The Exchange

NEWS FROM THE FINANCIAL ECONOMICS INSTITUTE AT CLAREMONT MCKENNA COLLEGE

VOLUME 9, FALL 2009

Director's Report

by Eric Hughson

Eric Hughson

THIS YEAR, THE FEI embarked on its sixth year. The FEI is the finance research arm of the Robert Day School of Economics and Finance, providing data and research support for faculty, and more importantly, providing research experience for students. Indeed, in the last two years, three coauthored collaborations between faculty and students have been published, one in *Journal of Financial Economics*, one in *Economics Letters*, and one in the *China Economic Review*. To our knowledge, this is the first time an undergraduate has ever had a publication in *Journal of Financial Economics*, which is one of the top finance journals. In addition, the FEI administers the Financial Economics Sequence, which each year, is completed by over thirty graduating seniors—over ten percent of the entire senior class!

This year, we are sponsoring two public lectures at the Athenaeum by respected finance academics. Professor Chester Spatt, from Carnegie Mellon University and former chief economist at the Securities and Exchange Commission, spoke in November about the efficacy of government regulation associated with the current financial crisis. Wayne Ferson of USC is coming this spring. In addition, we hope to have a visiting scholar, Jonathan Berk from Stanford University, on campus for a week where he will give a talk for students as well as a research seminar for faculty and students. Finally, this year on March 5, 2010, the FEI will have an academic finance conference. The support for these activities is made possible by generous contributions from our Board of Advisors and Associates and the BGI Fellowship Program, which provides support for faculty-student research on investment management topics.

This was also the first year of the Robert Day School Master's Program in Finance, which is staffed entirely by FEI-affiliated faculty. The first incoming class

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Financial Economics Institute
Claremont McKenna College

The Financial Economics Institute fosters education and research in financial economics by offering a unique undergraduate curricular program, the Financial Economics Sequence, supporting state-of-the-art databases, and encouraging student-faculty interaction on research.

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has twenty students, and although it is too early to call the program a complete success, student quality is high and students appear to be receiving employment offers. As of this date, roughly half of the class has had employment offers.

We were very sorry to say good-bye to Brian Denis, who is now the Director of Administration and Programs at the Robert Day School of Economics and Finance. Brian was the Assistant Director of the FEI for the first five years of its existence and was instrumental in not only the day-to-day operations, but also in advising students and organizing the New York Networking Trip. As the Director of Administration and Programs at the Robert Day School, he has been instrumental in using the New York model to create a San Francisco Networking Trip for the students in the new Finance Master's Program. We miss Brian's many contributions to the FEI, even if he has just moved downstairs.

Finally, we are very pleased to welcome two new FEI Board Associates, Kerry Fanwick and Jim Koon. Kerry is a 1976 graduate of CMC as well as a graduate of Stanford Law School. He is currently the Executive Vice President, General Counsel and Secretary at BRE Properties, Inc., a REIT that manages over 80 communities and 25,000 units in the Western U.S. Jim is a 1981 CMC graduate who holds an MBA from Duke University. He is now a Consumer Lending Division Executive for TCF Corporation, and is responsible for the performance of their mortgage lending business. ▲

2009–2010 BGI/Larson Asset Management Fellows

The BGI/Larson Asset Management Fellowship Program offers financial support and research experience for juniors and seniors at Claremont McKenna College who are interested in careers involving asset management and investment management. The recipients of this year's scholarships are:

Kyle Casella '10

Kyle, originally from Tiburon, California, is a senior at Claremont McKenna College pursuing an Economics degree with a Financial Economics Sequence. Kyle works as a research analyst for the RAND Corporation (in conjunction with CMC's Lowe Institute) and the Financial Economics Institute. He recently finished his tenure as Chief Investment Officer of the CMC Student Investment Fund and was selected as a Robert Day Scholar, as well as a BGI/Larson Asset Management Fellow. Additionally, he co-captains the top-ranked CMS golf team and serves on the Student Athlete Advisory Committee. As a sophomore, Kyle interned at Aspiriant, a San Francisco-based wealth management firm for high net-worth individuals and families. Last summer he interned with Morgan Stanley & Co. in New York City as a Fixed Income Trading summer analyst. He is interested in pursuing a career in investment banking or investment management.

Harshvardhan Chowdhary'10

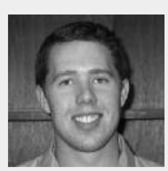
Harsh, originally from Calcutta, is a senior at CMC majoring in Economics-Accounting and plans to complete the Financial Economics Sequence. Harsh worked at Fieldglass, Inc., a technology consulting firm in Chicago, Illinois this past summer. In addition to working at the FEI, he is the Principal of the Special Situations Group in the Student Investment Fund, Co-President of the Aspiring Economists Society and Editor of the McKenomics Newsletter.

Rajat Gupta '11

Rajat Gupta is a junior at CMC pursuing a degree in Economics and Mathematics with the Financial Economics Sequence. Originally from Lucknow, India, Rajat worked for the RAND Corporation/Lowe Institute project doing statistical research about judicial compensation and the stock prices of pharmaceutical firms. An avid cricket and soccer fan, he was a national semi-finalist on the ESPN School Quiz. Rajat won the inaugural Harvey Mudd Integration Bee in 2008 and was adjudged an Outstanding Sophomore in Economics at Claremont McKenna College for 2009. After graduation, Rajat plans to pursue a graduate degree in finance and work in asset and portfolio management.

Nikolas Miller '10

Nikolas is a senior at CMC, pursuing a dual major in Economics and Mathematics along with the Financial Economics Sequence. Nikolas is from Pasadena, California and is a member of the Student Investment Fund (Tech, Media, and Gaming Chief Analyst) and the CMC Bridge Team. In addition to working as a BGI Asset Management Fellow at the Financial Economics Institute, Nikolas is a Robert Day Scholar, Advanced Corporate Finance Tutor, and on the planning committee for the Claremont Finance Conference and the FEI New York City Networking Trip. This past summer he interned at Cascade Investment in Kirkland, Washington.



Nicholas Sparks '10

Nick is a senior at Claremont McKenna College majoring in Economics and Finance. As a Robert Day Scholar and a BGI/Larson Asset Management Fellow, Nick appreciates finance for its utility in leadership and hopes to one day work in investment management or corporate finance. On campus, Nick plays varsity soccer for the Stags, is the CEO of CMC's Student Investment Fund, and leads the Claremont Finance Conference Planning Committee.

Identifying the Effects of a Lender of Last Resort on Financial Markets: Lessons from the Founding of the Fed

Accepted for publication by the *Journal of Financial Economics*

Asaf Bernstein (Harvey Mudd College), Eric Hughson (Universtiy of Colorado and Claremont McKenna College), and Marc D. Weidenmier (Claremont McKenna College and NBER)

Summarized by Justin Eskind CMC '11, FEI Student Research Analyst

THE LENDER OF LAST RESORT IN the United States, the Federal Reserve Bank, responded aggressively to the credit crunch resulting from the sub-prime mortgage crisis. The Federal Reserve cut the Fed Funds Rate 5.25 percent in September 2007 to where it currently resides at near zero percent by December 2008. In addition to the rate cuts, the Federal Reserve Bank increased the monetary supply, orchestrated bailouts of various financial firms, purchased mortgage backed securities, and invested in long term corporate debt. The issue at hand now becomes whether or not the policies of a lender of last resort are effective in reducing market volatility and liquidity risk.

In *Identifying the Effects of a Lender of Last Resort on Financial Markets*: *Lessons from the Founding of the Fed*, Asaf Bernstein, Professor Eric Hughson, and Professor Marc D. Weidenmier look into the founding of a lender of last resort in the United States by the Aldrich-Vreeland Act of 1908 and the Federal Reserve Act of 1913 to provide insight.

The National Banking System (1816-1913) created a uniform currency and standardized the banking system in the United States. The system created a three tiered reserve structure with central reserve city banks at the top, followed by reserve city banks, and country banks. Reserve city banks were permitted to hold up to half of their deposits in central reserve city banks. Likewise, country banks were permitted to hold up to three-fifths of their reserves in the top two tier type banks. Reserves became concentrated in central city banks, because deposits held there would collect two percent interest. The National Banking system helped exacerbate financial crises because as outside banks would pull their deposits, central city banks would be forced to call in the loans they lent to investors in order to buy stock on margins. The end result would be a drop in stock prices, as investors were forced to sell their holdings to repay the loan. Another flaw of the National Banking system was the inability to commensurate the increase in interest rates seen by the seasonal factors of the harvest with an increase in the money supply. The increased interest rates unaccompanied by an increase in the money supply could lead to a bank run as banks are forced to call in loans to meet deposit demand. The passage of the Aldrich-Vreeland Act and then the Federal Reserve Act enabled the money supply to be increased in response to raising interest rates and the accompanying liquidity shortage.

The paper examined the standard deviation of stock returns and short-run interest rates over time across the months of September and October with the other ten months of the year, for the periods before and after the establishment of a lender of last resort. The months of September and October were examined due to their relation to the harvest season, where the markets were the least liquid, thus increasing the effect a lender of last resort would have on the market.

The authors find that stock market volatility declined nearly 50 percent and interest rate volatility fell 70 percent in the months of September and October after the monetary regime change. Perhaps more importantly, the statistically significant difference in financial market volatility between the harvest months and the other ten months of the year, was eliminated after the establishment of a lender of last resort. The authors find it important to note that their findings are not significant if the major panic years are not included or if the Cowles Index is used to compute the stock returns as opposed to the superior GIP Index.

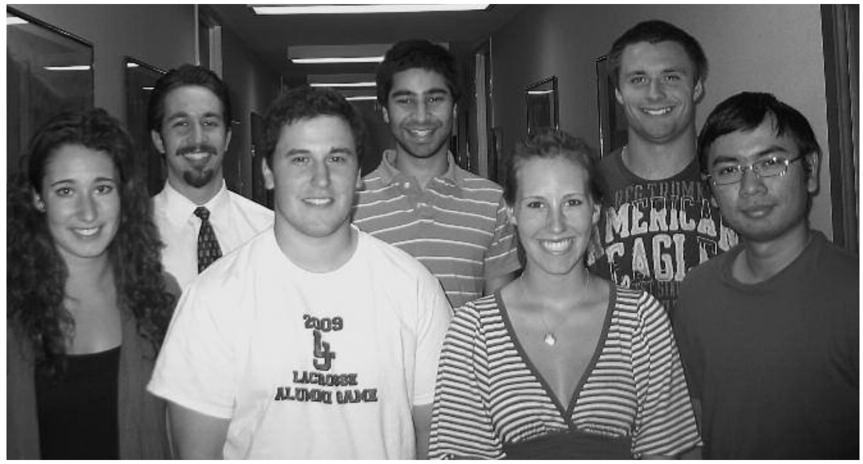
The paper's findings strongly support the hypothesis that a lender of last resort reduces the probability of a financial crisis and its potentially negative effects on the real economy. The authors conclude that, "liquidity assistance from a lender of last resort can be very important in preventing a larger meltdown in financial markets that can have real economic effects." ▲

ASAF BERNSTEIN is currently in the Quantitative Trading and Analysis Program with Citigroup, New York. He graduated from Harvey Mudd College in 2008 and passed all the required courses for CMC's Financial Economics Sequence.

▲ **ERIC HUGHSON** is the Don and Lorraine Freeberg Professor of Economics and Finance at CMC and also the Director of the Financial Economics Institute. He specializes in financial economics.

▲ **MARC WEIDENMIER** is the William F. Podlich Associate Professor of Economics and Director of the Lowe Institute of Political Economy at CMC and also an NBER Research Fellow. He specializes in international finance and public policy.

Financial Economics Institute
2009 Summer Research Analyst Internship Projects


Back row, from left: Noah Franz '10, Raghav Dhawan '10, and Scott Yingling '11. Front row, from left: Hannah Gregg '12, Eric Zacharias '10, Jennifer Volk '11, and Wunna Hlaing '10.

RAGHAV DHAWAN '10
Faculty Advisors: Paul Zak (CGU) and Henrik Cronqvist

Project 1: (For Zak) Trading Rules Based on Market Sentiment
- Examined database of sentences from financial news publications, annual reports, and web forums, categorizing for various filters including: relevancy, objectivity, urgency, and positivity

Project 2: (For Cronqvist) Impact of Founders' Behavioral Traits on Firm Behavior
- Collected educational and biographical information for a database of firm founders

NOAH FRANZ '10
Faculty Advisors: Lisa Meulbroek and Janet Smith

Project 1: College and University Endowments in the Current Recession
- Compile, digitize, and decode NACUBO (National Association of College and University Business Officers) data sets
- Collect and summarize academic literature
- Collect and study College/University Bond Prospectuses
- Collect IRS Form 990 for 501 (c) (3) non-profit organizations

HANNAH GREGG '12
Faculty Advisor: Henrik Cronqvist

Project 1: Company Founder Bio Database
- Created and organized a database with biographical information on top company founders
- Researched and wrote a literature review and data appendix

Project 2: Nature or Nurture: What Determines Investor Behavior?
- Researched and wrote a literature review for recent neuroscience and genetic studies, focused on twins

WUNNA HLAING '10
Faculty Advisor: Eric Hughson

Project 1: Identifying the Effects of a Lender-of-Last Resort on Financial Markets: Lessons from the Founding of the Fed
- Created database of the Bank of England information such as prime rate, money at call, and interest on deposit accounts from 1870-1925
- Researched and collected similar data on France and Germany using books and the Global Financial Data website
- Calculated monthly weighted average of the Central Bank of France interest rates from January 1840 – June 1914
- Used MS Excel to calculate the correlation between each data set for all the data, and to run F-test, T-test and Z-test on all the data
- Plotted all the raw data and the results

JENNIFER VOLK '11
Faculty Advisors: Sven Arndt and Henrik Cronqvist

Project 1: (For Arndt) Conducted data searches on certain types of financial flows into and out of the US and collected data on portfolio and wealth positions for households, firms, and financial institutions
- Sources included the Federal Reserve, Bureau of Economic Analysis, and several financial regulators

Project 2: (For Cronqvist) The Impact of LBOs on Executive Compensation Contracts
- Used SEC Edgar database to collect executive compensation contract details from both pre LBO and post LBO financial statements
- Created database of 40 companies' executive compensation contract details

SCOTT YINGLING '11
Faculty Advisor: Joshua Rosett

Project 1: Analyzed the change in disclosure detail reported on the income statements of 500 companies from 1981-2008
- Used LexisNexis and Stata to analyze income statements

Project 2: Tracked college department donations and their effects on the overall school rankings
- Used Excel, US News and World Report college rankings, and the National Research Council department rankings to chart the effects of large donations on the university as a whole

ERIC ZACHARIAS '11
Faculty Advisor: George Batta

Project 1: Analysis of Expropriation Risk, Valuation, and Corporate Behavior
- Used Compustat database to collect financial data on Venezuelan firms both before and after their opinions on Hugo Chavez's political regime were made public
- Created a database of over 80 companies from 1990-2008
- Developed a measure of connectedness between Venezuelan business owners and political regimes

Claremont Finance Conference

By Nicholas Sparks CMC '10, FEI Student Research Analyst and 2009-2010 BGI/Larson Asset Management Fellow

ON OCTOBER 2, 2009, OVER 100 students, alumni, and professors gathered in business attire at the Marian Miner Cook Athenaeum for lunch, signifying the opening event of the third annual Claremont Finance Conference.

The Claremont Colleges have a long history and reputation of generating leaders in the financial services industry, producing such names as Henry Kravis (CMC '67) and Robert Day (CMC '65). This tradition is still recognized today, and with the implementation of the Robert Day School of Economics and Finance, both undergraduate and graduate students pursue this legacy with a heightened emphasis on leadership and responsibility.

The Claremont Finance Conference is one of the many ways student interest in finance manifests itself on the campuses. The conference is planned exclusively by students of the five undergraduate colleges with the goal of providing a forum to discuss relevant issues in finance as well as facilitate connections with alumni and professionals that would otherwise be inaccessible.

With the collapse of financial markets came a collapse in confidence in the financial services industry. As students of finance, the planners of this year's conference recognized the importance of education in understanding such mistakes and subsequently preventing them in the future. For the third year in a row, the Colleges have been able to leverage a powerful alumni network into a knowledge sharing opportunity. This year the Colleges were fortunate to host a keynote speaker and two panels to address some of the most pressing issues in the aftermath of one of the largest financial crashes in this country's history.

After the inaugural Athenaeum lunch sponsored by the Financial Economics Institute at Claremont McKenna College, Harry McMahon (CMC '75), Vice Chairman of Global Corporate and Investment Banking at Bank of America Merrill Lynch, addressed the audience with a keynote speech focused on the banking industry in a changing regulatory environment. Integrating lessons from history in order to illuminate current issues, Mr. McMahon provided valuable insight into the origins of the financial crisis and a context from which to view the political and financial problems that we have yet to face. In addition to serving as the conference's keynote address, Mr. McMahon's talk was a featured installment of the Robert Day School's Distinguished Speaker Series.

> *"The Claremont Finance Conference is one of the many ways student interest in finance manifests itself on the campuses."*

Following Mr. McMahon's keynote address, the conference relocated to Scripps College's beautiful Balch Auditorium for the first panel discussion: Banking & Regulation. The panelists were intentionally chosen to reflect a diverse set of backgrounds and opinions on the topic. The panelists included Julie Spellman Sweet (CMC '89), Partner at Cravath, Swain & Moore; John Barrymore, Managing Partner and Chairman of 6Pacific Partners; and Ryan Haight (CMC '00), Associate Account Officer at Wells Fargo Specialty Finance. Moderated with pace and humor by Professor Ludwig Chincarini of Pomona College, the panel discussed the evolving banking landscape from legal, commercial, and investment banking perspectives.

The conference switched gears for the second panel of the day, Wealth Management, again in Balch Auditorium. The planners of the conference believed that in addition to understanding the institutional changes wrought in recent times, were the implications for individual investors as they considered new wealth management strategies. Thus, another diverse panel was chosen that included David Ward (POM '83), Senior Portfolio Manager at U.S. Trust Bank of America Private Wealth Management; Patrick Shim (CMC '04), Principal of the Bluepine Group, and Eric Bright (CMC '04), Vice President at Bel Air Investment Advisors. Guiding the discussion was experienced moderator Professor Gary Evans of Harvey Mudd College. The panel covered topics from emerging markets to the structure of the industry.

Following the Wealth Management panel, a formal networking reception was hosted in Scripps' Humanities Lounge where beverages and pastries from local bakery, Some Crust, were served. To conclude the event, all speakers and guests were invited to attend an informal gathering at the Back Abbey. Dinner was paid for with student funds allocated to the Claremont Finance Conference by the Colleges' associated student governments.

The conference would not have been possible without the time and effort of many administrators and faculty members across all five colleges. Particular thanks are due to the alumni and career services offices across the campuses, as well as the Robert Day School.

After its third successful installment, the leadership of the Claremont Finance Conference Planning Committee will be passed on to the committee's younger members who will further the mission and continue the tradition of the conference next year. ▲

FEI Board of Advisors Profile: Grant Kvalheim '78 P'12 Retired from Barclays Capital

By Kyle Casella '10, FEI Student Research Analyst and 2009-2010 BGI/Larson Asset Management Fellow

GRANT KVALHEIM '78 P'12

WHEN DID YOU FIRST BECOME INTERESTED IN FINANCE?

I grew up in Claremont, went to Claremont High and then to Claremont McKenna College. When I came to CMC I didn't really know anything about Wall Street, my dad was in the aluminum recycling business, I knew I wanted to get involved in business, potentially overseas. I graduated from CMC in three years and immediately went to the University of Chicago to get my MBA. Between my first and second year at Chicago I interned at JP Morgan in New York. It's where I first found finance and I was drawn to the job because it is always changing. I thought I would come back to LA in a couple of years, but I took the full-time offer at JPMorgan and was on Wall Street until retiring in 2007.

WHAT WAS YOUR CAREER PATH LIKE AFTER LEAVING CMC?

After Chicago, I worked at JP Morgan on their corporate banking side. These were the days when Glass-Steagall was still in effect and JPM couldn't play a part in investment banking. I then worked for Morgan Guarantee Corporation, the capital markets division of JP Morgan. At JP, I really enjoyed the experience of building something from scratch, but I left because we couldn't underwrite securities in the US market. I went to Merrill Lynch because it was a firm that was lagging behind the competition in debt underwriting. I helped take Merrill from last in the league table to first and pioneered the use of the crossover market. After a stint at Merrill Lynch, I left for Deutsche Bank because it was a bigger global platform. I underestimated the difference in brand image at the time between Deutsche Bank and Merrill in the US market and it was a tremendous challenge to build out Deutsche Bank's corporate bond origination business in the United States. I joined Barclays in 2001 to help grow the business and eventually rose to Co-President of the firm before retiring in 2001.

DID ANY PART OF YOUR CMC EXPERIENCE HELP YOU DEVELOP LEADERSHIP ABILITY THAT TRANSFERRED TO YOUR CAREER OF BUILDING AND GROWING BUSINESSES?

Although there was no formal training in leadership at CMC, like there is today through the Kravis Leadership Institute, there was a pervading feeling of leadership on campus. Additionally, CMC gives students an approach to critical thinking that is invaluable in the workplace.

HAVING WORKED EXTENSIVELY IN THE DEBT MARKETS IN YOUR CAREER, WHAT DO YOU THINK OF THE MALADIES THAT PLAGUED THE CREDIT MARKETS OVER THE PAST TWO YEARS AND THE REGULATORY RESPONSE?

I find the government intervention in markets extremely troubling. A consensus has built that nobody should have a bad day and that is the way to run an economy. I'm nervous about the market; current monetary policy is bad for markets and has the potential to create future asset price bubbles. The problem was not a lack of regulation but ineffective regulation. Before firms could use the risk-based capital models that priced credit derivatives that had to be approved by regulators, who explicitly approved the use of such models.

SO IN YOUR MIND, WHO IS AT FAULT? THE REGULATORS? OR DOES EVERYONE SHARE A PIECE OF THE BLAME?

There is not one party to blame in this crisis. The Community Reinvestment Act allowed homeowners to borrow more and banks to invest more and relax lending standards. Wall Street has to bear some of the blame, but they came in to the picture much later. They sold these securities, but there were a lot of willing buyers, and these buyers, pension funds, hedge funds, and others, employed extremely smart analysts. There is a misconception to paint Wall Street as the bad guys—that they knew the loans would go bad. If that were the case, why then did the banks keep the equity tranche in mortgage-backed securities to themselves? It was the riskiest, first loss piece. They wanted these securities to appreciate in value as well.

WHAT ARE THE LESSONS THAT WE CAN TAKE FORWARD FROM THE CRISIS?

We do not need any drastic change in regulation, rather more effective enactment of current regulation. We learned that analytics based on historic losses is dead, because this wasn't like history. Additionally, under-capitalized institutions like Northern Rock or auto finance companies that relied on 24/7 market access are not viable instances. They assumed they could always go to market for liquidity, but that's not the case any more.

WHAT ADVICE DO YOU HAVE FOR CURRENT CMC STUDENTS WHO WANT TO PURSUE A CAREER IN FINANCE?

Working on Wall Street is still a great career. It's dynamic and a lot of fun, but you have to do it for the right reasons. It's not about the money—you have to be passionate about the business and want to be good at it. Without the passion you cannot be successful. ▲

Economic Principles, Government Policy and the Market Crisis

By Chester S. Spatt

Summarized by Hannah Gregg CMC 12, FEI Student Research Analyst

CHESTER S. SPATT

ON NOVEMBER 16, 2009, THE Marian Miner Cook Athenaeum was pleased to host dinner with Professor Chester S. Spatt as part of the Financial Economics Institute Speaker Series. Professor Spatt is currently the Pamela R. and Kenneth B. Dunn Professor of Finance at the Tepper School of Business at Carnegie Mellon University and the Director of its Center for Financial Markets. Additionally, he served as Chief Economist of the U.S. Securities and Exchange Commission and Director of its Office of Economic Analysis from July 2004 through July 2007.

To open his talk, entitled "Economic Principles, Government Policy and the Market Crisis," Professor Spatt made the claim that traditional economic principles have great relevance to current financial events, especially for policy makers looking to deal with challenges such as deleveraging, a limited availability of credit, and systemic risk inviting increased government involvement in the financial sector.

Proceeding to outline the current financial crisis in terms of a contraction in the supply and demand for loans, Professor Spatt made a point to show how firms being excessively leveraged and then subjected to severe capital losses resulted in the credit crunch of 2008. Congress then sought to inject capital into the financial system through the Trouble Asset Recovery Program (TARP), but institutions receiving these funds were more inclined to reduce leverage and fill capital holes instead of lending more, thus relieving less of the burden on credit than Congress had hoped. Another opposition to financial institutions' attempts to deleverage was the Federal Reserve Fund's suspension of liquidity resulting in aggressive drawing on pre-existing credit lines. Such a suspension, Professor Spatt hypothesized, would have significant long-term effect on the types of new credit lines that will become available in the future.

Not only were institutions deleveraging, but consumers were forced to do so as well because of the dramatic decline in equity values, specifically real estate. Seeing as investment generally drives economic booms, the wealth effect of the current recession led to a fall in the demand for funds in addition to a limited supply of available funds to lend. In the future, suppliers of funds will be much less inclined to take on the risk of consumers with weak credit.

Professor Spatt then raised the question of how this wealth effect should be combated if a fiscal stimulus package is going to be approved, specifically by using either tax cuts or increased government spending. There are traditional economic theories supporting both arguments, and Spatt argued that given the significant wealth effect of this recession, neither tax cuts nor additional government spending is going to be able to completely offset the reduction in demand for private and public goods.

Professor Spatt went on to address the issue of unpredictable government decisions and economic policies which are too often subject to change. With examples such as the Bear Sterns government intervention versus the Lehman Brothers intervention and the Treasury's initial proposal and withdrawal of the Troubled Asset Recovery Program, Spatt raised concerns of how investors are expected to respond in the face of the government changing what he calls the "rules of the game." It is not only inconsistent government policy decisions during a crisis that are cause for concern, but also the potential conflict between trying to reduce systemic risk and government becoming too big of a player and interfering in the market system. This happens when the government designates certain companies as too big to fail and thus commit themselves to significantly high cost safety-net policies in an attempt to reduce such systemic risk at the cost of market discipline. Professor Spatt expressed his view that specific plans ought to be developed in advance for the dissolution of major institutions so that if they fail financially there would be less of a burden on government to interfere with high cost bailouts.

In conclusion, Professor Spatt left his audience with a few big questions that he believes are crucial to understanding the financial crisis and to making more informed and successful policy in the future: "How can we make progress on restoring market discipline and allowing failure? How can we reduce systemic risk, including the portion that is a consequence of government guarantees? And should we be comfortable with relatively more ad hoc handling of bankruptcies?" ▲

Financial Economics Institute

Fall 2009 Student Research Analysts

During the fall 2009 semester, seventeen Student Research Analysts are assisting faculty members with research projects. The following is a list of students, their faculty advisors, and a brief description of the research:


Kyle Casella '10


Harshvardhan Chowdhary '10


Raghav Dhawan '10


Nathan Doctor '11


Justin Eskind '11


Noah Franz '10


Hannah Gregg '12


Rajat Gupta '10

▶ **KYLE CASELLA '10** is working with Professor Richard Burdekin using a new database on publicly traded European football clubs to examine sentiment in European equity markets.

▶ **HARSHVARDHAN CHOWDHARY '10** is working with Professor Joshua Rosett on a project about the effects of gifts on department quality in higher education.

▶ **RAGHAV DHAWAN '10** is working with Professor Amir Barnea on a variety of projects. He examined the previous literature on the impact of health status on household asset allocation choices and the relationship between corporate social responsibility and the financial performance of firms. Primarily, Raghav began developing a database of corporate expenditures on community giving and philanthropy over the last seven years for firms listed on the S&P500.

▶ **NATHAN DOCTOR '11** is working with Professor Eric Helland to put together a new database of pharmaceutical litigation to examine the effect of punitive damages on firm value.

▶ **JUSTIN ESKIND '11** is working with Professor Ananda Ganguly on the analysis of laboratory experiments on investors' reliance on information disclosure.

▶ **NOAH FRANZ '10** is working with Professor Lisa Meulbroek and Dean Janet Smith on a project about college and university endowments in the current recession. He is continuing the project he began last summer.

▶ **HANNAH GREGG '12** is working with Professor Henrik Cronqvist on classifying mutual funds by fee structure.

▶ **RAJAT GUPTA '10** is working with Professor Paul Zak at CGU. Zak's Center for Neuroeconomic Studies at CGU and MarketPsych LLC are working jointly on a project to determine how expectations regarding stock prices and information can be quantitatively used to predict changes in prices of those scrips in the near future. This project focuses on indicators relating to people's risk-taking ability and their assessment of current market conditions as they relate to publicly traded securities. Intuitively, a sense of general optimism about a firm's performance will help in the price build up of its stock. The Center for Neuroeconomic Studies is focusing on developing a multivariable regression model to use psychological indicators as the basis for formulating financial expectations.

▶ **WUNNA HLAING '10** is working with Professor Eric Hughson on a project entitled, Identifying the Effects of a Lender-of-Last Resort on Financial Markets: Lessons from the Founding of the Fed which is a continuation of the project he worked on last summer at the FEI. This fall, he created a database of the Second Bank of the US information such as bills discounted on personal security, funded debt and bank stock, domestic bills of exchange, specie, and notes issued from 1825-1835. After creating the database, Wunna used MS Excel and Stata to calculate the the correlation between each data set, and to run F-test, T-test and Z-test on all the data. He also plotted all the raw data and the results obtained.

▶ **MARIA LÖHNER '10** is working with Professor Eric Helland to put together a new database of pharmaceutical litigation to examine the effect of punitive damages on firm value.

▶ **NIKOLAS MILLER '10** is working with Professor Sven Arndt on research that explores the causes and consequences of global financial instability in the context of multi-country production networks and increased financial openness. As countries with weak and underdeveloped financial systems have come to rely more on external financial markets and institutions for financial intermediation, they have become more vulnerable to global instability. This has raised renewed questions, in some parts of the world, about "decoupling" and establishment of regional defense mechanisms. The focus is on financial flows in East Asia, and particularly in Southeast Asia, and in financial intermediation between that group of countries and the United States and other financial centers.

▶ **ALEXANDER REICHERT '11** is working with Professor Ananda Ganguly on the analysis of laboratory experiments on investors' reliance on information disclosure.

▶ **NICHOLAS SPARKS '10** is working with Professor Eric Hughson and Professor Lisa Meulbroek on a project that is analyzing the efficiency of existing beta prediction techniques through modifications of grouping choices including industry, time, and standard error.

▶ **YANG (AMANDA) YANG '10** is working with Professor George Batta on a project that looks into winemakers' mobility and portability in the wine industry. By gathering data from surveys, this research hopes to find out the trends and dynamics among winemakers and their performance.

▶ **NANAKO YANO '11 (POM)** is working with Professor Sven Arndt on research that explores the causes and consequences of global financial instability in the context of multi-country production networks and increased financial openness. As countries with weak and underdeveloped financial systems have come to rely more on external financial markets and institutions for financial intermediation, they have become more vulnerable to global instability. This has raised renewed questions, in some parts of the world, about "decoupling" and establishment of regional defense mechanisms. The focus is on financial flows in East Asia, and particularly in Southeast Asia, and in financial intermediation between that group of countries and the United States and other financial centers.

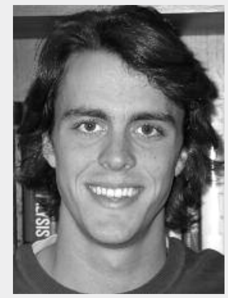
▶ **ERIC ZACHARIAS '11** is working with Professor George Batta performing an analysis of how expropriation risks affect corporate behavior and valuation. The project looks specifically at changes in Venezuelan businesses after high level employee's feelings on political regimes were made public. To do this, Eric is compiling and analyzing an extensive database of companies' key financials both before and after votes in a 2004 recall election were made public.

▶ **YUCHEN ZHANG '10** Yuchen is working with Professor Yu Fan on an event study project on the impact of risk events on companies' stock prices and bond spreads. They are examining the effects of various default and fraud events by collecting news (announcement dates and settlement dates) from LexisNexis and Factiva.

Wunna Hlaing '10


Maria Löhner '10

Nikolas Miller '10

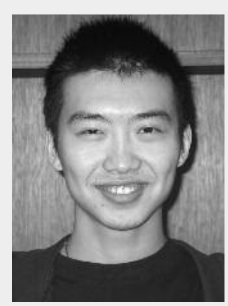

Alexander Reichert '11


Nicholas Sparks '10


Yang (Amanda) Yang '10


Nanako Yano '11 (POM)


Eric Zacharias '11


Yuchen Zhang '10

Amir Barnea, Assistant Professor of Financial Economics Questions on his study "Nature or Nurture: What Determines Investor Behavior

With Stephan Siegel and Henrik Cronqvist

By Nathan Doctor CMC '11, FEI Student Research Analyst

AMIR BARNEA

WHY IS IT IMPORTANT TO STUDY INVESTOR BEHAVIOR?

Studying investor behavior is one of the fundamental things we do in finance, and you can just look around and see the implications of some of these decisions. They have very extreme consequences on people's lives, in terms of, for example, their income and their retirement.

WHY IS THIS AN AREA OF INTEREST TO YOU IN PARTICULAR?

I have always been attracted to non-mainstream questions in finance, and this is reflected in papers that I have written before. These were on topics such as social networks of directors, green investors and corporate social responsibility. I've always been attracted to sexy topics such as these and the current twins study is as sexy as it can get.

WHAT CAN EXAMINING TWINS, BOTH IDENTICAL AND FRATERNAL, TELL YOU THAT A STUDY OF OTHER INVESTORS CAN'T?

The difficulty with many research questions is finding the best control. Say you are looking for a specific phenomenon, you have to worry that you have controlled for all of the other things that are important. For example, if you think about investment decisions of an individual, you have to be sure you take into account these individuals' education, age, gender, income, wealth and other background. In this project, we were interested in the role that genes have in explaining investor behavior and this is just not one of the variables which is available out there. The trick was to use data on twins that allows you to compare two groups of twins, the group of monozygotic, or identical twins, to the group of dizygotic, or non-identical twins. The idea there is that if you find for a specific trait or a specific behavior that correlations among identical twins, is higher than that of non-identical twins, then you have to attribute this additional level of correlation to the genetic component.

HOW WERE YOU ABLE TO FIND TWINS FOR YOUR STUDY, AND HOW DID YOU TRACK THEIR INVESTING BEHAVIOR?

We took advantage of some very rich data from Sweden that has a well established twin registry that tracks three different cohorts of twins. We ended up using 38,000 twins for our paper. For each one of these individuals, Statistics Sweden matched for us their information from the twin registry, with their portfolio holdings that come from Swedish tax records. We could get all the information we wanted with respect to their zygosity classification, age, gender and a bunch of other different variables and their financial records from the tax data.

DID YOU FIND THE GENETIC COMPONENT EXISTS?

Yes, what we found is that, on average, the genetic component accounts for up to 45% of different investor behavior, such as stock market participation, asset allocation, and portfolio volatility. It is different if we cut the group into different subcategories for comparison. I think one of the coolest results in our paper is that when we do this exercise for twins that are 80 years old or older, we still find that about 20% of their investing behavior is attributed to the genetic component. This is really dramatic—even when you are 80 years old, the genetic code really accounts for quite a significant portion of your investing behavior. To maybe highlight the magnitude of this, if you take a look at all other variables that are used in the literature to try to explain these different investor behaviors, like education, wealth, age and gender, stuff like that, you typically find that they account for up to 10 percent of the total variance.

WHAT ASPECTS OF 'NURTURE', OR NON-GENETIC FACTORS, DID YOU FIND CONTRIBUTED TO INVESTOR BEHAVIOR?

What we found is that nurture affects investor behavior mostly when individuals are young. We partitioned the group of individuals into four age categories. In the youngest age category, which is between 18 and 30 years old, we found that nurture, the common family environment, actually shapes their decisions, but this tends to disappear as these individuals mature and they gain more individual unique experiences that shape their investment behavior.

HAS THIS STUDY RAISED ANY FURTHER QUESTIONS FOR YOU? ARE YOU PLANNING TO PURSUE ANY OF THESE QUESTIONS FURTHER?

These are very important questions in finance that were asked for a long time so we thought that this would be the most important first question to ask, but there are many other questions one would be interested in. One specific question I'm interested in is whether there is a relationship between how balanced one's life is and how balanced her portfolio is. For example, if an individual is drinking a lot of alcohol, 10 cups of coffee a day, and sleeps only 5 hours at night, can we find "extreme" patterns in her portfolio holdings as well. Having the twins' data allows us to explore this question making sure that we control for genes in our analysis. ▲

FEI Affiliated Faculty Research

Selected 2009 publications by faculty members affiliated with the FEI:

- "Production Networks, Exchange Rates, and Macroeconomic Stability" (**Sven Arndt**) in J.A. Brox and N.C. Baltas (eds.), The Global Economics of a Changing Environment, Waterloo, Canada: North Waterloo Academic Press, 2009

- "Fragmentation" (**Sven Arndt**) The Princeton Encyclopedia of the World Economy, Princeton University Press, 2009

- "Stock Market Sentiment and the Draining of China's Savings Deposits" (**Richard C.K. Burdekin** with Luke Redfern), *Economics Letters*, Vol. 102, No. 1, January 2009, pp. 27-29

- "Macroeconomic Interdependence between Mainland China and Taiwan: A Cross-Strait Perspective on Globalization" (**Richard C.K. Burdekin** with Hsin-hui I. H. Whited), *The Chinese Economy*, Vol. 42, No. 1, January-February 2009, pp. 5-39

- "Sentiment Effects on Chinese Share Prices and Savings Deposits: The Post-2003 Experience" (**Richard C.K. Burdekin** with Luke Redfern), *China Economic Review*, Vol. 20, No. 2, June 2009, pp. 246-261

- "The Evolution of Bank-Lending Patterns in China: A Post-1994 Province-by-Province Analysis" (**Richard C.K. Burdekin** with Ran Tao), in James R. Barth, John A. Tatom and Glen Yago (eds.), China's Emerging Financial Markets: Challenges and Opportunities, New York: Springer, 2009, pp. 423-447

- "The Development of 'Non-Traditional' Open Market Operations: Lessons from FDR's Silver Purchase Program" (**Richard C.K. Burdekin** with **Marc D. Weidenmier**), in Jeremy Atack and Larry Neal (eds.), The Origins and Development of Financial Markets and Institutions: From the Seventeenth Century to the Present, New York: Cambridge University Press, 2009, pp. 319-344

- "Demand for Attendance–Price Measurement" (**Richard C.K. Burdekin**) in Stephen Shmanske and Leo H. Kahane (eds.), Oxford Handbook of Sports Economics, New York: Oxford University Press, forthcoming

- "Sugar in Hawaii: The Potential for Sugarcane Ethanol in Reducing Energy Dependence" (**Richard C.K. Burdekin** with Erin Liu), in Frank Columbus (ed.), Sugar Industry: Challenges, Issues and Prospects, Hauppauge, NY: Nova Science Publishers, forthcoming

- "Large shareholders and corporate policies" (**Henrik Cronqvist** with Rüdiger Fahlenbrach) *Review of Financial Studies*, forthcoming

- "Do entrenched managers pay their workers more?" (**Henrik Cronqvist** with Fredrik Heyman, Mattias Nilsson, Helena Svaleryd, and Jonas Vlachos), *Journal of Finance*, February 2009, 64, 309-339

- "The Impact of Liability on the Physician Labor Market" (**Eric Helland** with Mark Showalter) *Journal of Law and Economics*, forthcoming

- "Identifying the Effects of a Lender-of-Last Resort on Financial Markets: Lessons from the Founding of the Fed" (**Eric Hughson** with Asaf Bernstein and **Marc Weidenmier**), *Journal of Financial Economics*, forthcoming

- "Would a Stock By Any Other Ticker Smell as Sweet?" (**Gary Smith** with Alex Head and Julia Wilson) *Quarterly Review of Economics and Finance*, 49 (2), 2009, 551-561

- "Harvesting Capital Gains and Losses" (**Gary Smith** with Margaret Hwang Smith) *Financial Services Review*, forthcoming

- "Public Information, IPO Price Formation, and Long-run Returns: Japanese Evidence" (**Janet Smith** with Kenji Kutsuna and Richard Smith) *The Journal of Finance*, 2009, 64 (1) 505-546

- "Currency Crises" (**Thomas Willett** with Eric Chiu, Joshua Walton and Stefanie Walter), "Contagion" (**Thomas Willett** with Priscilla Liang), "Discipline" (**Thomas Willett** with Sirathorn Dechsakulthorn), "Petrodollar Recycling" (**Thomas Willett** with Nancy Auerbach), "Sovereign Wealth Funds" (**Thomas Willett** with Ramkishen Rajan) all in Kenneth Reinert, Ramkishen Rajan, Amy Jocelyn Glass, and Lewis Davis (eds.), *The Princeton Encyclopedia of the World Economy*, Princeton University Press, 2009

- "A New Framework for Analyzing Adequate and Excessive Reserve Levels Under High Capital Mobility" (**Thomas Willett** with Jie Li and Ozan Sula) in Yin-Wong Cheung and Kar-Yiu Wong (eds.), China and Asia, Routledge, 2009, pp. 230-245

- "The RMB Debate and International Influences on China's Money and Financial Markets" (**Thomas Willett** with Priscilla Liang and Alice Ouyang) in James Barth and John Tatom (eds.), China's Emerging Financial Markets: Challenges and Opportunities, Milken Institute, forthcoming

- "Asian Monetary Cooperation: Perspectives from the European Experience and Optimum Currency Area Analysis" (**Thomas Willett** with Orawan Permpoon and Lalana Srisorn) *Singapore Economic Review*, forthcoming

- "The Political Economy of Delayed Devaluation" (**Thomas Willett** with Graham Bird) *World Economics*, 2009, forthcoming

- "The Market for Corporate Control and the Cost of Debt" (**Fan Yu** with Jiaping Qiu) *Journal of Financial Economics*, 2009, forthcoming

These students were selected to participate in the January 2010 NYC Networking Trip. This year, the trip was organized by a student organizing committee: Kyle Casella '10, Maria Löhner '10 (Chair), Noah Franz '10, and Nikolas Miller '10. Back row, from left: Noah Franz '10, Alexander Reichert '11, Nathan Doctor '11, Scott Yingling '11, Jeffrey McNerney '12, Alexander Berman '12, and Christophe Bindert '11. Front row, from left: Eric Zacharias '11, Justin Eskind '11, Maria Löhner '10, Dana Staley '11, Kaitlyn Desai '11, Kyle Casella '10, and Nikolas Miller '10. Not pictured: Juliet Archer '11, Samantha Bastien '11, and Andrew Grimm '11.

Upcoming Events

New York City Networking Trip

JANUARY 11–14, 2010
Seventeen students will visit prestigious firms in NYC to gain exposure to various job opportunities in the financial markets and to establish relationships with CMC alumni working at these companies.

FEI Financial Conference

MARCH 5, 2010

FEI-Sponsored Marian Miner Cook Athenaeum Talk

APRIL 22, 2010
Wayne E. Ferson
Ivadelle and Theodore Johnson Chair of Banking and Finance
Marshall School of Business
University of Southern California

FinancialEconomics INSTITUTE
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