takeover Decisions”

5/2/08 – **Diego Garcia**, *University of North Carolina*: “Relative Wealth Concerns and Complementarities in Information Acquisition” ■

Guest Speakers

An important aspect of the education of MBA students and the faculty at the Owen School is the opportunity to listen to and question senior executives from financial industries. Outside speakers are sponsored directly by the Financial Markets Research Center, the Owen Lecture Series, or the Finance Association, or are invited as an integral part of courses such as Monetary and Fiscal Policy and Financial Institutions. Guest speakers during the 2007-2008 academic year were:

Roger E. Brinner, Partner and Chief Economist, *The Parthenon Group*

Richard Clarke, President, *Health Care Financial Management Association*

Bruce L. Crockett, Chairman, *AIM Family of Mutual Funds*

Robert R. Davis, Executive Vice President, *American Bankers Association*

Jim Forbes, Managing Director and Global Head of the Healthcare Investment Banking Group, *Merrill Lynch*

Adena Friedman, Executive Vice President, *NASDAQ Stock Market*

Jeffrey M. Holland, Chief of Projections Unit, *Congressional Budget Office*

Karen H. Johnson, Former Director, Division of International Finance, *Board of Governors of the Federal Reserve System*

Donald L. Kohn, Vice Chairman, *Board of Governors of the Federal Reserve System*

Dennis P. Lockhart, President, *Federal Reserve Bank of Atlanta*

Catherine L. Mann, Professor of International Economics and Finance, *Brandeis University*; and Senior Fellow, *Peterson Institute for International Economics*

Martin J. Mauro, Vice President: Fixed Income Strategist, *Merrill Lynch*

Rudolph G. Penner, Senior Fellow, *The Urban Institute*, (former Managing Director, *Barents Group KPMG*, and former Director, *Congressional Budget Office*)

Deborah Perelmuter, Senior Vice President, *Federal Reserve Bank of New York*

Allen Sinai, Chief Global Economist, President & Co-Founder, *Decision Economics, Inc.*

Gary H. Stern, President, *Federal Reserve Bank of Minneapolis*

Jack Tyrrell, Managing Partner, *Richland Ventures*

Paul Volcker, Former Chairman, *Board of Governors of the Federal Reserve System*

John G. Walsh, Chief of Staff and Public Affairs, *Office of the Comptroller of the Currency*

Lawrence Yun, Chief Economist and Senior Vice President, *National Association of REALTORS* ■

Current Activities of Center Faculty

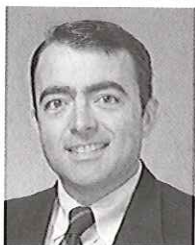


CLIFFORD A. BALL, Professor (finance and statistics) and Faculty Director of the PhD Program. MSc, Nottingham 1975, PhD (mathematics), New Mexico 1980.

Research interests include portfolio theory, interest rate dynamics, derivatives, volatility and correlation of asset returns, risk management, and equities. Current research includes: multivariate time series and nonlinear filtering methods applied to stochastic covariance estimation and prediction; financial contagion and stochastic interdependence of asset returns. More recent research deals with the modeling and pricing of credit default swap index tranches using copula methods.

Professor Ball teaches statistical and econometric analysis and the intricacies of equities, bonds, options, and futures contracts. His classes also cover empirical testing of financial models; stochastic processes and statistical applications to finance. In Risk Management, Ball covers value-at-risk, credit derivatives, and capital requirements.

Ball has stepped down from his position as founding director of the one-year Masters Degree in Finance, which was launched by the Owen School in 2005. He currently serves as faculty director of the Finance PhD program. Ball also serves as associate editor for the *Journal of Empirical Finance* and as referee for numerous other finance and economics journals.



NICOLAS P.B. BOLLEN, The E. Bronson Ingram Associate Professor of Finance and Faculty Director of the MS Finance Program. MBA, PhD, Duke 1997.

Research interests include financial markets, derivatives, mutual funds, and hedge funds.

Professor Bollen was named the E. Bronson Ingram Associate Professor in Finance in 2007. He is also the faculty director of Owen's Master of Science in Finance program, having taken over from Professor Cliff Ball, who launched the program in 2005.

In the past year, Professor Bollen has had two papers published in the *Journal of Financial and Quantitative Analysis*. "Mutual fund attributes and investor behavior" appeared in the September 2007 issue, and "Conditional return smoothing in the hedge fund industry" (with Veronika Krepely Pool) appeared in the June 2008 issue. Bollen presented his paper, "Hedge fund risk dynamics: Implications for performance appraisal" (with Robert Whaley), at Indiana

University in December 2007 and at the annual meeting of the American Finance Association in New Orleans in January 2008. It was accepted for publication in the *Journal of Finance* in April 2008.

Bollen presented a new paper titled "Do hedge fund managers misreport returns? Evidence from the pooled distribution" (with Veronika Krepely Pool) at Georgetown University and the University of Massachusetts in September 2007 and at the Financial Markets Research Center conference on securitization in April 2008. The paper has generated a great deal of media attention, including an extensive article in the *Wall Street Journal* on October 9, 2007. Bollen will present the paper at a week-long symposium at Oxford University in June 2008.



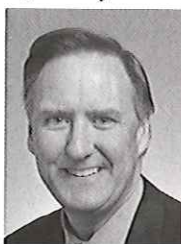
PAUL K. CHANEY, Professor (accounting). MBA, PhD, Indiana 1983, CPA, CMA.

Research interests include auditor reputation, the quality of earnings, earnings management, and audit

pricing.

Professor Chaney presented his paper (with Debra Jeter and Lakshmanan Shivakumar), "Selection Models and Endogeneity: Issues in Accounting Research," at the 17th annual Southeast Summer Accounting Research Conference held at Emory University in July 2007. His paper, "Joint Accounting Choices: An Examination of Firms' Adoption Strategies for SFAS No. 106 and SFAS No. 109" (with Debra Jeter), was published in the *Review of Quantitative Finance and Accounting*.

Professor Chaney was appointed to the editorial board of *The Accounting Review* and continues to serve on the editorial boards of *The International Journal of Accounting and Auditing: A Journal of Practice and Theory*.



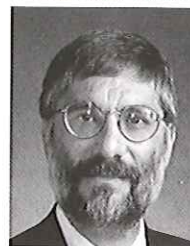
WILLIAM G. CHRISTIE, The Frances Hampton Currey Professor of Management, Associate Dean for Faculty Development, and Professor of Law. MBA, PhD, Chicago 1989.

Research interests include financial markets, market microstructure, and corporate finance.

Professor Christie serves as Editor of *Financial Management*, the flagship journal of the Financial Management Association. His paper, "Wall Street Scandals: The Curative Effects of Law and Finance" co-authored with Professor Bob Thompson from the Law School, has been published in the *Washington University Law Review*. His co-authored paper with Gene Kandel

and Jeff Harris, "Tick size, market structure and trading costs," has been published in an edited volume titled *Liquidity* by John Wiley and Sons. He is currently studying the microstructure of the Pink Sheets market with Nick Bollen.

Christie serves as the Faculty Director of the Executive MBA program at Owen, Chair of the Research Committee, and continues in his role as faculty advisor to the Max Adler Student Investment Club. He taught in the Ingram Scholars Program this past year, and will be teaching in the MBA and Executive MBA programs in the 2008-2009 academic year. He also serves on the dissertation committees for two doctoral students at Owen.



MARK A. COHEN, The Justin Potter Professor of American Competitive Enterprise, Professor of Law, and Co-Director of the Vanderbilt Center for Environmental Management Studies. MA, PhD, Carnegie-

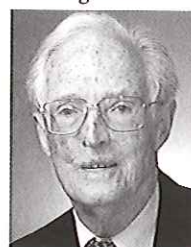
Mellon 1985.

Research interests include law and economics, government regulation, white-collar and corporate crime, and environmental management and sustainability.

Professor Cohen is a member of the Stakeholder Council of the Global Reporting Initiative, the Leverhulme Visiting Professor at the University of York (UK), and Senior Fellow and Member of the Executive Committee of the Center for the Americas at Vanderbilt. He serves on the editorial boards of *Managerial and Decision Economics* and the *Journal of Forensic Economics*.

Over the past year, Professor Cohen presented seminars at universities around the world on topics such as the economic costs of crime and the effectiveness of government oil spill enforcement activities – including recent talks at the University of Warsaw (Poland), Michigan State University, City University of New York, University of Stockholm (Sweden), INCAE Business School (San Jose, Costa Rica), and the Polish Academy of Sciences (Warsaw, Poland).

Effective September 2008, Professor Cohen has accepted the position of Vice President for Research at Resources for the Future in Washington DC.



J. DEWEY DAANE, The Frank K. Houston Professor of Finance, Emeritus and Senior Advisor to the Financial Markets Research Center. MPA, DPA, Harvard 1949.

Research interests include monetary economics and international

finance. During the spring semester, as part of his Seminar in Monetary and Fiscal Policy, Professor Daane arranged for many of the guest speakers listed elsewhere in this newsletter.

In September of 2007, Professor Daane attended two celebrations, one in Washington and one at the Federal Reserve Bank of New York, honoring Paul Volcker on his 80th birthday. In October, he attended the annual meeting of the International Monetary Fund (Group of Thirty) in Washington. In November, he attended the seventh annual Philadelphia Fed Policy Forum. In April 2008, he participated in the Financial Markets Research Center Conference on "Securitization" at Vanderbilt. In May, he attended the 44th Bank Structure & Competition Conference at the Federal Reserve Bank of Chicago. In June, he attended the Federal Reserve Bank of Boston's 53rd Annual Economic Conference.

Professor Daane is a monthly contributor to the *Wall Street Journal's* economic forecast and has earned a spot in their annual US economic-forecasting rankings. He also contributes to the *USA TODAY's* quarterly economic forecast.



LUKE M. FROEB,
The William C. and Margaret M. Oehmig Associate Professor of Entrepreneurship and Free Enterprise. PhD, Wisconsin 1983.

Professor Froeb teaches managerial

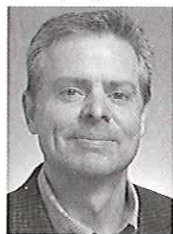
economics and recently stepped down as Chief Economist at the Federal Trade Commission.

During the past year, Froeb spoke on Anti-Trust Policy and related topics at several conferences including conferences at George Mason University, Peking University, the Italian Competition Authority, Washington University, and Cornell University. His papers, "Antitrust" (with Gregory Werden) and "Consumer Protection" (with Paul Pautler), are forthcoming in the *International Encyclopedia of the Social Sciences*. Froeb's textbook, *Managerial Economics*, was published in 2007.

In the fall of 2007, Professor Froeb went to Peking University to celebrate the inauguration of antitrust enforcement in China. He warned the Chinese government that over-enforcement of their antitrust laws could shave a couple of points off their GDP growth rates. This spring, Professor Froeb celebrated the 25-year anniversary of the break-up of AT&T at the University of Pennsylvania by moderating a round table discussion on whether, in retrospect, it was a good idea. Now that the phone industry has largely re-consolidated, there was some finger pointing, but no conclusions were reached. Froeb also gave talks at the ABA meetings in Washington DC on how courts can make better use of econometrics and at the annual IIOC meetings on his search for a theory to explain the curious finding that mergers cause

hotels to reduce price and increase output (capacity utilization).

Professor Froeb's three-year winning streak for "Outstanding Professor" of the Vanderbilt Executive MBA program was broken by Nancy Hyer.



KARL E. HACKENBRACK, Associate Professor (accounting), Faculty Director of the Master of Accountancy Program and Co-Director of the Law and Business Program. MBA, Shippensburg 1983, PhD, Ohio State 1989. CPA.

Research interests include audit service production and mandated corporate disclosure. Current research topics include mandatory disclosure of auditor-sourced non-audit services, audit committee oversight of the financial reporting process, and auditor selection. Hackenbrack teaches primarily the external audit courses in the Master of Accountancy program. He also teaches a seminar in the law school titled Advising Corporate Boards.

This past year Professor Hackenbrack presented "Enabling Auditor-sourced Management Advisory Services" at the University of Arkansas, and he presented "Local Preference in Audit Markets" at The Ohio State University. He is active in numerous academic and professional conferences, including the PricewaterhouseCoopers Accounting and Auditing Symposium, KPMG's Audit Committee Roundtable, the American Accounting Association annual meeting, and its Audit Section mid-year meeting where he presented his manuscript, "Mandatory Disclosure of Non-audit Services is Consequential."

The inaugural class of the one-year Master of Accountancy program graduated spring 2008. As faculty director of this new program, Hackenbrack is heavily involved in all aspects of the program. He also serves on the editorial board of *Auditing: A Journal of Practice and Theory* and is a referee for numerous academic journals.



NICOLE THORNE JENKINS, Associate Professor (accounting), PhD, University of Iowa 2002, CPA.

Research interests include corporate finance and financial accounting with specific emphasis on the quality of accounting information. Current research topics include an expanded investigation of how repurchased shares are used as a form of currency and how the act of repurchasing serves as a signal of future cash flows for intangible intensive firms as well as an attenuating factor in financial restatements.

Professor Jenkins's work has been published in top academic journals, including the *Journal of Accounting and Economics*, *The Accounting Review*,

and *The Review of Accounting Studies*. Her paper, "The Contagion Effects of Accounting Restatements" (with Cristi Gleason and Bruce Johnson), was published in the January 2008 issue of *The Accounting Review*. In the past year Jenkins has presented at The Ohio State University, University of Kentucky, Washington University, and the AAA annual conference. During the past year she has attended many academic conferences and has served as a referee for several accounting and finance journals.

Professor Jenkins is currently teaching financial accounting, advanced financial reporting, and a newly developed course titled accounting and financial communications.



DEBRA C. JETER, Associate Professor (accounting), MBA, Murray State 1981, PhD, Vanderbilt 1990, CPA.

Research interests include financial accounting and auditing, with specific interests in earnings and audit quality, earnings management, components of earnings, the market for audit services, audit pricing, and audit opinions.

Professor Jeter teaches financial accounting at Owen, and she taught in Executive Programs for TVA and Bridgestone in 2008. She just finished revising her textbook, Study Guide, and FASB Update for *Advanced Accounting*, with coauthor Paul Chaney, for its third edition (John Wiley & Sons Inc., publishers). She is currently serving on the Editorial Boards of *Issues in Accounting Education* and *International Journal of Accounting, Auditing, and Performance Evaluation*.

Jeter presented her paper, "The Role of Auditing and Internal Controls in Buyer-Supplier Relations" (with H. Chen), at the Joint Symposium of *Journal of Contemporary Accounting & Economics, and Auditing: A Journal of Practice & Theory*, Plenary Paper Session in Hong Kong in January 2008. This paper has since been published as "The Role of Auditing in Buyer-Supplier Relations" in the *Journal of Contemporary Accounting and Economics*. In March 2008, Jeter presented her paper, "Analysts and Audit Quality: Forecast Revisions during the Arthur Andersen Crisis" (with S. Cahan, P. Chaney, and W. Zhang), at the University of Auckland. Her paper, "Joint Accounting Choices: An Examination of Firms' Adoption Strategies for SFAS No. 106 and SFAS No. 109" (with D. Jeter, P. Chaney, and M. Daly), was published in the *Review of Quantitative Finance & Accounting*, and her paper, "Auditor Specialization: The Influence of Investment Opportunities" (with S. Cahan, J. Godfrey, and J. Hamilton), is forthcoming in *The Accounting Review*. Her paper, "The Pricing of Industry Specialization by Auditors in New Zealand" (with D. Hay), was presented at the ANCAAR Forum (Australian National Centre for Auditing and Assurance Research) at Australian National

Faculty Activities (continued)

University in December 2007, and at the 31st Annual Congress of the European Accounting Association in Rotterdam, in April 2008.



CRAIG M. LEWIS,

The Madison S. Wiggington Professor of Management (finance). MS, PhD, Wisconsin 1986, CPA.

Research interests include equity analyst behavior, the security issue process, corporate financial policy, and the time series properties of stock market volatility. Current research topics include the estimation of expected bankruptcy costs, security issue cycles, specification of option pricing models when assets follow Levy processes, and convertible debt security design. Lewis has published papers on the topics of the behavior of equity research analysts, information content of implied volatilities, volatility forecasting, capital structure, debt maturity structure, the interaction between debt and lease financing, earnings management, and the design and use of convertible debt.

Professor Lewis primarily teaches courses in corporate finance and in company valuation and corporate financial policy. In addition to his role as Finance Area Coordinator, Lewis is the Corporate Finance Track Coordinator.

During the past year, Lewis's paper, "Shareholder Initiated Class Action Lawsuits: Shareholder Wealth Effects and Industry Feedback" (with Amar Gande), was accepted for publication in the *Journal of Financial and Quantitative Analysis*. His paper, "Information and Selective Disclosure" (with Anchada Charoenrook), was also accepted for publication in *Financial Management*.

Lewis attended the Financial Management Association meetings in Orlando and Prague and the Journal of Corporate Finance Conference on Corporate Control and Mergers and Acquisitions in Atlanta, where he discussed several papers and served as a session chair. He will serve as Program Chairman for the Financial Management Association meetings to be held in Torino in 2009.

Lewis is an associate editor of the *Journal of Corporate Finance* and serves as referee for numerous academic journals.



RONALD W.

MASULIS, The Frank K. Houston Professor of Finance and Professor of Law. MBA, PhD, Chicago 1978.

Research interests include corporate finance, corporate governance, executive compensation, investment banking, and international

finance. Professor Masulis teaches courses in mergers and acquisitions, law and finance of mergers & acquisitions, venture capital, and corporate finance theory and evidence.

Professor Masulis is currently Academic Director on the Board of the Financial Management Association. He serves as associate editor of the *Journal of Financial and Quantitative Analysis* and was recently appointed associate editor of *Pacific Basin Finance Journal* for a three year term, and he is a referee for numerous other finance journals. Masulis is chair of the Finance PhD Program at Owen.

Masulis' recent publications include "Corporate Governance and Acquirer Returns" and "Agency Costs at Dual-Class Companies" (both with C. Wang and F. Xie) in the *Journal of Finance* and "Seasoned Equity Offerings: Quality of Accounting Information and Expected Flotation Costs" (with G. Lee) in the *Journal of Financial Economics*. During the past year he has presented papers at the American Accounting Association Meetings, the American Economic Association Meetings, the Financial Management Association Meetings, the European Finance Association Meetings, the 3rd FIRS Finance Conference, Hong Kong University of Science and Technology, and Oxford University.



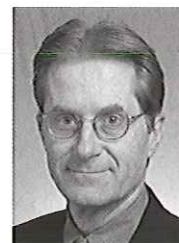
ALEXEI

OVCHINNIKOV, Assistant Professor (finance). MBA, University of California, Riverside 2000, PhD, Purdue University 2004.

Research interests include regulation and mergers, board characteristics and firm performance, and the effect of market timing on firms' cost of capital. Ovtchinnikov came to Owen in 2007 from the Pamplin College of Business at Virginia Tech. His work in the field of corporate finance has appeared in such leading publications as the *Journal of Finance* and the *Journal of Investment Management*. He teaches Corporate Valuation and Empirical Methods in Finance.

Professor Ovtchinnikov's paper, "Corporate Political Contributions and Stock Returns" (with Michael J. Cooper and Huseyin Gulen), was third prize winner of the Q-Group's 2007 Robert F. Murray prize competition. His paper, "Capital Market Imperfections and the Sensitivity of Investment to Stock Prices: (with John J. McConnell), is forthcoming in the *Journal of Financial and Quantitative Analysis*.

Ovtchinnikov serves as referee for the *Journal of Banking and Finance*, the *Journal of Corporate Finance*, the *Journal of Financial and Quantitative Analysis*, and the *Review of Financial Studies*.



DAVID C. PARSLEY, Professor (economics). AM, Indiana 1979, PhD, California, Berkeley 1990.

Research interests are in the fields of international finance and macroeconomics. His recent research examines links across countries, both in financial markets and in markets for goods and services. The role that exchange rates play in the market integration process is central to this research.

Professor Parsley was a Visiting Scholar at the International Monetary Fund in August 2007 and conducted a training seminar at the IMF Institute in November on the subject, "Real Exchange Rate Movements and Trade." He has been invited to be a Visiting Scholar at the South Africa Reserve Bank in 2009.

Parsley presented his paper, "In Search of a Euro Effect: Big Lessons from a Big Mac Meal?" (with Shang-Jin Wei), at the 11th annual Conference on Macroeconomic Analysis and International Finance in Crete and at the International Monetary Fund. He also presented "A Prism into the PPP Puzzles: The Micro-Foundations of the Big Mac Real Exchange Rates" (with Shang-Jin Wei) at the IMF. Both papers have since been published. Two other papers, "Accounting for Real Exchange Rate Changes in East Asia" and "Measuring Financial Integration via Idiosyncratic Risk: What Effects Are We Really Picking Up?" (with Christian Schlag), were published in 2007, and his paper, "Sudden Deaths: Taking Stock of Geographic Ties" (with Mara Faccio), is forthcoming in the *Journal of Financial and Quantitative Analysis*.

In November 2007, Parsley presented his paper, "Slow Passthrough around the World: A New Import for Developing Countries" (with Jeffrey Frankel and Shang-Jin Wei), at North Carolina State University. In July 2008, he presented his paper, "Corporate Lobbying and Financial Performance" (with Hui Chen and Ya-Wen Yang). This paper has been covered in news stories in the *National Journal*, *CFO.com*, and *Business Week*.



JACOB S. SAGI,

Associate Professor (finance). BS, University of Toronto 1991, PhD, University of British Columbia (physics) 1995, (financial economics) 2000.

Research is focused on decision-making under risk and uncertainty, as well as asset pricing. An expert on financial economics and decision theory, Sagi has been published in *Econometrica*, the *Journal of Economic Theory* and other highly regarded journals. His research has been recognized with

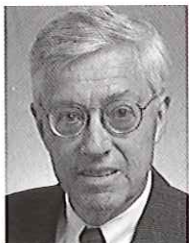
numerous grants and distinctions, including awards from the Research Grants Council of Hong Kong and the National Institute on Aging (NIA). He previously served as assistant professor of finance at the Haas School of Business at the University of California, Berkeley.

Professor Sagi was a discussant at five leading conferences in finance and winner of the "Best Discussant Award" at the Caesarea Centre 5th Annual Academic Conference. He was invited to present a seminar at the Sorbonne (University of Paris), and he was on the program committee of the 2008 Utah Winter Finance Conference. His paper, "Liquidity and Closed-End Funds" (with Martin Cherkes and Richard H. Stanton), which was winner of the "Best Paper" award at the 2006 Utah Winter Finance Conference, is forthcoming in the *Review of Financial Studies*. His paper, "Small Worlds: Modeling Attitudes Towards Sources of Uncertainty" (with Chew Soo Hong), was published in 2008 as the lead article in the *Journal of Economic Theory*.

Sagi is a referee for numerous journals and serves as Associate Editor for *Emerging Markets Review*.

HANS R. STOLL,

The Anne Marie and Thomas B. Walker Professor of Finance and Director of the Financial Markets Research Center. MBA 1963, PhD 1966, U of Chicago.



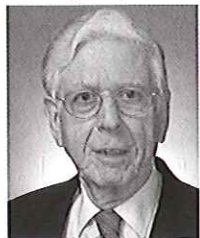
Research interests include market microstructure, derivatives and other aspects of financial markets. Stoll teaches in the areas of international finance, derivatives and financial markets.

Professor Stoll was awarded an honorary doctorate degree by Goethe University Frankfurt in 2007. His talk at the award ceremony was on the topic, "Liquidity." Goethe University is the leading German university in the area of financial markets. Professor Stoll's article, "Failure to exercise call options: An anomaly and a trading game" (with Veronika Krepley Pool and Robert Whaley), appeared in the *Journal of Financial Markets* in 2008. Stoll is a past president of the American Finance Association. He currently serves on the editorial boards of five academic finance journals. He recently stepped down as a public director of the Options Clearing Corporation.

H. MARTIN

WEINGARTNER, The Brownlee O. Currey Professor of Finance, Emeritus. MS, PhD, Carnegie Mellon 1962.

Before his retirement from Owen in January 1998, Professor



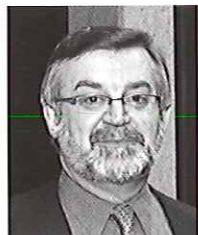
Weingartner taught courses in negotiation, case

studies in finance, financial decision making, and real estate finance. His research over the years focused on the premise that specialty is the financial strategy of organizations – particularly entrepreneurial ventures. He has written extensively on the uses of mathematical models in financial decision making and approaches to capital budgeting and has consulted for major financial institutions and other organizations. Professor Weingartner is a past president of The Institute of Management Sciences and associate editor of *Management Science*.

In May, Weingartner participated in the meetings of the Council of Scientific Society Presidents (CSSP), of which he is an alumni network member. This organization, which meets in Washington DC, consists of the presidents-elect, presidents, and immediate past-presidents of about 60 scientific societies. Among other activities, sessions are devoted to the preparation of statements on science policy which are promulgated to members of Congress and others. Each meeting concludes with a Congressional breakfast meeting at the House of Representatives at which one or more Congress members discuss current issues and talk informally with CSSP members.

ROBERT E.

WHALEY, The Valere Blair Potter Professor of Management (finance) and Co-Director of the Financial Markets Research Center. PhD, University of Toronto 1978.



Research interests include derivatives, asset pricing, market microstructure, and market volatility. Much of Professor Whaley's past work focused on investigations of the effects of program trading on stock prices, the expiration day effects of index futures and options, and the valuation of option and futures option contracts and the efficiency of the markets in which they trade. His research has been published in the top academic and practitioner journals, and he is a frequent presenter, chairman, and/or discussant at major conferences and seminars.

Whaley's recent research includes "Hedge fund risk dynamics: Implications for performance appraisal" (with N.P.B. Bollen), *Journal of Finance* (forthcoming), "Elementary Statistics", *Handbook of Finance*, Frank Fabozzi (Editor), Hoboken, New Jersey: John Wiley & Sons, Inc. (forthcoming), "Regulation Fair Disclosure and the Cost of Adverse Selection" (with B. Sidhu, T. Smith and R. Willis), *Journal of Accounting Research* (June 2008), "Volatility Derivatives", *Handbook of Finance*, Frank Fabozzi (Editor), Hoboken, New Jersey: John Wiley & Sons, Inc. (forthcoming), "Failure to Exercise Call Options: An Anomaly and a Trading Game" (with V. Krepley and H.R. Stoll), *Journal of Financial*

Markets 11 (2008), 1-35, and "The Persistent Presidential Dummy" (with J.G. Powell, J. Shi, and T. Smith), *Journal of Portfolio Management* 33 (Winter 2007), 133-143.

Whaley holds a number of editorial positions, serves as a referee for many journals and granting agencies, and is a former member of the Board of Directors of the Western Finance Association and the American Finance Association. He is currently a member of the International Advisory Board of the University Centre for Financial Engineering at the National University of Singapore.

RICHARD H.

WILLIS, Associate Professor (accounting). BS, University of South Alabama 1983, MAS, Ohio State University 1984, MBA, Duke University 1992, PhD, University of Chicago



1998, CPA (State of Illinois), 1996.

Research interests include security analysts and, in particular, their earnings forecasts, stock recommendations, and target prices. Teaching interests are in managerial accounting and financial statement analysis, courses for which he has won several teaching awards.

Professor Willis's research has been published in top academic journals, including the *Journal of Accounting and Economics*, the *Journal of Financial Economics*, and *The Accounting Review*. His most recent paper in the *Journal of Accounting Research* (June 2008), "Regulation Fair Disclosure and the Cost of Adverse Selection" (with B. Sidhu, T. Smith, and R. Whaley), investigates the effect of Regulation Fair Disclosure (Regulation FD), adopted by the Securities and Exchange Commission in October 2000. The authors find that adverse selection costs, the risk premium that market makers charge to cover losses they realize from trading against individuals with superior information, increased approximately 36% following Regulation FD. According to Willis, these findings are inconsistent with at least one of the SEC's primary objectives in imposing Regulation FD.

Willis is on the editorial board of *The Accounting Review* and serves as a referee for numerous accounting and finance journals. ■

Faculty Research Papers

Current working papers, completed or revised since January 1, 2007, are listed below.

“Market Microstructure of the Pink Sheets,” **Nicolas P.B. Bollen** and **William G. Christie**, April 2008

We study the microstructure of the Pink Sheets and assess the ability of existing theory to capture salient features of this relatively unstructured and unregulated market. Clustering patterns in quotes, quoted spreads, and trade prices indicate that market participants have selected price-dependent tick sizes for different stocks. Clustering intensity varies across stocks as a function of proxies for information availability. Similarly, the bid-ask spread varies as a function of volatility and liquidity. These results suggest (1) microstructure research has established robust predictions of market attributes and (2) unstructured markets are able to develop at least some effective behavioral norms endogenously.

“Do Hedge Fund Managers Misreport Returns? Evidence from the Pooled Distribution,” **Nicolas P.B. Bollen** and **Veronika Krepely Pool**, May 2008

We find a significant discontinuity in the pooled distribution of monthly hedge fund returns: the number of small gains far exceeds the number of small losses. The discontinuity is present in live and defunct funds, and funds of all ages, suggesting it is not caused by database biases. The discontinuity is absent in the three months culminating in an audit, suggesting it is not attributable to skillful avoidance of losses. The discontinuity disappears when using bimonthly returns, indicating a reversal in fund performance following small gains. This result suggests the discontinuity is caused at least in part by temporarily overstated returns.

“Hedge Fund Risk Dynamics: Implications for Performance Appraisal,” **Nicolas P.B. Bollen** and **Robert E. Whaley**, (forthcoming in *Journal of Finance*)

Accurate appraisal of hedge fund performance must recognize the freedom with

which managers shift asset classes, strategies, and leverage in response to changing market conditions and arbitrage opportunities. The standard measure of performance is the abnormal return defined by a hedge fund's exposure to risk factors. If exposures are assumed constant when, in fact, they vary through time, estimated abnormal returns may be incorrect. We employ an optimal changepoint regression that allows risk exposures to shift, and illustrate the impact on performance appraisal using a sample of live and dead funds during the period January 1994 through December 2005.

“A Latent Class Model of Earnings Attributes,” **Paul K. Chaney**, **Bruce Cooil** and **Debra C. Jeter**, June 2008

While the term *earnings quality* has been overused, rarely defined, and largely misunderstood, there is general agreement that users of financial statements react to their content, and that the accuracy and credibility of that content matters to them. To differentiate among financial reports, many papers rely on the association between one specific earnings attribute (such as accruals variability) and some observable outcome (auditor choice, for example). A notable exception, Francis, LaFond, Olsson and Schipper (2004) examine the relation between the cost of capital and several earnings attributes, including both accounting-based characteristics and market-based attributes. Whether each of these attributes provides incremental information for users of financial data beyond the others has not yet been established.

We draw upon Dechow and Dichev (2002), Francis et al. (2004), and Khan and Watts (2007) to identify potentially informative reporting dimensions or earnings attributes. We use a latent class analysis to show empirically that our measures for *Accrual Variability*, *Persistence*, *Smoothness*, *Predictability*, and *Conservatism* all have significant incremental value in differentiating among firms. The best across-firm latent class

model also allows us to identify and study six categories of firms that differ significantly in terms of these five distinct measures. We summarize how these groups of firms differ in terms of both the attributes themselves and various innate firm characteristics. We also show how this new classification of firms is related to a principal component analysis, and we seek the best within-group model for each attribute in terms of innate firm characteristics. We find that two primary principal components provide useful and complementary summaries of the primary dimensions of the attributes examined.

“The Quality of Accounting Information in Politically Connected Firms,” **Paul K. Chaney**, **Mara Faccio** and **David C. Parsley**, June 2008

Recent studies have documented systematic exchanges of favors between politicians and firms, and that connected firms, on average gain from political ties. Since these ties are often to a top manager or large shareholder, agency problems are likely more severe for politically connected firms. Moreover, in the case of political ties, the costs of lower quality disclosures may be mitigated. Empirically, we find that the quality of earnings reported by politically connected firms is significantly poorer than that of similar non-connected companies. Additionally, among connected firms, those that have stronger political ties have the poorest accruals quality. This evidence suggests that managers of connected firms appear to be less sensitive to market pressures to increase the quality of information. This choice seems to be justified in that lower quality reported earnings is associated with higher cost of debt only for the non-politically connected firms in the sample.

“Do Government Agencies Respond to Market Pressures? Evidence from Private Prisons,” **James E. Blumstein**, **Mark A. Cohen**, and **Suman Seth**, May 2008

This paper examines the role of privatization on the cost of government-provided services. We examine data on the cost of housing public and private prisoners

from all 50 states over the time period 1996-2004, and find that the existence of private prisons in a state reduces the growth in per prisoner expenditures by public prisons by a statistically significant amount. In 2004, the average Department of Corrections expenditures in states without private prisoners was approximately \$493 million. Our findings suggest that if the “average” state in that group were to introduce the use of private prisons, the potential savings for one year in Department of Corrections expenditures for public prisons could be approximately \$13 to \$15 million for that particular hypothetical state. These savings on public prisons would be in addition to any direct savings from the use of private prisons by itself.

“Mergers when Firms Compete by Choosing both Price and Advertising,” **Luke Froeb**, Steven Tenn, and Steven Tschantz, April 2007

Enforcement agencies have a relatively good understanding of how to measure the loss of price competition caused by merger. However, when firms compete in multiple dimensions, merger effects are not well understood. In this paper, we study mergers in industries where firms compete by setting both price and promotion, and ask what happens if we mistakenly assume that price is the only dimension of competition. To answer the question, we build a structural model of the super-premium ice cream industry, where a 2003 merger between Häagen-Dazs and Dreyer’s was challenged by the Federal Trade Commission. A structural merger model that ignores promotional competition underpredicts the price effects of a merger in this industry (5% instead of 12%). About three-fourths of the difference can be attributed to estimation bias (estimated demand is too elastic), with the remainder due to extrapolation bias from assuming post-merger promotional activity stays constant (instead it declines by 31%).

“Sophistication of Institutional Investors and the Market Reaction to Accounting Restatements,” S. P. Hribar, **Nicole Thorne Jenkins**, and J. Wang, Summer 2007

This paper investigates the role that institutional investors play in the market’s

reaction to accounting restatements. We show that transient institutional investors, defined as institutions with shorter investment horizons and higher portfolio turnover, significantly reduce their holdings in a restating firm at least one quarter prior to the quarter of the restatement. This result holds after controlling for factors such as return momentum, unexpected earnings, size, book-to-market, and the portfolio weight of the firm to the institution. Using previously identified predictors of earnings manipulation, we also show that institutional investors react most negatively to an increase in the days sales in receivables and high accruals. Finally, we demonstrate that the market reaction to accounting restatements for firms with high levels of transient institutional ownership is more negative in the period prior to the announcement and less negative at the announcement date. Taken together, these results suggest that institutional investors act as though they partially anticipate potential accounting irregularities and adjust their holdings downward prior to the restatement.

“Quasi-rents and Auditor Turnover,” L. Chen, R. Frankel, and **Nicole Thorne Jenkins**, Fall 2007

We investigate whether the bond between the auditor and the client is affected by quasi rents. We use auditor turnover to identify situations of reduced client-specific quasi rents and examine the relation between auditor turnover and non audit fees — a proxy for quasi rents. We find that the existence of non audit fees provides quasi rents, which decrease the occurrence of auditor turnover. In addition, we show that the magnitude of the negative relation between non audit fees and auditor turnover is significantly smaller post SOX than pre SOX, consistent with the evidence that non audit services are prohibited after the adoption of SOX.

“The Use of Interest Rate Swaps to Generate Earnings,” S. Chernenko, M. Faulkender, and **Nicole Thorne Jenkins**, December 2007

This paper finds the relation between term structure and swap usage intensifies when firms engage in earnings management. We investigate the market’s response to earnings

generated from changes in current swap usage and find that firms swapping from floating-to-fixed receive a significantly larger market premium relative to those swapping from fixed-to-floating. In a follow up analysis we document that firms that use swaps to increase earnings access the debt market within two years of the swap, indicating that some swap usage may be strategic. Overall, the market appears to differentiate between swaps used to hedge risk versus meet expectations.

“Are Stock Repurchases Credible Signals of Intangible Investment Quality?” **Nicole Thorne Jenkins** and M. Kimbrough, Spring 2008

Prior research indicates that firms with significant intangible investments (e.g. research and development or advertising) are more likely to engage in stock repurchase activity, presumably because the managers of such firms believe their firms to be undervalued as a result of the lack of financial statement transparency surrounding their intangible resources. In this study, we provide direct evidence on whether repurchases are effective signals of the value of intangible investments. We first examine whether repurchasing firms are motivated by a desire to signal the above-average quality of their intangible investments by examining whether the intangible investments of firms that engage in stock repurchases are associated with higher future payoffs and/or lower risk (i.e. future earnings volatility) than a matched sample of firms with similar intangible investments that do not repurchase. We next examine whether the market interprets stock repurchases as credible signals of the above-average quality of firms’ intangible investments by exploring whether the market values repurchasing firms’ intangible investments more highly than the corresponding investments of non-repurchasing firms and whether the market’s valuation of intangible investments of repurchasing firms increases after the repurchase announcement.

“Put Your Money Where Your Mouth Is...Treasury Stock as Currency,” **Nicole Thorne Jenkins** and **Alexei Ovtchinnikov**, Spring 2008

In this paper we reexamine the choice of payment methods in acquiring public and

private targets and consider the effect of the existence of financial slack on market valuation. We find that the market responds less negatively (positively) to the announcement of a stock (cash) merger when the acquirer has financial slack. We also find that the positive market reaction to stock based mergers of private targets is also attenuated. All of these findings drive the undervaluation hypothesis that states that firms with financial slack are undervalued. Of equal important, this paper show that shares held in treasury are differentially priced from newly issued shares.

“Supporting Stock Prices with Stock Repurchases and Insider Buying,” B. Badertcher, S.P. Hribar, and Nicole Thorne Jenkins, Spring 2008

In this analysis we show that new stock repurchases and net insider buying are effective mechanisms in attenuating the negative price reaction of financial restatements. It appears that the selling of firm owned shares and the purchase of shares by insiders are both informative corporate transactions that assist the market in properly interpreting bad news events such as a financial restatement. In contrast to recent work that documents the opportunism that occurs in insider trading activity immediately prior to financial restatements, we find that the trading activity of insiders and the firm both provide a context in which the market is able to better interpret the subsequent restatement.

“The Pricing of Industry Specialization by Auditors in New Zealand,” David Hay and Debra Jeter, March 2008

A number of recent research papers examine the impact of industry specialization by auditors on audit fees in a variety of contexts. Most propose that auditors who specialize in an industry are able to perform higher quality audits, which are recognized and valued by financial statement users and thus by managers to such an extent that higher audit fees are warranted and paid to such specialists. Evidence consistent with this proposition has been presented in some studies, while others have generated conflicting findings. To the extent that specialist premiums are supported, this result

is a satisfying one for auditors, as it suggests that managers value high quality audits and view audit services as something other than a necessary evil. In this study, we partition New Zealand companies into various market segments to consider the possible benefits of hiring a specialist auditor, and whether (and when) such benefits justify higher audit fees.

We find that there are fee premiums for auditor specialization defined at the city level but not at the national level. The issue of self-selection, whereby clients choose auditors based on the same variables that determine audit fees, does not appear to arise with respect to the choice of a specialist auditor in our setting. Somewhat surprisingly, we find that audit premiums for specialization apply most consistently to larger client firms, and to unlisted companies and low-risk companies. One explanation for this finding is that auditors without specialist expertise in an industry have to offer discounts to attract the most desirable clients, i.e. those that are large, those that are less visible and thus are associated with less vulnerability to litigation, and those that exhibit low risk; while these clients are not able to negotiate fees as successfully with auditors who have differentiated themselves via industry specialization.

“Auditor Specialization: The Influence of Investment Opportunities,” S. Cahan, J. Godfrey, J. Hamilton, and Debra Jeter, (forthcoming in *The Accounting Review*)

A report issued by the U.S. General Accounting Office (GAO) in 2003 identified industry specialization as a key driver of consolidation among audit firms and highlighted the extreme levels of auditor concentration in some industries. Like the GAO, we view auditor concentration as a measure of industry specialization, and we examine one feasible explanation for why auditor specialization differs across industries. We posit that the investment opportunity set (IOS) plays an important role in determining whether an industry is an attractive target for auditor specialization and in creating barriers to auditor entry. We argue that when industry-specific IOS is high, auditors will make costly industry-specific investments that allow them to offer a differentiated product and to create entry barriers for other audit firms. However, when a large component of IOS is specific to

individual firms within an industry so that IOS is highly variable within the industry, the auditors' knowledge requirements are highly specific to those firms and it is more difficult to transfer knowledge and spread costs across clients in that industry. Using two different measures of IOS and three alternative industry classification schemes, we present evidence that auditor specialization is increasing in industry IOS levels and decreasing in within-industry IOS variability.

“The Determinants of Market-Wide Issue Cycles for Initial Public Offerings,” Vladimir Ivanov and Craig M. Lewis, April 2007

This paper identifies the determinants of market-wide and industry-specific security issue cycles using an autoregressive conditional duration model. We examine the business conditions, investor sentiment, and time-varying asymmetric information hypotheses and show that issue activity in different industries is consistent with different explanations. We find that the business conditions and sentiment hypotheses explain issue activity by manufacturing firms; while issue activity by financial institutions is partly explained by the sentiment hypothesis. On the other hand, none of these explanations are capable of explaining issue activity in the business services industry. Surprisingly, when all of these industries are pooled to examine market-wide activity, we find that none of these hypotheses are significantly related to issue activity. One explanation is that market-wide aggregation washes out much of the industry-specific information because issue activity is not perfectly correlated across industries. Using this observation, we then consider whether technological innovations are important determinants of industry-specific issue activity. We test for industry contagion by examining the periods before and after the Netscape initial public offering. We find evidence of an increase in the correlation of issue activity in related industries, which is consistent with the technological innovations hypothesis.

“Information and Selective Disclosure,” Anchada Charoenrook and Craig M. Lewis, (forthcoming in *Financial Management*)

This paper examines whether the prohibition of selective disclosures to equity

research analysts mandated by Regulation FD alters the amount of information and the manner in which it is revealed to the market. We demonstrate that equity research analysts are more responsive to information contained in company-initiated disclosures after Reg. FD, suggesting that regulation has affected the importance of various channels of communication. We also present evidence consistent with the notion that managers use earnings guidance as a substitute for selective disclosure following the passage of Reg FD.

“Shareholder Initiated Class Action Lawsuits: Shareholder Wealth Effects and Industry Feedback,” Amar Gande and **Craig M. Lewis**, (forthcoming in *Journal of Financial and Quantitative Analysis*)

This paper documents significantly negative stock price reactions to shareholder initiated class action lawsuits. We find that shareholders partially anticipate these lawsuits based on lawsuit filings against other firms in the same industry and capitalize part of these losses prior to a lawsuit filing date. We show that the more likely a firm is to be sued, the larger is the partial anticipation effect (shareholder losses capitalized prior to a lawsuit filing date) and smaller is the filing date effect (shareholder losses measured on the lawsuit filing date). Our evidence suggests that previous research that typically focuses on the filing date effect understates the magnitude of shareholder losses, and such an understatement is greater for firms with a higher likelihood of being sued.

“Do Underwriters or Venture Capitalists Restrain Earnings Management by IPO Issuers,” Gemma Lee and **Ronald W. Masulis**, August 2007

This study investigates whether financial intermediaries participating in the IPO process appear to play a significant role in restraining earnings management. More specifically, we examine whether earnings management around an IPO is negatively related to the reputations of underwriters and venture capital (VC) investors. We find strong evidence that more reputable investment banks are associated with significantly less earnings management, which is consistent with them implicitly certifying the quality of issuers' financial reporting. In contrast, neither VC investment, nor backing by more

reputable VCs significantly restrains earnings management by IPO issuers. These conclusions are invariant to adjustments for potential endogeneity of underwriter reputation and VC-backing.

“Strategic Investing: Evidence from Corporate Venture Capital,” **Ronald W. Masulis** and Rajarishi Nahata, November 2007

We analyze financial contracting in start-ups backed by corporate venture capitalists. CVCs' strategic goals can economically hurt or benefit the start-ups, depending on product market relationships between start-ups and CVC parents. Empirically, start-ups prefer funding from CVCs with complementary products. Second, start-up insiders commonly limit the influence of competitive CVCs, awarding them lower board power, while retaining higher board representation for themselves. Third, lead CVCs receive lower board representation, indicating heightened concerns about their greater influence in start-ups' early stages. Fourth, start-ups extract higher valuations from competitive CVCs, reflecting greater moral hazard problems. Overall, CVC strategic objectives affect their inclusion in VC syndicates, their control rights and share pricing.

“How Do Venture Investments by Different Classes of Financial Institutions Affect the Equity Underwriting Process?” Xie Li and **Ronald W. Masulis**, April 2008

Over the 1993-2000 period, a majority of U.S. venture-backed IPOs have venture backing by financial institutions. Each class of financial institutions has its own asset expertise, investment criteria and access to proprietary information on private firms, which we exploit evaluating whether venture investments by commercial banks, investment banks and insurance companies have independent effects on the equity underwriting process. We also examine whether these effects are a function of investment size and whether the effects differ for debt (loans) and equity investments. We find that each class of financial institutions making venture investments in a firm going public is associated with evidence of lower adverse selection risk; namely reduced underpricing and absolute offer price revisions and stronger long-term operating performance. The impacts of debt or equity investments by

separate classes of financial institutions are largely additive. Moreover, the size of financial institution ownership in an issuer is more informative than the presence of financial institution investors. This body of evidence is consistent with equity holdings and loans by each class of financial institutions providing independent certification of issuer quality.

“IPOs and Venture Capital Reputation,” Vladimir I. Ivanov, C.N.V. Krishnan, **Ronald W. Masulis**, and Ajai K. Singh, May 2008

We examine how venture capital (VC) reputation is associated with post-IPO performance of its portfolio companies and the frequency of subsequent IPOs in its venture investment portfolio. Issuer long term performance is measured by three well known standards: industry-adjusted operating performance, market-to-book ratio, and long-run listing survival as well as the probability of post-IPO acquisitions, their takeover premiums and firm expected growth rates. Examining alternative VC reputation measures we find that prior market share of VC-backed IPOs has the strongest association with these long term performance measures and the frequency of future IPOs. These results are robust to adjustments for VC self-selection. More reputable VCs are more actively involved in their firms post-IPO and are associated with better quality corporate governance, which are partial explanations for these firms stronger post-IPO issuer performance. More reputable VCs are also associated with superior private equity networking and greater investor demand for the IPOs they back, which are partial explanations for subsequent VC success in the IPO market.

“Venture Capital Conflicts of Interest: Evidence from Acquisitions of Venture Backed Firms,” **Ronald W. Masulis** and R. Nahata, June 2008

Examining private firm acquisitions, we analyze acquirer announcement returns and target purchase pricing, the impact of venture capital (VC) backing and the importance of VC conflicts of interest with other private equity investors. We find that VC backing leads to significantly higher acquirer announcement returns, averaging 2 to 4 percent, even after controlling for deal

continued on page 14

characteristics and endogeneity in venture funding. On further investigation of the VC-backed sample, we find that acquirer announcement returns are particularly high when VC investors have close financial ties to acquirers and the announcement effect increases with a VC's acquirer shareholdings. For these same acquisitions, target firms receive significantly lower purchase prices relative to their book values. Also, acquisitions of targets backed by corporate VCs exhibit higher acquirer announcement returns, which is consistent with corporate VCs having strategic goals that can conflict with maximizing financial returns. We also show that targets backed by VC funds nearing maturity have lower purchase price to book value ratios, which supports VC willingness to accept lower financial returns to obtain liquidity as their funds near maturity. Taken together, this evidence is consistent with VC conflicts of interest with other target investors affecting the acquisition negotiation process. We conclude that VC conflicts of interest adversely affect target acquisition prices and enhance acquirer profitability, and outweigh any negotiation expertise or certification benefits VCs provide to their portfolio companies.

"Seasoned Equity Offerings: Quality of Accounting Information and Expected Flotation Costs," Gemma Lee and **Ronald W. Masulis**, (forthcoming in *Journal of Financial Economics*)

Flotation costs represent a significant loss of capital to firms and are positively related to information asymmetry between managers and outside investors. We measure a firm's information asymmetry by its accounting information quality based on two extensions of the Dechow and Dichev earnings accruals model (2002), which is a more direct approach to assessing the information available to outside investors than the more commonly used proxies. Our main hypothesis is that poor accounting information quality raises uncertainty about a firm's financial condition for outside investors, though not necessarily for insiders. This accounting effect lowers demand for a firm's new equity, thereby raising underwriting costs and risk. Using a large sample of seasoned equity offerings, we show that poor accounting information quality is associated with higher flotation costs in terms

of (1) larger underwriting fees, (2) larger negative SEO announcement effects, and (3) a higher probability of SEO withdrawals. These results are robust to joint determination of offer size and flotation cost components and to adjustments for sample selection bias.

"Agency Costs at Dual-Class Companies," **Ronald W. Masulis**, Cong Wang, and Fei Xie, (forthcoming in *Journal of Finance*)

We use a sample of U.S. dual-class companies to examine how the divergence between insider voting rights and cash-flow rights affects managerial extraction of private benefits of control. We find that as the divergence widens at dual-class companies, corporate cash holdings are worth less to outside shareholders, CEOs receive higher levels of compensation, managers are more likely to make shareholder-value destroying acquisitions, and capital expenditures contribute less to shareholder value. These findings support the hypothesis that managers with greater control rights in excess of cash-flow rights are prone to waste corporate resources to pursue private benefits at the expense of shareholders. As such, they contribute to our understanding of why firm value is decreasing in the insider control-cash flow rights divergence.

"Corporate Political Contributions and Stock Returns," Michael J. Cooper, Husseyin Gulen, and **Alexei V. Ovtchinnikov**, March 7, 2008

We develop a new and comprehensive database of firm-level contributions to U.S. political campaigns from 1979 to 2004. We construct variables that measure the extent of firm support for candidates. We find that these measures are positively and significantly correlated with the cross-section of future returns. The effect is strongest for firms that support a greater number of candidates which hold office in the same state that the firm is based. In addition, there are stronger effects for firms whose contributions are slanted toward House candidates. Overall, our results are consistent with firms being rewarded with increases in shareholder wealth for their involvement in the U.S. political system.

"Capital Market Imperfections and the Sensitivity of Investment to Stock Prices," John J. McConnell and **Alexei V. Ovtchinnikov**, (forthcoming in *Journal of Financial and Quantitative Analysis*)

Prior studies argue that investment by undervalued firms that require external equity is particularly sensitive to stock prices in irrational capital markets. We present a model in which investment can appear to be more sensitive to stock prices when capital markets are rational, but subject to imperfections such as debt overhang, information asymmetries, and financial distress costs. Our empirical tests support the rational (but imperfect) capital markets view. Specifically, investment-stock price sensitivity is related to firm leverage, financial slack, and probability of financial distress, but is not related to proxies for firm undervaluation. Because, in our model, stock prices reflect the NPVs of investment opportunities, our results are consistent with rational capital markets improving the allocation of capital by channeling more funds to firms with positive NPV projects.

"Slow Passthrough Around the World: A New Import for Developing Countries?" Jeffrey A. Frankel, **David C. Parsley**, and Shang-Jin Wei, 2007

Developing countries traditionally exhibit passthrough of exchange rate changes that is greater and more rapid than high-income countries. In recent years, however, they have experienced a rapid downward trend in the degree of short-run passthrough, and in the adjustment speed. As a consequence, slow and incomplete passthrough is no longer exclusively a luxury of industrial countries. Using a new data set – prices of eight narrowly defined brand commodities, observed in 76 countries – we find empirical support for some of the factors that have been hypothesized in the literature, but not for others. Significant determinants of the passthrough coefficient include per capita incomes, bilateral distance, tariffs, country size, wages, long-term inflation, and long-term exchange rate variability. Some of these factors changed during the 1990s. Part (and only part) of the downward trend in passthrough to imported goods prices, and in turn to competitors' prices and the CPI, can be explained by changes in the monetary

environment. Real wages also work to reduce passthrough to competitors' prices and the CPI, confirming the hypothesized role of distribution and retail costs in pricing to market. Rising distribution costs, due perhaps to the Balassa-Samuelson-Baumol effect, could contribute to the decline in the passthrough coefficient in some developing countries.

"Corporate Lobbying and Financial Performance," Hui Chen, **David C. Parsley**, and Ya-Wen Yang, June 2008

Corporate lobbying activities are designed to influence legislators and thus to further corporate goals by encouraging favorable policies and/or outcomes. Using data that became available after the passage of the Lobbying Disclosure Act of 1995, this study evaluates the effectiveness of corporate lobbying from a financial perspective. We find that a firm's lobbying expenses are positively correlated with its accounting-based financial performance. We also demonstrate that lobbying expenses are value-relevant to firms' market valuation. Finally, we use a portfolio approach to compare stock returns of lobbying firms with non-lobbying firms. We find that portfolios of firms with higher lobbying intensities significantly outperform their benchmarks as well as portfolios of firms with zero lobbying spending.

"Sudden Deaths: Taking Stock of Geographic Ties," Mara Faccio and **David C. Parsley**, (forthcoming in *Journal of Financial and Quantitative Analysis*)

Many firms voluntarily incur the costs of attempting to influence politicians. However, estimates of the value of political connections have been made in only a few extreme cases. We propose a new approach to valuing political ties that builds on these previous studies. We consider connected to a politician all companies headquartered in the politician's home town, and use an event study approach to value these ties at their unexpected termination. Analysis of a large number of sudden deaths from around the world since 1973 reveals a market adjusted 1.7% decline in the value of geographically connected companies. The decline in value is followed by a drop in the rate of growth in sales and access to credit. Our results additionally show a larger effect for family firms, firms with

high growth prospects, firms operating in industries over which the politician has jurisdiction, and firms headquartered in highly corrupt countries.

"Modeling Implications of Source-Invariance to Machina's 'almost objective fair bets'." **Jacob Sagi**, January 2008

Machina (2004) introduced the notion of an 'almost objective' event in a continuous state space-high frequency events in a subjective setting such as 'the realization of the n th decimal place of a stock index.' Payoffs on such events intuitively appear as objective lotteries in the sense that decision makers should not prefer to place bets on any particular digit when n is large even if the state space is fully subjective. This paper investigates the implications of requiring decision makers to treat almost objective events the same regardless of their source (e.g., regardless of the identity of the stock index). Multi-prior models in which the set of representing priors are smooth (i.e., possess densities) can accommodate such source indifference. The major contribution of this paper is to demonstrate that, under mild behavioral conditions, a multi-prior representation with smooth priors is also necessary.

"A Liquidity-Based Theory of Closed-End Funds," Martin Cherkes, **Jacob Sagi**, and Richard H. Stanton, (forthcoming in *Review of Financial Studies*)

This paper develops a rational, liquidity-based model of closed-end funds (CEFs) that provides an economic motivation for the existence of this organizational form: They offer a means for investors to buy illiquid securities, without facing the potential costs associated with direct trading and without the externalities imposed by an open-end fund structure. Our theory predicts the patterns observed in CEF initial public offerings (IPOs) and the observed behavior of the CEF discount, which results from a tradeoff between the liquidity benefits of investing in the CEF and the fees charged by the fund's managers. In particular, the model explains why IPOs occur in waves in certain sectors at a time, why funds are issued at a premium to net asset value (NAV), and why they later usually trade at a discount. We also conduct an empirical investigation, which,

overall, provides more support for a liquidity-based model than for an alternative sentiment-based explanation.

"Political Regimes, Business Cycles, Seasonalities, and Returns," John G. Powell, Jing Shi, Tom Smith, and **Robert E. Whaley**, May 29, 2007

This paper provides a method for testing for regime differences when regimes are long-lasting. Standard testing procedures are generally inappropriate because regime persistence causes a spurious regression problem — a problem that has led to incorrect inference in a broad range of studies involving regimes representing political, business, and seasonal cycles. The paper outlines analytically how standard estimators can be adjusted for regime dummy variable persistence. While the adjustments are helpful asymptotically, spurious regression remains a problem in small samples and must be addressed using simulation or bootstrap procedures. We provide a simulation procedure for testing hypotheses in situations where an independent variable in a time-series regression is a persistent regime dummy variable. We also develop a procedure for testing hypotheses in situations where the dependent variable has similar properties.

"Volatility Derivatives," **Robert E. Whaley**, (forthcoming in *Handbook of Finance*)

A relatively new stock index product is the *volatility derivative*. The Chicago Board Options Exchange (CBOE) contemplated launching trading volatility options as early as 1993. On January 19, 1998, the Deutsche Terminbörse (DTB) became the first exchange in the world to list volatility futures. The CBOE launched trading of VIX futures on its CBOE Futures Exchange on March 26, 2004, with contracts on three-month realized variance being launched on May 18, 2004. The CBOE launched VIX options on February 24, 2006. It was not until the Long-Term Capital Management (LTCM) fiasco in late 1998 that the market finally began to recognize the value of trading stock market volatility as a separate asset class. ■



2007-2008 PUBLICATIONS

- Bollen, Nicolas P.**, 2007. Mutual fund attributes and investor behavior. *Journal of Financial and Quantitative Analysis*, 42, 683-708.
- Bollen, Nicolas P.**, Pool, V.K., 2008. Conditional Return Smoothing in the Hedge Fund Industry. *Journal of Financial and Quantitative Analysis*, 43, 267-298.
- Chaney, Paul, Jeter, Debra C.**, 2007. *Advanced Accounting*, 3rd edition, John Wiley & Sons, New York, NY.
- Chaney, Paul, Daly, M., Jeter, Debra C.**, 2008. Joint Accounting Choices: An Examination of Firms' Adoption Strategies for SFAS No. 106 and SFAS No. 109. *Review of Quantitative Finance & Accounting*, 30:2.
- Christie, William G.**, Harris, Jeff, Kandel, Eugene, 2008. Tick size, market structure and trading costs. *Stock Market Liquidity: Implications for Market Microstructure and Asset Pricing*, Wiley Finance, 173-197.
- Cohen, Mark A.**, Santhakumar, V., 2007. Information disclosure as environmental regulation: A theoretical analysis. *Environmental and Resource Economics*, 37 (3) (July), 599-620.
- Cohen, Mark A.**, 2008. The Effect of Crime on Life Satisfaction. *Journal of Legal Studies*, 37.
- Froeb, Luke, McCann, B.**, 2007. *Managerial Economics: A Problem-Solving Approach*. New York, Southwestern.
- Froeb, Luke, Tschantz, Steven, Werden, Gregory**, 2007. Vertical restraints and the effects of upstream horizontal mergers. *The Political Economy of Antitrust*, Vivek Ghosal and Johann Stennek (Eds.), Amsterdam: North-Holland Publishing, chapter 14, 349-381.
- Gandhi, A., Froeb, Luke, Tschantz, S., Werden, G.**, 2008. Post-Merger Product Repositioning. *Journal of Industrial Economics*, 41 (March) 49-67.
- Gleason, C., Johnson, W.B., Jenkins, Nicole Thorne**, 2008. Financial statement credibility: The contagion effects of accounting restatements. *The Accounting Review*, 81, 83-110.
- Jeter, Debra C., Mkrtychyan**, 2007. *Study Guide, Advanced Accounting*, 3rd edition. NY, John Wiley & Sons, Inc.
- Chen, H., Jeter, Debra C.**, 2008. The Role of Auditing in Buyer-Supplier Relations. *Journal of Contemporary Accounting and Economics*, 4:1.
- Masulis, Ronald W., Xie, F.**, 2007. Corporate Governance and Acquirer Returns. *Journal of Finance*, 62:4, 1851-1889.
- Masulis, Ronald W., Eckbo, Espen, Norli, Oyvind**, 2007. Security offerings. *Handbook of Corporate Finance: Empirical Corporate Finance*, E. Eckbo, North-Holland/Elsevier, chapter 13.
- Parsley, David C.**, 2007. Accounting for Real Exchange Rate Changes in East Asia. *Journal of International Money and Finance*, 26, 1355-1377.
- Parsley, David C., Wei, Shang-Jin**, 2007. A Prism into the PPP Puzzles: The Micro-Foundations of Big Mac Real Exchange Rates. *Economic Journal*, 117, 1336-1356.
- Parsley, David C., Schlag, Christian**, 2007. Measuring Financial Integration via Idiosyncratic Risk: What Effects are we Really Picking Up? *Journal of Money, Credit, and Banking*, 39, 1267-1273.
- Parsley, David C., Wei, Shang-Jin**, 2008. In Search of a Euro Effect: Big Lessons from a Big Mac Meal? *Journal of International Money and Finance*, 27 (2), 260-276.
- Sagi, Jacob S., Seasholes, Mark S.**, 2007. Firm Specific Attributes and the Cross-Section of Momentum. *Journal of Financial Economics*, 84, 389-434.
- Chew, Soo Hong, Sagi, Jacob S.**, 2008. Small Worlds: Modeling Attitudes Toward Sources of Uncertainty. *Journal of Economic Theory*, 139, 1-24.
- Pool, Veronika Krepely, Stoll, Hans R., Whaley, Robert E.**, 2008. Failure to Exercise Call Options: An Anomaly and a Trading Game. *Journal of Financial Markets*, 11, 1-35.
- Powell, John G., Shi, Jing., Smith, Tom., Whaley, Robert E.**, 2007. The Persistent Presidential Dummy. *Journal of Portfolio Management*, 33, (Winter) 133-143.
- Bilson, Chris, Birt, Jacqueline, Smith, Tom, Whaley, Robert E.**, 2007. Ownership, competition, and financial disclosure. *Australian Journal of Management*, 31 (December), 235-264.
- Sidhu, Baljit., Smith, Tom., Whaley, Robert E., Willis, Richard H.**, 2008. Regulation Fair Disclosure and the Cost of Adverse Selection. *Journal of Accounting Research*, 46, (June) 1-32.
- Mikhail, M., Walther, B., Willis, R.** (October, 2007). When security analysts talk, who listens? *The Accounting Review*, 82, 1227-1253. ■