

LSE Colloquium Sargent and Sims Macro-Econometric Perspectives

29 May 2007

Timothy Cogley (University California, Davis)

Thomas Sargent (New York University)

Eric Leeper (Indiana University)

Christopher Sims (Princeton University)



Thomas Sargent (New York University)



Christopher Sims (Princeton University)

On 26 May the FMG held a colloquium to bring together **Thomas Sargent** (New York University) and **Christopher Sims** (Princeton University), two of the outstanding scholars in the fields of macroeconomic dynamics and macro-econometrics. Organised by **Christian Julliard**, **Oliver Linton**, **Bob Nobay**, and **Andrew Patton** all of FMG/LSE, the colloquium featured presentations from both Sargent and Sims and from two of their students and co-authors, **Timothy Cogley** (University California, Davis) and **Eric Leeper** (Indiana University). Taking a workshop format the event attracted an international audience of academics, policymakers and practitioners.

The morning session of the conference was chaired by **Andrew Patton**.

Timothy Cogley presented the first paper of the day, entitled 'Inflation Gap Persistence' and co-authored with Thomas Sargent. This paper explores how inflation persistence has changed since the Great Inflation. They argue that to detect changes in inflation persistence, one should look at the inflation gap, not inflation itself. They decompose inflation into two parts, a stochastic trend that evolves as a driftless random walk, and an inflation gap that represents temporary differences between actual and trend inflation. Because trend inflation is a driftless random walk, actual inflation has a unit autoregressive root and is highly persistent.



Timothy Cogley (University California, Davis)

The authors then define persistence in terms of the predictability of the inflation gap, in particular, as the proportion of the variation of future inflation gaps that is due to past shocks. A high proportion means that past shocks retain influence for some time, while a low proportion signifies that past shocks decay quickly.

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The connection between predictability and persistence arises because past shocks give rise to forecastable movements in the inflation gap, while future shocks contribute to the forecast error. Therefore, the continuing influence of past shocks can be measured by the proportion of predictable variation in the inflation gap. Using Bayesian Markov Chain Monte Carlo methods, they estimate both univariate and multivariate models of post Second World War US inflation rates. As a first step, they estimate a univariate model by introducing an autoregressive term into Stock and Watson's representation and modeling innovation variances as stochastic volatility processes. They find that univariate estimates are mixed, with significant evidence of a rise and fall in the persistence for personal consumption expenditure inflation and marginal evidence for GDP inflation. To fully model changes in the autocorrelations of the inflation gap and also in cross-correlations with lags of other variables, they further estimate a trivariate VAR for inflation, unemployment, and a short-term nominal interest rate. They also assume that the innovation variances follow multivariate stochastic volatility processes. The VAR estimates point to a statistically significant increase in inflation-gap predictability during the Great Inflation and also to a statistically significant decline in predictability after the Volcker disinflation.



Thomas Sargent (New York University)

In the second session **Thomas Sargent** presented his joint work with Lars Hansen (University of Chicago) on 'Fragile Beliefs and the Market Price of Model Uncertainty'. The authors' starting point is a departure from the standard rational expectations assumption that agents are fully confident about the statistical properties of the model they use in their intertemporal optimisation

process. Instead, agents are assumed to be faced recurrently with a model selection and a parameter estimation problem. Agents are concerned both about which model is relevant and also about the specification of each submodel. This has important consequences for asset pricing by introducing a 'model uncertainty premia' into prices.

The authors operationalise these ideas by introducing a hidden Markov model with Bayesian learning. The representative consumer applies a maxi-min approach when valuing consumption streams, or, in other words, minimises expected discounted utility over the set of probability measures over sub-models, and hence is pessimistic with respect to model probabilities. With the arrival of news, the consumer updates his posterior distribution over models and parameters, and this process introduces a time-varying component into the market price of risk which is related to model uncertainty.

The paper studies an example of these ideas in which a consumer faces two competing models, an i.i.d. consumption growth model and a long run risk model. These two models are difficult to distinguish from each other when the amount of historical evidence is limited so the agent has doubts about his posterior distribution over the submodels at each date in addition to doubting about their specification. This problem generates countercyclical market prices of uncertainty. Intuitively, the long run risk model introduces an extra layer of model misspecification coming from the additional hidden shock related to long-run risk. This introduces a negative term in the value function for that sub-model, and means that the differences in valuations across the two sub-models will be larger after a series of consecutive negative consumption growth shocks than after a series of positive ones. Application of the agent's robustness-induced slanting of probabilities towards the most cautious sub-model implies that premia are larger in downturns. The presentation of the papers was followed by a lively discussion, which the biggest concern of the audience related to the extent to which results would carry over to other distributional assumptions, in particular to distributions where the tails are fatter.



Eric Leeper (Indiana University)

The first paper in the afternoon session, chaired by **Chris Julliard** (FMG/LSE), was presented by **Eric Leeper** and entitled 'What has financed government debt?'. The joint work with Hess Chung (Indiana University) studies, within a VAR framework, the implications for macro variables of fiscal policy shocks when satisfaction of the intertemporal fiscal budget constraint is imposed,

ie when the real value of publicly-held government debt must equal the expected present value of fiscal surpluses. Whilst the intertemporal fiscal constraint clearly matters in theoretical models, in empirical models it is rarely considered. The authors also distinguish themselves from other research work on this topic by including the debt stock in the set of VAR variables. Indeed it is this feature which leads to the greater variation in the impulse response than the imposition of the intertemporal fiscal constraint alone.

Having derived the restrictions on the VAR imposed by satisfaction of a linearised version of the intertemporal fiscal constraint, the empirical analysis is undertaken using quarterly US data from 1947 to 2006 with a set of federal fiscal policy variables (including debt, taxes, transfers and spending). Using disaggregated taxes and transfers is found to be preferable to using the commonly-used net taxes (defined as taxes minus transfers). One of the key findings is that changes in expected discount rates play a major role in financing government debt innovations, often as significant

a role as changes in the expected present value of surpluses. In addition, there are often substantial differences in the funding horizon and funding sources depending on the source of the fiscal shock, for example, transfer or spending disturbances are financed over around six decades compared to around one decade for tax shocks. The impulse responses also suggest that the response of the present value of surpluses to fiscal shocks can be non-monotonic over extended funding horizons. These empirical findings suggest more complex dynamics than those generally found in dynamic stochastic general equilibrium models and thus they present a major challenge for such theoretical models.



Sargent and Sims Macro-Econometric Perspective 2007



Christopher Sims (Princeton University)

In the second afternoon session, **Christopher Sims** presented his work on 'Rational Inattention: A Research Agenda.' As a starting point this research agenda recognises the fact that even if economic agents are rational, they can process information only at a finite rate. In other words, they cannot react arbitrarily quickly and precisely to market signals.

In earlier research Christopher Sims has argued for modelling

the observed inertial reaction of economic agents to external information of all kinds as arising from an inability to attend to all the information available, and for treating that inability as arising from finite Shannon capacity. Shannon capacity is a measure of information flow rate that is inherently probabilistic. This leads to well defined dynamic optimisation problems whose solutions differ systematically from those of the usual dynamic stochastic optimisation setups.

This paper applies information-theoretic ideas to economics without relying on Gaussian uncertainty. This is potentially an important advancement in view of the fact that ex post Gaussian uncertainty can be justified as optimal when the associated optimisation problem is linear-quadratic and there is considerable evidence against these utility specifications. In particular, the paper considers a simple two-period optimal saving problem with a Shannon capacity constraint and non-quadratic utility. It derives an optimal ex post probability density for wealth in a couple of cases and proposes a general approach for handling other cases numerically. The paper also suggests promising directions for further research in applying Shannon capacity to economic modelling.



Lars Hansen (University of Chicago)

Lars Hansen (University of Chicago) concluded the colloquium with a personal perspective. As a student of Sargent and Sims, and a leading scholar in the area of macro economics and econometrics, Hansen is uniquely placed to reflect on the highest standards of economics and time-series analysis that both demanded and instilled. He reflected on their contributions in the rational expectations revolution

and as importantly, their continued quest to pursue a rich research agenda which recognises and confronts challenging issues.

The Colloquium was organised with the support of **The Bank of England**, the **LSE Economics and Finance Departments** and the **Suntory and Toyota International Centre for Economics and Related Disciplines (STICERD)** at LSE.

Copies of the colloquium papers are available on the FMG website, <http://fmg.lse.ac.uk>

The complete Colloquium is now available to **watch online on the FMG website**. Please visit the FMG website for further news and information.

Corporate Governance at LSE

Corporate Governance and Regulation: Can There be Too Much of a Good Thing?

Stijn Claessens, IMF and University of Amsterdam

2 May 2007

In the **Corporate Governance at LSE** programme's latest Research Debate, **Stijn Claessens** (IMF & University of Amsterdam) presented his joint paper with Valentina Bruno (World Bank and FMG/LSE) on 'Corporate Governance and Regulation: Can There be Too Much of a Good Thing?'. An important recent theme in the debate on the role of corporate governance relates to its potential relationship with the legal environment in which a firm operates. This paper addresses the issue by analysing what matters most for corporate performance; company-level corporate governance practices or the country-level legal environment and more importantly the interaction between the two? The paper uses rich dataset of company-level corporate governance indicators across 23 developed countries and combines it with country-level data on investor protection. Based on their econometric analysis the authors find that, from a performance perspective, the most important corporate governance provisions are those relating to board independence and also the existence and independence of board committees. Further, country-level protection for minority investors appears to matter but not in a uniform way. For companies with poor corporate governance, country level protection does not help. However, for companies with good corporate governance stringent country-level protection could in fact have an adverse effect. Finally, the paper also finds that corporate governance appears to matter more for larger firms and those firms more reliant on external finance. This analysis thus identifies specific channels through which corporate governance affects corporate performance and more importantly, shows that too much regulation at the country level can hurt good firms.

The discussant, **Antoine Faure-Grimaud** (FMG/LSE), began by pointing out some flaws in the country-level dataset, especially for the UK. He then raised the issue of the interaction between country- and company- level provisions, namely whether country-level corporate governance and company-level provisions are independent of each other. The discussant emphasised that it is difficult to believe that changes in laws pertaining to investor protection will surely not affect individual company governance. The paper therefore needs to be careful in drawing conclusions about the interaction of these effects.

New 'Corporate Governance at LSE' website

www.lse.ac.uk/corporategovernance/



Corporate Governance at LSE

Private Equity Roundtable Debate

Paul Myners, Eli Talmor, Johannes Huth, Conor Kehoe, Guy Paisner

Chair: **Sir Geoffrey Owen** (Department of Management, LSE)

31 May 2007



Paul Myners

On 31 May 2007, FMG hosted a private equity roundtable under the 'Corporate Governance at the LSE' programme. The roundtable was attended by academics as well as practitioners from a wide array of financial industry institutions. The discussion was chaired by **Sir Geoffrey Owen** (Department of Management, LSE), and was opened with introductory speeches by a panel consisting

of **Paul Myners**, **Eli Talmor** (London Business School), **Johannes Huth** (Kolberg Kravis Roberts & Co), **Conor Kehoe** (McKinsey & Company) and **Guy Paisner** (Altius Associates). **Paul Myners** initiated the panel debate by discussing whether private equity funds generate superior returns, questioning the importance of leverage, performance driven remuneration and the business cycle for the success of the private equity industry. Further, he raised concerns regarding leverage and the impact private equity funds have on public companies.

Eli Talmor provided a brief overview of activity in the private equity industry, and suggested that there was still much room for growth. He suggested that private equity funds create value by changing the ownership structure and by eliminating the conflicts of interests that arise from dispersed ownership. **Johannes Huth** stressed the importance of private ownership when implementing structural changes to a company. He supported the notion that private equity funds add value by their ability to make structural changes and



Eli Talmor (London Business School) and **Conor Kehoe** (McKinsey & Company)

their ability to correct corporate inefficiencies. He did not perceive increased leverage of the private equity industry as a systemic threat given the ability to hedge credit exposure via credit derivatives. **Conor Kehoe** underscored the importance of incentives and performance remuneration in private equity funds' ability to undertake corporate restructurings. The panel discussion was closed by **Guy Paisner**, who discussed the heterogeneity of the private equity business. He noted that a larger number of players was equivalent to a more competitive pricing of some but not all deals.

In the open discussion, comparisons were made between holding companies and private equity funds. The major difference between the two structures was suggested to be that private equity funds concentrate the ownership of companies and thereby realign shareholders and managers interests. This enhances their ability to restructure the company, and reduces resources spent on communication with dispersed shareholders. Performance remuneration and the ensuing incentive structures were noted as a

Corporate Governance at LSE



Eli Talmor (London Business School), **Conor Kehoe** (McKinsey & Company), **Paul Myners**, **Johannes Huth** (Kolberg Kravis Roberts & Co), **Guy Paisner** (Altius Associates)

distinguishing feature of private equity funds. The discussion turned to the transparency of private equity funds' business. **Johannes Huth** noted that private equity funds publish quarterly reports and performance evaluations which increase the transparency of what the audience perceived to be an untransparent business. The conflicts of interest between private equity funds and IPO investors were discussed. **Johannes Huth** underscored the importance of trust between institutional investors and private equity fund managers in order for the private equity fund to undertake future listings. Lastly, on the importance of debt for private equity funds performance, **Conor Kehoe** noted that proprietary data indicated that private equity funds outperform public market comparables even when adjusting for differences in leverage ratios. The discussion was closed with the open ended question on why the leverage ratios in public companies were 5-6 times lower than those observed in companies floated by private equity funds.

The next Corporate Governance at LSE Research Debate will take place on 25 October 2007. The presentation will be given by **John Armour** (CBR, University of Oxford).

Attendance at the Research Debates is by invitation only. Further information will be available on the Corporate Governance at LSE website: www.lse.ac.uk/corporateGovernance/

The 'Corporate Governance at LSE' initiative is led by:

Professor Paul Davies, Department of Law, LSE

Professor Antoine Faure-Grimaud, Financial Markets Group, LSE

Dr Thomas Kirchmaier, MBS and Financial Markets Group, LSE

Sir Geoffrey Owen, Department of Management, LSE

UBS Pensions Research Programme

The Future of Pension Plan Funding

7-8 June 2007



On 7 and 8 June, FMG hosted a conference under the UBS Pension Research Programme at LSE. The main issues discussed in this two day conference include: retirement savings behaviour; the design of pension plans and the switch from defined benefit (DB) to defined contribution (DC); and the implication of uncertainty to DC pension schemes.



David Laibson (Harvard University)

In the first session **David Laibson** (Harvard University) presented joint work with John Breshears (Harvard University), James Loi (Yale University) and Brigitte Madrian (University of Pennsylvania and NBER), entitled 'The Importance of Default Options for Retirement Saving Outcomes: Evidence from the United States.' This study summarises the empirical evidence on how defaults impact retirement savings outcomes. After outlining the salient features of the various sources of retirement income in the US, David Laibson presented the empirical evidence on how defaults impact on retirement savings outcomes at all stages of the savings lifecycle, including savings plan participation, savings rates, asset allocation, and post-retirement savings distributions. The author then discussed why defaults have such a tremendous impact on savings outcomes, and concluded with a discussion of the role of public policy towards retirement saving when defaults matter. The paper was discussed by **David McCarthy** (Imperial College) on the underlying economic issues.



David McCarthy (Imperial College)

The second presentation was delivered by **Sarah Smith** (University of Bristol) on her recent work on 'What do defined contribution pensions mean for retirement? Evidence from the UK.' Sarah Smith examined what the shift from DB to DC in pension provision might mean for the timing of retirement. In DB schemes, early retirement windows create powerful incentives for people to leave work and cluster retirements around a narrow range of ages. By contrast, there are no age-related incentives in DC schemes and the spread of retirements is likely to be far smoother. The author presented estimates about the impact of wealth and accrual incentives in DC schemes on retirement, using data from the English Longitudinal Study of Ageing. The results suggest that DC pension wealth does not affect retirement in the same way as DB pension wealth. This is consistent with the greater flexibility of DC schemes and a less close link between the timing of retirement, and pension receipt. The discussant, **Joachim Inkmann** (Tilburg University) emphasised the fact that these results imply higher job tenure under DC scheme participants than DB scheme participants.

The last presentation of the morning entitled 'How deep is the Annuity Market Participation Puzzle?' was presented by **Paula Lopes** (FMG/LSE) and represents joint work with Joachim Inkmann (Tilburg University) and Alex Michaelides (FMG/

LSE). Using UK microeconomic data the authors analyse the empirical determinants of voluntary annuity market demand. They find that annuity market participation increases with financial wealth, life expectancy, education and stock market participation and decreases in the presence of other pension income and a possible bequest motive for surviving spouses. Paula Lopes demonstrated that these empirically motivated determinants of annuity market participation have the same, quantitatively important, effects in a calibrated life-cycle model of annuity demand, saving and portfolio choice. Moreover, the authors estimate preference parameters to match the data. The model predicts annuity demand levels comparable to the data, thereby questioning the conventional wisdom that treats limited annuity market participation as a puzzle to be explained. The discussant, **Edmund Cannon** (University of Bristol) suggested that the model should also incorporate non-economic variables, which are empirically significant.

The second session commenced with **David Miles** (Morgan Stanley) on the 'Optimal Portfolio Allocation for Pension Funds in the Presence of Background Risk.' David Miles presented his joint work with David McCarthy (Imperial College) on the modeling of the asset allocation decision of a defined benefit pension fund in the UK using a stochastic dynamic programming approach. Their model recognises the fact that asset allocation decisions are made by trustees who are mandated to act in the best interests of beneficiaries – not by the sponsoring employers – and that trustees face payoffs that are linked in an indirect way to the value of the underlying assets. The model also includes an allowance for uncertainty of the future value of assets and liabilities. David Miles then demonstrated how the authors are able to substantially replicate observed DB pension asset allocations in the UK and concludes that institutional details – in particular asymmetries in payoffs to pension trustees – are crucial in understanding pension asset allocation. The discussant, **Francisco Gomes** (London Business School) suggested the possible use of numerical solution methodologies, used in Operations Research, to solve the numerical programme.

The session continued with **Theo Nijman** (Tilburg University) presenting joint work with Lans Bovenberg (Tilburg University), Ralph Koijen (Tilburg University), and Coen Teulings (Tilburg University) entitled 'Saving and Investing Over the Life-Cycle and the Role of Collective Pension Funds.' The paper surveys the academic literature on optimal saving and investment over an individual's life cycle. The authors start out with a simple benchmark model with separable and smooth preferences, an aggregate risk factor and riskless wage income. Within this

simple context, optimal saving and investment behavior are explored from the perspective of individuals. Subsequently, the paper investigates various constraints to optimal individual decision making. Theo Nijman discussed how collective pension schemes might help to relieve some of the market incompleteness that arise from these constraints while at the same time introducing new types of constraints. The discussant **Andrea Prat** (FMG/LSE), suggested the incorporation of higher labor market flexibility and other assets in the model.

The last presentation of this session was delivered by **Luciano Greco** (Padova University) on his recent work on 'The Optimal Design of Individual Retirement Accounts.' Luciano Greco began by highlighting the fact that in many countries, individual retirement accounts have been affected by high operating costs, and how contract theory helps to unravel the nature of such a problem. In other words, managers of pension funds have strong incentives to signal their capacity through wasteful activities (eg, promotion). Regulations capping fees or costs of pension funds deteriorate market efficiency, while a public pension fund competing with private ones improves it. Taking into account political and commitment considerations affecting public institutions, a quasi-competitive pension scheme – centralising contribution collection, auctioning the right to manage raised money to competitive fund managers, and according an opting out choice to households Pareto-dominates the market of pension funds. The presentation was discussed by **Paolo Volpin** (London Business School) who provided empirical references in support of the assumptions of Luciano Greco's model.

The first speaker of the third session was **Seán Finucane** (University of Exeter) who presented his joint paper with James Brander (University of British Columbia) on 'Pensions and Corporate Performance: Effects of the Shift from Defined Benefit to Defined Contribution Pension Plans.' In this study the authors investigate the effect of cross-firm and time-series variation in the DC share of pension assets on corporate financial performance. The data set consists of a group of large American corporations contained in the both the Pension and Investment top 1,000 pension sponsors and Compustat and covers the period from 1997 to 2003. Using several return measures, including the return on assets, the operating return on assets, and the return on equity, we find that larger DC shares tend to be associated with higher returns. Seán Finucane demonstrated how these results could be interpreted as arising in part from more efficient worker retirement and mobility decisions under DC plans. The discussant, **Yves Nosbusch** (FMG/LSE) pointed out the fact that risk could also play an important role, both for the cross section and for time series.





Conference participants

The second presentation of this session was delivered by **Edmund Cannon** (University of Bristol) on 'The Risks in Defined Contribution Pension Schemes: International Evidence.' This project, which is joint work with Ian Tonks (University of Exeter), uses data on historical returns on international financial assets to simulate replacement ratios. The simulated replacement ratios are then used to build up a frequency distribution of the pension replacement ratio for individuals saving in a defined contribution pension plan in different countries. Edmund Cannon illustrated how these frequency distributions exemplify the risk in the pension replacement ratio faced by individuals who save in a typical defined contribution pension scheme. The presentation was followed by a discussion from **Anthony Neuberger** (Warwick Business School) who emphasised that these results are particularly important in terms of their policy implications.

The session was concluded by **João Cocco** (London Business School) on 'Longevity Risk, Retirement Savings, and Individual

Welfare', joint with Francisco Gomes (London Business School). In this recent work the authors study optimal consumption and saving choices in an empirically parameterized life-cycle model, in which they allow for changes in the distribution of survival probabilities. The authors document the existing empirical evidence on changes in longevity and outline how these evidence are used to parameterize the model. They find that when individuals know the true probability of an increase in life expectancy, longevity risk has a relatively small welfare effect. However, when agents are uninformed about improvements in life expectancy the effects of longevity risk on individual welfare can be substantial. This is particularly so in the case of more risk averse individual, and in the context of declining payouts of defined benefit pensions. The discussant, **Alex Michaelides** (FMG/LSE) suggested that the welfare measures should also be related to an empirical wealth distribution.

David Webb gave the concluding and summarising remarks of this event.

This event was sponsored by UBS Global Asset Management.
Organised by **Professor David Webb** (FMG/LSE) and **Dr Paula Lopez** (FMG/LSE)



Discussion papers



DP 571

Incentive Design under Loss Aversion

David de Meza, David C Webb

Compensation schemes often reward success but do not penalize failure. Fixed salaries with stock options or bonuses have this feature. Yet the standard principal – agent model implies that pay is normally monotonically increasing in performance. This paper shows that, under loss aversion, there will be intervals over which pay is insensitive to performance, with the use of carrots but not sticks frequently optimal, especially when risk aversion is low and reference income is endogenous. A further benefit of capping losses, for example through options, is to discourage reckless behaviour by executives seeking to resurrect their fortunes. (JEL: F3, F4)

DP 572

Recovery Rates, Default Probabilities and the Credit Cycle

Max Bruche, Carlos González-Aguado

Recovery rates are negatively related to default probabilities (Altman et al. 2005). This paper proposes and estimates a model in which this dependence is the result of an unobserved credit cycle: when times are bad, the default probability is high and recovery rates are low; when times are good, the default probability is low and recovery

rates are high. The proposed dynamic model is shown to produce a better fit of the data than a standard static approach. It indicates that ignoring the dynamic nature of credit risk could lead to a severe underestimation of credit risk (eg, by a factor of up to 1.7 in terms of the 95 per cent VaR). Also, the model indicates that the credit cycle is related to, but distinct from, the business cycle as eg, determined by the NBER, which might explain why previous studies have found the power of macroeconomic variables in explaining default probabilities and recoveries to be low.

DP 573

Liquidity and Capital Structure

Ron Anderson, Andrew Carverhill

This paper solves for a firm's optimal cash holding policy within a continuous time, contingent claims framework that has been extended to incorporate most of the significant contracting frictions that have been identified in the corporate finance literature. Under the optimal policy the firm targets a level of cash holding that is a non-monotonic function of business conditions and an increasing function of the amount of long-term debt outstanding. By allowing firms to either issue equity or to borrow short-term, we show how share issue and dividends on the one hand and cash accumulation and bank borrowing on the other are all mutually interlinked. We calibrate the model and show that it matches closely a wide range of empirical benchmarks including cash holdings,

leverage, equity volatility, yield spreads, default probabilities and recovery rates. Furthermore, we show the predicted dynamics of cash and leverage are in line with the empirical literature. Despite the presence of significant contracting frictions we show that the model exhibits a near irrelevance of long-term capital structure property. Furthermore, the optimal policy exhibits a state-dependent hierarchy among financing alternatives that is consistent with recent explorations of pecking order theory. We calculate the agency costs generated by the conflict of interest between shareholders and creditors regarding the firm's liquidity policy and show that bond covenants that establish an earnings restriction on dividend payments may be value increasing.

DP 574

Corporate Governance and Regulation: Can There Be Too Much of a Good Thing?

Valentina G Bruno, Stijn Claessens

For a large number of companies from different countries, we analyze how company corporate governance practices and country regulatory regimes interact in terms of company valuation. We confirm that corporate governance plays a crucial role in efficient company monitoring and shareholder protection, and consequently positively impacts valuation. We find substitution in valuation impact between corporate



governance measures at the company and country level, with a possibility of over-regulation. Corporate governance appears also more valuable for companies that rely heavily on external financing, consistent with the hypothesis that corporate governance's main role is to protect external financiers.

DP 575

Security-Voting Structure and Bidder Screening

Samuel Lee, Christian At, Mike Burkart

This paper analyzes how non-voting shares affect the takeover outcome in a single-bidder model with asymmetric information and private benefit extraction. In equilibrium, the target firm's security-voting structure influences the bidder's participation constraint and in response the shareholders' conditional expectations about the post-takeover share value. Therefore, the structure can be chosen to discriminate among bidder types. Typically, the socially optimal structure deviates from one share – one vote to promote all and only value-increasing bids. As target shareholders ignore takeover costs, they prefer more takeovers and hence choose a smaller fraction of voting shares than is socially optimal. In either case, the optimal fraction of voting shares decreases with the quality of shareholder protection and increases with the incumbent manager's ability. Finally, shareholder returns are higher when a given takeover probability is implemented by (more) non-voting shares rather than by (larger) private benefits.

DP 576

Financial structure, managerial compensation and monitoring

Sonja Daltung, Vittoria Cerasi

When a firm has external debt and monitoring by shareholders is essential, managerial bonuses are shown to be an optimal solution. A small managerial bonus linked to firm's performance not only reduces moral hazard between managers and shareholders, but also between creditors and monitoring shareholders. A negative relation between corporate bond yields and managerial bonuses can be predicted. Furthermore, the model shows how higher managerial pay-performance sensitivity goes hand in hand with greater company leverage and lower company diversification. These predictions find some support in the empirical literature.

DP 577

A Search-Based Theory of the On-the-Run Phenomenon

Pierre-Olivier Weill, Dimitri Vayanos

We propose a model in which assets with identical cash flows can trade at different prices. Infinitely-lived agents can establish long positions in a search spot market, or short positions by first borrowing an asset in a search repo market. We show that short-sellers can endogenously concentrate in one asset because of search externalities and the constraint that they must deliver the asset they borrowed. That asset enjoys greater liquidity, measured by search times, and a higher lending fee ('specialness'). Liquidity and specialness translate into price premia that are consistent with no-arbitrage. We derive closed-form solutions for small frictions, and can generate price differentials in line with observed on-the-run premia.

DP 578

The Gambler's and Hot-Hand Fallacies: Theory and Applications

Matthew Rabin, Dimitri Vayanos

We develop a model of the gambler's fallacy – the mistaken belief that random sequences should exhibit systematic reversals. We show that an individual who holds this belief and observes a sequence of signals can exaggerate the magnitude of changes in an underlying state but underestimate their duration. When the state is constant, and so signals are i.i.d., the individual can predict that long streaks of similar signals will continue – a hot-hand fallacy. When signals are serially correlated, the individual typically under-reacts to short streaks, over-reacts to longer ones, and under-reacts to very long ones. We explore several applications, showing, for example, that investors may move assets too much in and out of mutual funds, and exaggerate the value of financial information and expertise.



Special Papers

SP 169

Is Forbearance always Bad? How can we test whether its use lessened the incidence of crises?

C A E Goodhart

No abstract available

SP 170

Did NASDAQ market makers successfully collude to increase spreads? A reexamination of evidence from stocks that moved from NASDAQ to the New York or American Stock Exchanges

George J Benston

This paper examines all movements of stock from NASDAQ to the NYSE or Amex from 1983 through 1997 (1044 observations), as did Barclay (1997) for 472 stocks through 1992. He found a greater average decrease in spreads for NASDAQ stocks quoted on even eighths compared to stocks quoted on mixed eighths, from which he concluded that NASDAQ market makers had

successfully colluded to widen spreads. A closer examination of the data and consideration of an important difference between how quotes are set on NASDAQ compared to the NYSE/Amex finds no support for the collusion hypothesis. Spreads on stocks with quoted spreads of one-eighth have no or limited scope for change, as this was the minimum quoted tick size on NYSE/Amex as well as on NASDAQ; hence inclusion of these observations reduces the average post-move spread decrease of mixed stocks, thereby biasing the finding. In fact, the higher average decrease in percentage effective spreads (%EPS) for even-eighth-quoted stocks is due entirely to the few stocks with high spreads (twelve eighths or higher). These stocks are relatively thinly traded and have small capitalizations and, when traded on NASDAQ (but not the NYSE/Amex) are subject to informed (adverse) trading.

Furthermore, in the period after the alleged collusion was publicly identified and, presumably, stopped, there was no change in post-move decrease in %EPS on even-eighth stocks that supports the collusion hypotheses.

Forthcoming Discussion and Special Papers

Discussion Papers

DP 579

'Money Illusion and Housing Frenzies'

Markus K Brunnermeier, Christian Julliard

DP 580

'Market Liquidity and Funding Liquidity'

Lasse Heje Pederson, Markus K Brunnermeier

DP 581 (Corporate Governance Series No 001)

'Corporate Governance in the UK: is the Comply-or-Explain Approach Working?'

Antoine Faure-Grimaud, Valentina Bruno, Sridhar Arcot

DP 582 (Corporate Governance Series No 002)

'The role of prestige and networks in outside director appointment'

Michael Kollo, Thomas Kirchmaier

DP 583

'Endogenous State Prices, Liquidity, Default, and the Yield Curve'

Raphael A Espinoza, Dimitrios Tsomocos, Charles Goodhart

DP 584

'Regionality Revisited: An Examination of the Direction of Spread of Currency Crises '

Anja Shortland, Roberto Leon-Gonzalez, Amil Dasgupta

Special Papers

SP 171

'Prompt Corrective Action and Cross-Border Supervisory Issues in Europe'

Robert A Eisenbeis, George G Kaufman, David G Mayes, María J Nieto, Larry Wall, Rosa María Lastra, Clas Wihlborg, Thomas F Huertas, Gillian G H Garcia

Visitors to the FMG

May – July 2007

Yacine Ait-Sahalia (Princeton University)

John Avery Jones (LSE and the Finance and Tax Tribunals)

Söhnke M Bartram (Lancaster University)

Andrea Buraschi (Imperial College London)

Edmund Cannon (University of Bristol)

Jagjit Chadha (University of Kent)

Stijn Claessens (IMF & University of Amsterdam)

Joao Cocco (London Business School)

Timothy Cogley (University California, Davis)

Camille Cornand (CRNS-BETA)

Steve Donzé (Adviser to Swiss Bankers Association)

Sean Finucane (University of Exeter)

Francisco Gomes (London Business School)

Luciano Greco (Padova University and FMG/LSE)

Lars Hansen (University of Chicago)

Christopher Hennessy (University of California Berkeley)

Patrick Honohan (Trinity College Dublin)

Ossip Huhnerbein (Munich Graduate School of Economics)

Joachim Inkermann (Tilburg University)

David Laibson (Harvard University)

Eric Leeper (Indiana University)

David McCarthy (Imperial College)

David Miles (Morgan Stanley)

Marcus Miller (Warwick University)

Anthony Neuberger (Warwick Business School)

Theo Nijman (Tilburg University)

Thomas Noe (Tulane University)

Enrico Perotti (University of Amsterdam)

Lev Ratnovski (Bank of England/University of Amsterdam)

Jean-Charles Rochet (Toulouse University)

Maria Grazia Romano (Università degli Studi di Napoli Federico II)

Stefano Rossi (Stockholm School of Economics)

Thomas Sargent (New York University)

Jose Scheinkman (Princeton University)

Hyun Shin (Princeton University)

Anja Shortland (Brunel University)

Christopher Sims (Princeton University)

Sarah Smith (University of Bristol)

Jakub Steiner (University of Edinburgh)

Eli Talmor (London Business School)

Ian Tonks (University of Exeter)

Stijn van Nieuwerburgh (New York University)

Laura Veldkamp (NYU Stern)

Paolo Volpin (London Business School)

Luis Viceira (Harvard University)

Jiang Wang (MIT Sloan School of Management)

Toni Whited (UW-Madison)



FMG
Financial Markets Group

The Financial Markets Group Research Centre at LSE is one of the leading centres in Europe for academic research into financial markets. more about FMG

Events this week @ FMG

Wednesday, 1st November 2006 - 13.00pm - 14.00pm
Lunchtime Workshop | Competing Influence | Enrico Sette (LSE)
location: R407, 4th Floor, Lionel Robbins Building, LSE

Wednesday, 1st November 2006 - 5.00pm
Capital Markets Workshop | Risk Aversion and Clientele Effects | Will Goetzmann (Yale University)
location: R405, 4th Floor, Lionel Robbins Building, LSE

In the news

GAM Gilbert de Botton Award in Finance Research 2006 Results - 29 Oct 2006
The Financial Markets at LSE is pleased to announce Valentina Bruno & Sridhar Arcot as the winners

Launch of the new Internal Corporate Governance at LSE research seminars - 24 Oct 2006
FMG would like to announce the launch of a new series of informal research seminars in the area of C

announce Valentina Bruno & Sridhar Arcot as the winners Launch of the new Internal Corporate Governance at LSE research seminars - FMG w

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research people be involved mailing list contact

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FMG Review

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