

PROFESSOR SUDIPTO BHATTACHARYA, 1951-2012



The death of Professor Sudipto Bhattacharya was met with considerable shock and sadness, both in the Department of Finance and the whole of LSE. This has also been reflected in the wider international academic community. Sudipto had been Professor of Finance at LSE since 1995 and played an instrumental role in transforming the School's finance group from a handful of academics into a large and vibrant modern finance department, with a faculty of over 30. Sudipto was particularly influential in the design of the MSc Finance and Economics, whilst at the same time contributing greatly to the international projection of finance at LSE, enabling us to recruit outstanding faculty and students. All those that met and worked with him will know of his intellectual integrity and acute and very individual analytical skills, which he applied in all of

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FIFTH ANNUAL PAUL WOOLLEY CENTRE CONFERENCE 7-8 JUNE 2012

The Paul Woolley Centre for the Study of **Capital Market Dysfunctionalities**

The Fifth Annual Paul Woolley Centre Conference took place at the FMG on 7-8 June 2012. It comprised of four sessions:

1. Incentives of fund managers
2. Asset prices and intermediary capital
3. Information asymmetries and market performance
4. Return predictability and real decisions



Peter Kondor (Central European University)

The conference began with a presentation by **Amil Dasgupta** (FMG, LSE), who presented a joint work with Giorgia Piacentino (FMG, LSE) titled "The Wall Street walk when blockholders compete for flows". Their starting point was the theoretical literature which argues that the threat of exit can be an effective governance device when the blockholder is a principal. However, in many cases the blockholder is a money manager whose objectives may not be aligned with those of the principal. Hence the threat of exit may be less effective if blockholders are money managers.

The authors showed that this depends on how much money managers care about investor flows. In particular, when blockholders are sufficiently flow-motivated, exit will fail as a disciplining device, while if they are sufficiently profit-motivated, it is effective. They concluded that the threat of exit complements shareholder voice, which provides an explanation for the observed variation in how different types of funds use voice.

The discussant, **Andrey Malenko** (Massachusetts Institute of Technology), was intrigued by the empirical predictions of the paper. He suggested that the empirical analysis should focus on just one class of funds, rather than comparing mutual and hedge funds. He also encouraged the authors to enrich the model and to develop further, certain aspects of the framework.

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PROFESSOR SUDIPTO BHATTACHARYA, 1951-2012

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his research and in his seminar and conference participation. However, to many of us, both staff and students, he will be most fondly remembered for his somewhat unorthodox sense of humour and personal style.

Raised in an academic family in India, Sudipto began his education with a BSc in physics from the University of Delhi, followed by postgraduate studies in business administration at the Indian Institute of Management, Ahmedabad. He then travelled to the USA, where he obtained a PhD in economics and finance at MIT under the supervision of Professor Stewart Myers. Sudipto was recognised as one of the outstanding young economists of his time, holding assistant professorships at the University of Chicago and Stanford University, during which he won prestigious Batterymarch and Bell Labs Research Fellowships. These appointments were followed by tenured positions at the University of California, Berkeley and the University of Michigan. In 1989 Sudipto returned to his roots as Professor of Economics at the University of Delhi, where he remained for five years, before joining LSE faculty in 1995.

In the early part of his career Sudipto's work was concerned with the role of information in financial markets, writing seminal papers on signaling and delegated portfolio management. At the same time he showed the breadth of his skills and insights in a number of papers on theoretical asset pricing. His later work, post 1987, had two main themes, one a deeper understanding of banking and financial intermediation and a second, concerning innovation, research and development. In the latter, his work on the sharing of knowledge is generally regarded as seminal. Most recently, Sudipto was working on a number of projects relating to financial crises and contagion in financial markets aimed at improving our understanding of the risks facing the financial system and how to manage them. Scattered throughout his career are a number of edited volumes (notably with George Constantinides and Arnoud Boot and Anjan Thakor) and

survey papers, in which Sudipto demonstrated a remarkable ability to draw together large literatures and organise the key contributions around a small number of salient principles. In this his skill and knowledge of the literature was second to none. At times it seemed as if there was nothing that he hadn't read and understood thoroughly. His contributions are broad and many and will be long remembered.

Sudipto worked with many co-authors, some of whom were his PhD students. Notable amongst his students are Jay Ritter, Kathleen Haggerty and Charles Jacklin. Countless students and young faculty members benefited from conversations with him and learnt from his skill as a seminar participant, where his comments were often extraordinarily illuminating and insightful, and often interwoven with (sometimes good) jokes. Sudipto was a one off. He was an unusually idiosyncratic individual, so for most of us our memories will be quite personal and very special. However, it is certainly the case that his unique personality, intellect and engaging personal style will be missed by many of us and will leave a gap that will be impossible to fill. We will remember him with affection and admiration. Our thoughts and thanks are with his family.



Professor David Webb (Head of the Finance Department and former FMG Director; 1991-2009)

FIFTH ANNUAL PAUL WOOLLEY CENTRE CONFERENCE 7-8 JUNE 2012

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The second paper of the session was presented by **Simon Gervais** (Duke University). The paper, titled "The industrial organisation of money management", is a joint work with Günter Strobl (UNC Kenan Flagler) in which they study how the skills of a money manager lead to different forms of money management. In particular, they present a model in which money managers signal their investment skills via their choice of transparency for their fund.

They found that in a natural equilibrium, high and low-skill managers pool into opaque funds, while medium-skill managers separate into transparent funds. In this equilibrium, high-skill managers rely on their eventual performance to separate them from low-skill managers over time, saving the monitoring costs associated with transparency. In contrast, medium-skill managers rely on transparency to separate them from low-skill managers, especially when it is difficult for investors to tell them apart through performance alone. Low-skill managers prefer mimicking high-skill managers in opaque funds in the hope of replicating their performance and compensation. Gervais also discussed several novel empirical predictions coming from the model that contrast transparent funds (eg mutual funds) and opaque funds (eg hedge funds).

The paper was discussed by **Hongjun Yan** (Yale University) who emphasised the good work done by the authors in providing a coherent framework and deriving testable implications. His discussion emphasised the need to model the cost of transparency. Yan concluded his discussion by suggesting that the model could be used to derive interesting policy implications.

The last paper of the session, titled "How safe are money market funds? Evidence from the financial crisis of 2007-2010", was presented by **Philipp Schnabl** (Stern School of Business, NYU). The paper, coauthored with Marcin Kacperczyk (Stern School of Business, NYU), examines the risk-taking behaviour of money market funds during the financial crisis of 2007-10.

The Paul Woolley Centre for the Study of Capital Market Dysfunctionalities



Patrick McCabe (Federal Reserve System)

The authors showed that as a result of the crisis: (1) money market funds experienced an unprecedented expansion in their risk-taking opportunities; (2) funds had strong incentives to take on risk because fund inflows were highly responsive to fund returns; (3) funds sponsored by financial intermediaries that also offered non-money market mutual funds and other financial services took on less risk, consistent with their sponsors internalising concerns over negative spillovers to the rest of their business in case of a run; (4) funds sponsored by financial intermediaries with limited financial resources took on less risk, consistent with their sponsors having limited ability to stop potential runs. Schnabl concluded by suggesting that their results indicate that money market funds' risk-taking decisions, trade off the benefits of fund inflows with the risk of causing negative spillovers to other parts of fund sponsors' business.

The discussion, by **Patrick McCabe** (Federal Reserve System), emphasised the need to take into account the benefits that money market funds obtain by taking risk. McCabe also suggested that the behaviour of money market funds in the run-up to the crisis may reflect the expectations of a future bailout.

The second session started with **S. Viswanathan** (Duke University) presenting his joint work with Adriano Rampini (Duke University). Viswanathan presented a version of "Financial intermediary capital" in which banks have an advantage in collateralising loans. In

equilibrium, banks pledge their financial assets to borrow from households and lend to firms, charging an intermediation spread. Firms pledge their tangible assets to borrow from households and banks. In this environment, a fall in firm net worth may lower the intermediation spread. The corporate sector can absorb less debt and banks observe a fall in corporate loan demand. In contrast, a fall in bank net worth may raise the spread. Banks can access fewer funds and the supply of corporate loans falls.

By moving to dynamic analysis, this framework implies that banks recapitalise at a slower rate than the corporate sector after a negative shock to net worth. Furthermore, even if corporate sector net worth is resilient, a fall in banking sector net worth (a credit crunch) has substantial effects on the real economy. By driving up the cost of marginal bank funding, the return threshold that firms apply to investment projects rises.

The discussant for this paper, **Peter Kondor** (Central European University), praised this project for its modelling beauty and for analysing the interaction between a credit-constrained corporate sector and a credit-constrained banking sector.

Francesco Franzoni (University of Lugano) then presented his work "ETFs, arbitrage, and contagion", co-authored with Itzhak Ben-David (Fischer College of Business) and Rabih Moussawi (The Wharton School, University of Pennsylvania), on how mispricing related to Exchange Traded Fund (ETF) activities might affect their underlying securities. In principle, ETF prices should be equal to the net asset values (NAV) of the underlying securities. Nonetheless, the authors provided evidence that proxies of limits to arbitrage are correlated with ETF mispricing. More interestingly, they investigated how it propagates into the underlying securities, suggesting a non-fundamental shock in ETF prices feeds into the underlying securities' prices. In particular, they show ETF mispricing predicts next day securities' NAV returns and issuance of ETF shares, which in turn predicts an increase in the volatility

and turnover of the stocks held by those ETFs. Finally, the authors link the events of the Flash Crash, on 6 May 2010, when the S&P500 index fell by 6 per cent and recovered in less than 2 hours, to a contagion channel through ETFs, as those represented 60 per cent of the trades in this event.

Harald Hau (University of Geneva) commented on their work and highlighted the need to investigate the differences between ETFs and Index Funds. According to Hau, the former might have better liquidity features than the latter, which should be further explored in the paper. He also raised some potential econometrics issues and suggested on how those might be tackled.

Jaehoon Lee (University of Illinois) then presented his paper "Funding liquidity and its risk premiums" which provided evidence that during a crisis, the correlation of large stocks liquidity with the stock market is higher than the correlation of small stocks liquidity with the stock market. He defined asset liquidity as the ease with which an asset is traded, which is related to bid-ask spreads. Funding liquidity is the capacity for a trader to raise funds and



Hongjun Yan (Yale University)

is related to margin requirements. In his study, he estimated funding liquidity as the difference of the correlation of small stocks Amihud's illiquidity with stock market return and the correlation of big stocks Amihud's illiquidity with stock market return. He continued by providing empirical evidence that the estimated funding liquidity is positively correlated to aggregate hedge fund leverage ratios, stock market sentiment and an increase in merger and acquisition activity. It is also negatively correlated with bond liquidity premia, corporate bond spreads and the relative prevalence of liquidity mergers. Finally, he showed that the estimated funding liquidity significantly predicts the next month's stock market return and future GDP growth and provides robust evidence to his finding.

Jean-Sebastien Fontaine (Bank of Canada) discussed Lee's paper and remarked that the predictability results of the estimated funding liquidity measure seem robust. However, he argued that the link with the theoretical model is weak and the main theoretical prediction could arise from existing mechanisms in the literature. He also pointed out that it is not clear whether the measure could be interpreted as a risk factor or a conditioning variable.

Session 3 began with **Bruno Biais** (Toulouse School of Economics) who presented "Equilibrium

high frequency trading", a joint paper with Thierry Foucault (Hautes Etudes Commerciales) and Sophie Moinas (Toulouse School of Economics). The paper studies the trade-off between the increase in information efficiency of prices and the social cost brought about by High Frequency Trading (HFT). In a one-trade model, HFTs can become fast at a cost and observe and react to information before slow traders, and thus contact counterparties with higher probability than slow traders. The type of equilibria depend upon whether HFTs and slow traders are strategic substitutes or complements. In the former case, there is a unique equilibrium as the greater the fraction of HFTs, the lower their advantage over slower traders. In contrast, if they are strategic complements, there are multiple equilibria and the slow traders are crowded out when there are many HFTs. In this case, the entry of a new fast trader increases price impact and creates a negative externality on all traders. As a result, there is over-investment: the equilibrium level of investment in HFT is higher than the socially optimal investment.

Emiliano Pagnotta (Stern School of Business, NYU) discussed this paper and remarked that empirical evidence shows that HFT competition should render the market more liquid. This is not explored in the model, in which there are no liquidity externalities. He then compared



Dimitri Vayanos (FMG, LSE)

the equilibrium results in this paper with his own research and highlighted that this paper is the first to integrate information and welfare in a model of HFT. Finally he suggested how to extend it by exploring micro foundations of speed demand.

Anastasia Kartasheva (University of Pennsylvania) presented her paper "Precision of ratings", co-authored with Bilge Yilmaz (University of Pennsylvania), which investigates the incentives of credit rating agencies to produce information. In particular when: market conditions worsen; the value of aggregate liquidity increases; or information asymmetries get more severe, ratings become less precise. In a model with uniformed and informed investors, the former are more likely to obtain an issue when the latter do not subscribe (winner's curse problem). By studying the optimal rating precision problem faced by the credit rating agencies, the authors found that ratings become less precise when the share of uniformed investors increases and as high quality assets become scarcer. Finally, they suggested that policies should aim to reduce the reliance on ratings and ratings fees should be regulated. In contrast, there should be no standardisation of precision for different ratings and different asset classes, as it would reduce market efficiency.

Joel Shapiro (Oxford University) started his discussion on "Precision of ratings" by pointing out that the model did not consider credit rating agencies' reputational concerns, which is an important explanation in the literature for the poor performance in ratings of complex assets. He also argued that the main reason behind a lack of rating of an issuer is probably ratings shopping, rather than credit rating agencies excluding risky issuers due to information structure incentives, as modelled in the discussed paper.



Philipp Schnabl (Stern School of Business, NYU)

Session 4 began with **Ralph Koijen's** (University of Chicago) paper "Carry", which was co-authored with Tobias Makowitz (University of Chicago), Lasse Pedersen (New York University) and Evert Vrugt (University of Amsterdam). Koijen's presentation showed how the concept of 'carry' can be applied beyond currency markets to shed new light on trading returns in global equity, the bond market and commodities.

By defining 'carry' as the expected return on a trading strategy if prices do not change, he showed that carry is a strong and positive predictor of subsequent expected asset return across the major asset classes considered. Moreover, he identified global recessions as periods in which carry strategies perform poorly ("carry downturns"). Interestingly, while the high Sharpe ratios of the currency carry trade generalise to other asset classes, Koijen's work suggests that the crash risk associated with strategies in the currency market does not.

In his discussion of "Carry", **Kent Daniel** (Columbia University) added that the high Sharpe ratios for the carry trade continue to represent a puzzle for the consumption-based asset pricing literature: discount factors must be extremely volatile in order to justify the size of expected returns. Furthermore, he noted that carry trades generally require traders to post collateral. In computing returns to the carry trade, he therefore suggested to take into account capital costs associated with the strategy. Noting the large discrepancies on the carry trade within sub-categories of the commodities market, he recommended a more disaggregated analysis for this asset class.

Finally, **Dong Lou** (FMG, LSE) presented "Cross-market timing in security issuance, a joint work with Pengjie Gao (University of Notre Dame). By combining mutual fund, equity, bond and corporate balance sheet data, the authors shed new light on the market timing hypothesis.

The conventional view of this theory suggests that firms take advantage of equity overvaluation by issuing more shares and by driving down their leverage ratio and vice versa. By identifying equity overpricing using a measure of flow-induced mutual fund buying pressure, Lou found empirical support for this prediction but only for the subset of financially unconstrained firms. Considering credit-constrained firms only, the data suggested a reversed relationship: overpriced equity leads to a rise in leverage, because these firms issue even more debt than equity in response to mutual fund buying pressure.



S. Viswanathan (Duke University)

To understand these findings, Lou argued for a more refined version of the market timing hypothesis. Once firms are credit-constrained, they may exploit gains in net worth following equity overvaluation to access more credit and start more investment projects.

As discussant, **Adi Sunderam** (Harvard University) praised the project for offering a more holistic picture of how firms' financing decisions depend on their circumstances and on how markets value their equity. He pointed out that the effects of mispricing on firms' capital structure were much smaller in Lou's work than in earlier studies of market timing. Furthermore, he stressed that a more fleshed-out version of the market timing hypothesis for credit-constrained firms may reveal non-linearities in the firm response to equity overpricing.

The call for papers for the 6th Annual Paul Woolley Centre Conference is now open. Details can be found on the Paul Woolley Centre website: lse.ac.uk/pwcConference

The conference was organised by: **Bruno Biais** (Toulouse School of Economics), **Georgy Chabakauri** (FMG, LSE), **Amil Dasgupta** (FMG, LSE), **Denis Gromb** (INSEAD), **Christopher Polk** (FMG, LSE), **Dimitri Vayanos** (FMG, LSE), **Michela Verardo** (FMG, LSE) **Kathy Yuan** (FMG, LSE) and **Kostas Zachariadis** (FMG, LSE)

Article written by the 2011-2012 Paul Woolley Centre Scholars: **Nelson Costa Neto**, **Luca Fornaro** and **Christoph Ungerer**.

CORPORATE GOVERNANCE AT LSE: BROWNBAG SEMINAR SERIES

Corporate Governance at LSE is a research initiative launched by the FMG as part of the Group's Corporate Finance and Governance Research Programme. Its mission is to conduct and encourage high quality research in corporate governance, to facilitate debate between professionals and policy-makers, and to promote the implementation of best corporate governance practices.

In 2010 Corporate Governance at LSE launched its Brownbag Seminar series, the objective being to provide a platform for Programme members to discuss their own work and how it relates to corporate governance. Work that is presented can be at any stage of the development process, but never fails to prompt some lively discussion.

The content discussed in our 2012 summer term seminars is summarised here.

All Corporate Governance Brownbag seminars are organised by **Tom Kirchmaier** (FMG, LSE). For details of upcoming events please visit: lse.ac.uk/FMGCorporateGovernance

If you would like to be added to the Corporate Governance mailing list please email: Fmg.Corporate.Governance@lse.ac.uk



21 MAY

Moqi Xu (FMG/ Department of Finance, LSE) presented her paper "Rights offerings and coercion". By taking a sample of 9,615 rights issues, announced

between 1995 and 2008 in 69 countries, Xu found that only 72 per cent of rights are traded. In many countries issuers can restrict the trading of rights and in some countries rights can never be sold. The rights that are traded quote at a significant discount from fair value; on 17 per cent of trading days the closing price of the rights is so low that it violates the lower put-call parity bounds, on average by 58 per cent. Without the possibility to sell pre-emptive rights, shareholders must subscribe to new shares to prevent dilution. Subscribing to rights issues with no rights market or with a discounted rights market is a bad decision for long-term investors, as stocks will underperform after offerings where the rights are not traded and when rights are traded but undervalued.



11 JUNE

Pedro Matos (University of Virginia) presented his paper "Are US CEOs paid more? New international evidence", in which he challenges the widely

accepted fact that US CEOs are paid significantly more than their foreign counterparts. By using CEO pay data across 14 countries with mandated pay disclosures, Matos showed that the US pay premium is economically modest and primarily reflects the performance-based pay demanded by institutional shareholders and independent boards. He went on to demonstrate that there is no significant difference in either the level of CEO pay or the use of equity-based pay between US and non-US firms which are exposed to international and US capital, product, and labour markets. According to Matos' research, any differences in US and non-US CEO pay ceased to exist in the 2000s, when the two largely converged.

Matos co-authored this paper with Nuno Fernandes (IMD International), Miguel A. Ferreira (Nova School of Business and Economics) and Kevin J Murphy (University of Southern California).



25 JUNE

Carsten Gerner-Beuerle (Department of Law, LSE) presented his research on "Who writes corporate governance codes, and

does it matter?" He started his presentation with an overview of both the history of corporate governance codes in Europe and the academic literature that exists on this topic. He then introduced the question that his own project seeks to answer; whether the composition of corporate governance committees really affects the extent to which codes are shareholder versus management friendly.

In order to answer this question, Gerner-Beuerle and his co-author gathered information from the CVs of corporate governance committee members along with the content of codes from 28 European countries. According to the information found they classified each member as either; likely to be appointed by investors; likely to be appointed by management; or to be neutral. They also classified corporate governance codes according to how investor friendly they are. This proved difficult to do because of the varying legal systems across European countries and the inherent subjectivity that comes with interpreting legal texts. Once this hurdle was negotiated they then conducted statistical analysis which consisted of regression analyses- using the index of corporate governance codes investor friendliness as the outcome variable, the committee's composition as the main regressor and a host of mainly country-specific control variables. The results were somewhat surprising; showing that committee composition does not seem to have an effect on the investor friendliness of codes. The time trend however was highly significant, showing that corporate governance codes in Europe are becoming more investor-friendly over time.

NEW MEMBERS OF STAFF



Ian Martin is a Visiting Reader in Finance from Stanford University's Graduate School of Business, where he is an Associate Professor of Finance. Ian's current research focuses on

theoretical models of asset price behaviour and more specifically on: co-movement between assets; on the valuation of long-dated assets; on the measurement of the equity premium; and on the impact of disasters on financial markets.



Stavros Panageas is a Visiting Professor of Finance from the University of Chicago Booth School of Business, where he is an Associate Professor of Finance.

Stavros' research interest lies within the study of asset pricing and macroeconomics.



Andrea Tamoni joined the Department of Finance and the FMG in July as a Lecturer in Finance. His specialisation and interests lie within the fields of theoretical and empirical asset pricing, and financial

econometrics. He obtained his PhD from the Bocconi University.

VISITING SCHOLARS



Maurizio Montone is a third year PhD student at the University of Cassino. His main research interests are theoretical and empirical asset pricing, behavioural finance and corporate finance.

Maurizio has previously been a visiting scholar at EIEF, Indiana University and the University of Miami and he was a finalist for the IAES Best Undergraduate Paper Award. He has taught courses both at graduate and undergraduate level including: asset pricing, political economy and derivatives. Prior to starting his PhD Maurizio obtained a 2nd-level degree in Finance and a Masters in Economics and Finance at the University of Naples 'Federico II'.



Ilaria Piatti is visiting the FMG from the University of Lugano where she is a PhD student in the Department of Finance, and is expecting to complete her PhD in autumn 2013. Her research interests are in the field of

empirical and theoretical asset pricing, term structure modelling and financial econometrics. In particular, two recent working papers, co-authored with Fabio Trojani (University of Lugano), focus on understanding return and cash flow growth predictability. The first extends the present-value model literature; introducing latent time-varying features of return and dividend growth risks, and studies the implications for the detection of predictive relations and the estimation of time-varying risk features. The second shows that standard testing procedures of present-value models with latent variables tend to over-reject the null of no predictability and develop a consistent testing framework, based on nonparametric resampling methods, with more reliable finite-sample properties.

NEW RESEARCH STUDENTS



Hoyong Choi is a 2nd year Finance PhD candidate under the supervision of Mikhail Chernov and Andrea Vedolin (both FMG/ Department of Finance, LSE). His research interests are empirical and theoretical asset pricing.



Nathan Converse is a 5th year PhD student in the Department of Economics as well as a 2012-13 Deutsche Bank Doctoral Fellow. Nathan's research interests include international

macroeconomics and applied econometrics. His research examines how the volatility of portfolio capital flows affects investment and growth in emerging market economies, and the role for policy in mitigating the risks of these so called hot money flows. Prior to joining LSE Nathan worked as a senior research assistant at the Institute of International Finance in Washington DC. He also holds a BA from the George Washington University and an MPhil from the University of Oxford.



Christian von Drathen is in the 5th year of his PhD in the Department of Finance. Christian's research interests include empirical corporate finance, microeconometrics, corporate governance and private equity, and he is

currently working on a paper on CEO succession. Christian had this to say about the FMG:

"A great place to interact with fellow students and scholars from other universities about a wide range of finance-related topics. There are excellent seminars and conferences, as well as a strong network of academics, policymakers and practitioners."



Sergei Glebkin joins the FMG from the Department of Finance where he is a second year PhD candidate. His main research interest is asset pricing theory.



Isabelle Roland is a second year PhD candidate in Economics, under the supervision of Margaret Bray (FMG/ Economics Department, LSE). Isabelle's research interests are: banking, financial regulation,

capital and debt structure, Knightian uncertainty and financial markets, and the relationship between finance and growth. She is currently working on the topic of asset encumbrance and its regulatory treatment.



Ji Shen joins the FMG from the Department of Finance where he is in the 2nd year of his PhD. He is under the supervision of Amil Dasgupta and Daniel Ferreira (both FMG/ Department of Finance, LSE) and lists his research

interests as: financial intermediation and corporate finance.



Luana Zaccaria is a 2nd year PhD candidate in Finance, under the supervision of Christian Julliard (FMG/Finance Department, LSE). Her research interests include corporate finance, financial regulation,

contract theory and financial economics. Luana had this to say about the FMG:

"I'm really excited about being exposed to cutting-edge innovative research and sharing ideas with other FMG members. I look forward to interacting with researchers from diverse backgrounds and with varied interests within the broad financial economics discipline, and taking advantage of the links that the FMG has built with other academic institutions, corporations, banks and regulators."



Cheng Zhang is a 2nd year PhD candidate in the Department of Finance under the supervision of Christopher Polk (Director of the FMG). Her research interests are theoretical and empirical asset pricing as well as derivative

markets. Cheng had this to say about the FMG:

"I will gain access to advanced training through FMG seminars, and will benefit from interaction with academic staff as well as visitors and associates."



Shengqing Zhu joins the FMG from the Department of Finance where he is a 2nd year PhD student. His research interests include asset pricing and capital markets.

FMG EVENTS

Events that have taken place since the publication of the previous *Review* in August 2012 (Spring/Summer issue)

Conferences

European Banking Union Conference

22 October 2012

Organised by Harald Benink, Charles Goodhart and Rosa M Lastra

Pros and Cons of Banking Union

5 November 2012

Organised by Dirk Schoenmaker and Charles Goodhart

Public Lectures

What I learned by Doing Capitalism

11 October 2012

Chair: Professor Craig Calhoun (Director of LSE)

Speaker: Dr William H Janeway

Discussant: Professor Dimitri Vayanos (FMG, LSE)

Capital Markets Workshops

Technological Innovation: winners and losers

10 October 2012

Dimitris Papanikolaou (Kellogg School of Management)

Capital Structure and Taxes: what happens when you (also) subsidise equity?

17 October 2012

Francisco Perez-Gonzalez (Stanford University)

A Theory of Asset Prices Based on Heterogeneous Information

24 October 2012

Christian Hellwig (Toulouse School of Economics)

Contracting with Synergies

31 October 2012

Alex Edmans (Wharton School, University of Pennsylvania)

What Explains High Unemployment?

The Aggregate Demand Channel

7 November 2012

Atif Mian (Princeton University)

An Empirical (S,s) Model of Dynamic Capital Structure

14 November 2012

Arthur Korteweg (Stanford University)

Liquidity-Based Security Design: the case of uninformed sellers

21 November 2012

Christopher Hennessy (London Business School)

A Model of Financialization of Commodities

28 November 2012

Anna Pavlova (London Business School)

Macroprudential Policy, Countercyclical Bank Capital Buffers and Credit Supply: Evidence from the Spanish Dynamic Provisioning Experiments

5 December 2012

José-Luis Peydró (Universitat Pompeu Fabra, Barcelona)

Lunchtime Workshops

Do Institutional Investors Improve Capital Allocation?

10 October 2012

Giorgia Piacentino (FMG, LSE)

Contingent Capital and Bank Regulation

17 October 2012

Jing Zeng (FMG, LSE)

Crisis, Coordination and Contagion

24 October 2012

Toni Ahnert (FMG, LSE)

Does Wage Rigidity Make Firms Riskier? Evidence from Long-Horizon Return Predictability

31 October 2012

Jack Favilukis (FMG, LSE)

Assessing Sovereign Debt Default Risk: a bottom up approach and The Fate of the Euro: it is still Italia!

7 November 2012

Edward Altman (Stern School of Business, NYU)

Performance Chasing Behaviour in Mutual Funds: new evidence from multi-fund managers

14 November 2012

Bige Kahraman (Stockholm School of Economics)

FMG EVENTS CONTINUED

Economic Effects of Runs on Early "Shadow Banks": trust companies and the impact of the panic of 1907

21 November 2012

Carola Frydman (Boston University)

Simple Variance Swaps

28 November 2012

Ian Martin (Visiting Reader at LSE)

Expectations, Liquidity, and Short-term Trading

5 December 2012

Giovanni Cespa (Cass Business School)

London Financial Regulation Seminars

Register, Issue, Cap and Trade: a proposal for ending current and future financial crises

1 October 2012

Alistair Milne (Loughborough University)

The Source of Monetary Instability

6 November 2012

Robert Z Aliber (Booth School of Business)

Towards a Sustainable Business Model

12 November 2012

Hugo Bänziger (EDTF, Financial Stability Board)

Competition Issues in Retail Banking

19 November 2012

Roger Witcomb (Chairman, Competition Commission)

The Chicago Plan Revisited

26 November 2012

Michael Kumhof (International Monetary Fund)

Confidence and Capital: a significant failure mode for systemically important banks and its mitigants

3 December 2012

David Murphy (Rivast Consulting)

PhD Seminars

All seminars are given by current LSE PhD students

Endogenous Information Acquisition and a Monopolistic Market Maker

11 October 2012

Sean Lew (Department of Finance)

Global Liquidity, Limit Orders and Future Volatility

18 October 2012

Iknur Zer (FMG/Department of Finance)

Crisis, Coordination and Contagion

25 October 2012

Toni Ahnert (FMG/Department of Finance)

The Puzzling Counter Cyclical of the Value Premium: empirics and theory

8 November 2012

Maurizio Montone (FMG Visiting Scholar/ University of Cassino)

Uncertainty Shocks and Investment in the Presence of Maturity Mismatch

15 November 2012

Nathan Converse (FMG/Department of Economics)

Firm Size and Financial Constraints

22 November 2012

Jason Donaldson (FMG/Department of Finance)

Do Institutional Investors Improve Capital Allocation?

29 November 2012

Giorgia Piacentino (FMG/Department of Finance)

Corporate Governance at LSE: Research Debates

On Short Termism: a discussion of his final report

8 November 2012

John Kay (LSE)

Firm Commitment

15 November 2012

Colin Mayer (Said Business School)

Shareholder Empowerment and Bank Bailouts

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Daniel Ferreira, David Kershaw, Tom Kirchmaier and Edmund Schuster (all LSE)

Corporate Governance at LSE: Brownbag Seminars

Changing Organizational Form to Avoid Regulatory Constraints: the effect of mandatory gender balance in the boardroom

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Hedging in Fixed Income Markets

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Philippe Mueller and Andrea Vedolin (both FMG, LSE)

Competing on Speed

27 November 2012

Emiliano Pagnotta (Stern School of Business, NYU)

DISCUSSION PAPERS

Discussion papers are authored primarily by FMG staff, associates and research students, and provide specialist insights into cutting edge financial markets research currently being carried out at the FMG.

Research undertaken under the core FMG Research Programmes is published in the FMG Discussion Paper (DP) series. The Paul Woolley Centre for Capital Market Dysfunctionality (PWC) and the AXA-funded Risk Management Programme (AXA) have also published some of their research as FMG Discussion Papers.

DP 706 and PWC Paper 29

Stock market tournaments

Emre Ozdenoren and Kathy Yuan

We propose a new theory of suboptimal risk-taking based on contractual externalities. We examine an industry with a continuum of firms. Each firm's manager exerts costly hidden effort. The productivity of effort is subject to systematic shocks. Firms' stock prices reflect their performance relative to the industry average. In this setting, stock-based incentives cause complementarities in managerial effort choices. Externalities arise because shareholders do not internalize the impact of their incentive provision on the average effort. During booms, they over-incentivise managers, triggering a rat-race in effort exertion, resulting in excessive risk relative to the second-best. The opposite occurs during busts.

portfolio constraints. We provide a tractable characterization of equilibrium without relying on the assumption of logarithmic constrained investors, popular in the literature, under which wealth consumption ratios of these investors are unaffected by constraints. In one-tree economy we focus on the impact of limited stock market participation and margin constraints on market prices of risk, interest rates, stock return volatilities and price-dividend ratios. We demonstrate conditions under which constraints increase or decrease these equilibrium processes, and generate dynamic patterns consistent with empirical findings. In a two-trees economy we demonstrate that investor heterogeneity gives rise to large countercyclical excess stock return correlations, but margin constraints significantly reduce them by restricting the leverage in the economy, and give rise to rich saddle-type pattern. We also derive a new closed-form consumption CAPM that captures the impact of constraints on stock risk premia.

DP 707 and PWC Paper 30

Asset pricing with heterogeneous investors and portfolio constraints

Georgy Chabakauri

We study dynamic general equilibrium in one-tree and two-trees Lucas economies with one consumption good and two CRRA investors with heterogeneous risk aversions and

DP 708 and PWC Paper 31

Liquidity and asset returns under asymmetric information and imperfect competition

Dimitri Vayanos and Jiang Wang

We analyse how asymmetric information and imperfect competition affect liquidity and asset



DISCUSSION PAPERS CONTINUED

prices. Our model has three periods: agents are identical in the first, become heterogeneous and trade in the second, and consume asset payoffs in the third. We show that asymmetric information in the second period raises ex ante expected asset returns in the first, comparing both to the case where all private signals are made public and to that where private signals are not observed. Imperfect competition can instead lower expected returns. Each imperfection can move common measures of illiquidity in opposite directions.

DP 709 and PWC Paper 32

Market liquidity – theory and empirical evidence

Dimitri Vayanos and Jiang Wang

In this paper we survey the theoretical and empirical literature on market liquidity. We organise both literatures around three basic questions: (a) how to measure illiquidity, (b) how illiquidity relates to underlying market imperfections and other asset characteristics, and (c) how illiquidity affects expected asset returns. Using a unified model from Vayanos and Wang (2010), we survey theoretical work on six main imperfections: participation costs, transaction costs, asymmetric information, imperfect competition, funding constraints, and search – and for each imperfection we address the three basic questions within that model. We review the empirical literature through the lens of the theory, using the theory to both interpret existing results and suggest new tests and analysis.

DP 710

Do standard corporate governance practices matter in family firms?

Sridhar Arcot and Valentina Bruno

We study the unique governance dynamics surrounding family ownership in a voluntary regulatory arena where we can directly observe the impact of firm ownership on corporate governance practices pertaining to the composition of the board of directors. We find that family firms are more likely to deviate from standards of best practice in corporate governance. However, lesser governance standards in family firms are not associated with lower performance because the family shareholder is the monitor in-place. In contrast, governance practices and disclosures matter in widely-held firms because they alleviate the conflicts between managers and dispersed shareholders. More broadly, our results show that family ownership and board governance practices are substitute governance mechanisms.

DP 711

Agency, firm growth, and managerial turnover

Ronald W Anderson, M. Cecilia Bustamante and Stéphane Guibaud

We study managerial incentive provision under moral hazard in a firm subject to stochastic growth opportunities. In our model, managers are dismissed after poor performance, but also when an alternative manager is more capable

of growing the firm. The optimal contract may involve managerial entrenchment, such that growth opportunities are foregone after good performance. Firms with better growth prospects have higher managerial turnover and more front-loaded compensation. Firms may pay severance to incentivize their managers to report truthfully the arrival of growth opportunities. By ignoring the externality of the dismissal policy onto future managers, the optimal contract implies excessive retention.

DP 712

Bankers and bank investors: reconsidering the economies of scale in banking

Ronald W Anderson and Karin Joeveer

We study economies of scale in banking by viewing banks as combinations of financial and human capital that create rents which accrue to investors and bankers. Applying this approach to annual data of US bank holding companies since 1990, we find much stronger evidence of economies of scale in returns to bankers as compared to returns to investors. The scale economies appear to be particularly strong in the top size decile of banks measured by total assets. We find that rents accruing to bankers are particularly strong in banks with a relatively large share of non-interest income and that for the largest banks a reduction of net interest margin is associated with an increase in bankers' rents. We find incorporating observable proxies for funding efficiency and presence in wholesale banking activities greatly reduces the pure size effect.

DP 713

The structure of CEO pay: pay-for-luck and stock-options

Pierre Chaigneau and Nicolas Sahuguet

We develop a model of stylized model of efficient contracting in which firms compete for CEOs. The optimal contracts are designed to retain and insure CEOs. The retention motive explains pay-for-luck in executive compensation, while the insurance feature explains asymmetric pay-for-luck. We show that the optimal contract can be implemented with stock-options based on a single performance measure which does not filter out luck. When the capacity to dismiss underperforming CEOs differs across firms, and the ability of different CEOs is more or less precisely estimated ex-ante, endogenous matching between CEOs and firms can explain the observed association between pay-for-luck and bad corporate governance. The model also predicts that an improvement in the governance of badly governed firms has spillover effects that increase CEO pay in all firms.

DP 714 and AXA 11

Shareholder empowerment and bank bailouts

Daniel Ferreira, David Kershaw, Tom Kirchmaier and Edmund Schuster

We investigate the hypothesis that shareholder empowerment may have led to more bank bailouts during the recent financial crisis. To test this hypothesis, we propose a management

insulation index based on banks' charter and by-law provisions and on the provisions of the applicable state corporate law that make it difficult for shareholders to oust a firm's management. Our index is both conceptually and practically different from the existing alternatives. In a sample of US commercial banks, we show that management insulation is a good predictor of bank bailouts: banks in which managers are fully insulated from shareholders are roughly 19 to 26 percentage points less likely to be bailed out. We also find that banks in which the management insulation index was reduced between 2003 and 2006 are more likely to be bailed out. We discuss alternative interpretations of the evidence. The evidence is mostly consistent with the hypothesis that banks in which shareholders were more empowered performed poorly during the crisis.

You can download all FMG Discussion Papers for free from: lse.ac.uk/fmg/workingPapers/home.aspx

SPECIAL PAPERS

Special Papers investigate broader ideas in the financial markets than the Discussion Papers. They often follow conferences at which debates have stimulated further research and cooperation between participants and the wider academic and professional financial community.

SP 212

Adjustment mechanisms in a currency area

Charles Goodhart and D J Lee

Both the euro-area and the United States suffered an initially quite similar housing and financial shock in 2007/8, with several states in both regions being particularly badly affected. Yet there was never any question that the worst hit US states would need a special bail-out or leave the dollar area, whereas such concerns have worsened in the euro-area. We focus on three badly affected states, Arizona, Spain and Latvia, to examine the working of relative adjustment mechanisms within the currency region. We concentrate on four such mechanisms, relative wage adjustment, migration, net fiscal flows and bank flows. Only in Latvia was there any relative wage adjustment. Intra-EU migration has increased, but is more costly for those involved in the EU (than in the USA). Net federal financing helped Arizona and Latvia in the crisis, but not Spain. The locally focussed structure of banking amplified the crisis in Spain, whereas the role of out-of-state banks eased adjustment in Arizona and Latvia. The latter reinforces the case for an EU banking union.

SP 213

Banking union: what will it mean for Europe?

Thomas F Huertas

Banking union will change the face of Europe. It will significantly deepen integration in what is arguably the key sector of the economy. For the Member States that join the banking union, this will mean signing up for 'more Europe'. This will raise not only technical questions as to how banking union will actually work, but also political questions. These relate to how that deeper Europe should be governed and how the banking union will fit within the EU as a whole.

This paper outlines what has to be done in order to make banking union a change for the better, one that will in fact break the link between banks and sovereigns so that neither the euro nor the EU is at risk from banks and banks are not at risk from sovereigns.

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FORTHCOMING PAPERS

FMG Discussion Papers

International correlation risk

Philippe Mueller and Andrea Vedolin

From female labour force participation to boardroom gender diversity

Renée Adams and Tom Kirchmaier

Network risk and key players: a structural analysis of interbank liquidity

Kathy Yuan

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FMG Review

Editor: Frankie Clarke

Prepared by: Svetlana Bryzgalova, Nelson Costa Neto,
Jason R Donaldson, Luca Fornaro, Min Park,
Giorgia Piacentino, Christoph Ungerer and Wendy Yan

Photographs by: Frank Huang, Nigel Stead and Simon Tuck

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