Northern Finance Association 2009 Conference

Program

Friday, September 25, 2009

2.00 PM - 3.15 PM

PhD Session - Asset Pricing and Trading (Loyalist)
Chairperson: Adlai Fisher

Managerial Incentives And The Risk-taking Behavior Of Hedge Fund Managers
Serge Patrick Amvella Motaze, HEC Montréal, Canada

> We use a multi-period binomial model to assess the impact that endogenous changes in the volatility of the fund have on manager fees and on investor wealth. Our results suggest that hedge fund managers will not increase the volatility in order to maximize the value of their option-like compensation contract. These results are in line with the findings of Panageas and Westerfield (2008) and suggest that with an incentive contract over a time horizon superior to one year, the manager will not take excessive risk given the path-dependent nature of the payoffs.

Market Response To Investor Sentiment
Jördis Hengelbrock, University of Bonn, Germany
Erik Theissen, University of Bonn, Germany
Christian Westheide, University of Bonn, Germany

> Recent empirical research suggests that measures of investor sentiment have predictive power for future stock returns at intermediate and long horizons. Given that sentiment indicators are widely published, smart investors should exploit the information conveyed by the indicator and thus trigger an immediate market response to the publication of the sentiment indicator. The present paper is the first to empirically analyze whether this immediate response can be identified in the data. We use survey-based sentiment indicators from two countries (Germany and the US). Consistent with previous research we find predictability at intermediate horizons. However, the predictability in the US disappears after 1994. Using event study methodology we find that the publication of sentiment indicators affects market returns. The sign of this immediate response is the same as the sign of the intermediate horizon predictability. This is consistent with sentiment being related to mispricing but is inconsistent with the sentiment indicator providing information about future expected returns.

Algorithmic Trading And Information
Ryan Riordan, Karlsruhe Institute of Technology, Germany
Terrence Hendershott, University of California at Berkeley, United States

> We examine algorithmic traders (AT) and their role in the price discovery process. AT represents 40% of trading volume in the DAX 30 stocks on the Deutsche Boerse. AT act strategically by monitoring the market for liquidity and deviations of price from fundamental value. AT demand liquidity when it is cheap and supply liquidity when it is expensive. AT trades demanding liquidity contain more information about future changes in the efficient price than human trades. This higher AT information content holds across days with high and low volatility and high and low volume.

Risk Shifting And Time Varying Mutual Fund Performance
Xiaolu Wang, Rotman School, University of Toronto, Canada

> Mutual funds do not disappear randomly. The survivorship bias introduced due to fund attrition has long been recognized. But the time varying nature of the attrition rate and the associated effect on the survivorship bias is much less discussed. This paper examines the relation between mutual

fund attrition rate and some market level variables, and finds that the attrition rate changes under different business condition. The observed attrition rate is a joint effect of potentially changing fund population and changing fund survival rule. Results from a probit regression show evidence of changing fund survival rule under different market conditions.

PhD Session -- Corporate Governance (Balmoral)
Chairperson: Ming Dong

Debt Vs. Equity: Analysis Using Shelf Offerings Under Universal Shelf Registrations
Sigitas Karpavicius, University of New South Wales, Australia
Jo-Ann Suchard, University of New South Wales, Australia

The goal of this paper is to examine the factors that determine choice of security offerings under universal shelf registrations. The results support our hypothesis that if a firm wants to raise a large amount of money, a firm is more likely to issue equity; similarly, a firm prefers debt if it does not want to raise significant funds. We find that the key factor of common stock vs. straight debt dilemma is firm size. Larger firms are more likely to issue debt. Overall, our results are consistent with three main theories of security issuance and capital structure: market timing, trade-off, and pecking order. The analysis of hybrid security's choice is limited by small sample size.

The Certification Role Of Listings
Sarah Draus, Université Paris Dauphine, France

I propose a model in which firms can convey their quality by listing on a stock exchange. To list, firms must comply with costly listing requirements allowing investors to recognize imperfectly their quality. A profit maximizing exchange may set listing requirements leading to high information efficiency in equilibrium. However, this is strongly linked to market conditions and firm characteristics. The information content of a listing depends not only on the level of listing requirements, but also on the characteristics of firms incited to list. High listing requirements are not a guarantee for the highest efficiency and the latter may be achieved with low requirements. Whether information efficiency is socially desirable depends on compliance costs and forgone growth opportunities which reduce welfare. The analysis yields implications for the choice of the listing locations by firms, as well as the organization of stock markets.

Increase In Cash Holdings: Pervasive Or Sector-specific?
Jun Zhou , Rotman School of Management, University of Toronto, Canada

Even though Bates, Kahle, and Stulz (2009) document that the average cash holdings for U.S. industrial firms more than doubled from 1980 to 2006, this increase has not been uniform across all sectors. In particular, this paper finds that the increase over the entire period occurred solely among firms in high-tech sector, whereas the average cash holdings of firms in non-high-technology sector remained quite flat until early this decade. Furthermore, this paper demonstrates that the discrepancy in the trends between high-tech and non-high-tech sectors is driven by different determinants. Before 2000, the discrepancy was primarily driven by new listings over 1980-2000 in high-tech sector, their changing firm characteristics inducing them to hold more cash. The pervasive increase in cash holdings after 2000 can be attributed to the precautionary action in response to adverse macroeconomic shocks.

3.45 PM - 5.00 PM

PhD Session -- Asset Pricing and Modelling (Loyalist)
Chairperson: Tim Simin

Volatility Dynamics Of Early-stage Firms With Jump Risk And Stage-clearing
Shu Feng, Boston University, United States
Xi Dong, Boston College, United States

Early-stage firms usually have a major large Research and Development (R&D) project that requires multi-stage investment. Firms' volatility can dramatically change due to the evolvement of

R&D efforts and stage clearing. First, the success (failure) of R&D efforts within each stage (jump risk) decreases (increases) the uncertainty (i.e. volatility) level of the firms' future returns -- "jump effect". Second, at the end of each stage, firms decide whether to continue next stage investment upon re-evaluating the project prospect conditional on the resolution of technical uncertainty and other information; as firms survive each investment stage and are becoming mature, the uncertainty level of their future returns should eventually decrease in later investment stages that lead to maturity -- "stage-clearing effect". Ignoring these effects results in incorrect estimation of firms' future volatility, an important element for early-stage firm valuation. In this paper, I develop a generalized Markov-Switching EARCH methodology for early-stage firms with discrete stage-clearing and jumps. My methodology can identify structural changes in the idiosyncratic volatility and also explore the relation between price changes and future volatility. Using a hand-collected dataset of early-stage biotech firms, I confirmed the existence of the "stage-clearing effect" and the "jump effect". In the second part of my paper, I model early-stage firms as sequences of nested call options with jumps that lead to mature firms. "Jump effect" arises because the early-stage firms are modeled as compound call options with jumps on the underlying cash flows, the volatility of the early-stage firms at each stage is determined by the compound call option elasticity to the underlying cash flows. If the downside (upside) jump happens, the value of the underlying cash flows decreases (increases), which makes the compound call option elasticity go up (down). As a result, the compound call option becomes riskier (less risky). "Stage-clearing effect" arises because as firms exercise their option to continue investment, the new options that firms enter into will eventually become a less risky option.

The Conditional Dynamic Dependences Between Herding And Return: Evidences From Us Equity Market

Xisong Jin, McGill University, Canada
Ya Tang, McGill University, Canada

The literature has been interested in how herding behavior affects security prices. Surprisingly, the dynamic correlation between return and herding has not been examined. This paper provides a comprehensive empirical analysis of conditional dynamic dependences among herding level, herding correlation, herding volatility, stock return, return correlation, and return volatility. This is conducted by joining the statistical herding measure developed by Lakonishok et al (1992) and the extended flexible dynamic correlation and equicorrelation techniques (Engle (2002), Engle and Kelly (2008)) in the framework of Gaussian Copula. We find that (1) while the level of herding is considerable in a volatile downside market, it is moderate in a unwavering market; (2) herding behavior is more contagious in a less stable market; (3) market herding level is positively and significantly correlated with market return, with an upward trend in a bull market and downward trend in a bear market; (4) contagions of herding and return comovement are negatively correlated. In addition, we find that the size effect is important in understanding the above dynamic dependences.

Contagion Among Major World Markets: A Wavelet Approach

Mikko Ranta, University of Vaasa, Finland

This paper examines contagion among the major world markets during the last 25 years. The analysis uses a novel way to study contagion with the help of wavelet methods. The comparison is made between correlations at different time scales. Clear signs of contagion among the major markets are found. A short time scale correlation increases during several major crisis while long time scale correlations remain approximately at the same level. Also a gradually increasing interdependence between markets is found.

Uninformed Momentum Traders

Ali Emre Konukoglu, Rotman School of Management , Canada

This paper studies the relation between momentum trading and information. We present a variety of evidence supporting the hypothesis that momentum trading is linked to a lack of information. Firstly, using foreign portfolio flows in individual stocks we document significant momentum trading concentrated in stocks with potentially inefficient information characteristics. Small stocks, stocks with high volatility and low liquidity, and stocks that are internationally less visible are

subject to greater momentum trading. In addition, stocks on which foreign trades indicate lower future profitability are subject to higher momentum trading. Secondly, we show that momentum trades exert contemporaneous price pressure and have no valuable medium-run information content. In the quarter following the momentum trades, stocks experience complete return reversal. Thirdly, there is strong evidence that momentum trading by foreign investors is sub-optimal. We show the negative profitability of a strategy that buys past winners and sells past losers on the cross-section of stocks.

PhD Session -- Financial Intermediation (Balmoral)
Chairperson: Vijay Jog

Bankruptcy Prediction
Zeynep Topaloglu, CUNY - Graduate Center, United States
Yildiray Yildirim, Syracuse University, United States

The hazard rate models used in the recent bankruptcy literature theorize the eventual failure of entire population, in a financial setting which translates into the collapse of the whole economy. We reject the assumption of complete break-down, in fact believing a fraction of the subjects shall be long-run survivors; we propose a mixture model to correct not only for survivors but also for the censored observations. Moreover this study models the event and the timing of default incident at the same time. For the event of default and the timing of default we utilize a logistic regression. The results have justified the superiority of our model over the standard hazard rate models and proved its predictive power. The companies identified as high default risk by our model proved to deliver extremely low returns in the market and all of the 107 bankruptcies in three years following our sample period were coming from the high risk group.

Information Production, Retail Investors, And Delegated Portfolio Management
Jie He, Boston College, United States

I analyze investors' choice to be active or passive and develop a model of the money management industry. I make use of a noisy rational expectations equilibrium framework with endogenous information production and endogenous choice of investment channels. In my model, agents can choose one of three investment channels: directly manage their own money, delegate the management of their money to professionals, or become money managers who charge proportional asset management fees. Retail investors and money managers then choose their own optimal level of effort to produce information and trade risky assets. While delegators do not pay costs to acquire information, their investment returns depend on the performance of money managers they hire. In equilibrium, agents with low information production costs and high initial wealth will manage their own money; those with low information production costs but low initial wealth will become money managers; and those with high information production costs will choose delegated portfolio management, regardless of wealth. I solve for the relative population of delegators and retail investors, the equilibrium size and structure of the money management industry, as well as the equilibrium asset prices. The model also yields new implications on the relationship between various attributes of the economy and the equilibrium equity premium. For example, I find that an investor base with lower average information production costs tends to have more total delegated wealth, more money managers, smaller individual holdings of corporate equity, higher price informativeness, and a lower equity premium.

Leasing From Regional Bank's Perspective: Is There A Trade-off To Competition?
Dilek Bulbul, Goethe University Frankfurt, Germany
Felix Noth, Goethe University Frankfurt, Germany

In the corporate finance literature the academic debate on leasing as a finance instrument was carried out primarily from the corporates' perspective. Particularly, academic research was conducted on the question whether leases and debts serve as substitutes or complements. We empirically re-examine the relationship between leases and debts by approaching this research question from banks' perspective. We argue that leasing is used by banks as an add-on to keep current customers or attract new one while giving them the choice between a loan and a leasing

contract from the same institute. In this paper we show that banks have strong incentive to maintain and increase their competitive stance by offering leasing services to their bank customers. We argue that banks identified leasing as an additional source of income to enhance their bank performance and optimize their risk-return profile. We find a robust and significant positive impact from bank's leasing volumes on it's profitability as well as on their competitiveness. Our results suggest that leases and loans serve as complements to the banks.

An Empirical Analysis Of The Impact Of The Credit Default Swap Index Market On Large Complex Financial Institutions

GIOVANNI CALICE, SCHOOL OF MANAGEMENT - UNIVERSITY OF BATH, United Kingdom
CHRISTOS IOANNIDIS, SCHOOL OF MANAGEMENT - UNIVERSITY OF BATH, United Kingdom

This paper contributes to the primarily empirical literature by conducting the first extensive empirical analysis of the impact of the degree of co-movement in the main standardized credit default swap (CDS) indices on the group of systemically relevant large complex financial institutions (LCFIs). We attempt to account for the dynamics between banks' equity returns and most liquid CDS market indices, the investment grade 5-year CDX North America and the investment grade 5-year iTraxx Europe, through conditioning our analysis on the historical correlation between the variables. Our most important findings are threefold. First, equity returns for all the LCFIs are negatively correlated to both the CDX and the iTraxx indices. Second, the CDX index is the dominant factor driving shocks across all the LCFIs and its influence varies substantially across the institutions included in this study. Third, we find that the impact of CDS market volatility on the equity return volatility of LCFIs appears very pronounced, suggesting a transmission mechanism which results in the destabilisation of banks and a subsequent increase in their default risk.

Saturday, September 26, 2009

8.30 AM - 10.00 AM

International Finance (Balmoral)
Chairperson: Andras Marosi, University of Alberta

Cross Listing Waves And The Search For Value Gains

Sergei Sarkissian, McGill University, Canada
MICHAEL SCHILL, University of Virginia, United States
Discussant: Michael King, Bank for International Settlements

In this study we identify waves in cross listing activity at the host market, home market, and industry level. We find these waves to be positively correlated with relative financial and economic market performance. We use these waves to increase the power of tests of the valuation gains to cross listing based on the assertion that periods of foreign listing intensity should be associated by revealed preference with periods of particular gains to listing. Despite our efforts, the data fails to show any durable valuation gains to listing abroad. The extended-term abnormal valuation ratio of firms listing abroad is no greater than that of firms that do not cross list regardless of time period, host market, home market, or industry. We do find evidence of temporary gains, particularly during periods of intensity in host market listing. We suggest that it is these temporary gains that motivate listing abroad.

Effects Of International Institutional Factors On Earnings Quality In Banks

KIRIDARAN KANAGARETNAM, McMaster University, Canada
Chee Yeow Lim, Singapore Management University, Singapore
Gerald Lobo, University of Houston, United States
Discussant: Mehdi Beyhaghi

We examine the relation between legal, extra-legal and political institutions and earnings quality of banks across countries. We predict that earnings quality is higher in countries with legal, extra-legal and political systems that reduce the consumption of private control benefits by insiders and

afford outside investors greater protection. Using a sample of banks from 29 countries over the period from 1993 to 2006, we find all five measures of earnings quality studied are higher in countries with stronger legal, extra-legal and political institutional structures. Our findings highlight the implications of institutional environments for financial reporting quality and are relevant to bank regulators who are considering additional regulations on bank financial reporting.

Liquidity Effects Of Listing Requirements
SARAH DRAUS, Université Paris Dauphine, France
Discussant: Carmen Stefanescu, ESSEC BUSINESS SCHOOL PARIS

I propose a model to analyze the complex relationships between listing requirements, the organization of trading on stock exchanges and the disparities between social and private optima regarding listing requirements. The effect of competition in volume on the regulatory activity of a self-regulating exchange regarding listings depends on the nature of competition for order-flow. If competition is mainly driven by prices, a profit maximizing exchange is induced to lower its level of listing requirements which is detrimental to uninformed investors and also inefficient from a social point of view. If competition is mainly driven by gains related to the fragmentation of orders, the exchange can benefit from the welfare increase of investors and is induced to raise its level of listing requirements, which is beneficial from the point of view of uninformed investors. This analysis also shows that there is an interdependence between the listing fee and trading fees. The association of listing and trading in one single profit maximizing entity contributes to reduce the overall level of trading fees. This model yields several implications about the organization of stock markets and the regulation of listings.

Asset Pricing and Risk (Somerset)
Chairperson: Raymond Kan, University of Toronto

Changes In Multiplicative Background Risk And Risk-taking Behaviour
OCTAVE JOKUNG, Edhec Business School, France
Discussant: Liyan Yang, Rotman, University of Toronto

This paper analyzes the conditions under which any change in a multiplicative background risk induces a more cautious behavior. We show that, with multiplicative risk, Eeckhoudt, Gollier and Schlesinger's (1996) findings for additive background risk are no longer valid. We give necessary and sufficient conditions under which any change in the multiplicative background risk with respect to the Nth-degree stochastic dominance raises local risk aversion. Surprisingly, decreasing relative risk aversion of any order up to order N in the sense of Pratt (1964) coupled with decreasing relative risk aversion in the sense of Ross (1981) sufficient to guarantee an increase in local risk aversion after any deterioration of the multiplicative background risk thanks to the Nth-degree stochastic dominance.

The Empirical Importance Of Background Risks
Darius Palia, Rutgers Business School, United States
YAXUAN QI, Concordia University, Canada
Yangru Wu, Rutgers Business School, United States
Discussant: Akiko Watanabe, University of Alberta School of Business

This paper uses a long panel data set to investigate the empirical importance of background risks—labor income risk, housing risk and business income risk—on a household's asset allocation and on asset returns. We construct a set of household-level background risk variables which capture the entire covariance structure between financial assets and three types of non-traded or illiquid assets - labor, housing, and private business. We show that all these background risks are statistically and economically important for a household's stock market participation and portfolio choice. When all background risk variables shift one standard deviation from their sample means, a household will decrease its likelihood to participate in the stock market by twelve percent and reduce the proportion of stock holdings by four percent. In addition, a stock more highly correlated with background risks is associated with a higher risk premium. Including the background risk factors significantly improves the performance of three benchmark asset pricing models, i.e., the

consumption-based CAPM, CAPM, and the Fama-French three-factor model in term of the Hansen-Jagannathan distance and the J-statistic of GMM estimation

Learning Complementarities Through Hedging-motivated Trades
Yan Li, Temple University,
LIYAN YANG, Rotman, University of Toronto,
Discussant: Octave Jokung, Edhec Business School

Banking (Loyalist)
Chairperson: Gordon Roberts, York University

Bank Competition And Collateral : Theory And Evidence
Christa Hainz, IFO, Germany
LAURENT WEILL, University of Strasbourg and EM Strasbourg Business School, France
Christophe Godlewski, University of Strasbourg and EM Strasbourg Business School, France
Discussant: Gordon Roberts, York University

We investigate the impact of bank competition on the use of collateral in loan contracts. We develop a theoretical model incorporating information asymmetries in a spatial competition framework where banks choose between screening the borrower and asking for collateral. We show that the presence of collateral is more likely when bank competition is low. We then test this prediction empirically on a sample of bank loans from 70 countries. We perform logit regressions of the presence of collateral on bank competition, measured by the Lerner index. Our empirical tests corroborate the theoretical predictions that bank competition reduces the presence of collateral. These findings survive several robustness checks.

Internal Capital Markets: The Bright Side Of Corporate Politics
ROCCO HUANG, Federal Reserve Bank of Philadelphia, United States
Discussant: Patricia McGraw, Ryerson University

This study looks inside the internal capital market of a large retail-banking group to study how internal corporate politics affect internal capital allocation. Our data is from the firm's managerial accounting system and covers all cash flows, internal capital transfers, and investments at the local member bank level. We find some evidence that member banks' investment (loan) growth is not fully independent from their own cash flow (deposit) growth. However, such inefficiencies are not apparent at more influential member banks as identified by the divergence of voting rights from ownership rights. The more influential banks are allocated more funds from the headquarters, but also restrain from overinvestment when experiencing large deposit inflows. Influence is more important for banks with more volatile deposit growth, where better information flow between the banks and the headquarters may be more important. Influence is also more important for small business loans, which contain more soft information than, for example, residential mortgage loans. These results suggest that internal politics inside an organization may have a 'bright side' in that influence is not abused but is helpful in overcoming asymmetric information problems between divisions (member banks in our case) and the headquarters.

It Use And The Competitiveness Of Small Banks
FELIX NOTH, Goethe-University Frankfurt, Germany
Michael Koetter, University of Groningen, Netherlands
Discussant: Laurent Weill, University of Strasbourg and EM Strasbourg Business School

Information management is a core process in banking, in particular when lending to small, opaque firms. But while a more intensive use of information technology (IT) can enhance information management, it is also costly. Merely increasing IT expenditure may thus not be a panacea to optimize information management. We use a unique dataset of universal banks that cater primarily to small and medium enterprises to estimate a measure of optimal IT use and relate it to the competitiveness of banks. We find excess IT expenditure of 40% and show that banks with better information management skills are also more competitive.

Behavioural Finance (Trillium)

Chairperson: Yuri Khoroshilov, University of Ottawa Telfer School of Management

Can Diversification Be Learned

ANN MARIE HIBBERT, West Virginia University, United States
Edward Lawrence, Florida International University, United States
Arun Prakash, Florida International University, United States
Discussant: Mikhail Simutin, University of British Columbia

This paper investigates the role of financial education in household portfolio allocation decisions using data from a survey of 1,385 professors at universities across the United States. The results suggest that knowledge of finance increases the likelihood that an investor will efficiently allocate his direct investments across the major asset classes, invest in foreign assets and hold a diversified equity portfolio. However, there is no evidence that investors who are more financially sophisticated make superior allocation decisions in their retirement savings. In particular, we find that irrespective of age and other domestic factors, Finance professors are more likely to allocate more than 70% of their retirement savings to Domestic Equities. We also find that English professors are more likely to practice a naïve diversification strategy of choosing a subset of the available funds and allocating equal proportion of their portfolio to each of the chosen funds.

Cultural Values And Corporate Risk-taking

Dale Griffin, UBC, Canada
KAI LI, UBC, Canada
Heng Yue, Peking University, China
Longkai Zhao, Peking University, China
Discussant: Fatma Sonmez Saryal, Rotman School of Management

We investigate the role of national culture in corporate risk-taking using firm-level data from 35 countries. We identify three dimensions of national culture predicted to influence corporate risk-taking: harmony, individualism, and uncertainty avoidance, and we isolate the effects of firm-level and country-level variables by using a hierarchical linear modeling approach. We show that harmony and uncertainty avoidance are negatively associated with firm-level riskiness, while individualism is positively associated with firm-level riskiness. Further, the presence of earnings smoothing exacerbates the effect of individualism on risk-taking, while larger firm size weakens the effects of individualism and uncertainty avoidance on risk-taking. Our results are robust to alternative specifications and samples.

Religious Beliefs, Gambling Attitudes, And Financial Market Outcomes

Alok Kumar, University of Texas at Austin, United States
JEREMY PAGE, University of Texas at Austin, United States
Oliver Spalt, University of Texas at Austin, United States
Discussant: Mohammad Rahaman, University of Toronto

We use religion as a proxy for gambling and investigate whether geographical variation in religion-induced gambling norms affects aggregate market outcomes. Motivated by the evidence from gambling studies, we conjecture that gambling propensity would be higher in regions with higher concentration of Catholics relative to Protestants. We consider four economic settings in which the existing literature has suggested a role for gambling and speculation. First, we show that gambling preferences influence the portfolio choices of institutional investors. Investors located in regions with a higher Catholic-Protestant ratio (CPRATIO) exhibit a greater propensity to hold stocks with lottery features. Next, in a corporate setting, we show that broad-based employee stock option plans, which are likely to appeal more to employees with stronger gambling preferences, are more popular in high CPRATIO regions. Examining the aggregate impact of gambling on stock returns, we find that the initial day return following an initial public offering is higher for firms located in high CPRATIO regions where local speculative demand is expected to be stronger. In a broader market setting, we find that the magnitude of the negative lottery-stock premium is larger in high CPRATIO regions. Collectively, our results indicate that religious beliefs, through their influence on gambling attitudes, impact investors' portfolio choices, corporate decisions, and stock returns.

Corporate Governance - Ownership (Imperial A)
Chairperson: Mark Huson, University of Alberta

Corporate Risk-taking And Ownership Structure
TEODORA PALIGOROVA, Bank of Canada, Canada
Discussant: Yisong Tian, York University

This paper investigates the determinants of corporate risk-taking. Shareholders with substantial equity ownership in a single company may advocate more conservative investment policies due to greater exposure to firm risk. Using large cross-country sample, I find that corporate risk-taking increases as equity ownership of shareholders increases. This result is entirely driven by the shareholders which have invested in a group of companies, and thus have achieved greater ownership diversification compared to shareholders with a single ownership stake. I also find that stronger legal protection of shareholder rights is associated with more risk-taking, while stronger legal protection of creditor rights reduces risk-taking.

Voting With Their Feet Or Activism? Institutional Investors' Impact On Ceo Turnover
JEAN HELWEGE, Penn State University, United States
Vincent Intintoli, Southern Illinois University Carbondale, United States
Andrew Zhang, University Nevada at Las Vegas, United States
Discussant: Karthik Krishnan, Northeastern University

Prior research suggests that institutions vote with their feet, bailing out of poorly performing stocks, and that this vote of "no confidence" ultimately leads to the board's decision to eject the firm's CEO. This view contrasts sharply with the idea that institutions are active monitors of firms and step in to force change when firms underperform. We examine these two mechanisms by which institutions affect forced CEO turnover by investigating the impact of institutional blocks on CEO turnover. We find that voting with one's feet is done largely by institutions that have less than 1% ownership in the firm while institutions that hold block levels of ownership at the time of the CEO turnover announcement significantly increase their ownership levels leading up to the turnover event. Moreover, we find evidence of activism in the financial press and these efforts are significantly related to the ouster of the CEO. We conclude that voting with one's feet, while a common phenomenon at underperforming firms, is not a major mechanism by which institutions force corporate change. In contrast, activists do have an effect on the tenure of the CEO.

Fixed Income 1 (Imperial B)
Chairperson: Kenneth Vetzal, University of Waterloo

Revisions To Short Rate Expectations: Policy Shocks And Macroeconomic News
MICHAEL BAUER, University of California, San Diego, United States
Discussant: Madhu Kalimipalli, Wilfrid Laurier University

How do financial markets react to monetary policy actions and macroeconomic news? This paper develops a coherent framework to capture the impact of monetary policy actions and macroeconomic news on the term structure of interest rates, based on a new affine-yield model that allows shock variances and covariances to differ between news events. We focus on the revisions to the entire path of future expected short rates, which the model allows to parsimoniously describe by means of the factor shocks, because these revisions completely characterize any news event. By integrating the different sources of volatility in one common framework we can assess and compare the differential impact of monetary policy and macro news on the term structure. The key findings are that policy actions have effects on the entire term structure, and that this impact varies greatly between policy actions but on average is hump-shaped, which contrasts with previous results in this literature. Furthermore, the revisions resulting from macroeconomic announcements show clear evidence for policy inertia, and they confirm the excess-sensitivity puzzle. Finally, there are important differences in comovement of forward rates between policy and macro news, which we attribute to the dimensionality of new information released on a given news event. The model also allows us to construct a horizon-specific measure for monetary policy shocks, and to consistently estimate the term structure of

announcement effects.

Idiosyncratic Volatility Vs. Liquidity? Evidence From The U.s. Corporate Bond Market

MADHU KALIMIPALLI, Wilfrid Laurier University, Canada
Subhankar Nayak, Wilfrid Laurier University, Canada
Discussant: Kenneth Vetzal, University of Waterloo

In this paper, we explore the relative contribution of equity volatility and bond liquidity in determining corporate bond spreads. Portfolio analysis and Fama-Macbeth regressions reveal that while both volatility and liquidity effects are significant, volatility has the primary impact, and liquidity (represented by bond characteristics and price impact measure) has the secondary impact on bond spreads. Conditional analysis, however, reveals that while distressed bonds and distress regimes are associated with overall higher impact of credit and liquidity shocks, the relative impact of these shocks do vary. Volatility effects are more prominent for distressed bonds and during distressed regimes; liquidity effects are stronger for less distressed bonds and during low distress regimes. Our findings indicate that, unlike equity markets, idiosyncratic risk does not subsume the information in liquidity in explaining corporate bond spreads. Our results also imply a regime-switching behavior of bond spreads with varying effects of volatility and liquidity across distress regimes.

Cash Flow Volatility And Corporate Bond Yield Spreads

ALAN HUANG, University of Waterloo, Canada
Alan Douglas, University of Waterloo, Canada
Kenneth Vetzal, University of Waterloo, Canada
Discussant: Yuriy Zabolotnyuk, Carleton University

A fundamental determinant of firm value is cash flow. Accordingly, the uncertainty or volatility associated with cash flow should be reflected in default probabilities and bond yield spreads. This paper tests the cross-sectional, inter-temporal and overall relationships between volatility and spread using both expected and historical measures of cash flow volatility. We find that cash flow volatility is economically significant in explaining yield spreads. Expected cash flow volatility explains 51 basis points of yield spread in the univariate regression, and 17 basis points after controlling for the commonly used spread-informative variables. Historical cash flow volatility explains yield spread with a similar magnitude. Importantly, we show that the cash flow volatility effect is robust to the closest proxies of asset volatility used in the literature, namely, stock return volatility, accounting earnings volatility, and analyst forecast dispersion of earnings. Our study highlights the importance of cash flow uncertainty risk in pricing corporate bonds.

10.15 AM - 11.45 AM

Asset Pricing Modelling (Somerset)
Chairperson: Tim Simin, Penn State

Is The Distribution Of Stock Returns Predictable?

TOLGA CENESIZOGLU, HEC Montreal, Canada
Allan Timmermann, UCSD, United States
Discussant: Oliver Boguth, Sauder School of Business, University of British Columbia

Risk averse investors generally require an estimate of the entire distribution of stock returns to make their portfolio decisions, yet most studies on return predictability have focused on modeling the mean and variance. Using a flexible econometric approach based on quantile regression, this paper explores the ability of economic state variables to predict the distribution of stock returns. Variables such as the T-bill rate, the default yield and the term spread are found to be able to predict parts of the return distribution not captured by variations in the mean or variance. For example, the T-bill rate does not significantly predict the probability of negative stock returns but low T-bill rates increase the probability of large positive returns, while high T-bill rates reduce it. Certainty equivalent returns and risk-adjusted alpha estimates suggest that state variables such as the T-bill rate predict economically important variations in the return distribution. Finally, payoffs

from option trades imply gains from using economic state variables to forecast outcomes in the right tail of the return distribution.

Pricing Model Performance And The Two-pass Cross-sectional Regression Methodology

RAYMOND KAN, University of Toronto, Canada
Jay Shanken, Emory University, United States
Cesare Robotti, Federal Reserve Bank of Atlanta, United States
Discussant: Tim Simin, Penn State

The Role Of Heterogeneity In Asset Pricing: The Effect Of Clustering Approach

OLESYA GRISHCHENKO, Penn State University, United States
Marco Rossi, Penn State University, United States
Discussant: Esther Eiling, University of Toronto, Rotman School of Management

We use novel clustering approach and local Taylor series approximations of the stochastic discount factor to examine the role of heterogeneity in asset pricing. We present evidence that the equity premium is consistent with a stochastic discount factor calculated as the weighted average of the clusters' intertemporal marginal rates of substitution in the 1984-2002 period. The result is driven by the skewness of the cross-sectional distribution of consumption growth, but cannot be explained by the cross-sectional variance and mean alone. We show that the result is sensitive to the construction of clusters as well as their number. We find that the nine clusters seems is sufficient to capture idiosyncratic risk with relative risk aversion coefficient equal to six. The same result cannot be reproduced using individual household data.

Corporate Finance (Balmoral)
Chairperson: Sean Cleary, Queen's University

Ceo General Skill And Firm Performance: What Does An External Ceo Bring To The Table?

MOHAMMAD RAHAMAN, University of Toronto, Canada
Varouj Aivazian, University of Toronto, Canada
Tat-Kei Lai, University of Toronto, Canada
Discussant: Jun Zhou , Rotman School of Management, University of Toronto

Economists disagree sharply on whether the breakdown of corporate governance or the mechanics of executive labor market explains the dramatic rise in executive compensation in recent decades. In this paper, we focus on the market-based explanation and design an empirical strategy to identify the effect of CEO's general skill on firm performance. We show that trends in executive compensation and external CEO hiring are significantly positively correlated with the importance of general skill at the industry level. We find that newly hired external CEOs in a high general skill industry create more shareholders' value relative to the industry median than newly hired internal CEOs in the same industry. The differential effect on firm performance increases in favor of external CEO-firms as general skill becomes more important in the industry. Furthermore, using a mediating instrument methodology we identify the strength and significance of the channel through which CEO skill translates into higher firm performance and better performance in turn explains excess CEO compensation relative to the typical firm in the industry. These findings are economically significant and do not seem to the driven by endogeneity, sample selection, and reverse causality. In hindsight, these results suggest that CEO skill has bearing on firm performance and seems to be correctly priced into the executive compensation contracts.

Corporate Precautionary Savings

NATHALIE MOYEN, University of Colorado at Boulder, United States
Martin Boileau, University of Colorado at Boulder, United States
Discussant: Mohammad Rahaman, University of Toronto

Cash holdings as a proportion of total assets of U.S. corporations have more than doubled since the 1980's. In light of the empirical evidence of Bates, Kahle, and Stulz (2008), we investigate which motive for precautionary cash holdings is responsible for the large increase. Precautionary savings can arise because various taxes, decreasing returns to scale in production, adjustment and

issuing costs induce the firm to be prudent and save more in the face of increased risk. Precautionary savings can also arise because liquidity constraints require the firm to save more in the face of increased risk to satisfy the constraint. We find that the prudence motive is no longer empirically relevant, because the capital share of revenues is too low to impart any prudence. When capital is less important in generating revenues, future bad shocks to the marginal product of capital become less threatening and the firm no longer saves as a precaution against the future bad shocks. In contrast, the liquidity constraint motive can by itself explain the observed increase in cash holdings.

Market Power And Dividend Policy: A Risk-based Perspective

JUN ZHOU, Rotman School of Management, University of Toronto, Canada
Laurence Booth, Rotman School of Management, University of Toronto, Canada
Discussant: Adlai Fisher, University of British Columbia

Over the past two decades, by some measures, paying dividends has become a less favorable choice for firms. At the same time, the business environment in which firms operate has also become more competitive. This raises an interesting question: does a firm"s market power in its product market have an effect on its dividend policy, that is, is the competitive structure of the industry within which the firm operates important for financial policy? This paper investigates how and why market power affects a firm"s dividend policy. We use three measures of market power, the Herfindahl-Hirschman index, the degree of import competition and the Lerner Index and find that market power positively affects the dividend decision, both in terms of the probability of paying a dividend and the amount of the dividend. We also provide evidence that the route through which market structure affects the dividend decision is business risk: more competitive firms are riskier and less likely to pay dividends than firms with market power.

Hedge Funds 1 (Loyalist)
Chairperson: Lorne Switzer

Being Locked Up Hurts

Frans de Roon, Tilburg University, Netherlands
JINQIANG GUO, Tilburg University, Netherlands
Jenke ter Horst, Tilburg University, Netherlands
Discussant: Phelim Boyle, Wilfrid Laurier University

This paper examines multi-period asset allocation when portfolio rebalancing is difficult or impossible for some assets due to the existence of a lockup period. A lockup period restricts an investor's ability to rebalance his portfolio and has non-trivial effects on the allocation decision and portfolio efficiency. Our empirical analysis shows that both the unconditional strategy and conditional strategy benefit from adding hedge funds. More importantly, both the unconditional strategy and conditional strategy are hurt by the presence of a hedge fund lockup period. In an unconditional setting, we find a Sharpe ratio of 1.23 for the portfolio of stocks, bonds and hedge funds, with a three-month lockup period for hedge funds and monthly rebalancing of stocks and bonds. For the same portfolio, but without a lockup, we find a significantly higher Sharpe ratio of 1.53. The certainty equivalent is 4.2%, i.e. a three-month lockup costs the investor 4.2% per annum. Therefore, the economic significance of a lockup period is also evident. Investors compensate for the lockup period of hedge funds by making adjustments to their equity and bond holdings. Adding hedge funds to the portfolio of stocks and bonds reduces the allocation to stocks and increases the allocation to bonds in each month. Finally, the effect of a lockup period on portfolio performance is less pronounced when investing in funds of hedge funds relative to investing in individual hedge funds when the investment horizon is short, suggesting that funds of funds are able to suppress the effect of a lockup period.

Mr Madoff's Amazing Returns: An Analysis Of The Split-strike Conversion Strategy

CAROLE BERNARD, University of Waterloo, Canada
Phelim Boyle, Wilfrid Laurier University, Canada
Discussant: Nadia Massoud

It is now known that the very impressive investment returns generated by Bernie Madoff were based on a sophisticated Ponzi scheme. Madoff claimed to use a split-strike conversion strategy. This strategy consists of a long equity position plus a long put and a short call. In this paper we examine Madoff's returns and compare his investment performance with what could have been obtained using the split-strike conversion strategy based on the historical data. We also analyze the split-strike strategy in general and derive expressions for the expected return, standard deviation, Sharpe ratio and correlation with the market of this strategy. We find that the Madoff's returns lie well outside their theoretical bounds and should have raised suspicions about Madoff's performance.

Do Hedge Funds Trade On Private Information? Evidence From Syndicated Lending

NADIA MASSOUD, ,
Debarshi Nandy, ,
Keke Song, ,
Discussant: Jinqiang Guo, Tilburg University

Informed Trading (Imperial B)
Chairperson: Katya Malinova, University of Toronto

Microstructure Analysis Of Informed Trading In Tender Offers

IGOR SEMENENKO, University of Alberta, Canada
Discussant: Andreas Park, University of Toronto

This paper establishes a link between non-public information and informed investors' strategic behaviour in tender offers over the period from 1993 through 2006. Prior to a tender offer announcement, we observe leakage of information and stock accumulation by informed traders in friendly takeover deals. Following the announcement, informed traders heavily sell the stock if there is no managerial opposition to the deal. Larger sales of stock by informed traders are assosiated with probability of successful tender offer completion. Our results lend support to the stealth trading hypothesis proposed by Barclay and Warner (1993) and contradict results reported by Jarrel and Poulsen (1989), who link prebid price runup in tender offers with the legitimate market for information in line with the public information hypothesis.

A Trans-niagara Tale Of Informed Traders

PAUL MOON SUB CHOI, Cornell University / SUNY Binghamton SOM, United States
Discussant: Igor Semenenko, University of Alberta

The existing theory of international asset pricing cannot sufficiently explain why there exist sizable cross-listing premia in the pairs of Canadian shares traded on the exchanges separated by the Niagara Falls. This research provides a sufficient condition under which cross-border dominance in private information leads to positive premia. The probability of informed trading (PIN) proves to be a pithy and robust measure of asymmetric information priced in stocks fragmented across the border, along the timeline, and beyond the event horizon. Relative to the New York Stock Exchange (NYSE), the Toronto Stock Exchange (TSX) is heavier with informed trades and accounts for more in information share -- this is an explicit evidence of informed traders' contribution to cross-border price discovery. The informational imbalance leads to positive premia, whose parity-convergence is fostered by discretionary liquidity traders -- relating the dynamics of synchronous cross-listing premia to information asymmetry is novel. Lastly, the PIN on a TSX-listed share, on average, rises upon cross-listing on the NYSE -- this exacerbating adverse selection not only explains negative event study returns on the TSX but also unifies and extends previous claims in the literature.

Are Short Sellers Really Informed?

LEONARDO FERNANDEZ, University of Technology, Sydney, Australia
David Michayluk, University of Technology, Sydney, Australia
Discussant: Andriy Shkilko, Wilfrid Laurier University

For the cross-listed financial stocks on the Toronto Stock Exchange, the short selling ban in the US

necessitated Canadian regulators mimicking the ban. Because other stocks in Canada were not directly affected by the ban, we can make a clean comparison of the impact of short sellers on private information assimilation and market efficiency. This paper finds that short sellers do contribute to liquidity but their role as information providers is not supported since informed trading increased for cross-listed stocks when short sellers were not allowed to trade. Our results imply that short selling 'circuit breakers' may be necessary to constrain uninformed short sellers in declining markets.

Investment Banking (Imperial A)
Chairperson: Michael Hertzel, Arizona State University

Advisor Skill And Acquisition Performance: Do Investment Bankers Make A Difference?

KARTHIK KRISHNAN, Northeastern University, United States
Mine Ertugrul, Northeastern University, United States
Discussant: Marco Perez

Using a hand-collected dataset of investment banker turnovers between 1996 and 2003, we analyze the relationship between individual investment bankers and acquisition outcomes. We find that investment bankers have a statistically and economically significant association with announcement period returns, operating performance, and the long horizon stock returns of the acquirer. Investment bankers also have a significant association with deal completion time. In addition, firms with better corporate governance are more likely to be associated with bankers that have higher deal performance and faster completion time fixed effects. Bankers with Ivy League graduate degrees, multiple industry expertise, and more deal experience are associated with better deal performance, shorter deal completion times, and higher deal completion probabilities. Finally, we also find that investment bankers are associated with various deal characteristics. Our results suggest that the investment banker skill may be an important attribute for clients seeking deal advice.

Geographic Proximity Of Financial Advisors And Value Creation By Mergers And Acquisitions

Cong Wang, Chinese University of Hong Kong, Hong Kong
FEI XIE, George Mason University, United States
Discussant: Kai Li, UBC

Using cross-border mergers and acquisitions as a testing ground, we provide evidence that the geographic proximity of acquirer financial advisors to targets affects their ability to mitigate the information asymmetry faced by bidders in acquisitions. We find that when transactions are associated with greater information asymmetry, cross-border acquirers are more likely to retain the service of investment banks from target home countries, i.e., local advisors. The presence of a local advisor in advisory syndicates reduces the propensity of acquirers to use stock as the payment method, and shortens the time to completion of acquisitions. Most importantly, acquirers with local advisors experience significantly higher announcement-period abnormal returns than those without. These results are consistent with the hypothesis that local advisors possess an information advantage that enables them to help acquirers avoid overpaying and facilitate the transaction process.

Public Market Staging: The Timing Of Capital Infusions In Newly Public Firms

Michael Hertzel, Arizona State University, United States
MARK HUSON, University of Alberta, Canada
Robert Parrino, University of Texas at Austin, United States
Discussant: Jean Helwege, Penn State University

We examine financing activities of newly public firms for evidence on whether factors that explain the structure of staged venture capital investment also explain the timing of capital infusions in newly public firms. The analysis is considered in an agency cost framework where investors face a sequential financing problem: sequential financing increases issue costs, but controls the overinvestment problem that can arise when funds are provided prior to the maturity of an investment option. Our analysis focuses on the time to the first post-IPO capital infusion. Using

hazard analysis, we find that the time to the first post-IPO capital infusion decreases with the ratio of intangible to total assets, R&D intensity, and in firms' investment intensity relative to funds raised. These findings are remarkably similar to findings on venture capital staging documented in Gompers (1995) and are consistent with the agency cost hypothesis. Our findings are relevant to the broad literature that considers alternative explanations of the timing of capital raising activities.

Option Pricing (Trillium)
Chairperson: Lars Stentoft, HEC Montreal

Valuation Of Housing Index Derivatives
MELANIE CAO, York University, Canada
Jason Wei, University of Toronto, Canada
Discussant: Alexander David, Haskayne School of Business, University of Calgary

This paper studies the housing index derivatives which are traded at the Chicago Mercantile Exchange (CME). First, we show that there exists a great potential benefit of using the CME housing index derivatives for asset allocation and portfolio management. Second, we propose and implement an equilibrium valuation framework for the housing index derivatives, to handle the illiquid nature of the underlying residential housing market. Based on the CRRA utility and a mean-reverting process for the aggregate dividend, we show that these derivatives prices depend only on the parameters for the underlying housing index, the interest rate and their correlation. We analytically and numerically examine the risk premiums for the CME futures and options. Three important observations are drawn from the analysis. First, the risk premiums are significant for all futures and options contracts with maturities longer than one year. Second, the expected growth rate of the underlying housing index is the key determinant for the magnitude of the risk premium. Third, the risk premiums can be positive or negative, depending on the whether the expected growth rate of the underlying index is higher than the riskfree yield-to-maturity.

Bayesian Option Pricing Using Mixed Model Normal Heteroskedasticity Models
Jeroen Rombouts, HEC Montreal, Canada
LARS STENTOFT, HEC Montreal, Canada
Discussant: Fuad Farooqi

While stochastic volatility models improve on the option pricing error when compared to the Black-Scholes-Merton model, mispricings remain. This paper uses mixed normal heteroskedasticity models to price options. Our model allows for significant negative skewness and time varying higher order moments of the risk neutral distribution. Parameter inference using Gibbs sampling is explained and we detail how to compute risk neutral predictive densities taking into account parameter uncertainty. When forecasting out-of-sample options on the S&P 500 index, substantial improvements are found compared to a benchmark model in terms of dollar losses and the ability to explain the smirk in implied volatilities.

Macroeconomic Uncertainty And Fear Measures Extracted From Index Options
ALEXANDER DAVID, Haskayne School of Business, University of Calgary, Canada
Pietro Veronesi, Booth School of Business, University of Chicago, United States
Discussant: Lars Stentoft, HEC Montreal

We demonstrate that about half the time series variation in two popular market-wide fear indices extracted from S&P 500 index options prices -- the at-the-money implied volatility (ATMIV), and the ratio of implied volatilities of out-of-the-money puts and calls (P/C)-- can be explained by investors' learning of the state of fundamentals through business cycles. Our model ATMIV is higher during periods of higher uncertainty about earnings growth and captures the information in standard macroeconomic variables in the volatility literature. The model P/C is higher during periods of higher expected earnings growth, but varies quite significantly with inflation expectations. It makes investor sentiment measures from the empirical behavioral finance literature insignificant. As further support for the learning mechanism we demonstrate the ability of our model to explain (i) the positive relation between volatility and the volatility of volatility, (ii)

the puzzling change in sign of the relation between P/E and put-call ratios in 1994, and (iii) The negative (positive) association between short rates and ATMIV in periods of stimulative (non-stimulative) monetary policy. None of these three stylized facts can be explained by standard option pricing models (such as Heston's stochastic volatility model).

1.45 PM - 3.15 PM

Accounting and Regulation (Trillium)
Chairperson: Edward Lawrence, Florida International University

Cross Listing, Management Earnings Forecasts, And Firm Values

YAQI SHI, Ivey Business School - UWO, Canada
JeongBon Kim, Hong Kong Polytechnic University,
Michel Magnan, Concordia University,
Discussant: Edward Lawrence, Florida International University

This paper examines the economic consequences of management earnings forecasts made by cross-listed firms migrating into the U.S. markets. Specifically, we test whether forecasting firms are associated with enhanced firm valuation compared to non-forecasting firms. We also study how firm-level forecasting practices interact with country-level legal institutions to influence the results. First, we find that cross-listed firms in the U.S. that make earnings forecasts are associated with higher valuation premiums (Tobin's Q). Further, we provide evidence that cross-listed firms from weaker legal regimes are valued more for their forecasts relative to firms from stronger legal regimes. We also indicate that cross-listed firms that release more precise and more frequent forecasts enjoy higher valuation premiums. Overall, the results suggest that cross-listed firms' sequential voluntary commitment to more transparent corporate governance is rewarded by the investors. In this light, this paper extends the literature on management earnings forecasts and on cross listing, and provides insight for the SEC regulators, and firm managers.

Effect Of Regulation Fd On Disclosure Of Information By Firms

Rashiqa Kamal, University of Wisconsin, Whitewater WI,, United States
EDWARD LAWRENCE, Florida International University, Miami FL, United States
George McCabe, University of Nebraska, Lincoln NE, United States
Arun Prakash, Florida International University, Miami FL, United States
Discussant: Yuri Khoroshilov, University of Ottawa Telfer School of Management

The SEC's fair disclosure (FD) law was aimed at removing the practice of selective disclosure by firms, but critics of the law argued that the law might result in reduced disclosure of information by issuers (firms) thus reducing the overall information in the market and hurting investors. In this paper we study the effect of Regulation FD on the disclosure of information by firms by comparing the informational value of additions to the S&P 500 in the pre and post FD periods. Our results indicate an increase in the public information disclosed by firms in the post FD period thus showing the effectiveness of Regulation FD.

Financial Restatements, Litigation, And Implied Cost Of Equity

KATSIARYNA SALAVEI, Fairfield University, United States
Dev Mishra, University of Saskatchewan, Canada
Discussant: Sean Cleary, Queen's University

We examine the effect of litigation-triggering financial restatements on the cost of equity using a sample of 91 financial restatements initiated from 1997 to 2002. While we find that the cost of equity increases subsequent to a restatement for all restating firms, the increase in the cost of equity is substantially greater for firms facing litigation as a result of the restatement. We also find that investors do not adjust for the cost of equity prior to the announcement of a financial restatement for firms facing post-restatement litigation. Overall, our findings suggest that the cost of equity is an important channel through which litigation associated with financial restatement is priced. The economic effect of post-restatement litigation is an increase in the firm's cost of equity of approximately 259 basis points.

Anomalies (Imperial B)
Chairperson: Laurence Booth, Rotman, University of Toronto

Excess Cash Holdings, Risk, And Stock Returns

MIKHAIL SIMUTIN, University of British Columbia, Canada
Discussant: Wendy Rotenberg, University of Toronto

Investing in firms with high excess cash levels while shorting those with low excess cash levels earns approximately 0.4% monthly, increasing to 0.5% after accounting for standard 3-factor risk adjustment. I explore whether excess cash serves as a proxy for growth options, and find that firms with larger liquid holdings have higher future investment and larger market betas. High-cash firms do not experience stronger profitability in the future and generate lower returns in market downturns than do their low-cash peers.

The Influence Of Unusual Economic Conditions On The Occurrence Of The Size Anomaly

Charles E. Mossman, University of Manitoba, Canada
SERGIY RAKHMAYIL, Ryerson University, Canada
Discussant: Esther Eiling, University of Toronto, Rotman School of Management

Much of the explanation for the size anomaly has been assigned to taxation and behavioural issues near the end of the calendar year. However, factor models based on company characteristics suggest that some type of risk may also have a long term effect on returns. We use a traditional multifactor model to re-examine the influence of macroeconomic variables on the magnitude and direction of size portfolio returns using traditional and Logit regression models. Our results indicate significant differences in sensitivity of returns to the market risk factor across size portfolios, but limited mean return effects of economic and financial factors. However, we find that macroeconomic factors that take on unusually extreme values influence the probable direction of annual size anomalies. The unusual economic conditions may influence investor risk-return expectations differentially across size portfolios. These differing expectations are reflected in the occurrence of a size anomaly.

Truly Ambiguous: Cheap Versus Chic

FATMA SONMEZ SARYAL, Rotman School of Management, Canada
Discussant: Olesya Grishchenko, Penn State University

This paper examines the nominal stock price as an investment criterion. I call low-price stocks that are $5 or less as cheap stocks, and high-priced stocks as chic stocks. I find three key results: First, ignoring transaction costs, an investment strategy that is chic minus cheap stocks earns abnormally positive return in the next month. However, the same trading rule earns abnormally negative return when January is the only holding period. Second, I document that idiosyncratic volatility is high for cheap stocks and low for chic stocks over the sample period. The differences in idiosyncratic volatility levels between the cheap and chic stocks can be interpreted as the source of the observed positive abnormal return of the chic minus cheap portfolio. Finally, I show that the relation between idiosyncratic volatility and future stock returns is negative for the cheap portfolio and positive for the chic portfolio.

Capital Structure (Balmoral)
Chairperson: Vijay Jog, Eric Sprott School of Business, Carleton University

Firm-specific Human Capital And Firm Leverage: A Test Of Stakeholder Theory Of Capital Structure

Kee-Hong Bae, York University, Canada
Jun-Koo Kang, Nanyang Technological University, Singapore
JIN WANG, Queen's University, Canada
Discussant: Hamed Mahmudi, Rotman School of Management, University of Toronto

We investigate the stakeholder theory of capital structure from the perspective of a firm's relationships with its employees. We find that firms that value employees' firm-specific human capital, as measured by high ratings on firms' friendliness towards their employees, maintain low debt ratios. This result is robust to a variety of model specifications. The negative relation between

leverage and the importance of employees' firm-specific human capital is also evident when we measure its importance as the number of a firm's patent activity. These results suggest that human asset specificity is an important consideration when firms make financing decisions.

International Tests Of The Pecking Order Theory

Wolfgang Bessler, University of Gießen, Germany
WOLFGANG DROBETZ, University of Hamburg, Germany
Matthias Grüninger, University of Basel, Switzerland
Discussant: Jin Wang, Queen's University

This paper conducts different tests of the pecking order theory using an international sample of more than 6,000 firms over the period from 1995 to 2005. Contrary to the prediction of the pecking order theory, net equity issues track the financing deficit more closely than net debt issues. In time-series tests with the changes in net debt as the dependent and the financing deficit as the explanatory variable, we report more evidence for the pecking order theory for non-U.S. firms and firms from civil law countries than for U.S. firms. In a nested model, standard capital structure variables are not wiped out from the model, and in many instances they have the signs as predicted by the trade-off theory. Although the financing deficit is empirically relevant, the corresponding coefficients are economically small. When we include a time-varying measure for information asymmetry based on the dispersion of analysts' forecasts, our findings indicate that U.S. firms and firms from common law countries tend to deviate from the static pecking order when adverse selection costs are low or growth opportunities are high. A possible explanation to reconcile our findings is that the financing hierarchy in non-U.S. firms and firms from civil law countries is driven by agency costs of managerial discretion rather than adverse selection costs.

Relative Tax Rates And Debt Shifting:new Evidence From Canada

VIJAY JOG, Carleton University, Canada
Discussant: Wolfgang Drobetz, University of Hamburg

The importance of foreign controlled corporations (FCCs) to Canadian economy, in general, and to its corporate tax base, in particular, remains high In 2002, according to the OECD, the Canadian Corporate tax rate went below the U.S. corporate tax rate for the first time since the 1980s - 3 percent lower than US tax rates - and it has remained there since. This represented a change of 9 percent when compared to the year 2000, when Canadian tax rates were almost 6 percent higher than US tax rates. In this paper, we focus on the debt equity decision of FCCs in light of these significant changes in relative tax rates and show that, consistent with the theoretical predictions, FCCs in Canada have a noticeably lower debt equity ratio than their Canadian counterparts. Our analysis of firm level data using an out of sample supports our main conclusion. Our estimates suggest that without the changes to the tax differential, FCCs in Canada would have increased their debt levels by $86.7 billion (a range of $69.2 – $104.2); their annual interest payments (assuming a 6 percent interest rate) would have been higher by $5.2 billion (a range of $4.2 – $6.3 billion); and tax receipts would have decreased by $1.8 billion (a range of $1.5 – $2.2 billion). None of these are insignificant numbers given that the total average annual taxes paid by these FCCs in our sample was $12.4 billion.

Correlation and Coskewness (Somerset)
Chairperson: Peter Klein, Simon Fraser University

Pricing Kernels With Coskewness And Volatility Risk

FOUSSENI CHABI-YO, Fisher College of Business, Ohio State University, United States
Discussant: Bo-Young Chang, McGill University

I investigate a pricing kernel in which coskewness and the market volatility risk factors are endogenously determined. I show that the price of coskewness and market volatility risk are restricted by investor risk aversion and skewness preference. The risk aversion is estimated to be between two and five and significant. The price of volatility risk ranges from -1.5% to -0.15% per year. Consistent with theory, I find that the pricing kernel is decreasing in the aggregate wealth and increasing in the market volatility. When I project my estimated pricing kernel on a polynomial

function of the market return, doing so produces the puzzling behaviors observed in pricing kernel. Using pricing kernels, I examine the sources of the idiosyncratic volatility premium. I find that nonzero risk aversion and firms' non-systematic coskewness determine the premium on idiosyncratic volatility risk. When I control for the non-systematic coskewness factor, I find no significant relation between idiosyncratic volatility and stock expected returns. My results are robust across different sample periods, different measures of market volatility and firm characteristics.

Default Risk, Idiosyncratic Coskewness And Equity Returns

Fousseni Chabi-Yo, Ohio State University, United States
JUN YANG, Bank of Canada, Canada
Discussant: Bill Bobey, St Mary's University Sobey School of Business

In this paper, we intend to explain an empirical finding that distressed stocks delivered anomalously low returns. We show that in a linear factor model where idiosyncratic volatility is priced, the marginal contribution of idiosyncratic skewness to equity returns depends on idiosyncratic coskewness betas, which measure the covariance between idiosyncratic variance and the risk factor. We provide empirical results that support the theoretical prediction that there is a negative (positive) relation between idiosyncratic skewness and equity returns when idiosyncratic coskewness betas are positive (negative). We construct two idiosyncratic coskewness factors to capture market-wide effect of idiosyncratic coskewness betas. When we control for these two idiosyncratic coskewness factors, the return difference for distress-sorted portfolios becomes insignificant. High stressed firm earn low returns because high stressed firms have high idiosyncratic coskewness betas when idiosyncratic coskewness betas are positive, and low idiosyncratic coskewness betas when idiosyncratic coskewness betas are negative.

The Effects Of Default Correlation On Corporate Bond Credit Spreads

BILL BOBEY, St Mary's University Sobey School of Business , Canada
Discussant: Yuriy Zabolotnyuk, Carleton University

The tendency for firms' defaults to cluster, although a widely accepted phenomenon in bond and credit derivatives markets, has yet to be related to corporate bond credit spreads. Default clustering indicates periods of increased default risk and highly correlated defaults, and therefore, it should be positively related with credit spreads. To test this I introduce a new systematic component to credit spread decomposition, a measure of default correlation that is implied from collateralized debt obligation market spreads, and I find evidence supporting the prediction. From January 2004 to June 2006 a 14% increase in the average one-year probability of default corresponds to an increase in credit spreads in the order of 2 basis points, or 5.7% of the mean credit spread; this after controlling for bond and firm characteristics, the risk-free term structure, equity market returns and volatility, and firm fixed effects. I also find evidence that credit spread changes with respect to default correlation are decreasing in firm size and diversity. This is consistent with contagion, wherein a large diversified firm's credit event is more likely to induce credit events in other firms than is a small non-diversified firm's credit event. In addition, I find the explained variation in credit spreads is predominately due to firm characteristics and report limited evidence of a missing common factor in the unexplained variation. In presenting the new systematic factor, I outline key features of CDOs and explain default correlation's role in their valuation.

Fixed Income 2 (Loyalist)
Chairperson: Usha Mittoo, University of Manitoba

Change Points In Term-structure Models: Pricing, Estimation And Forecasting

KYU HO KANG, Washington University in St. Louis, United States
Siddhartha Chib, Washington University in St. Louis, United States
Discussant: Marco Rossi, Penn State University

In this paper we theoretically and empirically examine structural changes in a dynamic term-structure model of zero-coupon bond yields. To do this, we develop a new arbitrage-free one latent

and two macro-economics factor affine model to price default-free bonds when the parameters in the dynamics of the factor evolution, in the model of the market price of factor risks, and in the process of the stochastic discount factor, are all subject to change at unknown time points. The bonds in our set-up can be priced straightforwardly once the change-point model is re-formulated in the manner of citet{Chib98} as a specific unidirectional Markov process with restricted transition probabilities. We consider four versions of our general model - with 0, 1, 2 and 3 change-points - to a collection of 16 yields measured quarterly over the period 1972:I to 2007:IV. Our empirical approach to inference is fully Bayesian with priors set up to reflect the assumption of a positive term-premium. The use of Bayesian techniques is particularly relevant because the models are high-dimensional (containing 168 parameters in the situation with 3 change-points) and non-linear, and because it is more straightforward to compare our different change-point models from the Bayesian perspective. Our estimation results indicate that the model with 3 change-points is most supported by the data (in comparison with models with 0, 1 and 2 change-points) and that the breaks occurred in 1980:II, 1986:I and 1995:II. These dates correspond (in turn) to the time of a change in monetary policy, the onset of what is termed the great moderation, and the start of technology driven period of economic growth. We also utilize the Bayesian framework to derive the out-of-sample predictive densities of the term-structure. We find that the forecasting performance of our proposed model is substantially better than that of the other models we examine.

The Geography Of European Convertible Bonds: Why Firms Issue Convertibles?

Franck Bancel, ESCP-EAP, France
Usha Mittoo, University of Manitoba, Canada
ZHOU ZHANG, University of Regina, Canada
Discussant: Anna Danielova, McMaster University

Why firms issue convertible debt is still one of the unresolved puzzles in finance. While several theories provide rationales for convertible issuance, empirical evidence is mixed and unclear. Another puzzling feature is that a small number of countries dominate the global convertible market, suggesting that country-specific factors may play an important role in the use of convertibles. However, little prior research has been done to examine their influence on the convertible issuance decision. In this paper, we attempt to fill this gap in the literature by looking at the geography of European convertibles to gain insight into the motivations for issuing convertibles. Using a unique European convertible database from 1992 to 2005, we show that country-specific factors, including legal and economic factors, have a significant impact on the likelihood of convertible issuance, after controlling for firm-specific and market-specific factors.

Volatility, Liquidity, And Corporate Bond Returns

MARCO ROSSI, Penn State, United States
Discussant: Kyu Ho Kang, Washington University in St. Louis

This study revisits the role of illiquidity as a determinant of corporate bond prices. Using transaction data from TRACE from January 2003 to December 2008, I find that credit risk is overwhelmingly more important than illiquidity in explaining the cross sectional variation of corporate yield spreads. In particular, high-frequency, firm-specific volatility measures such as equity realized volatility explain 40% of the variation, and as much as 79% of the variation in a multivariate context. In contrast, trading-based liquidity measures such as the percentage of zero trading days, the friction measure used by Chen, Lesmond, and Wei (2007), and a new measure of friction derived in this paper add very little explanatory power (approximately 1% of R2) to yield spread regressions. Unlike other friction models, my model includes firm-specfic factors in the return generating process and relaxes the assumption of constant liquidity. As a result, this modeling approach yields liquidity cost estimates that are lower and uncorrelated with yield spreads. Overall, my findings suggest that credit risk is the main driver of corporate yield spreads and that other commonly used trading-based liquidity measures actually capture credit risk.

Market Microstructure (Imperial A)
Chairperson: Aditya Kaul, University of Alberta

Herding, Contrarianism And Delay In Financial Market Trading

ANDREAS PARK, University of Toronto, Canada
Daniel Sgroi, University of Warwick, United Kingdom
Discussant: Carmen Stefanescu, ESSEC BUSINESS SCHOOL PARIS

Herding and contrarian behavior are often-cited features of real-world financial markets. Theoretical models of continuous trading that study herding and contrarianism, however, are inherently complex and usually do not allow traders to choose when to trade or to trade more than once. We present a large-scale experiment to explore these features within a tightly controlled laboratory environment. Herding and contrarianism are significantly more pronounced than in comparable studies that do not allow traders to time their decisions. Traders with extreme information tend to trade earliest, followed by those with information conducive to contrarianism, while those with the theoretical potential to herd delay the most.

Institutional Herding And Information Cascades: Evidence From Daily Trades

Susan Christoffersen, McGill University, Canada
YA TANG, McGill University, Canada
Discussant: Igor Semenenko , University of Alberta

The literature has documented that institutional investors trade together and that correlation in trading has an impact on future prices. Using daily trade and quote data, we test specifically whether institutional trading patterns are consistent with the theoretical models of information cascades. We find variables proxying for information asymmetry to positively predict increased levels of institutional herding at high frequencies and that herding decreases monotonically with the estimation horizon. There is evidence that days with high levels of herding are subsequently followed by price reversals but these are limited to those stocks where market makers are unlikely to adjust prices quickly believing trading is informative, consistent with the theoretical models of information cascades. The paper also shows that the daily trade and quote data can be used to provide similar estimates of herding as previously estimated in the literature.

Option Trading: Information Or Speculation?

SIU KAI CHOY, University of Toronto, Canada
Jason Wei, University of Toronto, Canada
Discussant: Keywan Rasekhschaffe

This paper investigates the motive of option trading. We show that option trading is driven by speculation or opinion dispersion, not by information. Our findings are in sharp contrast to the current literature that attempts to attribute option trading to information asymmetry. We present three specific findings. First, cross-section and time-series regressions reveal that option trading is significantly explained by opinion dispersion. While informed trading is present in stocks, it is absent in options. Second, option trading around earnings announcements is speculative in nature and mostly dominated by small, retail investors. Third, around earnings announcements, the preannouncement abnormal turnovers of options seem to predict the post-announcement abnormal returns. However, once we control for the pre-announcement returns, the predictability completely disappears.

3.30 PM - 5.00 PM

Asset Pricing and Liquidity (Imperial B)
Chairperson: David Goldreich, University of Toronto

Behavior Of Liquidity And Returns Around Canadian Seasoned Equity Offerings

LAWRENCE KRYZANOWSKI, Concordia University, Canada
Skander Lazrak, Brock University, Canada
Ian Rakita, Concordia University, Canada
Discussant: Kent Womack

Liquidity improves for announcement and closing windows for Canadian SEOs. The adverse selection (temporary) spread cost follows an approximate V-shaped pattern achieving its lowest

level at the announcement (closing) window. The adverse selection cost of privately-placed Canadian SEOs decreases after Multilateral Instrument 45-102 reduced the lock-up period to four months in 2001. Consistent with the reductions in information asymmetry, negative (not robust) abnormal returns occur in announcement and closing windows for undifferentiated SEOs. Abnormal returns are significantly different for public (significantly negative) versus private (insignificantly positive) SEOs. Conditional residual volatilities decrease post-announcement, consistent with a diminished temporary spread cost.

Flight-to-liquidity And Global Equity Returns
Ruslan Goyenko, McGill University, Canada
SERGEI SARKISSIAN, McGill University, Canada
Discussant: Dan Liang, School of Economics, Shanghai University of Finance and Economics

Investment practice and academic literature document a great degree of interaction between stock markets around the world and most liquid and safest assets such as the US Treasury bonds. Using data from 46 markets, we examine the joint impact of the "flight-to-liquidity" and "flight-to-quality" on global asset valuation. Our proxy for the flight-to-liquidity/quality is the illiquidity of US short-term Treasury bonds. We find that it is a leading indicator of the stock market illiquidity, and that it is also a strong predictor of future equity returns in both developed and emerging markets. This predictive relation remains intact after controlling for other global and local variables, including the lagged US term spread, dividend yields, equity market returns, as well as global and local stock market illiquidity. Subsequent tests reveal that the bond illiquidity is significantly correlated with contemporaneous stock market returns, and that it is a priced factor even in the presence of other conventional risk factors, such as the world stock market return, exchange rate, stock market illiquidity, and the term spread. Our results indicate that the flight-to-liquidity/quality risk is an important determinant of returns in global equity markets.

Liquidity Risk, Firm Risk, And Issue Risk Premium Effects On The Abnormal Returns To New Issues Of Convertible Bonds
LORNE SWITZER, ,
Jinlin Liu, ,
Discussant: Ambrus Kecskes

Corporate Governance (Balmoral)
Chairperson: Yisong Tian, York University

Compensation Contract Adjustments And The Economic Consequences Of Financial Reporting In Response To Fas 123r: Accelerated Vesting Of Employee Stock Options
FAYEZ ELAYAN, Brock University, Canada
Thomas Meyer, Southeastern Louisiana University, United States
Jingyu Li, Brock University, Canada
Discussant: Yi Feng, Ryerson University

Do mandated changes in accounting policy result in the reapportionment of executive equity compensation? Specifically, is this true for firms accounting for employee stock options (ESOs) under FAS 123R? This research addresses how this policy change motivated firms to substitute restricted stock awards (RSAs) and other non-option compensation for ESOs. Accelerating firms that overweighted options in their compensation structure are shown to utilize the implementation of FAS 123R as a deadline to reduce ESOs relative to RSAs. The evidence does not indicate that accelerating firms are managing option expense recognition in an effort to minimize management option compensation costs.

Does Mandatory Disclosure Of Directors' And Officers' Liability Insurance Curb Managerial Opportunism? Evidence From The Canadian Secondary Market
NABIL GHALLEB, King Fahad University of Petroleum & Minerals, Saudi Arabia
Narjess Boubakri, HEC Montreal, Canada
Discussant: Teodora Paligorova, Bank of Canada

[Entrenchment Or Incentive? Ceo Employment Contracts And Corporate Acquisition Decisions](#)
JING ZHAO, North Carolina State University, United States
Discussant: Daisy Li, Ivey Business School, UWO

Do CEO employment contracts insulate under-performing CEOs from the discipline and facilitate managerial entrenchment, or do contracts alleviate managerial myopia and encourage value-maximizing decisions? Using a unique hand-collected data on CEO employment contracts during 1990-2005, this study examines the impact of CEO contracts on acquirer profitability and risk-taking behavior. I find that acquirers with CEO contracts experience significantly higher announcement-period stock returns and long-run post-acquisition abnormal returns than acquirers without these contracts. Bidder CEOs with contracts also pay lower premia for their targets and tend to engage in riskier deals. The probability of using a CEO contract is higher when the likelihood of managerial myopia is higher and when the expected shareholder costs of managerial myopia are larger. Overall, the results support the notion that CEO employment contracts help mitigate managerial concerns over delivering short-term profits and motivate investments that maximize shareholder value in the long run.

Financial Crises (Somerset)
Chairperson: Michael King, Bank for International Settlements

[Central Bank Initiatives And Market Outcomes](#)
ERIC SANTOR, Bank of Canada,
Lena Suchanek, ,
Discussant: Jean Helwege, Penn State University

[Price Inflation And Uninformed Trader Losses Due To The 2008 Sec Short Sale Ban](#)
BLAKE PHILLIPS, University of Waterloo, Canada
Lawrence Harris, University of Southern California, United States
Ethan Namvar, University of California - Irvine, United States
Discussant: Paul Moon Sub Choi, Cornell University / SUNY Binghamton SOM

Using a factor-analytic model that extracts common valuation information from the prices of stocks that were not banned, we estimate that the ban on short-selling financial stocks imposed by the SEC in September 2008 led to substantial price inflation in the banned stocks. The inflation reversed somewhat following the ban, but the data are too noisy to conclusively link the reversal to the ban. If prices were inflated, buyers paid more than they otherwise would have paid for the banned stocks during the period of the ban. We provide a conservative estimate of $4.9B for the resulting transfer from buyers to sellers. Such transfers should interest policy makers concerned about maintaining fair markets.

[Systemic Risk-taking: Amplification Effects, Externalities, And Regulatory Responses](#)
ANTON KORINEK, University of Maryland, United States
Discussant: Eric Santor, Bank of Canada

This paper develops a simple model of systemic risk in the form of financial accelerator effects whereby adverse developments in financial markets and in the real economy mutually reinforce each other and lead to a feedback cycle of falling asset prices, deteriorating balance sheets and tightening financing conditions. The paper shows that the free market equilibrium in such an environment is generically inefficient because constrained market participants do not internalize that their actions entail amplification effects. Therefore they undervalue the social benefits of liquidity during crises and take on too much systemic risk. We use our framework to shed light on a number of current policy issues: We show that banks face socially insufficient incentives to raise more capital during systemic crises, that bailouts which are anticipated can be ineffective, and that expectational errors are considerably more costly during crises than in normal times. Furthermore we develop the basic building blocks of a new analytical framework of macro-prudential capital adequacy requirements that take into account systemic risk. We also analyze channels of financial contagion and explain why private agents will take insufficient precautions against contagion from other sectors in the economy.

Hedge Funds 2 (Loyalist)
Chairperson: Nadia Massoud

Analysis Of Hedge Fund Investment Choice

YUNHUA ZHU, Wilfrid Laurier University, Canada
Discussant: Evan Dudley, University of Florida

This paper analyzes hedge fund investment choice by studying the relationship among incentive fees, risk taking and managerial effort. In a simple one-period model, the hedge fund manager maximizes his expected utility of terminal wealth by choosing managerial effort and leverage subject to a participation constraint. We find both participation constraint and poor performance penalty can effectively restrict a hedge fund manager's risk taking. Managerial ownership can also restrict the manager's risk taking, but when the manager is close to risk neutral it's no longer effective. The manager tends to use more leverage and exerting more effort when the manager's ownership increases. With the participation constraint, the manager is willing to devote less effort and take lower leverage. This paper addresses the importance of maintaining a good track record to preserve capital and reputation and the needs to fulfill investors' expectations. In addition, we examine the impacts of model parameters such as the poor performance penalty parameter, the high-water mark, the incentive fee fraction and the cost of effort on the optimal investment choice.

Share Restrictions, Risk Taking And Hedge Fund Performance

JUHA JOENVääRä, University of Oulu, Faculty of Economics and Business administration, Department of accounting and finance, Finland
Pekka Tolonen, University of Oulu, Faculty of Economics and Business administration, Department of accounting and finance, Finland
Discussant: Yunhua Zhu, Wilfrid Laurier University

This paper examines the impact of share restrictions on the risk- taking and on the performance of hedge funds using the Hedge Fund Research (HFR) database. Share restrictions, in the form of longer lockup as well as notice and redemption periods, provide flexibility for the managers. Our results suggest that this flexibility allows hedge fund managers with lockup provision to take an excess risk, which is not compensated, when performance is measured as a unit of the risk taken by the manager. Specifically, we find that typical hedge funds with a lockup provision deliver 5.6-6.6% (3.8-5.4%) lower Fung and Hsieh (2004) appraisal ratios (Sharpe ratios) compared to their peers without a lockup provision. The results remain consistent even after controlling for various database biases, alternative risk and performance measures, and nonlinearities in hedge fund returns.

Hedge Fund Contagion, Liquidity Spirals And Flight To Quality

EVAN DUDLEY, University of Florida, United States
Mahendrarajah Nimalendran, University of Florida, United States
Discussant: Juha Joenväärä, University of Oulu, Faculty of Economics and Business administration, Department of accounting and finance

We develop a novel approach that investigates the economic determinants of contagion among hedge funds. Our approach explicitly takes into account the left tail dependency between returns. We empirically investigate the relative importance of three economic channels that potentially explain contagion among hedge fund indices. We find that funding liquidity (proxied by margins on equity and currency futures contracts for members of the Chicago Mercantile Exchange), which captures the extent to which a fund can finance its positions, is a significant determinant of financial contagion. Our results on funding liquidity confirm the predictions made by Brunnermeier and Pedersen (2009) that market liquidity and funding liquidity interact to create liquidity spirals in which shocks to market liquidity reduce funding liquidity which in turn further reduces market liquidity. Our results also show that ``flights to collateral" of the nature described in Fostel and Geanakoplos (2008) are a significant determinant of contagion among some types of hedge fund strategies. We find little support for the third channel, which is the consumption effect described in Fostel and Geanakoplos (2008), whereby asset prices decrease because bad news about one asset class increases the price of risk for all securities.

International Finance - Home Bias (Trillium)
Chairperson: Kai Li, UBC

Is Information The Motive For Home Bias? A New Perspective From Motives Of Trading
XI DONG, Boston College, United States
Discussant: Pei Shao, University of Northern British Columbia

The information-based explanation of home bias argues that informed investors have more precise private information about domestic stocks than about foreign stocks; they therefore have strong informational motive (to counterbalance their risk-sharing motive) to hold more domestic stocks. However, empirical evidence for information-based explanation is very controversial. This paper introduces a new perspective to understand the role of information in investors' motivation of home bias. My approach is based on Llorente, Michaely, Saar, and Wang (2002) in which the relative strength of return continuation (price momentum) vs return reversal following high volume days reflects the relative importance of information-motivated speculative trade vs risk-sharing trade. I find that non-U.S. cross-listed stocks traded in U.S. have weaker (stronger) return continuation (reversal) following high volume days than matched U.S. stocks controlling for size, industry, price, total risk, illiquidity, and the bid-ask bounce effect. This pattern is economically significant and it is especially strong for those non-U.S. stocks from regions where U.S. investors have more difficulty to obtain private information. Cross-listed stocks also have weaker (stronger) return continuation (reversal) following high volume days than their home country counterparts. This pattern is driven by cross-listed stocks from regions where local informed investors' private information trading is strong while U.S. investors have more difficulty to learn information. Overall, the findings suggest that even for cross-listed stocks, the type of stocks that foreign investors should have the least information disadvantage, cross-country information asymmetry is still an important factor in investors' trading. The results provide support for the information-based explanation of home bias.

Multi-country Event Study Methods
Cynthia Campbell, Iowa State University, United States
ARNOLD COWAN, Iowa State University and Eventus, United States
Valentina Salotti, Iowa State University, United States
Discussant: Michael Hertzel, Arizona State University

Which event study methods are best in non-U.S. multi-country samples? Nonparametric tests, especially the rank and generalized sign, are better specified and more powerful than common parametric tests, especially in multi-day windows. The generalized sign test is the best statistic but must be applied to buy-and-hold abnormal returns for correct specification. Market-adjusted and market-model methods with local market indexes, without conversion to a common currency, work well. The results are robust to limiting the samples to situations expected to be problematic for test specification or power. Applying the tests that perform best in simulation to merger announcements produces reasonable results.

Chinese Medicine
PETER KLEIN, Simon Fraser University, Canada
Discussant: Mark Huson, University of Alberta

In this paper we examine the extent to which diversification benefits from emerging equity markets disappear in times of increasing credit concern. We consider this issue from the perspective of a Canadian investor who has a large allocation to domestic equities. Our results generally show that diversification benefits from emerging market equities are still substantial overall and when credit conditions are good. During periods of increasing credit concern, however, these benefits are greatly diminished. In contrast, we find that China's low correlation with the TSX is relatively unchanged during periods of increasing credit concern when the benefits of diversification are needed most. This implies that allocations to the Chinese stock market should form a fairly large part of the non-domestic portfolio of most Canadian investors.

Trading (Imperial A)

Chairperson: Douglas Cumming, York University

Short Changed? The Market's Reaction To The Short Sale Ban Of 2008
Louis Gagnon, Queen's University, Canada
JONATHAN WITMER, Bank of Canada, Canada
Discussant: Dan Li

We exploit the natural experimental setting created by the short sale ban of 2008 in order to shed light on the impact of short sales restrictions on the price discovery process. Using a comprehensive sample of Canadian inter-listed stocks trading simultaneously in the U.S. and Canada, during the ban we report a 73 bps increase in price of the cross-listed financials stocks in the U.S. (from -5 bps pre- to +68 bps during the ban) relative to Canada as well as a substantial migration of the trading volume from the U.S. to Canada, both of which were reversed after the ban is terminated. Our findings lend support to Miller's (1977) investor optimism theory and imply that pessimistic investors are more preponderant in the cross-listed market than in the home market. This interpretation is reinforced by the fact that the proportion of shares shorted in the U.S. is much larger than in Canada for both groups of stocks. This is an important insight which, to the best of our knowledge, is new to the literature.

Compensating Executives By Insider Trading? International Evidence
JIN XU, Purdue University, United States
Discussant: Melanie Cao, York University

I examine whether and how the ability to conduct insider trading is related to executives' compensation. Insider trading may motivate managerial effort to innovate, but it may also create value-destroying incentives. Therefore, there can be less or more demand for explicit incentive compensation due to the possibility of insider trading. In a sample of 468 ADR firms headquartered in forty countries and 270 U.S. firms in 2006, I find that firms in countries with stricter insider trading laws pay higher total compensation and use a greater fraction of e1quity-based incentive compensation, consistent with insider trading being an incentive device. The effects are especially strong among firms with low insider ownership, as low ownership managers need more incentives and are more likely to exploit private information. My results suggest an insider trading-based explanation to the observed low pay-performance sensitivity in firms.

Exchange Trading Rules
Douglas Cumming, York University Schulich School of Business, Canada
Sofia Johan, Tilburg University, Netherlands
DAN LI, York University,
Discussant: Ya Tang, McGill University

This paper examines stock exchange trading rules for market manipulation, insider trading and broker agency conduct across countries and over time for 42 stock exchanges around the world. Some stock exchanges have extremely detailed rules which explicitly prohibit specific manipulative practices, while others use less precise and broadly framed rules. We create new indices for market manipulation, insider trading and broker-agency conduct based on the specific provisions in the exchange trading rules of each stock exchange. We show differences in exchange trading rules over time and across markets significantly affect trading activity.

Sunday, September 27, 2009

8.30 AM - 10.00 AM

Corporate Finance - Signalling (Balmoral)
Chairperson: David Stangeland, University of Manitoba

Security Design In Ipos
ARCHISHMAN CHAKRABORTY, Schulich School, York University, Canada
Simon Gervais, Fuqua School, Duke University, United States

Bilge Yilmaz, GSB Stanford University, United States
Discussant: Debarshi Nandy, York University

We investigate the security design problem in an initial public offering (IPO). In line with Rock (1986), we consider a situation in which some investors are better informed than others about the prospects of the firm, resulting in a winner's curse problem. To raise capital, the owners of the firm must underprice the securities they issue in order to compensate the less informed investors for their willingness to participate in the issue. In this context, we first show that firms can sometimes lower the cost of going public by using unit IPOs, in which equity and warrants are combined into a non-divisible package. Because warrants are less sensitive to low cash flow realizations, unit IPOs tend to be valuable to firms that face large downside risks or whose uncertainty revolves around the eventual performance of their assets in place. Second, we show that firms may be able to completely eliminate the winner's curse problem by making the warrants callable. Such a first-best scenario is possible when a firm's growth potential is sizeable even in bad states of the world, as the callability feature of the warrant allows the firm to dynamically create payoffs that are insensitive to the investors' private information. Our theory is consistent with the prominent use of unit IPOs and produces empirical implications that differentiate it from existing theories.

Stock Splits, Credible Signals, And Short Squeezes

ANDRIY SHKILKO, Wilfrid Laurier University, Canada
Fabricio Perez, Wilfrid Laurier University, Canada
Ning Tang, Wilfrid Laurier University, Canada
Discussant: Archishman Chakraborty, Schulich School, York University

We study sophisticated investors' reaction to stock split announcements. Contrary to the existing view, stock splits are often interpreted by such investors as negative signals. Short interest significantly increases in reaction to split announcements and, more importantly, remains elevated in the post-split period. This result is robust to controlling for the known factors that affect short selling and for the split characteristics identified in previous literature as amplifiers of positive signals. Notably, short sellers' reaction to splits varies with the size of the splitting firm. Significant increases in short interest are observed mostly for small splitters, whereas short interest decreases after splits by large firms. In contrast, returns react positively to split announcements by firms of all sizes, suggesting a disagreement between investors on the credibility of small firms' signals.

The Market Value Of The Vote: A Contingent Claims Approach

Avner Kalay, University of Utah and Tel Aviv University, Israel
SHAGUN PANT, University of Utah, United States
Discussant: David Stangeland, University of Manitoba

The paper presents a new methodology to estimate the market value of the right to vote that is embedded in common stocks. The difference in the price of the stock and the synthetic stock (constructed with options) quantifies the value of the right to vote during the expected life of the synthetic stock. Consistent with the theory we find that the value of the vote is an increasing function of the expected life of the synthetic stock. We estimate the market value of the right to vote during a year as 5.4%. As expected the value of the vote increases around special meetings and around M&A events.

Efficient Market Tests (Somerset)
Chairperson: Lawrence Kryzanowski, Concordia University

Information Revelation And Stock Returns

UMUT GOKCEN, Boston College, United States
Discussant: Sana Mohsni, Sprott, Carleton University

There have been several attempts in asset pricing theory to link information availability to expected returns, but empirical evidence has been hindered by the lack of a reliable information proxy that also happens to be available in a long time-series. I contribute to this literature by rst proposing a new proxy for infor- mation revelation, and second, by demonstrating its relation to

returns. My proxy is based on a widely known price/volume relation; that these two variables tend to move together around public news events. In the 1964-2007 period, I nd that the estimated correlation between the absolute value of price changes and dollar trading volume of individual NYSE stocks is signicantly negatively related to their future returns. Information revelation seems to imply lower expected returns going forward. The nding is robust with respect to di¤erent time periods and regres- sion methodologies. The results also show the e¤ect of information to be distinct from other variables that have been used to characterize returns such as market beta, size, book-to-market ratio, various liquidity measures, and past returns. A long/short trading strategy based on sorts on this information proxy reveals its eco- nomic signicance. A net-zero-investment portfolio generates alphas around 3% to 4% (annualized) depending on the portfolio construction scheme and the risk ad- justment. Alphas jump up to almost 7% per year among smaller stocks, indicating that the information risk premium might be larger when the asymmetry in the in- formation environment is greater. As it is with other asset-pricing anomalies, these results can be interpreted as time-varying expected returns in a rational setting or as over/under reaction of investors in a behavioral setting.

The Impact Of Reasons For Credit Rating Announcements In Equity And Cds Markets
BJORN IMBIEROWICZ, Goethe University Frankfurt, Germany
Mark Wahrenburg, Goethe University Frankfurt, Germany
Discussant: Fuad Farooqi, Rotman, University of Toronto

Over the last four decades the literature on bond rating changes and their effects on security prices increased significantly with almost all studies not controlling for the respective reason for the rating action. We therefore investigate the impact of rating events on the stock and the credit default swap (CDS) market incorporating rating reviews and rating changes together with the reason stated by the rating agency. Our results for the general capital market effects are in line with prior literature disclosing an anticipation as well as an announcement effect for negative rating actions but no economically meaningful abnormal market reaction to positive events. Moreover, the rating announcement effect for negative events increases by declining credit quality of firms for both rating reviews and rating changes. Analyzing rating actions conditional on their reason reveals that the significant anticipation effect shown for the overall results is largely driven by events related to firms' operating performance with the remaining reasons being of rather minor importance. Furthermore, we provide empirical evidence that a negative surprise rating announcement is in fact good news for stockholders when wealth is transferred from bondholders but bad news for all remaining rating reviews for downgrade and downgrades. On the other hand, negative rating actions are always bad news for bondholders although the change in CDS spreads differs substantially among reason categories. Our findings disclose several possible biases in the results on the general impact of rating events as these considerably depend on the choice of data set.

Time To Buy Or Just Buying Time? The Market Reaction To Bank Rescue Packages
MICHAEL KING, Bank for International Settlements, Switzerland
Discussant: Laurence Booth

This paper reviews the market reaction to government rescue packages announced in six countries between October 2008 and January 2009 using an event study methodology. The study distinguishes the impact on creditors as seen in the change of CDS spreads from the impact on shareholders as seen in the movement of bank stock prices. We examine both the average reaction of across banking sectors in different countries and the response of banks targeted by specific actions. Government interventions benefited creditors at the expense of shareholders, with bank CDS spreads narrowing around the announcements in all cases. Despite a brief positive reaction, bank stock prices continued to underperform in all countries except the United States where the generous terms of the government support allowed bank stocks to outperform. Stock prices of banks receiving support do worse than banks not receiving government capital, suggesting this support provided a negative signal to shareholders.

Emerging Markets (Trillium)
Chairperson: Madhu Kalimipalli, Wilfrid Laurier University

Information Asymmetry And Acquisition Premiums In Domestic And Cross Border M&as In Emerging Markets

PENGCHENG ZHU, Eberhardt School of Business, University of the Pacific, United States
Vijay Jog, Eric Sprott School of Business, Carleton University, Canada
Discussant: Francesca Carrieri, Faculty of Management McGill University

In this paper, we test and find a strong positive relationship between information asymmetry and acquisition premium in the acquisitions of emerging market firms. The results are based on a large sample of domestic and cross-border acquisitions in 20 emerging countries between 1990 and 2007. We also confirm that under higher level of information asymmetry,acquiring firms tend to use lower cash payments (i.e., higher stock payments) and they are more likely to acquire majority control (>50%) in the target firms. After considering the endogenous relationship among acquisition premium, payment method, and majority control based on a simultaneous equation model, the positive relationship between asymmetric information and acquisition premium continues to exist. We also conduct various robustness tests with respect to the choice of information asymmetry proxy, estimation period and the correction of sample selection bias and find that the results do not change. We argue that acquiring firms pay high premium in order to gain majority control in the target firms to mitigate the information asymmetry problem and to access more valuable private information resources that are not accessible to public investors.

Market Liquidity And Ownership Structure With Weak Protection For Minority Shareholders: Evidence From Brazil And Chile

DIEGO CUETO, Universidad ESAN , Peru
Discussant: Pengcheng Zhu, Eberhardt School of Business, University of the Pacific

This project focuses on the effects of ownership structures on the liquidity of the stock market in a context of low protection for minority shareholders and large ownership concentration. The ultimate defense strategy of an expropriated investor is to exit the position, provided that a market liquid enough exists. In principle, this should not be a problem for a stock in the local index. However, a run by blockholders may hurt minority shareholders more than the consumption of private benefits by dominant shareholders. Moreover, to the extent that blockholders such as local pension funds have few diversification opportunities and their funds increase overtime, they are themselves locked into their positions and they would prefer increasing their monitoring than exiting large positions. Large stakes by blockholders reduce the availability of floating shares. Therefore, the monitoring roles of institutional investors seem to have a high cost in terms of market liquidity. I show that a number of corporate governance mechanisms including ownership concentrations by dominant shareholders have stabilizing effects and converge to reduce asymmetric information and increase market transparency. Providers of liquidity are thus encouraged to post smaller spreads.

Do Implicit Barriers Matter For Investability And Globalization?

FRANCESCA CARRIERI, Faculty of Management McGill University, Canada
Ines Chaieb, University of Amsterdam, Netherlands
Vihang Errunza, Faculty of Management, Canada
Discussant: Diego Cueto, Universidad ESAN

Academics and practitioners implicitly assume that investable emerging market securities are priced in the global context. However the removal of explicit barriers does not necessarily result in increased market integration if implicit barriers are important. To test this proposition, we use the conditional version of the Errunza and Losq (1985) model to estimate pricing of investable indices from twenty two emerging markets. Our results show that reduction in explicit barriers in conjunction with market liberalization does not lead to global pricing. The evidence suggests that across our sample of emerging markets the state and corporate governance together with the information environment plays a major role in globalization.

Fixed Income 3 (Loyalist)
Chairperson: Marcos Perez, Wilfrid Laurier University

Timing Ability Of Government Bond Fund Managers: Evidence From Portfolio Holdings

JING-ZHI HUANG, Penn State University, United States
Ying Wang, SUNY at Albany, United States
Discussant: Kyu Ho Kang, Washington University in St. Louis

This paper examines the ability of government bond fund managers to time the market, based on their holdings of Treasury securities during the period 1997-2006. We find that, on average, government bond fund managers exhibit significant and positive timing ability at the one-month horizon, under a holdings-based timing measure. In particular, fund managers specializing in Treasury securities are more likely to better time the market than general government bond fund managers. We also find that more successful market timers tend to have relatively higher Morningstar ratings, larger fund flows, lower expense ratios, higher Sharpe ratios, and higher concentrations of holdings of Treasury securities.

Measuring Bond Mutual Fund Performance With Portfolio Characteristics

FABIO MONETA, Boston College, Carroll School of Management, United States
Discussant: Alan Huang, University of Waterloo

Employing a novel data set of portfolio weights from 1997 to 2006, the performance of taxable bond mutual funds is studied. The timing ability of fund managers is examined considering different asset allocation choices such as asset class, credit quality allocation, and portfolio maturity decisions. I show that active managers engage in strategies of rotating their portfolios across fixed-income sectors and bond characteristics. Some bond funds exhibit successful timing ability by adopting these strategies. Comparing fund returns plus expenses and transaction costs with the returns of a portfolio that is invested in the previously disclosed holdings, I document that active managers exhibit some ability to select securities that deliver better returns than the securities in the indices. In particular, on average, active managers generate gross returns of 1% per annum over the benchmark portfolio constructed using past holdings. This is approximately enough to cover expenses and transaction costs. Using portfolio data therefore reveals a more optimistic picture of active bond portfolio management, relative to the findings in the existing literature.

Implied Interest Rates In A Market With Frictions

LORENZO NARANJO, New York University, United States
Discussant: Jingzhi Huang, Pennsylvania State University

There are many proxies for the short-term interest rate that are used in asset pricing. Yet, they behave differently, especially in periods of economic stress. Derivatives markets offer a unique laboratory to extract a short-term borrowing and lending rate available to all investors that is relatively free from liquidity and credit effects. Interestingly, implied interest rates do not resemble benchmark interest rates such as the three-month T-bill rate or LIBOR, but instead are much more volatile. I argue that the volatility in the implied short-term rate in futures and option markets is due to frictions arising from borrowing and short-selling costs. I derive an equilibrium model of the futures market where demand imbalances from traders affect the implied interest rate. In the model, the implied interest rate depends on the ``true'' risk-free rate and a latent demand factor. I estimate the model based on S&P 500 index futures using the Kalman filter. The risk-free rate that results from this estimation has time-series properties similar to Treasury and LIBOR rates, and anticipates interest rate changes. The spread between the risk-free and the T-bill rate correlates with liquidity proxies of the Treasury market, while the spread between LIBOR and the risk-free rate is related to economic distress. The latent demand factor is closely related to proxies for demand pressure in the futures market, such as large speculator positions as well as investor sentiment. The demand factor is positive (negative) when buying (selling) pressure is high and is difficult to borrow (to short-sell the underlying). I also find that demand imbalances are correlated across different indexes, for both futures and options.

Institutional Investors (Imperial B)
Chairperson: Paul Halpern, Rotman, University of Toronto

When Shareholders Are Creditors: Effects Of The Simultaneous Holding Of Equity And Debt By Institutional Investors

Wei Jiang, Columbia University , United States
Kai Li, University of British Columbia, Canada
PEI SHAO, University of Northern British Columbia, Canada
Discussant: Nadia Massoud

This paper provides a comprehensive analysis of a new and increasingly important phenomenon: the simultaneous holding of both equity and debt claims of the same company by nonbank institutional investors ("dual-holders"). The presence of dual-holders offers a unique opportunity to assess the existence and magnitude of shareholder-debtholder conflicts. We find that syndicated loans with dual-holder participation have significantly lower loan yield spreads by 12 to 22 basis points as compared to those without, and the difference is even larger after accounting for the selection effect. Further investigation of dual-holders' investment horizon and changes in borrowers' credit quality lends support to the hypothesis that better incentive alignment between shareholders and creditors are responsible for the lower loan yield spread.

Risk Taking And Incentives Of Institutional Investors: Evidence From Us Defined Benefit Pension Plans

Christina Atanasova, Simon Fraser University, Canada
EVAN GATEV, Simon Fraser University, Canada
Discussant: Sean Cleary, Queen's University

This paper investigates the volatility of defined benefit of pension plans over the period 1999-2006. We document economically significant relationships between the asset-liability structure and the risk-taking of pension plans. We find that increasing the underfunding of a bottom size-decile plan by one-standard deviation on average implies a 36% increase in the volatility of the plan. In contrast, the relationship between funding status and risk is reversed for top size-decile plans. The returns of pension plans are explained with the upside-risk exposure of the asset allocation benchmarks, consistent with hedging using instruments with non-linear payoffs.

The Evolution Of Aggregate Stock Ownership---a Unified Explanation

KRISTIAN RYDQVIST, Binghamton University, United States
Joshua Spizman, Binghamton University, United States
Ilya Strebulaev, Stanford University, United States
Discussant: Robert Kieschnick, University of Texas at Dallas

Since World War II, direct stock ownership by households has largely been replaced by indirect stock ownership by financial institutions. We argue that tax policy is the driving force. Using data from eight countries, we show that the fraction of household ownership decreases with measures of the tax advantage of holding stocks inside a retirement account. This finding is important for policy considerations on effective taxation and for financial economics research on the long-term effects of taxation on corporate finance and asset prices.

Leverage and the Cost of Borrowing (Imperial A)
Chairperson: Padma Kadiyala, Pace University

On The Determinants Of The Implied Default Barrier

Georges Dionne, HEC Montreal, Canada
SADOK LAAJIMI, HEC Montreal, Canada
Discussant: Simiao Zhou, University of Toronto

We use the maximum likelihood (ML) estimation approach to estimate the default barriers from market values of equities for a sample of 762 public industrial Canadian firms. The ML approach allows us to estimate the asset instantaneous drift, volatility and barrier level simultaneously, when the firm's equity is priced as a Down-and-Out European call (DOC) option. We find that the estimated barrier is positive and significant in our sample. Moreover, we compare the default prediction accuracy of the DOC framework with the KMV-Merton approach. Using probit estimation, we find that the default probability from the two structural models provides similar in-sample fits,

but the barrier option framework achieves better out-of-sample forecasts. Regression analysis shows that leverage is not the only determinant of the default barrier. The implied default threshold is also positively related to financing costs, and negatively to liquidity, asset volatility and firm size. We also find that liquidation costs, renegotiation frictions and equity holders' bargaining power increase the implied default barrier level.

The Impact Of Corporate Social Responsibility On The Cost Of Bank Loans

Allen Goss, Ryerson University, Canada
GORDON ROBERTS, York University, Canada
Discussant: Sadok Laajimi, HEC Montreal

This study examines the link between corporate social responsibility and bank debt. Our focus on banks exploits their specialized role as quasi-insider delegated monitors. We find that firms with the worst social responsibility scores pay higher spreads (16 bps) but firms with average or good social scores benefit very little from increasing them further. The modest premium charged the worst firms together with the absence of a payoff for the best firms suggest that banks do not regard corporate social responsibility as significantly value enhancing or risk reducing.

Corporate Investment, Leverage, And Unanticipated Growth Opportunities

SIMIAO ZHOU, University of Toronto, Canada
Discussant: Padma Kadiyala, Pace University

This paper investigates the impact of financial constraints on corporate investment decisions. In a seminal paper, Myers (1977) shows that leverage tends to reduce a firm's incentive to invest in positive net-present-value projects; that highly leveraged firms are less likely to exploit valuable growth opportunities as opposed to those with lower leverage. In order to investigate the impact of leverage on firm investment, the empirical estimation strategy has to account for the endogeneity problem inherent in the relationship between leverage and investment. In anticipation of future growth opportunities, a firm can take corrective actions such as renegotiating with existing creditors. This paper addresses this endogeneity issue by incorporating anticipation explicitly into a model of the debt overhang problem. The model shows that the firm is less likely to successfully renegotiate with debtholders when future growth opportunities are less anticipated. Thus, the endogeneity problem is minimal for the sample of firms facing unanticipated growth opportunities. The paper makes use of measures of analysts' earnings forecasts reported in the IBES database, and shows that leverage has a negative effect on investment for firms with unanticipated growth opportunities, and that the impact is stronger for high-growth firms. Finally, this paper finds suggestive evidence that firms with anticipated growth opportunities suffer less from the debt overhang problem.

10.15 AM - 11.45 AM

Asset Pricing and Consumption (Somerset)
Chairperson: Dan Liang, School of Economics, Shanghai University of Finance and Economics

Consumption Volatility Risk

Oliver Boguth, Sauder School of Business, University of British Columbia, Canada
LARS-ALEXANDER KUEHN, Tepper School of Business, Carnegie Mellon University, United States
Discussant: Mao-wei Hung, National Taiwan University

Empirically, the conditional volatility of aggregate consumption growth varies over time. We show that in a model where (i) the agent has recursive preferences, (ii) the conditional first and second moments of consumption growth follow a Markov chain and (iii) the state of the economy is latent, the perception about conditional moments of consumption growth affect excess returns. In the data, we find that exposure to changes in the perceived consumption volatility strongly negatively predicts future returns in the cross-section. Further, we create a volatility risk (VR) factor based on consumption volatility loadings with a annual return of 5%. Importantly, both changes in beliefs about consumption volatility and the VR factor are priced in the cross-section. These results suggest that the representative agent has an elasticity of intertemporal substitution greater than

unity. In the time-series, changes in beliefs about the volatility state strongly forecast aggregate quarterly excess returns.

Dynamic Portfolio Choice And Consumption Plan Under Inflation With Nominal And Indexed Bonds

MAO-WEI HUNG, National Taiwan University, Taiwan, Province Of China
Nan-wei Han, Takming University of Science and Technology,, Taiwan, Province Of China
Discussant: Evgeny Lyandres, Boston University

We solve for an intertemporal portfolio-consumption choice problem under inflation. We assume that the nominal interest rate is observable while the expected inflation rate is not. The inclusion of the inflation-indexed bond in the investor's portfolio provides the investor an opportunity to perfectly hedge against the inflation risk, while the hedging demand of the nominal bonds would be crowded out in proportion to the demand of the indexed bonds. The estimation risk of the estimated inflation rate would introduce an additional hedging demand as well. We also show that the direction in which the interest rate and the inflation rate affect the optimal consumption-wealth ratio would rely on the elasticity of intertemporal substitution of the investor. When the elasticity of intertemporal substitution is smaller than one, the consumption-wealth ratio is increasing in the nominal interest rate and decreasing in the inflation rate; the income effect dominates. When the elasticity of intertemporal substitution is greater than one, the consumption-wealth ratio is affected in an opposite way; the substitution effect dominates. However, the consumption-wealth ratio is not completely decided by the real interest rate, i.e., the difference of the nominal interest rate and the inflation rate. It also depends on the absolute levels of the nominal interest rate and the inflation rate. The nominal and real consumption growth rates are derived. The expected nominal consumption growth is decided by the sum of the real consumption growth rate and the inflation rate.

Product Market Competition And Equity Returns

Evgeny Lyandres, Boston University, United States
MASAHIRO WATANABE, Rice University, United States
Discussant: Lars-Alexander Kuehn, Tepper School of Business, Carnegie Mellon University

We develop a general equilibrium model featuring investors, consumers, and rms that compete in an oligopolistic product market, with a goal of examining the link between competition among rms in output markets and stock returns. The model provides numerous empirical predictions regarding the relation between stock returns and various facets of product market competition. In addition, it relates rms characteristics relative to those of their product market rivals to expected returns. Finally, the model provides an industrial-organization-based motivation for the well-known empirical relations between expected returns and rm sizes, book-to-market ratios, and investment levels. Our empirical tests that employ proxies for the degree of competitive interaction among rms in product markets support many of the models predictions.

Fund Management (Loyalist)
Chairperson: Yuriy Zabolotnyuk, Carleton University

Currency Investing In Global Portfolios: Hedging Or Speculative Benefits?

Frans De Roon, Tilburg University, Netherlands
ESTHER EILING, University of Toronto, Rotman School of Management, Canada
Bruno Gerard, Norwegian School of Management BI, Norway
Pierre Hillion, Insead, France
Discussant: Chris Veld, University of Stirling

Adding currency forwards to international stock or bond portfolios may result in hedging or speculative benefits, or both. This paper compares the relative importance of these two sources of value added from currency investing. We develop a new test that decomposes the total change in the portfolio Sharpe ratio into a hedging and a speculative component. Based on stock and bond returns from seven developed markets between 1975 and 2007, we document large significant gains from adding currencies to these international portfolios. Strikingly, we find that the gains are predominantly due to speculative currency investing, which leads to economically meaningful and

statistically significant improvements in portfolio Sharpe ratios. In contrast, hedging benefits from combining international bonds and equities with currencies are not statistically significant and may even lead to a worsening of portfolio Sharpe ratios. These results are robust for a wide range of passive and active portfolio strategies as well as for different home currencies.

Economic Conditions, Flight To Quality And Mutual Fund Flow

BLAKE PHILLIPS, University of Alberta, Canada
Aditya Kaul, University of Alberta, Canada
Discussant: Wolfgang Bessler, University of Gießen

This paper examines the asset allocation decisions of mutual fund investors, focusing on flight to quality considerations. Specifically, we study monthly net flow for the universe of Canadian mutual funds between 1991 and 2005 to see how investors vary flow across fund categories as economic conditions change. Using the default spread, term spread and short term interest rate as proxies for economic conditions, we find that an expected improvement (deterioration) in Canadian economic conditions causes investors to direct flow away from (towards) fixed income-type funds and towards (out of) equity based funds. For example, a one standard deviation increase in the term spread (1.13%) results in an 84% increase and a 74% decrease in the percentage of flow directed at Canadian equity and money market funds respectively, relative to the previous month. We also examine the flow to equity and money market funds surrounding three major crises: the Long Term Capital Management debacle, the Y2K problem and the 9/11 terrorist attacks. Each episode is accompanied by significant flow into money market funds and out of equity funds. For example, the August 1998 Long Term Capital Management failure sees Canadian investors move $1,850 million into money market funds and $627 million out of equity funds. Analysis of investor returns suggests that this switching strategy has underperformed a simple buy-and-hold equity fund strategy. On a risk adjusted basis, moderate to high risk aversion investors may realize higher utility from the flight to quality portfolio due to its lower relative volatility to the equity portfolio. Our results provide evidence of a strong flight to quality motivation underlying aggregate mutual fund flow. The optimality of this course of action depends on individual investor risk preferences.

Why Is Persistent Mutual Fund Performance So Difficult To Achieve? The Impact Of Fund Flows And Manager Turnover

WOLFGANG BESSLER, Justus-Liebig-University Giessen, Germany
David Blake, Cass Business School, The Pensions Institute, United Kingdom
Peter Lueckoff, Justus-Liebig-University Giessen, Germany
Ian Tonks, University of Exeter, United Kingdom
Discussant: Vijay Jog, Eric Sprott School of Business, Carleton University

The objective of this research is to jointly investigate the impact that fund flows and manager turnover have on the investment performance of actively managed equity mutual funds. Both fund flows and manager turnover have been identified in the literature as relevant factors that significantly affect performance persistence. We analyze which of these factors has a stronger impact and how they interact. Using a sample of 3,948 U.S. equity mutual funds for the period from 1992 to 2007, our results support the notion that both mechanisms impact performance predictability over both the cross-section and time. The future performance of past top performing funds strongly suffers from both the departure of skilled fund managers and even more from excessive inflows. The future performance of past loser funds benefits from a replacement of their unskilled or unlucky managers, but does not benefit from cash outflows to the same degree. Furthermore, we provide empirical evidence that both factors have a marginal and mutually independent impact on performance and document a strong interaction between both variables. Including information on fund flows and changes in fund management in the mutual fund investment decision process would have yielded highly significant spreads in four-factor alphas of 3.12 for winner funds and 2.04 percent for loser funds per year.

Initial Public Offerings (Imperial A)
Chairperson: Craig Dunbar, Ivey Business School, University of Western Ontario

Does Information Production Reduce Ipo Overvaluation?

MING DONG, York University, Canada
Jean-Sébastien Michel, York University, Canada
Ari Pandes, York University, Canada
Discussant: Alexander Vedrashko, Simon Fraser University

This paper examines whether investors overvalue initial public offerings (IPOs) more when there is a lack of accurate feedback about the firm's fundamentals. We hypothesize that greater information production by underwriting syndicates should lead to less investor behavioral biases, and hence less IPO overvaluation. Using syndicate size and underwriter reputation as measures of information production, we find that high information production predicts better long-run performance than low information production. Furthermore, information production has the greatest effect on IPOs with the most uncertainty, suggesting a new role for underwriting syndicates in mitigating the effect of firm uncertainty and improving IPO long-run performance.

Ipo Waves, Product Market Competition, And The Going Public Decision: Theory And Evidence

Thomas Chemmanur, Boston College, United States
JIE HE, Boston College, United States
Discussant: Kristian Rydqvist, Binghamton University

We develop a new rationale for IPO waves based on product market considerations, and empirically test the implications of our theory. We model an industry with two competing firms, one of which has higher productivity of capital compared to the other. The two firms assess a significant probability of a positive productivity shock affecting their industry in the near future. Going public, though costly, not only allows each firm to raise external capital at a lower cost compared to a private firm, but also allows it to grab market share from its competitor if the latter remains private. In the above setting, we solve for the decision of each firm whether to go public or remain private, and if it chooses to go public, the optimal timing of going public. We show that, in equilibrium, even firms with suffcient internal capital to optimally fund their investment may go public, driven by the possibility of their product market competitors going public. We also show that IPO waves may arise in equilibrium even in industries which do not experience a positive productivity shock. Our model develops several testable predictions for IPO waves and post-IPO profitability, two of which are as follows. First, firms going public during an IPO wave will have lower post-IPO profitability than those going public off the wave. Second, firms going public earlier in an IPO wave will have higher post-IPO profitability than those going public later in the wave. We empirically test these and other predictions of our model and find supporting evidence.

What Can One Million Regressions Tell Us About Ipo Underpricing?

Alexander Butler, University of Texas at Dallas, United States
MICHAEL KEEFE, University of Texas at Dallas, United States
Robert Kieschnick, University of Texas at Dallas, United States
Discussant: Jie He, Boston College

We quantify the statistical robustness and economic importance of many different determinants of IPO initial returns. Standard empirical techniques are inadequate for this task because of the high correlations between many variables common in the literature. Using the methodologies developed in Leamer (1985), Levine and Renelt (1992), and Sala-i-Martin (1997), we run over a million regressions to examine the robustness of 44 commonly used explanatory variables during different periods from 1993 through 2006. We show that the characteristics of firms going public and the sensitivity of initial returns to various characteristics dramatically changed over our sample period. Nevertheless, we produce a parsimonious list of statistically robust explanatory variables and rule out certain explanations of IPO underpricing.

Reaction to Shocks (Imperial B)
Chairperson: Eric Santor, Bank of Canada

The Long Memory In Stock Price Shocks

HAI LU, University of Toronto, Canada

Kevin Wang, University of Toronto, Canada
Xiaolu Wang, University of Toronto, Canada
Discussant: Lars Norden, University of Mannheim

Do large short-term stock price changes have long-lasting effects on subsequent returns? Yes, they do! Sorting stocks by minimum short-term (one-, three-, or five-day) abnormal returns within a month, we find significant return differences between the top and bottom deciles, ranging from 6% to 8% over the subsequent 12 months. This shows that there is a significant long-lasting drift following a large short-term price drop. In contrast, there is a significant reversal after a large short-term price hike. The magnitude and asymmetry of the long-lasting effects are surprising. We explore various potential explanations, including microstructure effects, idiosyncratic volatility, investor disagreement, delay, retail trading, and news events. The results do not suggest that any of these conjectures can account for the long memory in stock price shocks.

Asset Growth And Idiosyncratic Return Volatility

ZHONGZHI SONG, University of British Columbia, Canada
Discussant: Hai Lu, University of Toronto

Evaluating new assets is often difficult due to a lack of information regarding the future cash flows that these assets may generate. Similarly, it is also difficult to evaluate firms with shrinking assets due to the uncertainty of future earnings of assets-in-place and growth prospects. Therefore, stocks in firms that have undergone substantial changes in assets should have relatively high idiosyncratic return volatility. This paper documents empirical evidence in support of this claim. Specifically, cross-sectional idiosyncratic return volatility for a given stock shows a V-shape relative to the past year's firm-level asset growth rate. The stocks with the lowest idiosyncratic volatility are associated with firms that have an annual asset growth rate of approximately 5%. Using a time series, the spread in average asset growth rate between high- and low-growth firms can positively predict the average idiosyncratic volatility for a firm. Moreover, the asset growth measure is the most important predictor (among other well-known predictors of volatility) of value-weighted, average idiosyncratic volatility.

Credit Derivatives, Corporate News, And Credit Ratings

LARS NORDEN, Rotterdam School of Management, Netherlands
Discussant: Zhongzhi Song, University of British Columbia

The market for credit default swaps (CDS) represents an interesting venue to study if and how public and private information is incorporated in market prices. This OTC market is neither regulated nor supervised and exclusively made up by institutional traders that buy and sell credit risk. Considering the key importance of rating announcements for market participants, this paper investigates announcement and anticipation effects, conditioning on public information and using proxies for private information about CDS underlyings. Analyzing an international sample of frequently traded firms during the period 2000-2005 on a daily basis yields the following results. First, CDS markets significantly react to rating downgrades and, even stronger, to reviews for downgrade, while the magnitude of anticipation effects is the other way round. Second, the CDS market response is stronger for firms with high general media coverage. Moreover, rating-related wire news prior to rating events significantly explain the anticipation of CDS markets when general media coverage is high. Third, the run up is more pronounced the higher a firm's number of major bank lenders and there is a signifcantly higher number of days with large positive abnormal price changes and no news (or no negative news) before rating events than in the full sample. These findings are consistent with the view that private information of banks spills over to these markets through their CDS trading.

Regulation (Balmoral)
Chairperson: Brian Smith, Wilfrid Laurier University

Bay Street's Broken Windows: Negligence In Insider Disclosure And Enforcement

WILLIAM McNALLY, Wilfrid Laurier University, Canada
Brian Smith, Wilfrid Laurier University, Canada

Discussant: Lukas Roth, Pennsylvania State University

This paper argues that error-ridden insider trading reports are the broken windows of the Canadian Financial system. The proportion of reports with errors is over 40% in 1988 and falls to just over 10% in 2006—still unacceptably high. The improvement is largely attributable to regulatory changes which improved transparency: the shortening of disclosure deadlines and the implementation of an internet-based reporting system. Between 1988 and 2006 there were relatively few OSC prosecutions for insider trading disclosure omissions and none for disclosure errors. The authors argue that the continuing high incidence of errors and the lax enforcement of rules creates a permissive regulatory environment in which major securities crimes, such as illegal insider trading, are more prevalent. The authors suggest some inexpensive policy prescriptions for eliminating errors in insider trading disclosure.

How Laws Affect Contracts: Evidence From Yankee Bond Covenants

Yaxuan Qi, Concordia University, Canada
LUKAS ROTH, University of Alberta, Canada
John Wald, University of Texas at San Antonio, United States
Discussant: Padma Kadiyala, Pace University

We examine how country-level legal and institutional differences in creditor and shareholder rights shape contractual creditor protection, that is, the use of bond covenants. Using comprehensive debt covenant information for a sample of foreign bonds issued in the U.S. by firms from more than 50 countries, we find that bond contracts for firms incorporated in countries with stronger creditor rights use fewer restrictive covenants. This finding suggests that creditor rights laws substitute for debt covenants in reducing the agency cost of debt. On the other hand, bond contracts for firms incorporated in legal regimes with stronger shareholder rights, or for those with stronger firm-level corporate governance, include more covenants. This is consistent with the view that firms which are more aligned with shareholders' interests actually face an increase in the shareholder-bondholder agency conflict. Additionally, better contract enforcement is associated with more covenants, suggesting that covenants are worth more if enforcement is more effective.

Real Options And Facilities Access Regulation

GORDON SICK, University of Calgary, Canada
Mark Cassano, Alberta Securities Commission, Canada
Discussant: Phelim Boyle, Wilfrid Laurier University

Real options achieve their value from flexible management response to signals about uncertainty. Any constraint on flexibility will obviously impair the real option value. Regulation imposes constraints on operations, but also provides tariffs to the regulated entity. Thus, it is not obvious that the regulated entity necessarily suffers a value loss from regulation, if the tariffs are sufficient or excessively generous. The question of whether the tariffs are excessively generous is part of the question of social optimality. We address this question in the context of facilities access, which is a popular method of ``deregulating'' industries that had monopoly power. The regulator determines tariffs for access to the production facilities of the oligopolist facility owner so that competitors can use the facilities and offer the consumption good in a competitive market. This is the basis for deregulation of power, gas distribution and telecom industries. It has also been proposed in industries that were not formerly regulated, such as rail infrastructure for integrated mining industries. Pindyck has suggested that access tariffs in these cases should include compensation for the capital costs plus the real option premium that was extinguished to establish the facility. But he offers no proof, nor any analysis of the magnitude and direction of the distortion if compensation is only offered for the capital costs only. Also, he does not consider a two-part tariff structure with an up-front access tariff, plus an annual tariff for capacity. In this paper, we investigate these issues numerically.

Volatility (Trillium)
Chairperson: Melanie Cao, York University

Equity Risk Premium And Volatility: A Correlation Structure

YONGGAN ZHAO, Dalhousie University, Canada
Discussant: Mehdi Beyhaghi, York University

This paper investigates the relation between stock market returns and volatility using a bivariate factor model governing the evolution of a volatility indicator and the market price of risk. The model-implied volatility measured by the conditional standard deviation of equity returns is compared with the predictable volatility measured by the expected value of the selected volatility indicator. Using the Standard and Poor's Composite Return Index and three volatility indicators (the VIX, the standard deviation of historical returns, and a GARCH(1,1)-fitted indicator), we study a predictive model with a set of the selected market state variables, such as past excess stock returns, current indicated volatility level, aggregate dividend yield, changes in the aggregate consumption, changes in the production output, and stock earnings. The daily risk premiums follow similar patterns for the three volatility indicators with the GARCH(1,1) indicator providing the most consistent predictability. While a positive relation between the intertemporal risk premium and volatility is plausible, the correlations between unexpected returns and volatility indicators are mixed with different volatility indicators. For the selected sample data, we find both strong leverage and volatility feedback effects. Finally, we discuss a portfolio strategy to show the predictive power of the model.

Option Based Forecasts Of Volatility: An Empirical Study In The Dax Index Options Market

SILVIA MUZZIOLI, University of Modena and Reggio Emilia , Italy
Discussant: Siu Kai Choy, University of Toronto

Volatility estimation and forecasting are essential for both the pricing and the risk management of derivative securities. Volatility forecasting methods can be divided into option based ones, that use prices of traded options in order to unlock volatility expectations, and time series volatility models, that use historical information in order to predict future volatility. Among option based volatility forecasts we distinguish between Black-Scholes implied volatility, that is a "model dependent" forecast since it relies on the Black and Scholes model, and the so called "model free" implied volatility, proposed by Britten-Jones and Neuberger (2000), that does not rely on a particular option pricing model. The aim of this paper is to investigate the unbiasedness and efficiency, with respect to past realised volatility, of the two option based volatility forecasts: Black-Scholes implied volatility and model free implied volatility. The comparison is pursued by using intradaily data on the Dax-index options market. Our results suggest that Black-Scholes implied volatility subsumes all the information contained in past realised volatility and is a better predictor for future realised volatility than model free implied volatility.

Spot And Forward Volatility In Foreign Exchange

Pasquale Della Corte, University of Warwick, United Kingdom
Lucio Sarno, City University London, United Kingdom
ILIAS TSIAKAS, University of Warwick, United Kingdom
Discussant: Yonggan Zhao, Dalhousie University

This paper investigates the empirical relation between spot and forward implied volatility in foreign exchange. We formulate and test the forward volatility unbiasedness hypothesis, which is the volatility analogue to the extensively researched hypothesis of unbiasedness in forward exchange rates. Using a new data set of spot implied volatility quoted on over-the-counter currency options, we compute the forward implied volatility that corresponds to the forward contract on future spot implied volatility known as a forward volatility agreement. We find statistically significant evidence that forward implied volatility is a systematically biased predictor that overestimates future spot implied volatility. The bias in forward volatility generates high economic value to an investor exploiting predictability in the returns to volatility speculation and indicates the presence of predictable volatility term premiums in foreign exchange.