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Paper Abstracts  
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## **Stocking Up: Executive Optimism and Share Retention**

Rik Sen, Hong Kong University of Science and Technology

Robert Tumarkin, University of New South Wales (UNSW) - School of  
Banking and Finance

### **Abstract**

We rigorously model the option exercise and portfolio choice problem of optimistic executives. Our analysis motivates a novel indicator of optimism, which is based on how an executive handles shares acquired on option exercise. Optimistic executives retain some of the stock received, while pessimistic executives sell all shares. The resulting indicator variable can be easily inferred using standard data sets. Theory suggests this indicator is superior to alternatives based on exercise behavior. In a large cross-section, our measure of CEO optimism explains investment intensity and leverage better than those used previously. We empirically confirm several theoretical implications of the model.

## **Banking Market Structure, Liquidity Needs, and Industrial Volatility**

Jiaren Pang, Tsinghua University - School of Economics & Management

Yanping Shi, University of International Business and Economics - School of  
International Trade and Economics

Haibin Wu, University of Alberta - School of Business

### **Abstract**

This paper examines the relationship between banking market structure and industrial growth volatility. We find that regulatory restrictions on entry and competition in the banking sector increase growth volatility of the real sector, and the effect is more pronounced for industries with higher liquidity needs. On the other hand, bank concentration seems to reduce volatility, especially for industries with higher liquidity needs. Our findings are not inconsistent with each other as bank concentration may not be a good measure for competition and they may actually measure different aspects of the banking market structure.

## **CEO Incentives and Institutional Trader Monitoring are Substitutes: Theory and Evidence**

Brandon Chen, University of New South Wales (UNSW) - School of Banking and Finance

Peter Swan, University of New South Wales (UNSW)

### **Abstract**

The traditional view on CEO pay suggests that the use of equity-based incentives (e.g., stocks and options) should increase when stock prices become more informative about managerial action. In this paper, we show this is only true in the relative sense, when comparing with CEOs non-equity-based incentives (e.g., bonus). We confirm our model's prediction to show that the use of equity-based incentives actually falls when institutional traders impound more information in stock prices. In other words, these two mechanisms are substitutes. These predictions are crystallized by our empirical results, focusing on S&P 1,500 firms from 1992-2007. Despite the lower use of equity-based incentives and even lower still use of bonus incentives, the CEO works harder and her total compensation increases, as suggested by our model. Our paper not only helps clarify the relation between CEO incentives and price efficiency due to informed trading, but also utilizes a new way to infer price informativeness from the number of institutional informed traders as well as the magnitude of their trades from a swing measure of informed trading. In its first application to the United States, we show that the swing measure can be inferred from SEC 13 f filings and is robust to a number of tests.

## **Optimal Deposit Pricing in Competitive, Oligopolistic Markets**

Basile Maire, Cantonal Bank of Zurich

Andreas Bloechlinger, Cantonal Bank of Zurich

### **Abstract**

We derive profit-optimal deposit rates in oligopolistic banking markets, considering the depositors supply sensitivities to deposit rates, the competing banks deposit rates and non-price factors. The resulting Nash equilibria agree with the empirical literature: Larger banks pay lower rates, the more similar the banks are in size the higher are the deposit rates. The average coupon rate decreases with increasing market concentration, bounded from above and below by simple functions of two well-known measures of concentration. Extending the framework to a multi-period economy relates the common banking approach to value deposits to the microeconomic approach used in industrial organization theory.

## Public Information and IPO Underpricing

Einar Bakke, University of Gothenburg

Tore Leite, Norwegian School of Economics and Business Administration  
(NHH)

Karin Thorburn, Norwegian School of Economics and Business  
Administration (NHH)

### Abstract

We analyze the effect of public information on rational investors' incentives to reveal private information during the bookbuilding process and their demand for allocations in the IPO. Our model generates several new predictions. First, investors require more underpricing to truthfully reveal positive private information in bear markets than in bull markets (the incentive effect). Second, the fraction of positive private signals and of underpriced IPOs is increasing in market returns (the demand effect). Combined, these two effects can explain why IPO underpricing is positively related to pre-issue market returns, consistent with extant evidence. Using a sample of 5,000 U.S. IPOs from 1981-2008, we show that the empirical implications of the model are borne out in the data.

## Institutional Ownership and Firm Cash Holdings

Christine Brown, Monash University - Department of Accounting and  
Finance

Yangyang Chen, Monash University - Department of Accounting and Finance

Chander Shekhar, University of Melbourne

### Abstract

The precautionary theory of firm cash holdings argues that firms hold cash to protect themselves against adverse cash flow shocks or external financial constraints that might force them to default on payments or forgo valuable investment opportunities. The aggressive trading of institutional investors magnifies the firm's stock return volatility and makes its external financing costly. This may induce the firm's precautionary demand for cash. Consistent with the hypothesis, I find that firms with greater institutional ownership have more cash holdings. The relationship is purely driven by short-term institutions that are more likely to engage in aggressive trading activities. The ownership of institutions that provide long-term, stable capital is negatively associated with cash holdings. Further tests show that the effect of institutional ownership on cash holdings is more significant for growth firms that rely more on external financing and suffer more from cash shortage.

## **The Market-Wide Consequences of Government Intervention**

Bradley Blaylock, Oklahoma State University - Spears School of Business

Alexander Edwards, University of Toronto - Rotman School of Management

Jared Stanfield, University of New South Wales (UNSW) - School of Banking and Finance

### **Abstract**

The US Government's intervention in Chrysler LLC's bankruptcy resulted in secured creditors receiving substantially less than the face value of their claims. In contrast, an unsecured creditor, the UAW, received substantial cash, notes, and equity in exchange for their claims. In this study, we examine the capital market consequences of this action on firms that face potential government intervention and find that firms most likely to experience similar future intervention experience negative abnormal bond and stock returns around the Chrysler bankruptcy, which we attribute to higher expected future debt costs. Our findings underscore the potential costs market participants face as a result of government intervention.

## **Options Trading and the Extent that Stock Prices Lead Future Earnings Information**

Cameron Truong, Monash University

### **Abstract**

We examine the relation between options trading and the extent that stock prices lead future earnings information in the period 1998-2009. In a firm specific approach, we find that stock prices reflect future earnings information to a greater extent in firms' post-options-listing period than in their pre-options-listing period. In a cross-sectional setting, we find that stock prices of firms with readily available options trading reflect future earnings information more and earlier than those of firms without available options. In a sub-sample containing only firms with listed options, we find that stock prices of firms with a high level of options trading volume reflect future earnings information more and earlier than those of firms with a low level of options trading volume. Findings in this study support the proposition that options trading results in more current information that is relevant for predicting future earnings being impounded into stock prices. Consistent with this proposition, we also document an inverse relation between options trading and the amount of new information provided by earnings announcements.

## The Lure of the Slant: Analyst Optimism and Asset Prices

Craig Brown, NUS Business School

### Abstract

This paper studies the effect of analyst optimism on asset prices. A common measure used to study analyst influence is ex-post earnings-forecast bias, which is endogenous in a traditional pricing model. Bias not only reflects optimism, which should not affect prices if investors are rational, but conveys future information which affects prices. To identify the optimism effect, I use two instrumental variables: forecast staleness and size-adjusted analyst tenure. Analyst optimism increases with tenure because of career concerns; analyst optimism increases with forecast staleness because of the "walk-down" hypothesis. However, there should be no systematic relation between fundamental information and tenure or between fundamental information and forecast staleness. Using these instruments, I identify a conditional price response to analyst optimism. If an optimistic analyst makes an upward revision, then investors respond by paying higher prices for stocks because the analyst is optimistic (in addition to the response to favorable information). However, if an analyst makes a downward revision, then analyst optimism has no effect on prices. Investors respond to the downward revision by paying lower prices for stocks because of unfavorable information only. In addition to the short-term price impact, analyst optimism affects asset prices over a longer term. Robust to trading costs, a zero-investment analyst tenure portfolio is significantly correlated with investor sentiment and earns an average abnormal return of 69 basis points per month for stocks that are likely influenced by good news only.

## Pitfalls in Modeling Loss Given Default of Bank Loans

Martin Hibbeln, University of Braunschweig - Institute of Technology,  
Department of Finance

Marc Gürtler, University of Braunschweig - Institute of Technology,  
Department of Finance

### Abstract

The parameter loss given default (LGD) of loans plays a crucial role for risk-based decision making of banks including risk-adjusted pricing. Depending on the quality of the estimation of LGDs, banks can gain significant competitive advantage. For bank loans, the estimation is usually based on discounted recovery cash flows, leading to workout LGDs. In this paper, we reveal several problems that may occur when modeling workout LGDs, leading to LGD estimates which are biased or have low explanatory power. Based on a data set of 71,463 defaulted bank loans, we analyze these issues and derive recommendations for action in order to avoid these problems. Due to the restricted observation period of recovery cash flows the problem of length-biased sampling occurs, where long workout processes are underrepresented in the sample, leading to an underestimation of LGDs. Write-offs and recoveries are often driven by different influencing factors, which is ignored by the empirical literature on LGD modeling. We propose a two-step approach for modeling LGDs of non-defaulted loans which accounts for these differences leading to an improved explanatory power. For LGDs of defaulted loans, the type of default and the length of the default period have high explanatory power, but estimates relying on these variables can lead to a significant underestimation of LGDs. We propose a model for defaulted loans which makes use of these influence factors and leads to consistent LGD estimates.

## **A Jump Diffusion Model for Spot Electricity Prices and Market Price of Risk**

Ramaprasad Bhar, University of New South Wales (UNSW) - School of  
Banking and Finance

David Colwell, University of New South Wales (UNSW) - School of Banking  
and Finance

Yuewen Xiao, University of New South Wales (UNSW) - School of Banking  
and Finance

### **Abstract**

We propose a jump-diffusion model with seasonality, mean-reversion, time-varying jump intensity and heteroscedastic disturbance for spot price of electricity in US market. We find that the spot price of electricity shows strong seasonality. We investigate market price of risk with five different maturities. Our results show that market price of risk is negative all the time and confirm the backwardation in PJM Western Hub between 2004 and 2009.

## **The Impact of the Originate-to-Distribute Model on Banks Before and During the Financial Crisis**

Richard Rosen, Federal Reserve Bank of Chicago - Economic Research

### **Abstract**

The growth of securitization made it easier for banks to sell home mortgage loans that they originated. I explore how mortgage sales affected banks in the years leading up to the financial crisis that began in 2007 and how banks pre-crisis mortgage sales affected them during the crisis. Loan sales are important because most banks sell mortgages as part of the securitization process, but few actually do the securitization. I find that some banks scale up lending during refinancing booms, possibly explaining why stock returns increase when banks sell more mortgages used for refis. This flexibility is both a plus and a potential minus of a liquid mortgage sale market, since banks and borrowers benefited from the scaling up during refi booms but borrowers during refi booms were riskier than at other times, possibly adding risk to the financial system. I also find that losses during the financial crisis were related to pre-crisis mortgage sales, with the losses being roughly of the same magnitude as the gains due to mortgage sales from 2001-2006.

## **Closing Call Auctions at the Index Futures Market**

Björn Hagströmer, Stockholm University - School of Business

Lars Nordén, Stockholm University - School of Business

### **Abstract**

This paper investigates how the introduction of a closing call auction in the OMXS 30 index futures market influences market quality and price accuracy. Index futures markets are characterized by traders with no or little private information. Limit order book models where trader patience (rather than private information) determines trading strategies, predict that a closing call auction increases trader patience and hence improves closing price accuracy and end-of-day market liquidity. We analyze market liquidity in three dimensions: tightness, depth, and resiliency. Our empirical results show that the closing call auction indeed leads to increased trader patience and successfully improves the closing price accuracy. However, tightness and resiliency are unaffected by the regulatory change, and depth is decreasing. We hypothesize that the depth effect is due to an order fishing phenomenon, which is not considered in current theoretical models. When the potential of large market orders is high, opportunistic patient traders post limit orders in the depth of the order book to profit from impatient traders. In line with our hypothesis, order fishing activity increases sharply in the last minute of the trading day. When the closing call auction is introduced, and trader patience increases, the order fishing behavior vanishes.

## **Capital Regulation and Tail Risk**

Enrico Perotti, University of Amsterdam - Finance Group

Lev Ratnovski, International Monetary Fund

Razvan Vlahu, De Nederlandsche Bank

### **Abstract**

The paper studies risk mitigation associated with capital regulation, in a context where banks may choose tail risk assets. We show that this undermines the traditional result that higher capital reduces excess risk-taking driven by limited liability. Moreover, higher capital may have an unintended effect of enabling banks to take more tail risk without the fear of breaching the minimal capital ratio in non-tail risky project realizations. The results are consistent with stylized facts about pre-crisis bank behavior, and suggest implications for the optimal design of capital regulation.



### **Forced Board Changes: Evidence from Norway**

Knut Nygaard, Norwegian School of Economics and Business Administration  
(NHH)

#### **Abstract**

The recently introduced gender quota on Norwegian corporate boards dramatically increased the share of female directors. This reform offers a natural experiment to investigate changes in corporate governance from forced increases in gender diversity, and whether these changes in turn impact firm performance. I find that investors anticipate the new directors to be more effective in firms with less information asymmetry between insiders of the firm and outsiders. Firms with low information asymmetry experience positive and significant cumulative abnormal returns (CAR) at the introduction of the quota, whereas firms with high information asymmetry show negative but insignificant CAR.

### **Against the Tide: The Commencement of Short Selling and Margin Trading in Mainland China**

Saqib Sharif, Massey University - School of Economics and Finance

Hamish Anderson, Massey University - School of Economics and Finance

Ben Marshall, Massey University - Department of Economics and Finance

#### **Abstract**

China's recent removal of short selling and margin trading bans on selected stocks enables testing of the relative effect of margin trading and short selling. We find the prices of the shortable stocks decrease, on average, relative to peer A-shares and cross-listed H-shares, suggesting that short selling dominates margin trading effects. However, there is negligible short sales activity and contrary to the regulators' intention, and recent empirical evidence, liquidity declines and bid-ask spreads increase in these shortable stocks. Consistent with Ausubel (1990), together these results imply uninformed-investors avoid these stocks to reduce the risk of trading with informed-investors.

## Liquidity Considerations in Estimating Implied Volatility

Rohini Grover, Indira Gandhi Institute of Development Research (IGIDR)

Susan Thomas, Indira Gandhi Institute of Development Research (IGIDR)

### Abstract

Option markets have significant variation in liquidity across different option series. Illiquidity reduces the informativeness of the price. Price information for illiquid options is more noisy, and thus the implied volatilities based on these prices are more noisy. In this paper, we propose a scheme to estimate implied volatility which reduces the importance attached to illiquid options. We find that this liquidity weighted scheme outperforms conventional schemes such as the traditional vxo, or vega weights, and volatility elasticity weights.

## Asset Pricing Implications of Demographic Change

Thomas Maurer, London School of Economics & Political Science (LSE)

### Abstract

An overlapping generations (OLG) model featuring demographic uncertainty (stochastic changes in birth and death rates) is solved in general equilibrium. Given a moderate level of relative risk aversion (RRA) and a low enough elasticity of intertemporal substitution (EIS), the interest rate is decreasing in the birth rate and increasing in the death rate. If agents have recursive preferences, demographic uncertainty is priced in financial markets. The market price of risk and the equity premium are time varying and under certain conditions they are higher during periods characterised by a high birth rate (baby boom) and low mortality than in times of a low birth rate and a high death rate. Demographic changes appear to explain substantial parts of the time variation in the real interest rate, the market price of risk and the equity premium. Due to demographic uncertainty the conditional volatility of stock returns is stochastically changing over time and the unconditional volatility of asset returns is substantially larger than the unconditional variation in aggregate consumption growth.

## **The Impact of Residual Government Ownership in Privatized Firms: New Evidence from China**

Jing Liao, Massey University

Martin Young, School of Economics and Finance, Massey University

### **Abstract**

This study investigates the determinants of residual government ownership and the impact of such ownership on post-privatization performance in China. Using panel data on 514 firms for the period from 1999 to 2004, the similar sample period with previous studies, we find that government shareholders are more likely to be present in small firms, while large firms are more likely to have politically connected CEOs on their boards. Contrary to the "political interference" hypothesis, our results show that residual government ownership has a positive impact on Tobin's Q. This study indicates that when the risk of expropriation by parent companies is high, government shareholders can add value to firms by signaling their commitment to privatization.

## **The Behavior and Determinants of Stock Market Index in Indonesia**

Gantiah Wuryandani, Bank Indonesia

### **Abstract**

This research proves that the movement of Stock Market Index (JSX) in Indonesia does not follow random walk. Therefore, certain variables in financial market influence the movement of JSX. VECM and ECM testings show that regional index in ASEAN countries and Hongkong as well as exchange rate significantly affect JSX movement. This indicates a strong contagious effect of the stock market in Asia on the Indonesian stock market, which joined the exchange rate effects concurrently. On the other hand, monetary policy through Bank Indonesia rate (BI rate) less strongly affects the movement of JSX, albeit significant. Implicitly, this indicates that monetary policy transmission path through the stock market is still weak. Given the limited authority to intervene other country's stock market, the policy implication of this study suggests the authorities to maintain exchange rate stability. This especially relates to policies for speculative capital flows. It is the time for the authorities to establish policies to improve the effectiveness and efficiency of financial markets as financial intermediation.

## **Where do Hedge Fund Managers Come from? Past Employment Experience and Managerial Performance**

Nicolas A. Papageorgiou, HEC Montreal - Department of Finance

Jerry Parwada, University of New South Wales (UNSW) - School of Banking and Finance

Kian Tan, Australian School of Business at UNSW

### **Abstract**

Hedge funds are secretive products whose quality is difficult to ascertain in advance of investment. We examine two views of past work experience as predictors of hedge fund manager pedigree. In one, sector specific (hedge fund) work experience is positively related to performance. In the other, related industry (mutual funds, prime brokerages, custodian firms and securities brokerages) experience correlates with superior performance. Overall, aspects of specific and generally related industry experience appear important in signaling hedge fund quality. Funds whose management team possesses past hedge fund experience report superior performance. However, diversifying across experience types in a fund has no impact on returns. Hedge fund manager teams with prime brokerage and custodian experience along both proportional and diversity dimensions experience higher survival probabilities.

## **European Financial Market Integration in the Wake of the Sovereign Debt Crisis: An Industry Analysis**

Söhnke Bartram, Warwick Business School - Department of Finance

Yaw-Huei Wang, National Taiwan University

### **Abstract**

This paper investigates the degree and determinants of European market integration across 10 industries in 12 Euro-zone stock markets during the period 1992-2010, comprising the introduction of the common European currency, the collapse of Lehman Brothers, and the European sovereign debt crisis. While most of the industries of countries with larger market capitalization show a dependence increase with their corresponding Euro-area markets after the introduction of the Euro, industries in Greece have particularly benefited, although it joined the Euro later than other countries. In most countries, the Financials, Consumer Goods, Oil & Gas, Technology, and Telecommunications industries show increased dependence around the Euro's introduction. Overall, the export intensity and interest rate sensitivity of an industry and the financial development of a country are the most important determinants of changes in equity market integration. The period around the Lehman collapse also shows higher equity market dependence between European countries, while the period of the recent European sovereign debt crisis reveals some doubts by market participants about the future of high-risk countries such as Greece in the monetary union.

## **Linkages between the Foreign Exchange Markets of BRIC Countries Brazil, Russia, India and China and the US**

Ramya Rajajagadeesan Aroul, University of Texas at Arlington

Peggy Swanson, University of Texas, Arlington

### **Abstract**

The aim of this paper is to examine long-run relationships and short-run causal linkages among the foreign exchange markets of BRIC countries (Brazil, Russia, India and China) and the US over a period beginning January 2000 and ending December 2010. Cointegration tests show that long run linkages exist between US, China and India. We conduct structural break test and find that there exists a structural break during the 2007 financial crisis. We also find that India is cointegrated with US and China only after the 2007 financial crisis. From the perspective of the US investor, Brazil and Russia provide better diversification benefits in the long run. Brazil and India provide greater diversification benefits in the short run. Also there is a wide array of possible short run diversification opportunities for investors from the BRIC countries.

## **Asymmetric Effects of the Financial Crisis: Collateral-Based Investment-Cash Flow Sensitivity Analysis**

Vadim Khramov, International Monetary Fund (IMF)

Megan Clifford, RAND Corporation - Santa Monica CA Offices

### **Abstract**

This paper argues that the investment-cash flow sensitivity must be measured taking into account the value of a firm's assets that can be used as collateral. To empirically test this hypothesis, data on U.S. firms from 1990 to 2011 is examined, using the financial crisis of 2008 as a natural experiment that changed the collateral value of firms' assets. First, it was found that the share of physical capital in assets has a strong influence on investment and investment-cash flow sensitivity. Investment is negatively dependent on the share of capital in assets. Firms with higher levels of capital had higher investment-cash flow sensitivity during the pre-crisis period, while after the crisis, these firms became less sensitive to cash flow when investing. We explain this observation by the fact that during the financial crisis, banks changed their expectations about the value of firms' assets that were on firms' balance sheets. Second, it was found that the effects of the crisis are not uniform across firms' sizes, and industry-specific effects are significant. The distribution of elasticity of investment to cash flow is bell-shaped across firms' sizes and firms with higher level of assets experienced lower increase in investment-cash flow sensitivity in most industries.

## **Who Issues Debt Securities in Emerging Countries?**

Mamoru Nagano, Nagoya City University

### **Abstract**

This paper focuses on the differences of capital market accessibility and investigates the determinants of firm debt securities issuance in emerging countries. The following results are derived from the empirical analysis. First, country panel analyses showed that the debt securities market development and domestic equity market development were positively related. Second, firm panel data analyses of ASEAN countries suggest that debt securities issuers and frequent equity issuers overlap. Third, analyses of daily stock price data of ASEAN firms reveal that debt securities are not issued for infrequent equity issuers, regardless of the stock price, whereas frequent equity issuers choose debt securities issuance as a funding tool when the stock price is low. Fourth, as compared to accessible frequent equity issuers, market-inaccessible firms are less sensitive to the financial cost of debt securities issuance.

## **The Effect of the Reduction in Price Discreteness on Ex-Day Stock Returns in a Unique Environment**

Khamis Al-Yahyaee, Sultan Qaboos University

### **Abstract**

This paper examines the effect of the reduction in tick size on ex-dividend day stock price behavior taking advantage of a unique data where there are no taxes on dividends and capital gains and the tick size is fixed for all traded securities. These data allow us to differentiate among competing ex-dividend day hypothesis in the absence of confounding tax effects present in other markets. We find that ex-day premiums increase and abnormal returns decrease as the tick size become smaller, which is in line with the market microstructure hypothesis. On the other hand, we do not find any significant increase in abnormal volume with the reduction in tick size. This finding is inconsistent with the pattern that should occur if transaction cost is the dominant factor causing the ex-day phenomenon.

## **Why Do Firms Issue Convertible Bonds? Evidence from the Field**

Ming Dong, York University - Schulich School of Business

Marie Dutordoir, University of Manchester - Manchester Business School

Chris Veld, University of Glasgow

### **Abstract**

We conduct in-depth interviews with top executives from corporations in Australia, Canada, the U.K., and the U.S. to examine why companies issue convertible bonds. We find that convertible debt issuers forgo straight debt because it is too costly and/or covenant-heavy, and rule out equity because of undervaluation and dilution concerns. Managers time their offering based on investor appetite and the valuation of their firms' straight debt and equity. The evidence provides considerable support for the theory of management-investor differences in opinion about firm risk, while risk shifting, sequential financing, and backdoor equity motivations seem to play only a minor role. A question-conditional analysis of the Graham and Harvey (2001) survey data set corroborates our findings.

## **Institutional Ownership, Retail Trading and Stock Return Comovement**

Si Cheng, National University of Singapore (NUS) - Department of Finance

### **Abstract**

Using mutual fund fire sales to proxy for an exogenous demand shock on institutional ownership, I show that fire sale stocks start to comove more with low institutional ownership stocks and comove less with high institutional ownership stocks. Moreover, the cumulative change in return comovement is driven by retail trading, especially for stocks favored by or familiar to retail investors, such as small stocks with low price, high turnover, more analyst coverage, and held by domestic mutual funds. In addition, the short-term price impact of institutional selling is absorbed by retail buying when investor sentiment is high, and in the long run retail investors provide liquidity to institutional trading when market liquidity is low. Across time, the institutional ownership-based return comovement is amplified during periods of high market sentiment, market declines and high market volatility. The overall results suggest that the institutional ownership-based excess return comovement is explained by category investment or clientele effect.

## **The Impact of Product Warranties on the Capital Structure of Australian Firms**

Bayan Arqawi, Bond University

William Bertin, Bond University - Faculty of Business, Technology and Sustainable Development

Laurie Prather, Bond University - Faculty of Business, Technology and Sustainable Development

### **Abstract**

This paper examines the impact of Australian firms' warranty policies on their capital structures. The sample consists of 261 firms and 937 firm-years for Australian public firms for the period 2007-2010. The results suggest that warranty policies impact on Australian firms' capital structures. Consistent with earlier Australian studies, size and asset tangibility are positively related to leverage; growth and profitability are negatively related to leverage; and earnings volatility and industry concentration are unrelated to leverage. In addition to these previously identified relationships, the firms' warranty policies have a negative impact on leverage.

## **Procyclical Bank Risk-Taking and the Lender of Last Resort**

Mark Mink, The Netherlands Bank

### **Abstract**

We show that through facilitating maturity transformation, the lender of last resort gives banks an incentive to lever, diversify, and lower their lending standards. Bank leverage increases shareholder value because maturity transformation effectively allows banks to borrow against lower interest rates than their shareholders. Bank diversification increases shareholder value by enabling banks to lever more. When the gains from maturity transformation are passed on to bank customers, lending standards deteriorate. This risk-taking intensifies when the term spread is steeper, and is thus procyclically related to the stance of the macro-economy. Regulatory liquidity requirements can reduce all forms of risk-taking examined.



## **Seasonality and Momentum -- Evidence from a Natural Experiment**

Thanh Huynh, Queensland University of Technology - School of Economics  
and Finance

Daniel Smith, Queensland University of Technology - School of Economics  
and Finance

### **Abstract**

This study employs the Australian market that has a different fiscal year end (i.e. June) from most countries and shows that the majority of momentum returns is due to the calendar seasonality effect. This seasonality is however weak in the top 300 stocks (by market capitalization). Our results particularly support the tax-loss selling hypothesis. We also show that the intermediate momentum effect of Novy-Marx (2010) is due to the July-June seasonality and hence not robust in different size sub-samples. Similar findings are also found in the annual seasonality of Heston and Sadka (2008). We document that the annual seasonal effect is weaker in the top 300 stocks and a large proportion of the annual seasonal profits comes from the seasonality in small stocks.

## **Asset Pricing Anomalies and Macroeconomic Risk**

Paul Docherty, University of Newcastle (Australia)

Howard Chan, University of Melbourne - Department of Finance

Steve Easton, University of Newcastle (Australia) - Newcastle Business  
School

### **Abstract**

This paper provides a comprehensive examination of whether portfolios formed on capital asset pricing model anomalies capture information related to changes in the investment opportunity set and therefore may appropriate candidates as state variables within Merton's (1973) ICAPM framework. Consistent with prior literature that relates them to macroeconomic risk, the size and momentum factors are shown to lose their explanatory power after controlling for innovations in state variables. In contrast, returns on portfolios formed using the book-to-market factor persist after controlling for state variables shown in previous literature to predict future market returns. This result suggests that this factor is not a risk factor within the ICAPM. The value premium varies counter-cyclically, suggesting the contrarian investment strategy is riskier. Two other anomalies, asset growth and tangibility, are also examined, with evidence suggesting that they are explained by mispricing rather than risk.

**Investor Sentiment and Momentum and Contrarian Trading Strategies:  
Mutual Fund Evidence**

Grant Cullen, affiliation not provided to SSRN

Dominic Gasbarro, Murdoch University

Gary Monroe, University of New South Wales (UNSW) - Australian School of  
Business

**Abstract**

Stocks with high sentiment betas are more sensitive to investor sentiment, with more subjective valuations. We contend that sentiment beta also captures the duration of mispricing. Accordingly, stocks with high (low) sentiment betas provide opportunities for momentum (contrarian) traders. We form hypothetical zero investment portfolios of high (low) sentiment betas stocks, and show that momentum profits decompose to reveal positive (negative) serial correlation of idiosyncratic returns, that contribute to momentum (contrarian) profits. Furthermore, actual mutual funds identified as momentum (contrarian) traders hold stocks with higher (lower) sentiment betas. Additionally, funds adjust sentiment betas to enhance performance as sentiment changes.

**Central Bank Communication and the Perception of Monetary Policy by  
Financial Market Experts**

Sandra Schmidt, Centre for European Economic Research (ZEW)

Dieter Nautz,

**Abstract**

This paper investigates how financial market experts perceive the interest rate policy of the European Central Bank (ECB). Assuming a Taylor-rule-type reaction function of the ECB, we use qualitative survey data on expectations about the future interest rate, inflation, and output to discover the sources of individual interest rate forecast errors. Based on a panel random coefficient model, we show that financial experts have systematically misperceived the ECB's interest rate rule. While the perception of monetary policy regarding inflation has become more accurate since the clarification of the ECB's monetary policy strategy in May 2003, the experts' misperception regarding the ECB's reaction to output has increased in the financial crisis.

## **Asset Securitizations and Audit Effort**

Yuyu Zhang, University of New South Wales (UNSW)

Gary Monroe, University of New South Wales (UNSW) - Australian School of Business

Dominic Gasbarro, Murdoch University

### **Abstract**

Asset securitizations increase audit complexity and audit risks, which are expected to increase audit effort. We predict auditors became more sensitive to banks' asset securitization risks in light of their role in bank failures and the financial downturn that commenced in 2007. Using bank holding company data from 2003 to 2009, we find that asset securitization risks (retained interests) are associated with bank audit fees during, but not before, the global financial crisis. This suggests auditors were previously less attentive to securitization risks before the GFC. The results are consistent with auditors previously treating securitizations as asset sales rather than recourse debt.

## **Estimation of Operational Risks Using Non-Parametric Approaches with an Application to US Business Losses**

Param Silvapulle, Monash University - Department of Econometrics & Business Statistics

Ainura Tursunaliyeva, Monash University - Department of Econometrics & Business Statistics

### **Abstract**

Following the recent global financial crisis, many banks and other businesses in the industrialized countries incurred notably heavy losses. As a consequence, reliable estimation of operational risk (OR) is becoming increasingly important to all internationally active banks and other financial institutions. The OR is the unexpected loss, which is the difference between the 99:9 per cent quantile and the mean of the loss distribution. This paper adapts non-parametric methods based on heavy-tailed distributions and constructs point and 95 per cent confidence interval (CI) estimates for ORs. The main advantage of these nonparametric methods is that there are no assumptions made about the shape of loss distributions and that data determines their shapes, providing robust estimates for ORs. Employing these methods, we construct point as well as interval estimates for ORs for US businesses. The noteworthy observation is that the CIs are asymmetric with huge upper bounds, highlighting the extent of uncertainties associated with the point estimates of ORs. The estimates of expected shortfalls lie within these intervals. The nonparametric methods introduced in this paper will have much wider applications, for example, in estimating another popular measure of risk, credit risk.

## **Market Uncertainty and Sentiment, and the Post-Earnings Announcement Drift**

Ronald Geoffrey Bird, University of Technology, Sydney (UTS) - School of Finance and Economics

Daniel Choi, The University of Waikato

Danny Yeung, University of Technology, Sydney (UTS)

### **Abstract**

The post-earnings announcement drift (PEAD) first identified over 40 years ago seems to be as much alive today as it ever was. Numerous attempts have been made to explain its continued existence. In this paper we provide evidence to support a new explanation: that the PEAD is a reflection of the level of market uncertainty and sentiment that prevails during the post-announcement period. The finding that uncertainty plays a role in explaining how investors respond to information suggests that it should be included as a factor in pricing models while the fact that market sentiment also has a role is another instance of the importance of human behaviour in establishing prices.

## **Benchmark Replication Portfolio Strategies**

Paskalis Glabadanidis, University of Adelaide Business School

Leon Zolotoy, Melbourne Business School

### **Abstract**

We propose a novel approach to the benchmark replication problem which uses a minimum tracking error variance as an objective subject to a target expected outperformance. When no budget constraint is imposed on the replicating portfolio, the solution involves that standard hedge portfolio and the tangent portfolio constructed from the replicating securities. In the presence of a budget constraint as well, the solution also includes the minimum variance portfolio constructed from the replicating securities. We implement our theoretical results using recent data for three widely followed US stock indices with very good out-of-sample performance.

## **Stock Market Fragility and the Quality of Governance of the Country**

Chunmei Lin, National University of Singapore (NUS) - Department of Finance

Massimo Massa, INSEAD - Finance

Hong Zhang, INSEAD - Finance

### **Abstract**

We study the relationship between the quality of governance of a country and its degree of financial fragility. We argue that bad governance affects the market by amplifying the reaction of fund manager to public information. This induces funds' rebalancing swings that create price fragility and excess market volatility for the assets hold by the funds. We test this hypothesis using data on international mutual funds and on stocks over the period 2000-2009. We show that the reaction of the fund managers to public information increases the worse the governance of the country of the stock they hold. We exploit this information by defining a variable (RPIW) that represent the incremental mutual fund reaction to public information in the presence of bad country governance and we use it to study the relation between stock value and the quality of governance of the country. We show that bad governance is related to a more positive stock reaction to good news and a more negative stock reaction to bad news. Also, stocks of countries with bad governance display a higher total volatility, idiosyncratic volatility, skewness and lower liquidity. This effect is stronger during crises. During the 2008-2009 period, stocks of bad governance countries over-react to public information, displaying higher volatility, skewness and illiquidity and overall stock price reaction to information.

## **The Role of Covenants in Mitigating Conflicts of Interest Within Lending Syndicates**

Nishant Dass, Georgia Institute of Technology

Vikram Nanda, Georgia Institute of Technology - College of Management

Qinghai Wang, Georgia Institute of Technology

### **Abstract**

We study the role of covenants in syndicated bank loans. We argue that, in addition to being a device for monitoring the borrower, covenants can help mitigate conflicts of interest between the lead arranger and participating banks in the syndicate. Such disagreements can arise when, for instance, a lead arranger has the incentive to support a poorly performing borrower and/or offer loan modifications while other syndicate lenders may prefer to discipline the borrower by accelerating the loan or enforcing default. We develop a simple model reflecting such conflicts and find empirical support for its predictions that covenants are less likely to be present: (i) in non-syndicated versus syndicated loans; (ii) when the lead's loan allocation is greater; and (iii) when participating bank affiliates hold substantial equity in the borrower. Consistent with this evidence, we find that lead arrangers are more likely to syndicate with banks that hold borrower's equity through affiliated entities.

## **How Smooth Is Price Discovery? Evidence from Cross-Listed Stock Trading**

Haiqiang Chen, Xiamen University - Wang Yanan Institute for studies in  
Economics

Moon Sub Choi,

Yongmiao Hong, Cornell University - Department of Economics

### **Abstract**

The adjustment to parity can be nonlinear for a cross-listed pair: Convergence may be quicker when the price deviation is sufficiently profitable. We propose a threshold error correction model (ECM) to gauge the market-respective information shares of Canadian listings traded on the Toronto Stock Exchange (TSX) and the New York Stock Exchange (NYSE). Since dynamics may alternatively be gradual, we further generalize the threshold framework to a smooth transition ECM. The empirical implications are as follows: First, the TSX and the NYSE have integrated over time. Second, parity-convergence accelerates upon discounts on the cross-listings on the NYSE. Third, we find a larger feedback from the NYSE if the price gap exceeds the threshold (required arbitrage return). Fourth, informed traders tend to cluster on the NYSE upon discounts on the cross-listings. Fifth, the information share and threshold are affected by the relative degree of private information, market friction and liquidity measures, and firm-level characteristics.

## **Prior Relationship, Industry Expertise, Information Leakage, and the Choice of M&A Advisor**

Xin Chang, Nanyang Technological University (NTU) - Nanyang Business  
School

Chander Shekhar, University of Melbourne

Lewis Tam, University of Macau - Faculty of Business Administration

### **Abstract**

This paper examines the impact of prior bank-firm relationships, bank's industry expertise and information leakage concerns on acquirers and targets' choice of financial advisors in mergers and acquisitions. We show that prior bank-firm merger advisory relationship and bank's industry expertise increase the likelihood of a bank being chosen as an advisor. In addition, banks with prior relationship with acquirers (targets) are more likely to be chosen by targets (acquirers), suggesting that information leakage through advisors is at work between acquirers and targets. Due to concerns of information leakage to product-market rivals, experienced acquirers are found to be reluctant to share advisors with rival firms in the same industry. We also document that advisors charge higher fees if they have prior relationship with merging firms' product-market rivals. Unlike acquirers, targets pay a fee premium to retain ongoing advisors.

## **Information Asymmetry and the Timing of Capital Issuance: An International Examination**

April Knill, Florida State University

Bong-Soo Lee, Florida State University

### **Abstract**

Using issuance data across 50 countries from 1996 through 2009, we examine the role of information asymmetry in market timing globally. We utilize a model that takes into account the possible feedback of security issues to past market returns allowing us to ascertain whether timing of capital issuance around the world is based on information asymmetry. We find evidence of both market timing and pseudo market timing. The evidence for (pseudo) market timing is (not) significantly stronger in international sub-samples with greater levels of information asymmetry when capital issuance is measured by (changes in equity) equity share. These results suggest that information asymmetry plays an important role in the ability of managers to time capital issuance and that counter to the implications of extant literature, market timing and pseudo market timing are not mutually exclusive, i.e., existence of one does not nullify the other.

## **Characteristic Liquidity, Systematic Liquidity and Expected Returns**

M. Reza Baradarannia, University of Sydney

Maurice Peat, University of Sydney

### **Abstract**

This paper investigates whether the effect of liquidity on equity returns can be attributed to the liquidity level, as a stock characteristic, or a market wide systematic liquidity risk. We employ a new low frequency liquidity measure, develop a CAPM liquidity-augmented risk model and test the characteristic hypothesis against the systematic risk hypothesis for the liquidity effect. We find that the two-factor systematic risk model explains the liquidity premium. The hypothesis that the liquidity characteristic is compensated irrespective of liquidity risk loadings is not supported in the data. This result is robust over 1930-2008 data and sub-samples of pre-1963 and post-1963 data. The results demonstrate that the liquidity augmented CAPM approach is the correct way to incorporate the liquidity risk.

## **The Impact of Derivatives Hedging on Stock Market: Evidence from Taiwan Covered Warrants Market**

San-Lin Chung, National Taiwan University - Department of Finance

Wen-Ranq Liu, National Taiwan University

Wei-Che Tsai, National Taiwan University - Department of Finance

### **Abstract**

This paper examines the hedging impact on the underlying stock market using a comprehensive dataset of covered warrants traded in the Taiwan Stock Exchange (TWSE). Since TWSE requires the warrant issuers to conduct dynamic hedging over the life of warrants, we can estimate the number of shares bought or sold for rebalancing the hedging portfolio and measure its impact. We find significant positive abnormal returns and trading volumes before the announcement day of warrants issuance, suggesting that issuers establish their hedging portfolios before the announcement day. The magnitude of the price effect is positively related to the size of the hedging portfolio. Moreover, there is a significantly positive relationship between stock return volatility and the price elasticity of hedging demand (defined as the percentage of shares needed for rebalancing hedge portfolio when the underlying stock price changes 1%). Finally, we also observe significantly negative price effect to the underlying stock before (after) the expiration date for call warrants that are expired out-of-the-money (in-the-money). For call warrants expired in-the-money, the negative price impact is due to the fact that warrants traded in TWSE are cash settlement when exercised, and thus the issuers have to liquidate the hedging portfolio after expiration, which results in selling pressure on the underlying stock.

## **Corporate Governance, Diversification, and Firm Value: Evidence from 'Spin-Ins'**

Yoon Choi, University of Central Florida - College of Business Administration  
- Department of Finance

Seung Han, Korea Advanced Institute of Science and Technology (KAIST)

### **Abstract**

We analyze the impact of corporate restructuring on firm value using a unique internal corporate restructuring created between the years of 2001 and 2003 in Japan. We show that excess value significantly increases after the internal restructuring even when the degree of diversification has not changed. This result supports the argument that diversification itself may not drive discounts or premiums.

We also explore these events to examine the effect of bank governance and keiretsu affiliation. Our results are consistent with the argument that recent Japanese restructuring reduces information asymmetries and agency problems, thus improving the efficiency of internal capital markets and firm value.



## Information Asymmetry and Momentum Anomalies

Xiaolin Qian, Univeristy of Macau

Chuan-Yang Hwang, Nanyang Technological University (NTU)

### Abstract

In this paper, we construct an information asymmetry factor (VECINF) based on the price discovery of large trades. VECINF is significantly negatively correlated with market excess return, indicating that market-wide information asymmetry is lower in bull markets, which is consistent with the view that more uninformed investors are attracted into stock markets when the markets offer high returns. In addition, VECINF has the most significant pricing effect among the considered risk factors (MKT, SMB, HML, and UMD), which suggests that ignoring the risk of information asymmetry may give rise to false discoveries of anomalies. As a case in point, we show that momentum anomalies disappear once we control for the risk of information asymmetry. This is because there are fewer informed traders, and hence lower risk of information asymmetry, in bad news firms (past losers or low earning surprise firms) than in good news firms (past winners or high earning surprise firms). The larger cost and risk of arbitrage in taking short positions makes bad news firms less attractive to informed traders. Consistent with this explanation, we find that the loading on VECINF is lower in bad news firms than in good news firms; and is lower only in the holding periods when momentum exists. This difference in loadings increases significantly with idiosyncratic volatility, and this explains why momentum is stronger in firms with large idiosyncratic volatility. Regardless of the level of idiosyncratic volatility, the significantly positive Fama-French factors risk-adjusted returns of zero investment momentum portfolios are no longer significant once we include VECINF as an additional factor for risk adjustment.

## Managerial Attitudes Toward to Market Valuations

Toshio Serita, Aoyama Gakuin University - Department of Economics

Peng Xu, Hosei University - Department of Economics

### Abstract

We use a survey-based approach to provide new insight on managerial attitudes toward to market valuations whether a corporate officer perceives her/his firm's stock price is undervalued or overvalued by the market. Our findings suggest that corporate officers are prone to attribute poor equity returns and poor industry adjusted market valuation to being undervalued by the market. Also managerial perceptions persist over time. Finally, we link managerial attitudes to payout policies.

## **Natural Disasters - Blessings in Disguise?**

Hardjo Koerniadi, Auckland University of Technology

Chandrasekhar Krishnamurti, University of Southern Queensland

Alireza Tourani-Rad, Auckland University of Technology - Faculty of Business

### **Abstract**

This study examines the impact of natural disasters on market returns and on several industries that are likely to be affected by the disasters. We find that different natural disasters have different impacts on the returns of the market and on those of industries. Our evidence suggests that while earthquake, hurricane and tornado could negatively affect market returns several weeks after the events, other disasters such as flood, tsunami and volcanic eruption may have limited impact on market returns. We also find that construction and materials industry is positively affected by natural disasters but nonlife and travel industries are likely to suffer when a natural disaster strikes.

## **Liquidity and Price Discovery of Algorithmic Trading: An Intraday Analysis on the SPI Futures Contract**

Tina Viljoen, The University of Sydney Business School

Hui Zheng, Discipline of Finance, The University of Sydney

P. Joakim Westerholm, The University of Sydney Business School

### **Abstract**

We study the intra-day impact of algorithmic trading on the futures market to increase our understanding of algorithmic trading and its role in the price formation process. First, we find that algorithmic trading provides liquidity when the spread is wide and that algorithms enter the market at a series of intervals that decrease the spread. Second, we show that algorithmic trading is related to lower adverse selection and is unrelated to realised spreads. Third, we confirm that information asymmetry is highest at the beginning of the trading day, and as the price stabilises during the trading day, we find that the trade becomes the information carrier and algorithmic trading increases. Fourth, we find that algorithmic trades strategically enter the market during periods with less informed trading, while the period following exhibits higher public and private information. Our results suggest that algorithmic traders contribute to the price discovery process of financial markets.

## **Real Estate Market Risk in Bank Stock Returns: Evidence for the EU-15 Countries**

António Martins,

F. Martins, affiliation not provided to SSRN

Ana Paula Serra, Universidade do Porto - Faculdade de Economia (FEP)

### **Abstract**

In countries with highly-developed financial systems bank portfolios have high exposure, directly or indirectly, to the real estate sector. Changes in the value of real estate can have a potentially significant impact on the default risk of banks and on their profitability as a result of this high exposure to the real estate sector. This scenario is especially critical during real estate crises, when bank losses tend to increase dramatically, placing the entire financial system at risk of collapse, as it was the case in the recent international subprime crisis. This article studies the sensitivity of bank stock returns to real estate returns. The results indicate that EU-15 bank stocks are sensitive to real estate returns; there is a positive relation between bank stock returns and real estate returns after controlling for general market conditions and interest rates. In particular, small banks with greater asset exposure to the real estate sector showed to be more sensitive to changes in the real estate returns.

## **Do Return Prediction Models Add Economic Value?**

Tolga Cenesizoglu, HEC Montreal - Department of Finance

Allan Timmermann, University of California, San Diego (UCSD) - Department of Economics

### **Abstract**

Return prediction models with a time-varying mean often fail to improve on the out-of-sample mean squared error of a constant equity premium model. However, this does not rule out that return prediction models that allow for a time-varying probability distribution can add economic value by helping improve investors' portfolio choice. This paper shows that statistical and economic measures of forecasting performance weight forecast errors very differently and that return forecasts from models with time-varying mean and variance, when used to guide the portfolio choice of an investor with power utility, can lead to significant improvements over the forecasts from a model that assumes a constant return distribution. Specifically, models with constant mean and volatility tend to overestimate the right tail of the return distribution and so lead to stock allocations that are on average too large with resulting lower average utility for risk averse investors. Our results demonstrate that return prediction models can add economic value even when they fail to produce accurate forecasts of mean returns and suggest the need for focusing on broader measures of distributional accuracy when evaluating the economic value of return prediction models.

## **The Components of the Illiquidity Premium: An Empirical Analysis of U.S. Stocks 1927-2010**

Björn Hagströmer, Stockholm University - School of Business

Bjorn Hansson, Lund University - Department of Economics

Birger Nilsson, Lund University

### **Abstract**

This paper estimates a conditional version of the liquidity adjusted CAPM by Acharya and Pedersen (2005) using NYSE and AMEX data from 1927 to 2010 to study the illiquidity premium and its variation over time. The components of the illiquidity premium in this model derived as the level of expected illiquidity together with three types of illiquidity risks. We measure illiquidity of individual stocks by the efficient spread proxy developed in Holden (2009) and employ illiquidity sorted portfolios as test assets. The average annual illiquidity premium is estimated to 1.55%, the respective contributions from illiquidity level being 1.15% and from the three different illiquidity risks 0.40%. Results also indicate that commonality risk is the least important component in the illiquidity risk premium, while a component related to the hedging of wealth shocks is the most important. The illiquidity premium varies substantially over time, with peaks in downturns and crises, but with no general tendency to decrease over time.

## **Systematic Liquidity Risk in the Australian Bond Market**

Timothy Whittaker, Griffith University - Department of Accounting, Finance and Economics

### **Abstract**

This research examines recent developments in asset pricing theories and their ability to explain Australian bond market returns. This study develops a multifactor bond pricing model in an Australian setting. We examine the Lin et al. (2011) systematic liquidity factor to evaluate its power in explaining Australian bond returns. This study shows that the term, default and liquidity factors are important systematic risk factors in explaining the variation of returns of individual bonds and bond portfolios in Australia. The Australian bond pricing model developed in this study allows market participants to evaluate the risk factors that drive Australian bond portfolio returns regardless of their credit rating, liquidity, duration or industry sector concentration. In a simple case study, the Australian bond pricing model explains more than 82 percent of the variation of returns of Public Private Partnership (PPP) bond portfolios comprising of firms that are financially solvent.

## **Earnings Growth Volatility and the Value Premium**

Jamie Alcock, University of Cambridge - Department of Land Economy

Eva Steiner, Department of Land Economy, The University of Cambridge

Kelvin Jui Keng Tan, University of Queensland - Business School

### **Abstract**

The volatility of future earnings growth is a significant determinant of Fama and French's Value premium. We use a stochastic earnings model of firm valuation to establish a formal link between the volatility of future earnings growth and the value premium. Furthermore we empirically confirm this relationship on the firm level and the portfolio level.

## **The 2001 Debt and Equity Tax Rules: Evidence of Non-Tax Neutrality in Australia**

Jean Fenech, Monash University

Victor Fang, Monash University - Department of Accounting and Finance

### **Abstract**

Tax arbitrage was extensive within the convertible market in Australia. The Treasury sought ways to minimize the tax misclassification issue and in 2001, the Commonwealth enacted the New Business Tax System (Debt and Equity) Bill 2001. This paper investigates whether the new tax rules classify convertibles in accordance to their economic substance rather than their legal form. The findings suggest evidence of stability and consistency within the convertible market post 2001. However, the economic substance of a security depends on the stock price at conversion/maturity. Hence, allocating a tax classification at issuance raises doubts on whether the security can be appropriately classified in accordance to its economic substance. The findings suggest that the non-financial cohort within the equity-like category are non-tax neutral. This category is highly unlikely to convert to common stock, similar to fixed-income securities.

Key words:

## Long-Term U.S. Infrastructure Returns and Portfolio Selection

Michael Howard, Griffith University

Robert Bianchi, Griffith University - Griffith Business School

Graham Bornholt, Griffith University - Department of Accounting, Finance  
and Economics

### Abstract

Industry professionals wish to understand the long-term return behaviour and portfolio characteristics of infrastructure investments, however, there is a relatively short history of empirical data. There is also a paucity of research in regards to the application of finance theory and how it relates to infrastructure investments. This research employs a procedure that constructs monthly U.S. infrastructure returns over the long-term from 1927 to 2010. We employ the Carhart (1997) framework and reveal that low market beta and the value risk premia explains U.S. infrastructure returns. The research also finds that some infrastructure indices (ie. the MSCI U.S. Infrastructure index) are undesirable in a portfolio selection framework while others (ie. the MSCI U.S. Broad and Small Utilities indices) exhibit promising return, risk and portfolio diversification benefits. The findings also reveal that U.S. infrastructure index returns suffer from larger extreme left tail-risk over the long-term in comparison to what has been experienced by investors from recent empirical returns. Overall, the findings reveal that the investment merits of U.S. infrastructure are mixed. This research provides a first glimpse of U.S. infrastructure over the long-term and lays the foundation for the assessment of infrastructure in other countries.

## An Empirical Analysis of Pricing in the Japanese Bond Markets

Toyoharu Takahashi, Faculty of Commerce, Chuo University

### Abstract

Both in the theoretical and applied literature of finance the difference in yield-to-maturity between corporate bonds and government bonds has been used as a measure of the risk of the former over the latter. While this approach has sometimes provided interesting results, the usefulness of yield spreads is lessened by ignoring the term structure of interest rate.

This paper presents an alternative measure, Asset swap spread, use asset swaps to convert fixed income cash flows to floaters which refer LIBOR plus spread as index coupon rate. This spreads show much broader characteristics as well as riskiness of each corporate and government bonds. Effectively by using the swap curve to create a set of equal and opposite fixed-rate cash flows, we create a synthetic floating rate note (FRN) with an index coupon rate. Moreover, this value is now being captured through the trading of bond asset swap packages.

Based on these ideas, we provide an introduction to government and corporate bond asset swaps, explaining their basic mechanics, the use of asset swap spreads in identifying and capturing relative value is discussed and the market drivers of asset swaps spreads are examined.

## **Looking at New Markets for International Diversification: Frontier Markets Perspective**

Rakesh Gupta, Griffith University - Griffith Business School

Thadavillil Jithendranathan, University of Saint Thomas, Saint Paul/Minneapolis, MN - Department of Financial Management

Aswini Sukumaran, Central Queensland University (CQUniversity)

### **Abstract**

The benefits of portfolio diversification have been acknowledged by researchers and investors equally. Frontier market diversification has become of greater interest in the recent years, however there are no studies on the benefits of an Australian investor from diversifying into frontier markets.

We estimate the potential gains for an Australian investor from frontier market diversification using Asymmetric Dynamic Conditional Correlation GARCH model and construction of optimal portfolios using these correlations. This study finds significant diversification benefits for an Australian investor from investing in ten frontier markets.

## **Liquidity Management Around Seasoned Equity Offerings**

David T.L. Siu, University of Queensland

Robert W. Faff, University of Queensland

### **Abstract**

This paper investigates the management of liquidity around seasoned equity offerings (SEOs) and also the relation between such liquidity management and long-run operating and market performance. We classify issuers as liquidity-rich ( liquidity-squeeze ) having net debt-to-assets lower (higher) than the median non-issuers. Liquidity-rich firms experience significant increases in cash following new equity issues, whereas for Liquidity-squeeze firms, there is a significant decline in long-term debt. We interpret these results to imply that offering proceeds are at least partly being used for liquidity motives. We also report new evidence that issuers who aggressively manage liquidity prior to the offering have lower post-issue operating profit. However, the relation does not hold for market performance because investors observing the liquidity information will immediately discount stock value at the time of the offerings. Rather, post-issue market underperformance can be attributed to investors downward revision related to the transitory nature of investment opportunities from the SEOs.

## **Entropic Least-Squares Valuation of American Options Subject to Moment Constraints**

Xisheng Yu, Southwestern University of Finance and Economics (SWUFE)

Li Yang, University of New South Wales (UNSW) - School of Banking and Finance

### **Abstract**

This paper contributes to the improvement of pricing accuracy of American options by incorporating a set of risk-neutral moment constraints into an entropic pricing framework, which is originally proposed by Stutzer (1996) for European options and extended by Alcock and Carmichael (2008) and Liu (2010) for American options. The risk-neutral moments of underlying asset return distribution are estimated using option data and therefore can capture efficient information such as volatility smile, skewness, and kurtosis for generating a better estimate of risk-neutral pricing measure. Simulation and empirical testing results demonstrate that our valuation approach outperforms the methods of both Alcock and Carmichael (2008) and Liu (2010) in terms of reducing pricing errors and capability of recovering risk-neutral moments. The results also suggest that our method is fairly accurate and completely comparable to the Black-Scholes model for American calls on non-dividend-paying stock and to the Crank-Nicolson Finite Difference method for American puts.

## **Can US Economic Variables Predict Chinese Stock Market?**

Jeremy Goh, Singapore Management University

Fuwei Jiang, Singapore Management University

Jun Tu, Singapore Management University

### **Abstract**

Given that the impact of the world economy on the China economy and its stock market may have increased substantially in the last few decades, we examine whether US economic variables can predict the Chinese stock market. We find that although before China joined the World Trade Organization (WTO) in the end of 2001, the US economic variables generally do not show significant predictive power on the Chinese stock market, they do provide significant predictive power after 2001. Moreover, we show that the US economic variables can be used in conjunction with China economic variables to achieve better return forecasts for the Chinese stock market, which turn out to be economically important from an investment perspective.



## **Systematic, Default and Systemic Risk Effects of International Bank Mergers - Empirical Evidence**

Gregor Weiß, TU Dortmund, Juniorprofessur für Finance

Sascha Neumann, University of Bochum

Denefa Bostandzic, University of Bochum

### **Abstract**

This paper proposes to measure the risk effects of bank mergers by the use of four different methodologies for both wealth (cumulative abnormal returns), idiosyncratic default (Merton's distance-to-default), systematic (beta factors) and systemic risk effects (lower tail dependence). As a unique feature of this study, we propose the use of the lower tail dependence coefficient between the bidding bank's stock return and a market index in order to capture any (positive or negative) merger-related changes in the systemic risk. In contrast to the existing studies on the lower tail dependence in financial returns, we estimate the lower tail dependence of bidding banks nonparametrically thus avoiding the otherwise necessary and error-prone choice of a parametric copula.

In order to answer the question, whether mergers generally have positive or negative effects on either idiosyncratic or systemic risk (or both), we apply the mentioned methodologies on a unique dataset of 440 domestic and cross-border mergers that took place between 1991 and 2009. In our empirical analysis we find clear empirical evidence for a significant increase in the systemic risk of acquirers following bank mergers. In addition to this and in contrast to our cross-sectional results on systematic and default risk, we can see that changes in the lower tail dependence can neither be explained by our set of idiosyncratic bank and deal characteristics nor by the acquirer's regional origin or regulatory environment.

## **How to Hedge if the Payment Date is Uncertain**

Olaf Korn, Georg-August-Universität Göttingen

Alexander Merz, Georg-August-University Göttingen

### **Abstract**

This paper studies the hedging of price risk if the payment date is uncertain, a problem that frequently occurs in practice. It derives and establishes the variance-minimizing hedging strategy, using forward contracts with different times to maturity. The resulting strategy fully hedges the expected price exposure for each possible payment date and is therefore easy to implement. An empirical study compares the performance of the variance-minimizing strategy with heuristic alternatives, using commodity prices and exchange rates. Our analysis shows that the variance-minimizing strategy clearly outperforms all the alternatives.

## Stock Market Liquidity and Short-Termism-Driven CEO Turnover

Min Jung Kang, Michigan State University

Young Han Kim, Nanyang Technological University (NTU)

### Abstract

Does an improvement in stock market liquidity make the shareholders more short-term oriented in firing the CEO? An improvement in stock market liquidity could have two opposing effects on short-termism: (1) the market could become more efficient and encourage shareholders to allow more long-term R&D investments; or (2) transient institutional investors (Bushee, 1998) could have increased flexibility to unwind their position, making the company more short-term oriented. Using data on CEO turnover of Execucomp firms from 1993 to 2009, we find that shareholders, in general, became more tolerant of long-term R&D investments in firing the CEOs after decimalization, an exogenous increase in liquidity. However, for firms with high ownership by transient institutions, the change was significantly smaller. Moreover, after decimalization, firms that dismiss their CEOs under pressure of transient institutions are more likely to reduce their R&D investments after the replacement. Our event study reveals that stock market investors see through and respond negatively to short-termism-driven CEO turnover.

## The Harsh Master: What Can We Learn from the Big Crises?

Angelo Corelli, University of Linköping

### Abstract

The paper identifies and discuss the main three issues related to the impact of financial crisis on markets. The first main concern of analyst and regulators is the Capital provision for banks, under the light of Basel II accord, and further, in the view of a better regulation. The focus is on the need for a counter-cycle regulation, allowing for more prudential behavior in better times so to build good defense against bad times. Liquidity regulation is the second issue considered in the paper, and relates to the optimal treasury management and the tips for an adequate liquidity provision to face customers needs. The final issue is the cross-border banking, condensed to the spot of the trade off between the need of interbank relations for business and trade and the risk of systemic contagion and propagation of shocks

## **SAFE: An Early Warning System for Systemic Banking Risk**

Mikhail Oet, Federal Reserve Bank of Cleveland

Ryan Eiben, Indiana University Bloomington

Timothy Bianco, Federal Reserve Banks - Federal Reserve Bank of Cleveland

### **Abstract**

From the financial supervisor's point of view, an early warning system involves an ex-ante approach to regulation, targeting to predict and prevent crises. An efficient EWS allows timely ex-ante policy action and can reduce the need for ex-post regulation. This paper builds on existing microprudential and macroprudential early warning systems (EWSs) to propose a hybrid class of models for systemic risk incorporating the structural characteristics of the financial system and feedback amplification mechanism. The models explain financial stress using data from five largest bank holding companies, regressing institutional imbalances using an optimal lag method. Z scores of institutional data are justified as explanatory imbalances. The models utilize both public and proprietary supervisory data. The SAFE EWS monitors micro-prudential information from systemically important institutions to anticipate build-up of macro-economic stresses in the financial markets at large. To the supervisor, SAFE presents a toolkit of possible institutional supervisory actions that can be used to diffuse the build-up of systemic stress in the financial markets. A hazard inherent for all ex-ante models is that the model uncertainty may lead to wrong policy choices. To mitigate this risk, SAFE develops two modeling perspectives: a set of medium term (six-quarter) forecasting specifications to allow the policymakers sufficient time for ex-ante policy action, and a set of short term (two-quarter) forecasting specifications for verification and adjustment of supervisory actions. Individual financial institutions may utilize public version of SAFE EWS to enhance systemic risk stress testing and scenario analysis. The paper shows econometric results and robustness support for the SAFE set of models. Discussion of results addresses usability and tests of usefulness of supervisory data. In addition, the paper investigates and suggests levels for action thresholds appropriate for this EWS.

## **The Effect of Public Debt Market Access on Bank Loan Spreads: Evidence of Competitive Spillover**

Matthew Gustafson, University of Rochester - William E. Simon Graduate School of Business Administration

### **Abstract**

My study shows that the implicit assumption or casual statement that access to the public debt market reduces all bank loan spreads is overstated. After controlling for firm quality, there is no evidence that recent public debt offerings affect average bank loan spreads. This finding is not consistent with the hypothesis that public debt offerings release information that increases inter-bank competition by reducing a lender's information monopoly. To gain more texture on this result, I use the fact that over 90% of public debt is shelf registered to justify the use of an active shelf registration as a new measure of future public debt market activity. I find that an active shelf registration is associated with a 53 basis point spread reduction, but only for long term, non-revolving, bank loans. Thus, public debt market access affects bank loan spreads, but only to the extent that the bank loan is substitutable with public debt and only if the measure of public debt market access is forward looking. Finally, I show that these effects are concentrated in non-growth firms and in firms without strong lending relationships. These results suggest that public debt market access increases ex ante inter-bank competition, but has no effect on mitigating lender's rent extraction for borrowers with strong banking relationships.

### **When do Stock Futures Dominate Price Discovery?**

Nidhi Aggarwal, Indira Gandhi Institute of Development Research

Susan Thomas, Indira Gandhi Institute of Development Research (IGIDR)

#### **Abstract**

Stock futures offer leveraged positions and are expected to attract informed traders. However, many researchers have found that the information share of the stock futures is surprisingly small; the equity spot market appears to play a large role in price discovery. In this paper, we investigate this phenomenon and offer two findings. First, liquidity of the stock futures plays a major role in influencing price discovery. The securities where the spot market plays a major role tend to be those with illiquid stock futures. The enhanced transactions costs appear to counterbalance the gains from leveraged trading. In addition, when large price movements take place, the stock futures appear to play a much more important role. These findings help fill out our understanding of the role of the equity spot and single stock futures markets in price discovery.

### **Metal Investments: Distrust Killer or Inflation Hedging?**

Ghulame Rubbaniy, Erasmus School of Economics, Erasmus University  
Rotterdam

Ken Lee, Erasmus University Rotterdam (EUR) - Erasmus School of  
Economics (ESE)

Willem Verschoor, Erasmus University Rotterdam (EUR) - Erasmus School of  
Economics (ESE)

#### **Abstract**

This study investigates long run metals properties using the extended version of Mccown and Zimmerman (2006) multifactor CAPM-model. By adding extra explanatory variables we improve the explanation power of the existing model in terms of R-squared. Taking German invertors perspective and using prices of gold, silver and platinum over the period 1985-2010, our findings show that metals are true zero market beta assets. We further show that the determinants of metal prices are dependent on market conditions reflected by different betas for stable and crisis periods. The inclusion of a new variable, economic sentiment index in the models shows explanation power for gold. Its significant negative effect reveals gold position as a safe haven in times of distrust. Our results show that gold is the only metal co-integrated with the consumer price index (CPI) of Germany, thus the only metal providing inflation hedging to the German investor in the long run. Our results are consistent with the theories that metals provide long term hedge against unemployment.

## **Integrated Framework for Portfolio Risk Management**

Thi Nguyen, Monash University

Lee Gordon-Brown, Monash University

### **Abstract**

Various risk measures are managed in a unique integrated framework for portfolio selection problems. They include normal risk (volatility), asymmetric risk (skewness), fat-tail risk (kurtosis) and downside risks, i.e. semi-variance, modified Value-at-Risk, and modified expected shortfall. The framework allows investors to change their preferences regarding these risks flexibly. The efficiency of the proposed approach is highlighted in its ability to handle investors' risk preferences well. Verification is deployed by performing portfolio selection experiments in developed markets (e.g. the U.S. stock market), emerging markets (e.g. the South Korean stock market) and global investments. A preselection process dealing with datasets that include a large number of stocks is also introduced to eliminate stocks that have low diversification potential. Portfolios are evaluated by four performance indices, i.e. the Sortino ratio, the Sharpe ratio, the Stutzer performance index, and the Omega measure, both in-sample and out-of-sample tests. High performance and also well-diversified portfolios can be obtained if modified Value-at-Risk, variance, or semi-variance is concerned whereas emphasising only skewness, kurtosis or higher moments in general produces low performance and poorly diversified portfolios. The results also demonstrate that the proposed approach is superior in terms of overall performance and diversification level compared to a conventional higher moment portfolio optimization model. In addition, while ranking portfolios based on the four performance measures we find that these measures result in almost similar ranking outcomes in the U.S. and Korean stock investments, and slightly less similar in the global investments.

## **Financial Stability Challenges in Microfinance - Drivers of the Pre-Crisis Credit Boom**

Charlotte Wagner, Frankfurt School of Finance & Management

Adalbert Winkler, Frankfurt School of Finance & Management

### **Abstract**

This paper uncovers the drivers of the credit boom in microfinance in developing and emerging market countries before the onset of the financial crisis. We find that key macroeconomic variables as well as credit growth in the traditional banking sector are significant factors explaining microfinance credit growth. Moreover, the ability of microfinance institutions to secure external funding beyond deposits and equity is a key variable determining the size of the boom. Thus, our results suggest that microfinance is subject to similar financial stability challenges that have been observed in the traditional banking sector. We also find robust evidence that commercialization contributes to the boom as microfinance banks experience more rapid growth than non-governmental institutions. By contrast we only find weak evidence that credit expansion is more pronounced in more difficult and underdeveloped microfinance markets.

## **The Value of Industrial Shareholdings in a Universal Bank: The Case of Deutsche Bank in the 1990s**

Stephan Späthe, Goethe University Frankfurt - House of Finance

### **Abstract**

This clinical paper analyzes which fraction of Deutsche Bank's market value of equity during the decade of 1990 to 1999 can be attributed to its portfolio of industrial shareholdings. The residuum then serves as a proxy for the valuation of its universal banking business. A new method for this kind of segmentation is presented and applied. Although Deutsche Bank traded during Brazil's currency and debt crisis in January 1999 close to the asset value of its portfolio of industrial shareholdings, I show that the myth that Deutsche Bank was first and foremost a closed-end fund and that the banking business was only of secondary importance is not true for the 1990s. Due to the fact that, for the first time, this study uses internal data on the book value of Deutsche Bank's industrial shareholdings, the tax effect which is a possible explanation for the closed-end fund puzzle can be quantified. On an after tax base, Deutsche Bank derives on average a maximum of one third of its market value of equity from its large and manifold portfolio of industrial shareholding and hence at least two thirds can be attributed to its universal banking business.

## **Cross-Listing and Pricing Efficiency: The Informational and Anchoring Role Played by the Reference Price**

Eric Chieh Chang, University of Hong Kong - School of Business

Yan Luo, University of Hong Kong - School of Business

Jinjuan Ren, University of Macau - Faculty of Business Administration

### **Abstract**

We propose that when a firm cross-lists in segmented markets, in pricing the second issued share, the first issued share price as a reference plays both an informational and anchoring role. We develop a model illustrating the dual-role and relating the anchoring bias to the IPO underpricing of the second issued share. Empirically, we examine a group of Chinese firms that first issued foreign shares and then domestic A-shares, in which the anchoring effect contributes to more A-share underpricing. The anchoring model predicts a positive association between differences in costs of capital and the A-share underpricing, and that this positive association is weaker when participants are less likely to resort to this anchoring heuristic or/and when the A-share valuation is less uncertain. Empirical results support our dual-role hypothesis.

## **Foreign Institutional Investors and Corporate Governance in Emerging Markets: Evidence from Chinese Share Structure Reform**

Wei Huang, University of Hawaii at Manoa - Shidler College of Business

Tao Zhu, Jinan University - Department of Finance

### **Abstract**

Using data on Qualified Foreign Institutional Investors (QFIIs) in China around the reform floating non-tradable shares, we study whether QFIIs play a different role in comparison to local mutual funds in the voting process. With the government mandate to implement the reform smoothly in a timely manner, non-tradable shareholders, particularly the state entities, face binding constraint to carry out the share floating reform quickly. The political cost for a prolonged negotiation is higher for state-controlled firm than for a non-state company. We hypothesize that state-controlled firms, given the political gains associated with speedy resolution in the reform, would be willing to make concession to the institutional shareholders whom they are not able to exert political pressure to reach a quicker resolution. Consistent with these predictions, we find companies with ownerships of both QFIIs and domestic mutual funds experience the shortest reform duration. Interestingly, for state-controlled firms with QFII ownership but not local mutual fund ownership, the average compensation ratio offered by non-tradable shareholders to tradable shareholders is the highest and is statistically significantly higher than the ratios for all other groups. Like in Firth et al (2008), we find that while companies with state ownership on average offer higher compensation ratio in the reform for a quicker approval, the state may exert political power and offer lower compensation ratio for companies with domestic mutual fund ownership. In addition, we find that the positive relation between state ownership and the final compensation ratio increases with the level of QFII ownership. Furthermore, QFII ownership increases the likelihood of plan change in the negotiation process. Our results imply that foreign institutional investors are less prone to political pressure than their local counterparts; their negotiation in the share structure reform seems to be driven by market principle. Further analyses show that this difference may not be due to their difference in portfolio preference. Nevertheless, both domestic mutual fund and QFII ownership can enhance firm value, especially for firms with higher ownership concentration. Overall, our results suggest that the involvement of major foreign institutional investors in corporate governance in emerging markets can promote the rule of market principle in corporate negotiation process.

## **CEO Turnover and Corporate Governance: Evidence from Korea**

Seung Han, Korea Advanced Institute of Science and Technology (KAIST)

Sangwon Lee, Korea Advanced Institute of Science and Technology (KAIST)

Hee Jong Yoo, Korea Advanced Institute of Science and Technology

### **Abstract**

This paper examines the impact of corporate governance on the announcement effect of CEO turnover. Using 567 CEO turnover announcements of Korean firms from 2006 to 2010, we find evidence that CEO turnover has a significant negative effect on the firm value. In particular, firms that are not affiliated with a business group (chaebol) experience significantly negative stock returns surrounding the CEO turnover. We find lower stock return declines surrounding the CEO turnover for firms with higher ownership concentration on the dominant shareholder. This suggests that high level of ownership concentration works in favor of shareholders wealth regarding the CEO selection. For chaebol-affiliated firms, we find no significant effect of ownership concentration on the announcement returns of CEO turnover. In sum, our evidence suggests that corporate governance is effective in an emerging market but does not fully prevent the opportunistic behavior of strong indigenous management of business groups.

## **Stock Markets, Banks and Economic Growth: Some Evidence on the Role of Stock Price Informativeness**

Fang-Chin Cheng, Monash University

Ferdinand Gul, Monash University - Faculty of Business & Economics

### **Abstract**

This paper extends the economic growth model tested by Levine and Zervos (1998) by including a measure for capital allocation efficiency proxied by stock price informativeness. Using a sample of 59 countries, this study finds that stock price informativeness as measured by firm-specific return variation is positively associated with economic growth after controlling for variables in the Levine and Zervos's (1998) model. However, when we split the countries into emerging versus developed countries, we find that stock price informativeness acts as a substitute for banking development and stock market liquidity in predicting economic growth in emerging countries but not in more developed countries. These results are consistent with the Roll's (1988) claim: more information-laden stock prices signal efficient stock markets and, therefore, stronger economic growth.

## **Optimal Capital Structure of Banks with Contingent Capital: A Structural Model**

Christine Maati-Sauvez, University of Lille North of France - Institute of Business Administration

Maati Jerome, University of Lille North of France - Lille Institute of Business Administration

### **Abstract**

This paper justifies, in an agency context, the existence of hybrid securities appeared very recently on the organized market: the cocos (contingent convertible bonds). Like the straight debt, they make it possible to profit from tax benefits of debt. And, like stocks, they provide protection against financial distress. Although cocos cannot completely protect banks against bankruptcy, they reduce significantly their probability of failure independent of regulator actions. The structural model shows that the cocos allow an increased valorization of the banks without jeopardizing their stability. However, it should pay special attention to their design under penalty of not being able to provide an efficient mean of financing to investors. Particular attention should be paid to the fixing of the value of the trigger. Its optimal value is highly dependent on the environment (structure and amount of bankruptcy costs, intensity of the dilution of shareholder claims, tax environmental and so on).



## Explaining Momentum Strategies Using Intrinsic Price Fluctuations

Akindynos-Nikolaos Baltas, Imperial College Business School

### Abstract

This paper focuses on cross-sectional equity momentum patterns by modeling a stock's price path as the interaction between a long-term growth component and a number of fluctuating price components that oscillate around the long-term trend at various distinct frequencies. Using this specification, the results are consistent with a behavioural overreaction-to-private-information and underreaction-to-public-information explanation of cross-sectional momentum patterns. Cross-sectional momentum profitability is found to be robust to realistic transaction costs and a 6-month holding period appears to be the optimal tradeoff investment horizon between the short-term and the longer-term effect of the transaction costs. Simple stop-loss rules are shown to improve the performance of strategies with long-term holding horizon by discarding big and growth stocks, which achieve higher levels of price efficiency and therefore realise their momentum potential faster than small and value stocks.

## Financial Stress Index: Identification of Systemic Risk Conditions

Stephen Ong, Federal Reserve Banks - Federal Reserve Bank of Cleveland

Mikhail Oet, Federal Reserve Bank of Cleveland

Timothy Bianco, Federal Reserve Banks - Federal Reserve Bank of Cleveland

### Abstract

This paper describes a financial stress index for the United States, the CFSI, which provides a continuous signal of financial stress and broad coverage of the areas that could indicate it. The index is based on daily public market data collected from four sectors of the financial markets: credit markets, foreign exchange markets, equity markets, and interbank markets. A dynamic weighting method is employed to capture changes in the relative importance of these four sectors as they occur. In addition, the design of the index allows the origin of the stress to be identified. We compare the CFSI to alternative indexes using a detailed benchmarking methodology and show how the index can be applied to systemic stress monitoring and early warning system design. To that end, we investigate alternative stress signaling thresholds and frequency regimes and establish optimal frequencies for filtering out market noise and idiosyncratic episodes. Finally, we quantify a powerful CFSI-based rating system that assigns a probability of systemic stress to ranges of CFSI outcomes.

## **Board Structure and Market Decline Liquidity Risk**

Te-Feng Chen, New York University (NYU)

Huimin Chung, National Chiao-Tung University - Graduate Institute of Finance

Ming-Ying Lin, National Chiao Tung University

### **Abstract**

This study investigates the empirical relation between board structure and stock market liquidity risk. We find that firms with better board structure have smaller sensitivity of illiquidity to stock market returns, to market decline selling pressure, and to capital constraint selling pressure. In addition, we find that strong board structure could mitigate the liquidity risk for firms that are vulnerable to funding liquidity risk with high proportion of short-term institutional investors, low earnings performance, and high accounting opacity, while idiosyncratic information flow would exacerbate the liquidity risk. Thus, the quality of board structure supports the systematic liquidity variation of flight to quality in the cross-section during economic downturn. Our findings imply that firms with high idiosyncratic information flow could reduce the cost of equity capital by strengthening the board structure.

## **Long-Run Growth Risk and Firm Value**

Te-Feng Chen, New York University (NYU)

### **Abstract**

Corporate risk taking could enhance the firm value. This study develops a simple approach to valuing stocks in the presence of short-run earnings risk and long-run growth risk. While expected stock return is positively related to risk premium, firm value (measured as Tobin's Q) also increases with to the long-run risk loading. Empirically, this study finds that young firms, single-segment firms, and firms that pay no dividends have higher exposure of market-wide long-run growth risk, contributing to the higher firm value. Using a cross-country firm-level panel and a U.S.-only sample, this study shows that cross-sectional firm values are positively related to the U.S. long-run growth risk. The findings suggest that market-wide long-run growth risk is priced internationally.

## What Motivates Block Share Ownership?

Asjeet Lamba, University of Melbourne - Faculty of Business and Economics

Geoffrey Stapledon, University of Melbourne - Law School

### Abstract

Diffuse share ownership is not as pronounced in the U.S. as many would assume. This has led to a body of research examining large shareholders, or blockholders. Issues addressed include whether firms with a blockholder perform better or worse than widely-held firms; whether firms with a blockholder pay their executives differently to widely-held firms; and whether the presence of a blockholder increases or decreases the incidence takeovers. Another issue, which this paper explores, is what motivates block share ownership. Bebchuk (1999a, 1999b) develops a model which predicts that a firm is more likely to have a controlling blockholder if the anticipated private benefits of control at that firm are comparatively large. This paper examines the factors associated with ownership structure among publicly traded Australian firms. Our results indicate that private benefits of control are a significant factor in explaining the differences in ownership structure among Australian firms. As importantly, we also find that the relationship between the existence of a blockholder and private benefits of control is endogenous. That is, the presence of a controlling blockholder strongly influences the prevalence of these private benefits of control.

## Are Australian Mutual Fund Fees Related to Fund Performance?

TARIQ HAQUE, University of Adelaide

### Abstract

We find that Australian mutual fund fees are generally negatively related to their risk-adjusted performance in periods of low economic activity and negatively related to their unconditional alpha where the unconditional alpha is reflective of periods of both high and low economic activity. Our results hold for retail Australian equity only funds and for large-cap and mid/small cap Australian equity-only mutual funds. This is contrary to the evidence provided by Glode (2011) who finds that for US mutual funds, fund fees are positively related to their risk-adjusted performance in periods of low economic activity and negatively related to their unconditional alpha. However, our results for Australian wholesale funds weakly support Glode's US based findings.

## **The Timing of Investment and Stock Returns**

Neal Galpin, University of Melbourne - Department of Finance

### **Abstract**

In a neoclassical investment model, returns and investment are linked. We show that the timing of investment and returns are also linked. Conditional on total investment, firms investing earlier in the year have lower returns than firms investing later in the year. We show empirical evidence consistent with this prediction. Our model further predicts that the effects are strongest when the firm has cash flows early in the year. We confirm this prediction, as well. Moreover, regressing returns on annual investment year produces a much weaker relationship between returns and investment than regressing returns on semi-annual investment.

## **Portfolio Credit Risk of Default and Spread Widening**

Hongbiao Zhao, London School of Economics

### **Abstract**

This paper introduces a new model for portfolio credit risk incorporating default and spread widening in a simple and consistent framework. Credit spreads are modelled by geometric Brownian motions with a dependence structure powered by a t-copula. Their joint evolution drives the spreads widening and triggers defaults, and then the loss can be calculated accordingly. It is a heterogeneous model that takes account of different credit ratings and term structures for each underlying spread. This model is applicable to portfolio credit risk management, stress test, or to fit into regulatory capital requirements. The procedures of parameter calibration and scenario simulation are provided. A detailed example is also given to see how this proposed model can be implemented in practice.