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Completion of ESRC – World Economy and Finance sponsored Research Programme

Stability of the Global Financial System: Regulation and Policy Response

Although rare events, financial crises have the potential to deal a devastating blow to the financial system and to the wider economy. The aim of this project was to address the following questions: What makes some crises so devastating? What can be done to stem them? What policies will be most effective in preventing them?

The timing of the research project has proved to be prescient. The initial proposal, written in 2004, was motivated by the 1997 Asian financial crisis and by concerns over the financial stability impact of the Basel II capital accord and moves to mark-to-market accounting. Over the course of the research project we have experienced the financial crisis, or 'credit crunch' of 2007-08. The experience of the crisis has validated many of the concerns expressed in the initial proposal, and explored under the project, regarding the impact of the current regulatory and accounting frameworks on financial institutions' behaviour. In addition, the crisis itself has thrown up a whole host of new, interesting research questions which fall under the topics in the original proposal.

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This project was funded by the ESRC under the World Economy and Finance Research Programme. The **ESRC World Economy and Finance** initiative was established to promote and support world-class theoretical, empirical and policy-oriented research focusing on the interrelationship between finance and the world economy. The programme is led by a panel of professional and academic experts and is directed by Professor John Driffill (Birkbeck – University of London). For more information please visit the programme website at www.worldeconomyandfinance.org

The FMG World Economy and Finance project ran for three years and was completed in March 2008. The final report was completed last May. The final dissemination event of this project was a conference on Cycles Contagion and Crises held on 28-29 June 2007 (Please see Review Number 75. A conference volume of the papers presented is under preparation with a view to publication by end of 2008).

We are grateful to ESRC and the World Economy and Finance Research Programme which made this research possible (RES-156-25-0026).



Charles Goodhart (FMG/LSE)



Hyun Song Shin (FMG/LSE and Princeton University)

Stability of the Global Financial System: Regulation and Policy Response

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The project, as set out in the original proposal, had five main goals:

- 1 To build a theoretical framework that captures all key channels of financial contagion.
- 2 To address the debate on the appropriate use of monetary policy during crises (the ex post policy response).
- 3 To contribute to the upcoming debate on the appropriate framework for financial regulation (the ex ante regulatory framework) for the next generation of the regulatory rules under the Basel process.
- 4 To provide an analytical framework that lays out the terms of the trade-off between a mark-to-market measurement system and a historical cost system in terms of their implications on financial stability.
- 5 To develop an overall theoretical framework of financial stability encompassing the role of multilateral organisations such as the IMF.

The first four goals have been fully addressed and met successfully through a wide range of academic research and policy papers with the results disseminated at various events and through the media. The specific fifth objective, to incorporate the role of multilateral organisations within an overall theoretical framework for financial stability, has not been fully addressed. The primary reason is that the 2007-08 financial crisis naturally focused activity on those areas most closely related to the salient academic and policy issues, namely objectives 2, 3 and 4 above. In addition, the recent crisis has affected developed countries' financial systems. As such, the priority attached to incorporating multilateral organisations such as the IMF, which have made no direct lending interventions in the current crisis, within a model of financial stability, appeared to be reduced. Notwithstanding this shift in focus, the research programme has produced a whole host of important research on issues relating to international financial crises and financial stability in emerging economies.

In line with the wide-ranging objectives of the research project, a variety of methods, both theoretical and empirical, have been employed. Theoretical models have ranged from general

equilibrium, heterogeneous agent models of the financial system designed to analyse issues of financial stability, through to global games models of currency attacks. On the empirical side, various techniques and datasets have been employed. For example, bank-level data has been used to analyse trends in leverage, aggregate-level data used to analyse the impact of banking sector default probabilities and equity values on aggregate output and high frequency data employed to analyse the transmission of financial crises in emerging markets.

Analysis of financial contagion and financial stability

There have been two main strands of work on financial contagion and financial stability. The first strand, led by Charles Goodhart, aimed to formulate a systematic way to quantify the degree of financial fragility of an economy, in an effort to increase the rigor with which issues related to financial stability are treated in the academic and policy literature. The second strand, led by Hyun Shin, focused on the interactions between liquidity and systemic risk. Both strands have gone beyond the theoretical approaches outlined in the original proposal to use empirical analysis to test the models developed.

An analytical framework for assessing financial stability

Charles Goodhart and co-authors have pursued an extensive research agenda with the objective of building a quantitative measure of financial stability. The first step involved building a tractable analytical model to capture the potential interlinkages and contagion within the financial system and the real economy. The second step involved empirical analysis to develop a realistic metric for financial fragility to inform policy. The work undertaken as part of this research agenda was presented, along with other work in the field, at an ESRC-funded conference on 'Financial Stability: Theory And Applications' held in May 2006, which was featured in a symposium edition of the *Annals of Finance* in January 2007 (Goodhart and Tsomocos, 2007)¹.

¹ Goodhart, C A E and Tsomocos, D (2007). 'Financial stability: theory and applications', *Annals of Finance*, 3 (1), pp 1-4.





John Driffill (Director of World Economy and Finance Research Programme)

The analytical model that was developed incorporates certain key features fundamental to any analysis of financial stability questions². First, there are heterogeneous banks, since otherwise there would be no interbank market and hence no contagion across institutions. Second, there must be the probability of default since otherwise crises would not exist. Third, financial markets must be incomplete since otherwise all states of the world could be hedged against. Fourth, as in reality, there must be a role for banks, money and interest rates. Whilst familiar to policy-makers and practitioners, many

academic models of financial stability abstract from such features for reasons of simplicity, for example through the use of representative agent models. The modelling approach can be used to examine a host of policy interventions, both regulatory and by the Central Bank, and illustrates some important results. For example, in an adverse economic environment, expansionary monetary policy can aggravate financial fragility since the extra liquidity injected by the Central Bank may be used by certain banks to gamble for resurrection, worsening their capital position, and therefore the economy's overall financial stability.

Liquidity and financial crises

The regulatory authorities, notably the Basel Committee of Banking Supervision (BCBS), have been concentrating on setting capital ratios (CARs) in the last two decades. Concern about the need for liquidity ratios had subsided into abeyance. However, the credit crunch which began in summer 2007 has led to increasing calls for some regulatory control over bank liquidity. But a theoretical analysis of the rationale for (required) liquidity holdings, and their appropriate form and composition, are also lacking. Professor Shin, together with a number of collaborators, has been examining the role of asset market liquidity in the origination and propagation of systemic shocks to a financial system. Existing studies of systemic risk have focused on the balance sheet interlinkages between financial institutions and the 'domino effect' of the failure of one institution cascading down to the others. Liquidity effects generate a more potent channel of contagion. When financial institutions mark their assets to

market, a shock to prices may induce some of them to adjust their asset holdings by selling into the market. These sales will give a further impetus to asset prices, which generate further sales, and so on. This work, which began before the advent of the crisis, has proved timely and has gained wide attention in academic and policymaking circles and in the financial media.

Monetary policy during crises (the ex post policy response)

The work on the appropriate use of monetary policy has encompassed two main issues. The first concerns the provision of liquidity assistance by Central Banks. The second field is the optimal form and degree of communication by Central Banks in their conduct of monetary policy.

Central bank provision of liquidity assistance

During the course of the financial crisis of 2007-08, the major Central Banks have adopted a range of approaches to the provision of liquidity assistance. The impact of the different policies of the Fed, the ECB and the Bank of England, on the incentives of market participants and hence their effectiveness in improving market liquidity has been a hotly debated topic. Professor Goodhart has written a series of papers and related non-academic articles for the financial media, which have addressed this issue.

Optimal Central Bank communication

In a series of theoretical papers with co-authors, Camille Cornand³, has explored the desirability of increased transparency, particularly in relation to Central Bank communication. In financial markets and macro environments in which agents' actions are strategic complements, previous work has shown that transparency may reduce expected welfare from an ex-ante point of view. Public announcements serve as a focal point for higher-order beliefs and affect agents' behaviour more than is justified by their informational content. This result may be taken as an argument to reduce the precision of public signals or entirely withhold information. However, Cornand and Heinemann⁴ challenge this conclusion by distinguishing two components of transparency: precision of information and degree of publicity.

² Goodhart, C A E, Sunirand, P and Tsomocos, D (2006). 'A model to analyse financial fragility', *Economic Theory*, 27, pp 107-142.

³ Cornand, C and Heinemann, F (2008a). 'Optimal Degree of Public Information Dissemination', *The Economic Journal*, 118 (528), pp 718-742.

⁴ Cornand, C and Heinemann, F (2008b). 'Speculative Attacks with Multiple Sources of Public Information', under revision in the *Scandinavian Journal of Economics*. Previous version published as Financial Markets Group Discussion Paper No 570.

Using global games methodology, they show that, instead, public information should always be provided with maximum precision, but under certain conditions not to all agents. These results provide a rationale for the actual communication strategies of Central Banks. These include publishing information in selected media, speeches, conferences, interviews, and meetings with representatives of selected financial institutions, ie, the provision of partially public information in addition to official publications.

Appropriate framework for financial regulation (the ex ante regulatory framework)

The financial crisis since mid-2007 has greatly influenced the research agenda on financial regulation. Within this ESRC project, it has motivated a range of publications and events. High-level presenters and attendees from across academia, policy institutions and market participants discussed the evolution of the crisis and its regulatory implications at 'The Financial Crisis Conference', October 2007, at a conference on 'The Regulatory Response to the Financial Crisis', January 2008, and at a joint FMG and Deutsche Bank Conference on 'The structure of regulation: lessons from the crisis of 2007', March 2008.

A series of papers by Charles Goodhart have analysed the origins of the financial crisis, their links to financial regulation, and the lessons for future regulation. He considers 'The Regulatory Response to the Financial Crisis' and at least seven fields of regulatory concern where the recent turmoil has thrown up major issues for discussion: (i) Deposit Insurance; (ii) Bank Insolvency Regimes, a.k.a. 'prompt corrective action'; (iii) Money market operations by Central Banks; (iv) Liquidity Risk Management; (v) Procyclicality in CARs, ie, Basel II, and general lack of counter-cyclical instruments; (vi) Boundaries of regulation, Conduits, SIVs and reputational risk; (vii) Crisis management. Research under the remit of the ESRC project on items (iii) and (iv) has been discussed in the above section on monetary policy whilst the potential procyclicality induced by targeting value-at-risk measures is key to Professor Shin's work on liquidity.

Finally, within the work on financial regulation, Danielsson and Zigrand explore the asset pricing implications of risk-sensitive regulations using a general equilibrium multi-asset pricing model with micro-founded systemic risk and heterogeneous investors. The model suggests that risk-sensitive regulation can lower systemic risk in equilibrium, at the expense of poor risk-sharing, an increase in risk premia, higher and asymmetric asset volatility, lower liquidity, more co movement in prices, and the chance that markets may not clear.

Mark-to-market vs system historical cost accounting implications for financial stability

The credit crisis has renewed interest in the impact of rule changes on the accounting treatment of securities. The past year has seen big steps toward the use of 'fair value' or 'mark-to-market' accounting for financial instruments – that is, accounting rules that value assets at prevailing market prices. Although the debate on marking to market is sometimes portrayed in simplistic terms as the choice between telling the truth and telling lies, the 2007 credit crisis has shown that the issues are not so clear-cut. Securities such as collateralised debt obligations (CDOs) and other over-the-counter instruments have seen trading volume dwindle to virtually nothing, so that no reliable prices can be obtained. More perniciously, the anticipation that others might sell could generate fire-sales of assets into a falling market. If this were to happen, market prices would then merely reflect distorted incentives rather than true fundamental values. Hyun Shin's work on the economics of accounting found fresh application in this year's credit crisis. A recent paper, Plantin et al (2008)⁵, 'Marking to Market: Panacea or Pandora's Box?', sets out a theory of accounting rules and their role in the smooth functioning of markets.

In a three period global games model in which assets have uncertain payoffs, the managers of banks seek to maximise accounting earnings but, due to agency problems, have shorter horizons than the durations of the loan portfolios. The choice between mark-to-market accounting and historical cost accounting turns out to be a difficult one. On the one hand, under marking-to-market, the anticipation of future prices affects managers' decisions which, in turn, injects artificial volatility into prices. On the other hand the excessive conservatism in the historical cost regime leads to some inefficiencies as accounting values are insensitive to price signals. It is shown that the damage done by marking to market is greatest when claims are (i) long-lived, (ii) illiquid, and (iii) senior. These are precisely the attributes of the key balance sheet items of banks and insurance companies who have been the most vocal opponents of the shift to marking to market. The Economist magazine picked up Shin's research during the summer 2007 credit crunch and ran a full page 'Economics

⁵ Plantin, G, Sapra, H and Shin, H S (2008). 'Marking to Market: Panacea or Pandora's Box?', *Journal of Accounting Research*, 46 (2), pp 435-460.



Focus' piece outlining how the failure of two Bear Stearns hedge funds could be understood in terms of the theory.⁶

Theoretical framework of financial stability

The final goal of the initial research proposal was to extend an overall theoretical framework for financial stability to incorporate the objectives and actions of multilateral institutions such as the IMF. As detailed above, developing a framework for the analysis of financial stability requires a complex model incorporating default risk, heterogeneous financial institutions and investors, plus the scope to analyse regulatory policies and central bank interventions. Extending such models to an open economy

framework with international financial institutions is an important challenge. However, given the focus of the recent crisis on developed markets and the wealth of research questions which have thus arisen, this complex task has not been completed under the current project. Nevertheless, much important research has been undertaken on issues concerning international financial crises and financial stability in emerging economies.

⁶ *Economist Magazine, Economics Focus*, 30 August, 2007
www.economist.com/finance/economicsfocus/displaystory.cfm?story_id=9724324

World Economy and Finance Research Programme Young Researchers

One of the main aspects of the work carried out in the context of this grant was the integration of research by young PhD students with the research of established academics in the area of financial regulation. To this effect we established from early on the PhD Study Group on Financial Regulation. The Group met in a weekly lunch time seminar where work in progress was presented and discussed with senior faculty. The PhD study group attendees were **Ashley Taylor, Nikolaj Schmidt, Ander Perez, Oriol Aspachs, Gara Minguez Afonso, Sarquis Sarquis, Enrico Sette** and **Katrin Tinn**. The students' involvement culminated in the projects' final conference (Cycles, Contagion and Crises, June 2007) where their papers featured in the programme and were discussed by senior faculty members. The PhD students also participated in the research by providing occasional research assistance for the delivery of the project's outputs and often participating in the final publication as co-authors. Examples of this work include:

Aspachs, O, Goodhart, C A E, Tsomocos, D and Zicchino, L (2007a). 'Towards a measure of financial fragility', *Annals of Finance*, 3 (1), pp 37-74.



Ashley Taylor (formerly FMG/LSE, now at the World Bank, Washington)

Aspachs, O, Goodhart, C A E, Segoviano, M, Tsomocos, D and Zicchino, L (2007b). 'Searching for a metric for financial stability', Financial Markets Group Special Paper No 167.

Goodhart, C A E, Shin, H S and Taylor, A D (eds). 'Cycles, Contagion and Crises', forthcoming FMG Special Paper Series. (Conference Volume for a June 2007 conference held as part of the ESRC RES-156-25-0026 project).

The Paul Woolley Centre for the Study of Capital Market Dysfunctional

First Annual Conference

12 and 13 June 2008

On 12 and 13 June, the FMG hosted the First Annual Conference of The Paul Woolley Centre to discuss the broad themes of Behavioural Finance, Incentives of Fund Managers and Pricing Implications, Collateral Constraints and Asset Pricing and Asset Pricing and Macro. Organised by **Bruno Biais** (University of Toulouse), **Denis Gromb** (LBS & LSE), **Christopher Polk** (FMG/LSE), **Dimitri Vayanos** (FMG/LSE) and **Paul Woolley** (FMG/LSE), the conference brought together researchers to disseminate their research and stimulate the development of new ideas. The conference was organised jointly with the Adam Smith Asset Pricing (ASAP) Workshop which took place on 14 June, (see page 10).

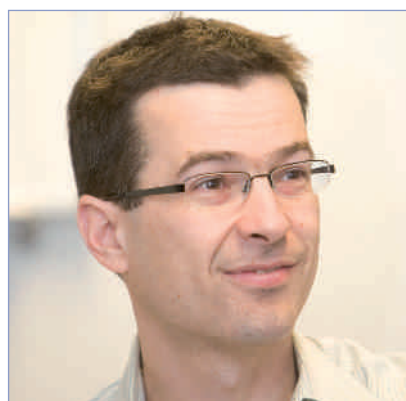
Review of conference proceedings

Dimitri Vayanos, Director of the Paul Woolley Centre, (FMG/LSE) opened the conference proceedings and welcomed the participants and contributors.

Joel Peress (INSEAD, FMG/LSE) presented the first paper entitled 'Media Coverage and Investors' Attention to Earnings Announcements'. Investors' under-reaction to corporate events and its effects on asset prices are widely documented phenomena in empirical finance. In his paper, Joel Peress analysed whether such under-reaction can be attributed to investor inattention. If investors face limitations on how much information they can process and there are limits to arbitrage, information will not be fully imputed into asset prices at the moment of its revelation. The more attention investors devote to a particular asset, the more timely and accurately will new information be reflected in the market price of the asset.

Joel Peress based his analysis on corporate earnings announcements of US listed companies and proxies for investor attention using the degree of the events' coverage in the Wall Street Journal. He then compared the stock price dynamics between pairs of earnings announcements with different degrees of media coverage, before, during and after the announcement. In order to isolate the effect of media coverage he only paired earnings announcements made by the same firm, during the same year, generating the same initial stock price response.

The results provided compelling evidence in favour of the author's hypothesis: the post-earnings announcement drift is significantly larger



Dimitri Vayanos (FMG/LSE)

for less covered earnings events, disregarding the direction of the earnings surprise. Good as well as bad news are incorporated only slowly into the prices of stocks that command low investor attention. In line with his hypothesis, Joel Peress found that in the case of highly covered stocks, most information contained in the announcement is already imputed into the

stock price *before* the event and during the announcement day. This result is fostered by the fact that trading volume during the announcement period is significantly higher for covered events than uncovered ones. Moreover, the effect of media coverage on abnormal returns during the earnings announcements is weaker for older growth firms, and when the announcement coincides with periods of high news flow. Similarly, this effect is less pronounced for stocks with high institutional ownership, supporting the conjecture that such investors are less constrained in their capacity to process information than the typical individual investor.

The next presentation entitled 'Realisation Utility' was presented by **Nicholas Barberis** (Yale University) co-authored with Wei Xiong (Princeton University). In contrast to classical financial models in which investors derive utility from consumption or wealth, the authors explored the possibility of investors deriving utility only from realised gains and losses on their investments. Empirical and anecdotal evidence for this idea is abundant, particularly in the context of individual investors. While practitioners and academics alike have long been interested in the concept of utility realisation, Nicholas Barberis explained that the authors' joint contribution lies in analytically deriving its implications on the trading behaviour of investors and the dynamics of asset prices.



Jean Charles Rochet (University of Toulouse)

The authors' infinite-horizon model allows investors to switch between a stock and a risk-free asset. Most importantly, the investor realises utility solely at the point of sale. Investors will generally only sell when the risky asset has appreciated sufficiently from the price that they purchased it at. However, the arrival of stochastic liquidity shocks will periodically force agents to

involuntary sell their holdings at a loss. This form of utility realisation is then embedded in a partial and general equilibrium framework, which allows the authors to explain aspects of investor behaviour that are difficult to address with traditional modelling techniques. This model, for instance, rationalises the systematic under-performance of private investors and the disposition effect, whereby investors are reluctant to let go of their losing positions. Moreover, it clearly explains why investors trade excessively, especially in rising markets as investors chase the utility jolts that they derive from selling above purchase price.

Besides their explanations for apparently irrational investor behaviour, Nicholas Barberis and Wei Xiong's idea of realisation utility, embedded into a general equilibrium, offers intriguing explanations for anomalies in the cross-section of asset prices. One issue is the apparent underperformance of stocks with high idiosyncratic volatility. Realisation utility makes investors risk-seeking and hence willing to pay a premium on assets that offer the prospect of realised utility in the near future. Similarly to standard stock options, volatility will raise the attractiveness and thus the price of the risky asset.

The proposed model also suggested new testable implications: the average holding period for stocks with high average returns is longer. High volatility stocks, however, are turned over quicker. Impatient investors trade more often in contrast to investors that are sensitive to losses.

The second session, chaired by **Christopher Polk** (FMG/LSE), focused on the theme of 'Incentives of Fund Managers and Pricing Implications'.

Peter Kondor, an alumni of the FMG (University of Chicago, GSB) presented 'Fund Managers and Defaultable Debt', jointly written with Veronica Guerrieri (University of Chicago, GSB). In their model, investors hire fund managers to invest their capital in a risky bond or in a riskless asset. The risky bonds are issued by borrowers who run risky projects and can decide to default ex-post. Only a small fraction of informed fund managers have private information about the true outcome of the risky project. As a consequence, investors are willing to find informed managers, and this, in turn, generates career concerns that distort the investment decision of the

uninformed fund managers. If the probability of default is high enough, uninformed managers require a 'reputational premium' on risky bonds as this investment increases their probability of being fired. This premium can switch sign depending on the economic and financial conditions. The mechanism of this model is able to generate an overreaction of the market, leading to excess volatility of spreads, capital flows and economic activity. The discussant **Dimitri Vayanos** (FMG/LSE) emphasised an important feature of this model: its wide scope, which embeds the micro relations of the investors to the real economy.

The second presentation of the session was given by **Hao Jiang** (RSM Erasmus University) on 'Institutional Investors, Intangible Information and the Book-to-Market Effect'. In this paper Hao Jiang detected and established a robust link between the trading behaviour of institutions and the book-to-market effect. Based on the paper of Daniel and Titman (2006)⁷ that states the book-to-market effect is driven by the reversal of intangible returns, Hao Jiang found that institutions show herding behaviour when buying and selling, as a response to positive or negative intangible information. The author provided a self-financing strategy that buys stocks with low past intangible returns and intense past institutional selling, and sells short stocks with high past intangible returns and intense past institutional buying; this strategy generates an average monthly return of 1.48 per cent and a Cahart four-factor alpha of 1.13 per cent. Hao Jiang also found that the book-to-market effect is more prominent in high institutional herding stocks, but nonexistent in low institutional herding stocks. Hao Jiang's results are consistent with the view that the propensity of institutions to herd in situations of intangible information increases price overreaction, contributing to the value premium. The discussant, **Michela Verardo** (FMG/LSE), highlighted how the tangible-intangible decomposition of returns is very similar to that of cash flow news and discount rate news.

Harrison Hong (Princeton University) closed the second session with a recent paper entitled 'Do Hedge Funds Profit From Mutual-Fund Distress?'. The author provided evidence of the fact that hedge funds could engage in front running strategies that exploit the predictable trades of others, especially mutual funds. Hedge funds could foresee when distressed mutual funds are forced to sell stocks they own. They document two pieces of evidence that are consistent with hedge funds taking advantage of this kind of opportunity. The first is in the time series data, where the average returns of long/short equity hedge funds are significantly higher in those months when a larger fraction of the mutual-fund sector is in distress. The second part is at the individual stock level, in which short interest rates rise in advance of sales by distressed mutual funds. In the discussion, **Ron Bird** (University of Technology Sydney) suggested that, as a natural extension, the author could examine positive large flow funds, in cases other than that associated with distressed mutual funds.

⁷ Daniel, K and Titman, S (2006). 'Market reactions to tangible and intangible information', *Journal of Finance* 61, 1605-1643

The Paul Woolley Centre First Annual Conference



Bruno Biais (University of Toulouse)

The third session of the conference focused on the theme of Collateral 'Constraints and Asset Pricing'. In their opening presentation, using a model of collateral-constrained lending, **Adriano Rampini** (Duke University) jointly written with S Viswanathan (Duke University), demonstrated that it is optimal for the most constrained borrowers

to exhaust their debt capacity. These borrowers must therefore downsize during a downturn, at which time less productive or more well-capitalised borrowers use their spare debt capacity to scale up and seize investment opportunities generated by low asset prices. This approach solves the risk management puzzle that more constrained firms hedge less; instead they fully use their debt capacity to finance investments. Finally, financial intermediaries are introduced that are more apt at collateralising claims, but have limited capital. Intermediary capital will therefore be expensive in bad times, which is reflected in wider spreads. During his discussion, **Amil Dasgupta** (FMG/LSE) pointed out that most key results are also obtained without borrowing and lending, when firms simply choose the allocation of their investment capacity.

S Viswanathan (Duke University) presented his paper 'Moral Hazard, Collateral and Liquidity' co-authored with Viral Acharya (LBS) which demonstrated how a classic risk shifting problem constrains leverage, and hence the ability of firms to meet their liquidity needs in all states of the world. During good times, firms typically lever up their balance sheets, which leaves them with insufficient debt capacity in a downturn. Having reached the maximum borrowing allowable, they cannot roll over their short-term debt, and are forced to liquidate assets to meet their financing needs. Since potential buyers are firms that incurred a low liquidity shock, the equilibrium price of productive assets is notably a function of the distribution of leverage and liquidity across firms. This also explains why an adverse macro shock that follows a period of stable economic expansion tends to produce deeper liquidity crises. In this setting, optimally designed collateral requirements alleviate the need to liquidate assets and have a stabilising influence on asset prices. The discussant, **Jean-Charles Rochet** (University of Toulouse), suggested a simpler way to solve for equilibrium, and emphasised that introducing a futures market for productive assets would enable firms to hedge against price fluctuations.

The fourth session focused on the subject of 'Asset Pricing and Macro'. **Bruno Biais** (University of Toulouse) presented the first paper entitled

'Booms, Crashes and Choking in the Financial Sector and Other Speculative Industries'. The paper, co-authored with Jean-Charles Rochet (University of Toulouse) and Paul Woolley (FMG/LSE), explored the mechanism of booms, busts and choking in speculative industry, such as new financial innovations in 2000s. Bruno Biais argued that the key factors are uncertainty and learning about sustainability of boom, and asymmetric information between insiders (managers) and outside investors. During the boom, which occurs after innovations, investors' belief in the strength of the industry is reinforced as long as there is no bad news; accordingly, the managerial compensation and the size of the industry increase. In the meanwhile, however, the information asymmetry problems are magnified: the rents earned by the managers grow faster than the value creation, discouraging the outside investors from investing in the industry; eventually, the industry size starts to shrink ('choking'). The discussant, **Guillaume Plantin** (LBS), pointed out that a crucial assumption for the result is that innovations with the highest net present value (NPV) are also the ones with the most severe agency problems, which may or may not be reasonable. He also suggested that the author could endogenise the timing of investments to further examine the dynamics of the model.



Annette Vissing-Jorgensen (Northwestern University)

Annette Vissing-Jorgensen (Northwestern University) presented her paper co-authored with Arvind Krishnamurthy (Northwestern University), entitled 'The Aggregate Demand for Treasury Debt'. Annette Vissing-Jorgensen demonstrated that the US Debt/GDP ratio is negatively correlated with the spread between corporate bond yields and Treasury bond yields,

and argued that the corporate bond spread reflects a convenience yield that investors attribute to Treasury debt. Annette Vissing-Jorgensen showed that the aggregate demand curve for the convenience provided by Treasury debt is downward sloping, and provided estimates of the elasticity of demand. She also analysed disaggregated data and found that demand curves are steeper for groups for whom liquidity motives for holding Treasuries are likely to be more important. The author continued to discuss implications for various questions in finance and macroeconomics, such as the behaviour of corporate bond spreads, interest rate swap spreads, the financing of the US deficit, or Ricardian equivalence. The discussant, **Mikhail Chernov** (LBS) conducted a calibration and obtained a negative correlation between AAA spread and Debt/GDP after controlling for the maturity of bonds. He suggested that more analysis is needed on a possible endogeneity between the AAA and Treasury demand shocks.



Markus Brunnermeier (Princeton University)

Markus Brunnermeier (Princeton University) presented the next paper entitled 'Carry Trades and Currency Crashes'. The paper, co-authored with Stefan Nagel (Stanford University) and Lasse H Pedersen (NYU), documented that carry traders are subject to crash risk, ie, exchange rate movements between high interest rate and low interest rate currencies are negatively

skewed. Markus Brunnermeier argued that this negative skewness is due to sudden unwinding of carry trades and increases when global volatility, as measured by the VIX, rises. Carry-trade losses reduce the future crash risk, but increase the price of crash risk. The paper also documented excess co-movement among currencies with similar interest rates. The author argued that the findings are consistent with a model in which carry traders are subject to funding liquidity constraints. In addition the findings call for new theoretical macroeconomic models in which risk premia is affected by funding and liquidity constraints, not just shocks to productivity, output, or the utility function. **Igor Makarov's** (LBS) discussion provided additional data and argued that there is overall supportive evidence for sudden FX moves and unwinding of carry trades. He also emphasised the importance of a dynamic model of carry trade that can be taken to the data.

The Paul Woolley Centre for the Study of
Capital Market Dysfunctional

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The Paul Woolley Centre for the Study of Capital Market Dysfunctional is established at the **Financial Markets Group** of the London School of Economics, with the generous support of **Dr. Paul Woolley** and under the directorship of **Professor Dimitri Vayanos**.

The main objective of The Paul Woolley Centre is to produce and disseminate high-quality research relating to understanding the workings of capital markets and the social efficiency of allocations achieved in these markets.

The Paul Woolley Centre's work programme involves a wide variety of activities, including the publication of the Paul Woolley **Working Paper Series**, the organization of dedicated **conferences and seminars**, a **visitors' programme**, the Paul Woolley **scholarships programme** and the support of **research projects**.

Centre Highlights

- 28/08/08 [PWRI Workshop, Toulouse](#)
- 21/07/08 [Announcement of the Centre's Scholars for 2008-9](#)
- 18/06/08 [First Annual Conference: download speaker and discussant presentations](#)

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Email: t.hall@lse.ac.uk

For more information about The Paul Woolley Centre for the Study of Capital Market Dysfunctional, please visit www.lse.ac.uk/PaulWoolleyCentre/

Paul Woolley Research Initiative – Workshop, 20 October, Toulouse

The Paul Woolley Centre for the Study of Capital Market Dysfunctional was established as an FMG research programme funded with the generous support of Dr. Paul Woolley and under the directorship of Professor Dimitri Vayanos. The Centre was established in conjunction with The Paul Woolley Centre at **University Technology Sydney** and The Paul Woolley Research Initiative at **IDEI-R Toulouse**. All three Centres were set up to research dysfunctionality in financial markets, and the financial institutions that operate within these markets. A capital market is dysfunctional when it suffers from chronic and systemic malfunctioning; a condition which can have far-reaching economic and social consequences. The researchers at the Centres analyse why inefficient outcomes arise, the impact that they have on the economy, and how adverse effects can be mitigated.

The **First Workshop of the Paul Woolley Research Initiative at IDEI**, University of Toulouse will be held on 20 October 2008. Researchers from The Paul Woolley Centre for the Study of Capital Market Dysfunctional, (LSE) and from the Paul Woolley Research Initiative, (Toulouse) will discuss their work relating to both centres' research agenda.

The workshop will be held at the Institut D'Economie Industrielle, Toulouse and will include papers by **Dimitri Vayanos** and **Paul Woolley** (PWC, FMG/LSE), **Catherine Casamatta** and **Sébastien Pouget** (PWRI – IDEI – Toulouse School of Economics), **Jamie McAndrews** (New York Fed), **Jérôme Mathis** (Toulouse School of Economics), **Jean-Charles Rochet** (PWRI – IDEI – Toulouse School of Economics), **Kostas Zachariadis** (PWC, FMG/LSE), **Andrea Attar** (Paul Woolley Fellow – PWRI – IDEI – Toulouse School of Economics), **Thomas Mariotti**, **François Salanié** (Toulouse School of Economics).

For more information about the IDEI workshop, please contact **Valerie Nowaczyk** at IDEI at vnowac@cict.fr / +33 (0) 5 61 12 85 or **Tanya Hall** at LSE at t.hall@lse.ac.uk / 020 7852 3502

Adam Smith Asset Pricing Conference

14 June 2008

The Paul Woolley Centre First Annual Conference was jointly organised with the **Adam Smith Asset Pricing (ASAP)** workshop which took place on 14 June at the FMG.

The **Adam Smith Asset Pricing (ASAP)** workshop was established in 2005 as a regular series of research meetings in the asset pricing field organised by **Tarun Ramadorai** (Oxford), **Raman Uppal** (LBS) and **Dimitri Vayanos** (FMG/LSE). The ASAP workshops take place twice a year, in the Fall term and in the Spring term; The Fall term conference is mainly an internal event, with speakers from the three organising universities, as well as other leading European universities such as Imperial, Insead, HEC, Stockholm, etc. The Spring term conference is a bigger event, with about half of the participants coming from US universities.

The first of the 2008 bi-annual Adam Smith Asset Pricing Conference took place at LSE. For further information about the ASAP workshops please contact Dimitri Vayanos <http://personal.lse.ac.uk/vayanos/>

Summary of conference proceedings

Hong Liu (Washington University at St Louis) opened the ASAP workshop with his paper 'A New Explanation for Underdiversification' which offers a risk-based explanation for why individual investors generally under-diversify their portfolios. The model is distinct from previous work, which explains this phenomenon through high transaction costs, behavioural biases such as overconfidence, and asymmetric information in financial markets. In contrast to common intuition, Hong Liu's model rationalises under diversification as a means to reduce consumption risk. The model is set in discrete time with investors facing the choice between a risk-free asset and a number of uncorrelated risky assets. Two assumptions are central to Hong Liu's explanation for under-diversification: first, investors need a minimum subsistence level of consumption at which the marginal utility of investing into risky assets is finite; second, investors cannot borrow or short-sell. Once investors' wealth passes this subsistence level they start to invest a tiny fraction of it into the risky asset. At this stage investors will select to invest into the asset with the highest expected return. The higher moments of the asset's return will be irrelevant to this choice, as they only have negligible effects on the higher moments of the investors

overall portfolio. Once the fraction of the investment into the first risky asset becomes larger and sufficiently affects the risk of the portfolio, the investor adds a second risky asset with the second highest expected return. As investors become wealthier they increase their allocation to the risky part of their portfolio and diversify it more strongly. Under-diversification is therefore associated with *lower* risk to the investor since a smaller fraction of his wealth is invested in risky assets.

This mechanism leads to several interesting insights: if wealth is sufficiently low, investors always under-diversify their portfolios. Under some additional assumptions and CARRA utility, investors will *always* under-diversify, no matter how wealthy they are. Hong Liu's model also implies that less wealthy investors will hold less diversified portfolios of risky assets, and that the higher moments of returns are irrelevant in their decision to include assets in their portfolio. In equilibrium, less diversified portfolios are more volatile and offer higher expected returns.

Hong Liu's presentation was discussed by **Joel Peress** (INSEAD) and a number of participants in the audience. One main point highlighted was the fact that the model's predictions strongly rely on the highly stylised nature of local preferences as well as the assumption that all risky assets offer distinct expected returns to the investor.

Jacques Olivier presented his joint paper with Anthony Tay (Singapore Management University School of Economics) 'Time-Varying Incentives in the Mutual Fund', an empirical paper that centres around the time varying nature of mutual fund performance tournaments. The convexity of the relationship between net flows into mutual funds, and their past performance relative to their peers, is a stylised fact in the literature on mutual fund tournaments. Relative performance differences within the top tier of fund managers have a much larger impact on their flows than relative performance differences between the worst performing funds. Since managers are paid proportional to the amount of assets in their fund, the convexity in the flow-performance relationship translates into convexity of their incentive contracts. Depending on the position of a fund in the performance ranking relative to its peers, the option-like profile of managers' remuneration will lead them to increase portfolio





Andrew Patton (FMG and University of Oxford at the ASAP conference)

risk beyond the level that is optimal for their investors. The authors' contribution to the previous literature lies in their finding that the degree of convexity in the flow-performance relationship depends on the

state of the business cycle. In years of economic booms this relationship becomes increasingly convex, while this curvature vanishes in years of economic downturns. They offer and test two alternative explanations of this finding: first, aggregate flows in and out of the mutual funds are strongly correlated to the business cycle as investors allocate additional income to mutual funds in booms and divest some of their monies in economic downturns. Moreover, it is known that gross inflows are more sensitive to performance than gross outflows, as the motivation for the latter often stems from liquidity needs of the fund investor. Both arguments together imply that net-flows into mutual funds become less sensitive to performance in economic downturns as outflows take up a larger proportion in aggregate fund flows. Second, economic downturns are associated with increased volatility in financial markets, which render historical performance a less reliable signal of management ability. Investors thus care less about observed relative performance in economic downturns than in periods of economic booms.

The paper demonstrates how the authors constructed tests to distinguish between both alternative explanations and conclude that the first explanation is more strongly supported by the data. To round-off their analysis, the authors also examine whether the time variation they observe in the incentives of fund managers translates into time variation of their risk taking. Poor mid-year performers will have an incentive to increase the risk of their portfolios, only when economic activity and thus convexity in the flow performance relationship are strong enough. They find that this prediction is clearly reflected in the data: in years with above average economic growth, managers have a significantly stronger tendency to gamble for resurrection by increasing the

idiosyncratic risk of their portfolios, in the hope that this will generate a spurious alpha by the end of the year.

Pretri T Jylha (Helsinki School of Economics) presented his paper 'Arbitrage Capital and Currency Carry Trade Returns' (joint with Jussi-Pekka Lyytinen and Matti J Suominen, Helsinki School of Economics) which develops a model to explain the sustained profitability of carry trade strategies. They combine a risk-based element with a limits-to-arbitrage argument in a rational expectations equilibrium framework. Carry trades involve the purchase of high yielding currencies financed by the sale of low yielding ones. The theory of uncovered interest-rate parity suggests that such strategies should not be profitable for extended periods of time: a simple no-arbitrage argument implies that interest rate differentials across countries should be offset by differing degrees of currency depreciation. Yet, historically carry trade strategies have been highly profitable as high interest rate currencies have experienced sustained appreciations against low interest rate currencies. The authors set up a simple two-country model with risk-averse investors, who can only deal in their own countries' currencies. The risk of inflation and hence the risk of holding the currencies differs across countries due to random shocks. The real interest rate is therefore higher in the country with higher inflation risk. Pretri Jylha then introduced a limited number of arbitrageurs, who exploit the interest rate differential between both countries' securities markets. Their presence naturally reduces this differential, but carry-trade returns remain positive due to the difference in inflation risk between the two countries. The model makes several empirical predictions: first, carry trade profits are positively related to transaction costs; second, profits to carry trade strategies are decreasing in the amount of capital devoted to arbitrage activity between two currencies; third, the returns to carry trade arbitrage are reduced with overall inflation risk and whenever investors become less risk averse.

In the empirical section of the paper, Pretri Jylha presented some support for these predictions of the model. She showed that hedge fund returns are highly correlated with profits to a mechanical carry-trade strategy, supporting their claim that arbitrageurs engage heavily in such trading activities. Moreover, the profitability of these strategies has decreased over time, which the author empirically links to the rapidly increasing amount of capital devoted to carry trades. Currency depreciations, in general, are followed by an inflow of arbitrage capital causing the target currency to appreciate to an extent that depends on the amount of capital devoted to this carry trade.



Adam Smith Asset Pricing Conference

Harald Hau (INSEAD) presented his paper on 'Global versus Local Asset Pricing: Evidence from Arbitrage of the MSCI Index Change'. In this paper he developed a model of limited arbitrage which characterised the cross-sectional return dynamics under multi-asset demand shocks. The main contribution is that it allows for asymmetric information where arbitrageurs learn about a demand shock before other market participants. In the case of an index revision, arbitrage by risk averse speculators implies that, prior to the announcement of the index revision, stock returns are positively proportional to the anticipated beta decrease of each stock and negatively proportional to the marginal arbitrage risk contribution of each speculative position. Harald Hau tested these predictions using the redefinition of the MSCI international equity index in 2001 and 2002 and found strong evidence in favour of the new model. Moreover, the global nature of the MSCI index revision implies that global and local beta changes differ substantially along with the respective marginal arbitrage risk incurred to exploit them. Furthermore, the author showed evidence that MSCI stocks are priced globally and not locally. The discussant **Alexander Guembel** (University of Oxford), emphasised that the model assumes the functional form of the agents' demand, rather than deriving it from their utility function. This implies that arbitrageurs are myopic and that uninformed traders do not account for the existence of arbitrageurs. Moreover, Alexander Guembel pointed out that it is hard to think of a utility function that generates a demand that is not influenced by changes in beta, as is the case for the liquidity providers' demand. The discussant also commented that the market integration conclusion of the paper (stocks are priced globally) is difficult to reach in this event-return analysis, since the model is mainly designed to study return events rather than market integration hypotheses.



Mike Chernov (London Business School)

The penultimate paper entitled 'Should Benchmark Indices Have Alpha? Revisiting Performance Evaluation' was presented by **Antti Petajisto** (Yale School of Management) joint with Eric Zitzewitz

(Dartmouth College) who studied the evaluation performance of money managers with the standard four-factor Carhart model. The author showed that this model produces economically and statistically significant nonzero alphas for passive benchmark indices such as the S&P 500 and Russell 2000. Antti Petajisto found that these alphas primarily arise from the way the Fama-French factors and the CRSP value-weighted market index are constructed. He used alternative ways to construct these factors as well as alternative models constructed from tradable benchmark indices and showed that index-based models outperform the standard models both in terms of asset pricing tests and performance evaluation of mutual fund managers. The discussant **Christopher Polk** (FMG/LSE) argued that current implementations of the Carhart model are inappropriate for evaluating money managers. He also highlighted the reason Antti Petajisto's (7-factor) model prices assets better than the Carhart model is that models which are more multifactor-efficient can price assets better. In addition, he pointed out that the results for mutual funds are mixed. For instance, the authors conclude the Carhart finding, that the worst performing managers continue to underperform, is much weaker. The discussant emphasised that such a claim relies on the model specification. For some specifications, persistence is found in both underperforming and outperforming managers.

Mike Chernov (LBS) closed the conference with the presentation of his paper with Philippe Mueller (Columbia University) on 'The Term Structure of Inflation Expectations', in which they constructed a model that accommodates forecasts over multiple horizons from multiple inflation surveys and Treasury yields by allowing for differences between risk-neutral, subjective and objective probability measures. From this model, the authors extracted private sector inflation expectations and found out that they are driven by inflation, real activity and a latent factor. Interest rates respond to this latent factor, which in turn correlates with the survey forecasts. The inflation premium and out-of-sample estimates of the inflation long-run mean and persistence suggest that monetary policy became effective over time. The discussant **Andrew Patton** (University of Oxford), linked the authors' research to some early work in forecasting and pointed out that, by allowing for heteroskedasticity, the authors could find stronger evidence that the objective measures are different from the subjective measures and thus strengthen their results. Andrew Patton also commented that the change of measure model for survey expectations might also be a useful tool in other areas of research (ie, aggregation of information from equity analysts).

Corporate Governance at LSE

Forthcoming Research Debate

The Fiduciary Duties of Activist Shareholders

25 November 2008

Lynn A Stout (Paul Hastings Professor of Corporate and Securities Law, UCLA)

Chair: **Paul Davies** (Department of Law, LSE)

Corporate law and scholarship generally assume that professional managers control public corporations, while shareholders play a weak and passive role. As a consequence officers and directors are understood to be subject to broad fiduciary duties, while shareholders are thought to have far more limited obligations to the firm and to each other. Outside the context of controlling shareholders and closely held firms, many experts argue shareholders have no duties at all.

The most important trend in corporate governance today, however, is the move toward greater 'shareholder democracy.' Changes in financial markets, in business practice, and in corporate law have given minority shareholders in public companies greater power than they have ever enjoyed before. Activist investors, especially rapidly growing hedge funds, are

using this new power to pressure managers into pursuing corporate transactions ranging from share repurchases, to special dividends, to the sale of assets or even the entire firm. In many cases these transactions uniquely benefit the activist while failing to benefit, or even harming, the firm and other shareholders.

Lynn Stout argues that greater shareholder power should be coupled with greater shareholder responsibility. In particular, she argues that the rules of fiduciary duty traditionally applied to officers and directors and, more rarely, to controlling shareholders should be applied to activist minority investors as well. This proposal may seem a radical expansion of fiduciary doctrine. Nonetheless, the foundations of an expanded shareholder duty have been laid in existing case law. Moreover, there is every reason to believe that newly empowered activist shareholders are vulnerable to the same forces of greed and self-interest widely understood to face corporate officers and directors. Corporate law can, and should, adapt to this reality.

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

Further information is available on the Corporate Governance at LSE website:

www.lse.ac.uk/corporateGovernance

Attendance at the Corporate Governance at LSE Research Debates is by invitation only. For more details please contact Sooraya Mohabeer on 020 7955 6301 or S.B.Mohabeer@lse.ac.uk



Job Market Candidates 2009

The following FMG students will enter the job market this year with the view to commence employment from September 2009.



Jan Bena

Research Interests: Corporate finance and governance; Finance and product market competition; Access to external finance and financial constraints; Financial development

and efficiency; Financial intermediation.

Job Market Paper: The Inverted-U Shape of the Competition-Innovation Relationship: A Credit Rationing Explanation.

Email: j.bena@lse.ac.uk



Pierre Chaigneau

Research Interests: Moral hazard and managerial compensation profiles; Risk sharing with prudent agents; Microeconomic foundations of asset pricing models.

Job Market Paper: Compensation Contracts for Prudent and Risk Averse Agents.

Email: p.chaigneau@lse.ac.uk



Anisha Ghosh

Research Interests: Asset pricing: Long Run Risks Asset Pricing Models, Rare Events and the Equity Premium Puzzle; Financial Econometrics: Nonparametric

Estimation of Risk-Return Trade-off and Conditional Factor Pricing Models using High-Frequency Data.

Job Market Paper: Asset Pricing with Regime Shifts in Consumption and Dividend Growth.

Email: A.Ghosh@lse.ac.uk

New FMG Students

The following students have joined the FMG in October 2008.



Pragyan Deb started his PhD in Finance in 2007, after graduating from the MSc in Finance and Economics (Research) programme at the LSE with distinction. He completed his BA and MA in Economics from

St. Stephens College and Delhi School of Economics, India. His research interests lie in the interaction of the macro-economic and regulatory framework with financial markets, and the implications of such interaction on overall market stability, and the financing constraint, capital structure and corporate governance of individual firms.



Ziad Daoud is a PhD student in the Economics Department at LSE. He completed an undergraduate degree in Economics and Statistics at UCL, and joined the LSE MRes/PhD programme

in Economics. He finished the MRes part of the degree in 2007 specialising in Econometrics and Empirical Finance. His research interests are in the econometric aspects of continuous-time processes that are widely used in financial modelling.



Dragana Cvijanovic started her PhD in 2006 in the Department of Finance, as a FSA/ LSE Economics of Financial Regulation fellow. Her research interests include asset pricing, hedge funds,

macroeconomics and real estate economics. Prior to her PhD studies, she worked as a researcher at the Centre for Advanced Studies in Economics, Belgrade. Her other professional activities include internship at an international property hedge fund, as well as several years spent working in the UK IT industry. She holds a Masters degree in Finance from the University of Belgrade, and a BSc (Hons) degree in Computer Science from UCL, London.

Scholarships

The Financial Markets Group is pleased to announce three new **Paul Woolley Centre** Scholarships for 2008-09.



Zijun Liu is a 2nd-year PhD student at the Department of Finance, LSE. He received his BA in Mathematics and Masters in Financial Economics from Oxford University, before

coming to LSE to start his PhD in 2007. His research interests lie in theories of the capital market, including its role, structure and behaviour, as well as its macro-economic implications.



Gyorgy Venter is a PhD student at the Department of Finance LSE. His research interests include asset pricing with market imperfections, strategic trading, liquidity

and behavioural finance. Before joining LSE in September 2005 he received his BSc and MSc in Economics at Corvinus University, Budapest and studied Mathematics at ELTE, Budapest.



Piotr Zurawski is a 3rd-year PhD student at the Department of Economics at LSE. Previously he studied at Warsaw School of Economics, where he received his Masters

in Finance degree and worked for two years as a research assistant in the Department of Econometrics. Before coming to London, he worked for two years in the Financial Markets Division of the National Bank of Poland. His research focus lies in the microstructure of financial markets, capital market imperfections and inflation derivatives.

The Paul Woolley Centre for the Study of Capital Market Dysfunctionality Scholarships

The Scholarship Programme aims to support students pursuing postgraduate research in the areas covered by The Paul Woolley Centre research agenda. The Centre's scholarships are awarded in June each year to outstanding PhD students who have been admitted to the PhD programme of the Finance Department or the Economics Department at LSE.

The scholarships are awarded by a committee consisting of Dr Paul Woolley, Professor Dimitri Vayanos and Professor David Webb. The Scholarships provide a stipend to support fees and/or living expenses for each recipient. The Paul Woolley Centre Scholars are based within the Financial Markets Group and have the opportunity to work closely with its staff and faculty.

For more information about The Paul Woolley Centre Scholarships visit www.lse.ac.uk/PaulWoolleyCentre/

Recent Advances in High Frequency Financial Econometrics

15 November 2008

The Financial Markets Group will host a one day conference on **Recent Advances in High Frequency Financial Econometrics** which will take place at LSE on 15 November 2008.

The conference will discuss recent theoretical and empirical advances in the area of financial econometrics as part of the 'Estimation and Testing with Realised Volatility' research project at LSE. The two-year research grant is funded by **The Leverhulme Trust** (F/07 004/AK). The project research is led by Professor Oliver Linton and the objective is to investigate some issues to do with recent work in continuous time econometrics and their application. More information about this project is available at the FMG website (<http://fmg.lse.ac.uk/research/>).

The **Recent Advances in High Frequency Financial Econometrics** conference will concentrate on the topics of volatility measures using high-frequency data, the detection and the role of jumps in continuous-time models, market microstructure.

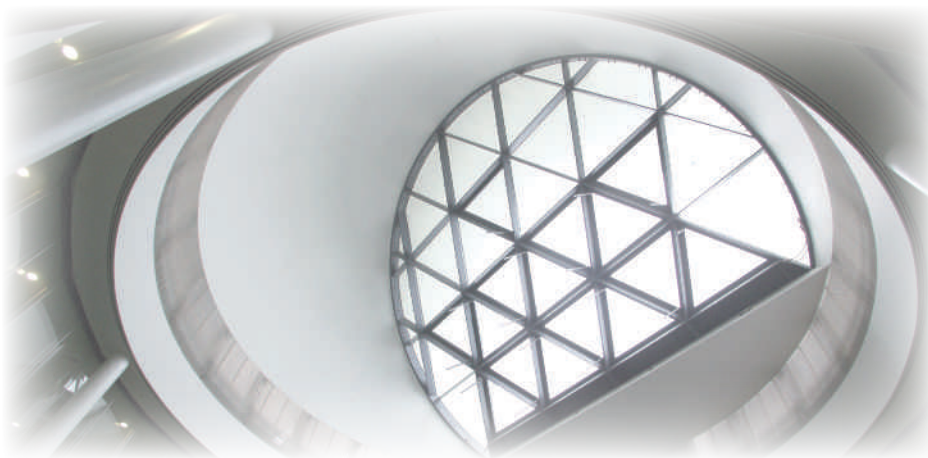
Confirmed presenters include:

- **Anisha Ghosh** (FMG/LSE)
- **Ilze Kalnina** (LSE)
- **Federico Bandi** (Chicago GSB)
- **Torben G Andersen** (Northwestern University)
- **Mark Podolskij** (ETH Zürich)
- **Matthieu Rosenbaum** (University of Paris-East)

The conference is organised by **Oliver Linton** (FMG and Economics Department, LSE), **Ziad Daoud** and **Anisha Ghosh** (FMG/LSE)

The full programme will be available from the FMG website soon. For more information and registration please contact Sooraya Mohabeer on 020 7955 6301 or s.b.mohabeer@lse.ac.uk

The Financial Markets Group would like to thank the Leverhulme Trust for supporting our research. The Leverhulme Trust, Estimation and Testing with Realised Volatility (F/07 004/AK)



Housing, Financial Assets and the Economy

19 May 2009

This conference is the final communication event of the '**Home Ownership, Housing Collateral and Aggregate Fluctuations**' research project at FMG. This three-year research grant is funded by the Economic and Social Research Council (ESRC) in the context of the Phase II of the Council's World Economy and Finance Research Programme. The project research is led by Dr Alex Michaelides and aims to understand the role of housing markets in business cycle fluctuations, and the monetary transmission mechanism in the presence of housing. More information about this project is available at the FMG website <http://fmg.lse.ac.uk/research/>

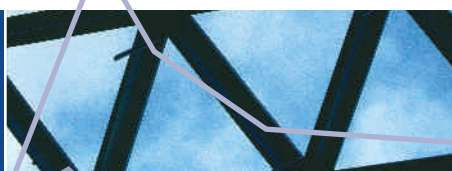
The **Housing, Financial Assets and the Economy** conference will concentrate on understanding the joint determination of consumption, housing and asset prices in the macroeconomy.

Confirmed presenters include:

- **Sydney Ludvigson** (New York University)
- **Martin Schneider** (Stanford University)
- **Francois Orttaglo Magne** (University of Wisconsin-Madison School of Business)
- **Joao Gomes** (The Wharton School University of Pennsylvania)
- **Paul Willen** (Federal Reserve Bank of Boston)
- **Paolo Surico** (Bank of England)
- **Tim Besley** (LSE)
- **Chris Carroll** (Johns Hopkins University)
- **Nobu Kiyotaki** (Princeton University)
- **Rachel Ngai** (LSE)
- **Morris Davis** (University of Wisconsin-Madison School of Business)
- **Kalin Nikolov** (Bank of England).

The conference is organised by **Alex Michaelides** (FMG and Economics Department, LSE)

The full programme will be available from the FMG website soon. Attendance at the conference is by invitation only. For more information please contact the FMG administration on 020 7955 6301 or fmg@lse.ac.uk





Regional Comparative Advantage and Knowledge-Based Entrepreneurship

RICAPE2 Third Conference

9 and 10 October 2008

University of Amsterdam Business School, Finance Group

The RICAPE2 Third Conference will be held on 9 and 10 October 2008 at the University of Amsterdam Business School. The conference will include empirical and theoretical papers on the financing of knowledge-based entrepreneurial firms, on the influence of venture capital on firms' ability to translate technological advances into successful products, and on the contribution of knowledge-based entrepreneurship to regional dynamics.

The conference will include the following papers:

'How do corporate venture capitalists create value for entrepreneurial firms?', by Elena Loutschina (University of Virginia) and Thomas Chemmanur (Boston College).

'Employee incentives, and teamwork in human capital intensive firms', by Paolo Fulghieri and Merih Sevilir (University of North Carolina)

'Occupational choice and the quality of entrepreneurs', by Eren Inci (Sabanci University)

'Incentives and Innovation Inside Firms: A multi-tasking approach', by Thomas Hellmann and Veikko Thiele (University of British Columbia)

'IPO waves, product market competition, and the Going Public Decision: Theory and evidence', by Thomas Chemmanur (Boston College) and Jie He (University of Sherbrooke)

'Going public to acquire? The acquisition motive in IPOs', by Ugur Celikyurt, Merih Sevilir and Anil Shivdasani (University of North Carolina)

'Small and medium-sized enterprises, banking relationships, and the use of venture capital', by Allen N Berger (Federal Reserve System, Washington) and Klaus Schaeck (Cass Business School)

'Why do contracts differ between vc types? Market segmentation versus corporate governance varieties', by Julia Hirsch (Iberoamerican University) and Uwe Walz (Goethe University Frankfurt)

'On the real effects of private equity investment: evidence from firm entry', by Alexander Popov (European Central Bank) and Peter Roosenboom (Erasmus University Rotterdam)

'Corporate Governance and Innovation: Theory and evidence', by Haresh Sapra (University of Chicago) and Ajay Subramanian (Georgia State University) and Krishnamurthy Subramanian (Emory University)

'The effect of litigation on venture capitalist reputation', by Vladimir Atanasov (Mason School of Business), Vladimir Ivanov (University of Kansas) and Kate Litvak (University of Texas)

'Connections and information acquisition in capital allocation', by Mariassunta Giannetti (Stockholm School of Economics) and Xiaoyun Yu (Indiana University Bloomington)

'Are financial incentives detrimental to innovation?', by Florian Ederer and Gustavo Manso (MIT)

'Firm Boundaries in the New Economy: Theory and evidence', by Krishnamurthy Subramanian (Emory University)

'Venture Capital Conflicts of Interest: Evidence from acquisitions of venture backed firms', by Ron Masulis (Vanderbilt University) and Rajarishi Nahata (City University of New York)

For further information on the RICAPE2 Third Conference please contact Armin Schwienbacher, a.schwienbacher@uva.nl or visit the RICAPE2 website www.lse.ac.uk/ricafe

RICAPE2 Newsletter Number 4

The latest edition of the RICAPE2 Newsletter is now published. The newsletter can be downloaded from the RICAPE2 website www.lse.ac.uk/ricafe. The contents include updates on the Third RICAPE2 Conference, the Policy Workshop to be held in Brussels in January 2009, Presentations of RICAPE2 Research, the project second year report and other news.

The Regional Comparative Advantage and Knowledge-Based Entrepreneurship (RICAPE2) Research network includes the London School of Economics (FMG), the Department of Economics and Finance of Turin University, the Center for Financial Studies (Frankfurt), HEC School of Management (Paris), University of Amsterdam, University of Tilburg, Baltic International Centre for Economic Policy Studies, University of Lugano, Indian School of Business, Technion (Israel), and the Belgrade Laboratory for Quantitative Finance.

RICAPE2 is funded by the European Commission, DG-Research, under the 'Citizens and governance in a knowledge-based society' (FP6) programme, grant CIT5-CT-2006-028942.



FMG Seminars Michaelmas Term 2008

Capital Markets Workshop

8 October	Ron Kaniel (Duke University)	12 November	Tobias Adrian (Federal Reserve Bank of New York)
15 October	Costis Skiadas (Northwestern University)	19 November	Pierre Collin-Dufresne (Columbia University)
22 October	Thierry Foucault (HEC Paris)	26 November	Carola Frydman (MIT)
29 October	Annette Vissing-Jorgensen (Northwestern University)	3 December	Patrick Bolton (Columbia University)
5 November	Leonid Kogan (MIT)	10 December	Christian Hellwig (UCLA)

The organisers of this seminar series are **Stephane Guibaud** and **Jack Favilukis** (FMG/LSE).

The Capital Markets Workshop is funded by:

The Department of Finance, LSE and The Suntory and Toyota International Centre and Related Disciplines (STICERD), LSE

The updated schedule is available on the FMG website at <http://fmg.lse.ac.uk>

If you require further information, please call 020 7955 6301 or email fmg@lse.ac.uk.

Taxation Seminar

27 October	'US tax policy: What will "change" mean under the new president?' Alan Granwell (DLA Piper) and James Sams (KPMG)
17 November	'Recent developments on foreign profits and interest limitations' Paul Morton (Reed Elsevier) and Stef van Weeghal (Linklaters)
8 December	The HMT-HMRC 'Policy partnership' three years on Chris Wales (Lucida plc)

The organisers of this seminar series are **Jonathan Leape**, **Ian Roxan**, **Judith Freedman**, **Malcolm Gammie** and **David Oliver**

The LSE Financial Markets Group gratefully acknowledges financial support from STICERD and the LSE Department of Law

For updated information on the seminars, please check <http://fmg.lse.ac.uk/events/>

London Financial Regulation Workshop

13 October	Brandon Davies (GARP Risk Academy), on 'Problems of Mark to Mark Accounting'
23 October	Professor Howell Jackson (Harvard Law School), on 'Regulatory Reform in the United States: Response to the Subprime Crisis and Recent Financial Market Turmoil'
27 October	Kai Kohlberger with Richard Johnson (FSA), on 'Using Logit analysis on a large sample of loan performance data to assess one dimension of regulation'
17 November	Professor Franco Bruni (Bocconi University), on 'Regulatory Reactions to the Financial Crisis'
1 December	Professor Lars Jonung (research advisor, DG ECFIN, European Commission), on 'Lessons from the Nordic Financial Crises of the 1990s'

The organisers of this seminar series are (by alphabetical order):

Professor E Philip Davis (Brunel University); **Professor Charles Goodhart** (Financial Markets Group, LSE); **Dr Thomas Huertas** (Financial Services Authority); **Professor Rosa Maria Lastra** (Queen Mary, University of London); **Dr Alistair Milne** (Cass Business School) and, **Professor Geoffrey Wood** (City University Business School).

For more information please call 020 7955 6301 or visit the FMG's website at <http://fmg.lse.ac.uk/>

Discussion Papers



DP 603

An Estimation of Economic Models with Recursive Preferences

Xiaohong Chen, Jack Favilukis,
Sydney C Ludvigson

This paper presents estimates of key preference parameters of the Epstein and Zin (1989, 1991) and Weil (1989) (EZW) recursive utility model, evaluates the model's ability to fit asset return data relative to other asset pricing models, and investigates the implications of such estimates for the unobservable aggregate wealth return. Our empirical results indicate that the estimated relative risk aversion parameter is high, ranging from 17-60, with higher values for aggregate consumption than for stockholder consumption, while the estimated elasticity of intertemporal substitution is above one. In addition, the estimated model-implied aggregate wealth return is found to be weakly correlated with the CRSP value-weighted stock market return, suggesting that the return to human wealth is negatively correlated with the aggregate stock market return. In quarterly data from 1952 to 2005, we find that an SMD estimated EZW recursive utility model can explain a cross-section of size and book-market sorted portfolio equity returns better than the standard consumption-based model based on power utility and better than the Lettau and Ludvigson (2001b) cay-scaled consumption CAPM model, but not as well as the Fama and French (1993) three-factor model with financial returns as risk factors.

DP 604

Performance Measurement and Evaluation

Bruce Lehmann, Allan Timmermann

We consider performance measurement and evaluation for managed funds. Similarities and differences – both in econometric practice and in interpretation of outcomes of empirical tests – between performance measurement and conventional asset pricing models are analyzed. We also discuss how inference on ‘skill’ is affected when fund managers have market timing information. Performance testing based on portfolio weights is also covered, as is recent developments in Bayesian models of performance measurement that can accommodate errors in the benchmark asset pricing model.

DP 605

Consistent Estimation of the Risk-Return Tradeoff in the Presence of Measurement Error

Anisha Ghosh, Oliver Linton

This paper proposes an approach to estimating the relation between risk (conditional variance) and expected returns in the aggregate stock market that allows us to escape some of the limitations of existing empirical analyses. First, we focus on a nonparametric volatility

measure that is void of any specific functional form assumptions about the stochastic process generating returns. Second, we offer a solution to the error-in-variables problem that arises because of the use of a proxy for the volatility in estimating the risk-return relation. Third, our estimation strategy involves the Generalized Method of Moments approach that overcomes the endogeneity problem in a least squares regression of an estimate of the conditional mean on the corresponding estimate of the conditional variance, that arises because both the above quantities are endogenously determined within a general equilibrium asset pricing model. Finally, we use our approach to assess the plausibility of the prominent Long Run Risks asset pricing models studied in the literature based on the restrictions that they imply on the time series properties of expected returns and conditional variances of market aggregates.

DP 607 The Paul Woolley Centre
Working Paper Series No 2

Bond Supply and Excess Bond Returns

Robin Greenwood, Dimitri Vayanos

We examine empirically how the maturity structure of government debt affects bond yields and excess returns. Our analysis is based on a theoretical model of preferred habitat in which clienteles with strong preferences for specific maturities trade with arbitrageurs. Consistent with the model, we find that (i) the supply of

long- relative to short-term bonds is positively related to the term spread, (ii) supply predicts positively long-term bonds' excess returns even after controlling for the term spread and the Cochrane-Piazzesi factor, (iii) the effects of supply are stronger for longer maturities, and (iv) following periods when arbitrageurs have lost money, both supply and the term spread are stronger predictors of excess returns.

DP 608 Corporate Governance at LSE, 004

From Fiction to Fact: The Impact of CEO Social Networks

Tom Kirchmaier, Konstantinos Stathopoulos

This paper investigates the relationship between a CEO's social network, firm identity, and firm performance. There are two competing theories that predict contradictory outcomes. Following social network theory, one would expect a positive relation between social networks and firm performance, while agency theory in general, and Bebchuk's managerial power approach in particular, predicts a negative relationship between social networks and firm performance. Based on a new and comprehensive measure of CEOs social networks, we observe for 363 non-financial firms in the UK that the size of a CEO's social network affects firm performance negatively. Even so, growth companies are actively seeking CEOs with a large social network, which is in line with the social network theory. Still, we find evidence in support of the argument that well-connected CEOs use the power they obtain through their social network to the detriment of shareholders.

Special Papers

P 175

'Liquidity Risk Management'

C A E Goodhart

No abstract available

Forthcoming Discussion and Special Papers

Discussion Papers

DP 609

'Asset Pricing Tests with Long Run Risks in Consumption Growth'

George M Constantinides, Anisha Ghosh

DP 610

'Can Rare Events Explain the Equity Premium Puzzle?'

Christian Julliard, Anisha Ghosh

DP 611

'Do Errors in Forecasting Inflation Lead to Errors in Forecasting Interest Rates?'

C A E Goodhart, Wen Bin Lim

DP 612

'Interest Rate Forecasts: A Pathology'

C A E Goodhart, Wen Bin Lim

DP 613

'Do Reputational Concerns Lead to Reliable Ratings?'

Beatriz Mariano

DP 614

'Forecasting Bankruptcy and Physical Default Intensity'

Ping Zhou

Special Papers

SP 176

'The Emergence of Cross-Border Insurance Groups within Europe with Centralised Risk Management'

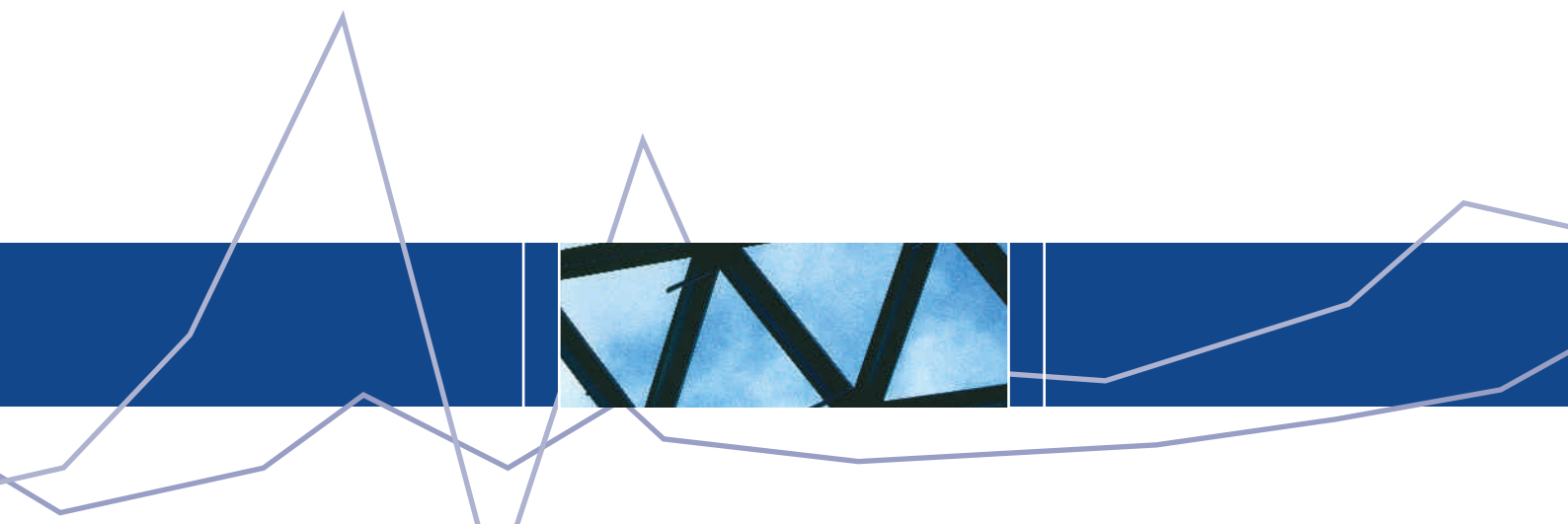
Dirk Schoenmaker, Sander Oosterloo,
Otto Winkels



Visitors to the FMG

August – October 2008

Nick Barberis (Yale University)
Bruno Biais (University of Toulouse)
Ron Bird (University of Technology, Sydney)
Markus Brunnermeier (Princeton University, NBER and CEPR)
Mikhail Chernov (London Business School)
Katarzyna Gabryelczyk (Poznan University of Economics)
Simon Gervais (Duke University)
Marianne Schulze-Ghattas (IMF)
Harrison Hong (Princeton University)
Hao Jiang (Erasmus University)
Petri Jylha (Helsinki School of Economics)
Peter Kondor (University of Chicago)
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Igor Makarov (London Business School)
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Adriano Rampini (Duke University)
Jean-Charles Rochet (University of Toulouse)
Matti Suominen (Helsinki School of Economics)
Annette Vissing-Jorgensen (Northwestern University and NBER)
S Viswanathan (Duke University)
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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, 15th October 2008 - at 1.00-2.00pm

Lunchtime Workshop | The Effect of Credit Rationing on the Shape of the Competition-Innovation Relationship | Jan Bena (FMG/LSE)
location: R407, FMG, 4th Floor, Lionel Robbins Building, LSE

Wednesday, 15th October 2008 - at 5.00pm

Capital Markets Workshop | Smooth Ambiguity Aversion Toward Small Risks and Continuous-Time Recursive Utility | Costis Skiadas

In the news

Special London Financial Regulation Seminar announced - Howell Jackson (Harvard Law School) **13 Oct 2008**
Professor Howell Jackson (Harvard Law School) will give a special lunch seminar as part of the London

Managing International Financial Instability Public Lecture - Conference slides available **9 Oct 2008**
Date: Tuesday 7 October 2008 Time: 6-7.30pm Venue: Sheikh Zayed Theatre, New Academic Building Speaker

In the press: Jon Danielsson provides an analysis on "What happened to Iceland" - Jon Danielsson (FMG/LSE) investigates the factors that caused

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