
**SPRING JOIM CONFERENCE SERIES
MARCH 8–10, 2009
THE STANFORD COURT, SAN FRANCISCO, CALIFORNIA
CONFERENCE SUMMARIES**



The program emphasized **Liquidity** and **Leverage**.

Meir Statman, Santa Clara University
Keynote Speaker

“Regulating Financial Markets: Protecting Us from Ourselves and Others”

Psychological excesses can lead investors to make poor financial decisions, possibly driving a wedge between market prices and fundamentals. For this reason, investors need protection not only from their own mistakes, but also from the mistakes of others. The financial crisis that began in 2008 provides ample evidence that such protection is valuable, and suggests that paternalistic regulation is warranted. I suggest that we draw on lessons from the past to institute a well funded regulatory framework that guards against asset pricing bubbles, limits excessive leverage by both institutional and individual investors, extends suitability criteria to the housing market, and features reminders about psychological pitfalls whose purpose is to impede regulatory dilution by the political process.

Hersh Shefrin, Santa Clara University
Keynote Speaker

“Errors in Judgment, Impact on Others, and Paternalistic Regulation”

The global financial and economic crisis of the late 2000s highlights the ongoing tug-of-war between those who pull toward free markets and those who pull toward strict regulation of markets. It also highlights the sometimes parallel and sometimes perpendicular tug-of-war between those who pull toward libertarianism and those who pull toward paternalism. Rising stock markets and economic prosperity add power to those who pull toward free markets and libertarianism, and stock market crashes and economic recessions add power to those who pull toward strict regulation and paternalism. I discuss the crisis of the late 2000s against the backdrop of earlier crises with special focus on margin regulations which limit leverage, suitability regulations which require providers of financial products to act in the interests of their clients, Blue Sky laws which prohibit securities deemed overly risky or unfair, and mandatory disclosure regulations which require providers of financial products to disclose

pertinent information even if potential buyers do not ask for it.

Commentary by Jack L. Treynor

To appreciate the suggestions of Meir Statman and Hirsch Shefrin, one has to appreciate the importance of liquidity. “Liquidity” sounds like an abstraction of interest only to finance professors and quants. It actually goes to the heart of our kind of society—a society where the middle class does most of the saving, most of the job creation.

When Adam Smith was writing in 1776 he was laying out a blueprint for a new way to organize society. The old way was large landed estates that paid their workers by using inherited land to provide them with food, clothing and shelter. For an example of the old way we don’t have to look any further than Thomas Jefferson.

In celebrating specialization, Adam Smith was celebrating a system that required cash—something the employers in the old system didn’t need. In Adam Smith’s new system, barter is so awkward that, when transactors don’t have enough money, demand collapses. The power of money was demonstrated in the collapse of demand in 1837, 1857, 1873, ... and 1929. Like the great panics of the past, the current panic is a sobering reminder that policymakers are still learning how to operate the new system.

As Adam Smith surely understood, the purpose of cities is specialization. The purpose of big cities is more specialization. As 1929 demonstrated, when the population shifts from the farms to the cities, cash becomes more important. Although they are still learning, policy makers now understand its importance. But the present panic goes beyond policy makers’ management of cash.

Securities and the Small Investor

The best way to exploit Adam Smith’s specialization was to introduce capital goods into your business

and then take full advantage of their potential for economies of scale. However, such capital goods required more money than most businessmen had. The solution was to gather the savings of hundreds of small investors, create a public company, and give them claims on the company.

The problem of the middle class is that their unexpected cash needs are large in relation to their wealth. They have savings to invest but, relative to their wealth, holding enough cash for contingencies was a big problem. The solution was a securities market where the claims on large public companies could be sold as easily as they were bought. The distinguishing feature of cash, however, is the absence of adversarial trading motives. Securities are substitutes for money only when they don’t have the “used car” problem—when we don’t have to worry about our counterparty’s trading motive. (To be sure, unlike sellers of used cars, sellers of securities are as ignorant about their value as buyers.) The principal obstacle to the kind of securities the middle class need is the presence of such motives.

Securities transactions are a zero-sum game, with a loser for every winner. It’s not in our counterparty’s interest for us to know why he is transacting. To be sure, we aren’t injured by his motive when we don’t transact. But then our security is no longer serving as a cash substitute. But when the middle class is relying on their securities to be a useful cash substitute, anything that undermines their confidence has the same effect on prosperity as a collapse in the supply of real cash.

Leverage and Transparency

When I have an adversarial trading motive, leverage gives me the opportunity to make a bigger trade—i.e., the opportunity to hurt more middle class investors who are just seeking liquidity. When leverage is available to me, it increases the odds against them.

Transparency, on the other hand, reduces the number of opportunities for me to trade on something middle class investors don't know. Anything that defeats transparency increases their suspicion about my trading motive and makes securities less money-like.

Moral: if you want to help the middle class with its task of saving and job creation, increase the transparency and reduce the leverage. Our speakers have offered policy makers valuable suggestions about how to do both.*

These are all commercial paper rates:

Year	2 Years before crisis	1 Year before crisis	Year of crisis
1837	7.00	18.00	14.25
1857	8.92	8.83	11.56
1873	6.98	8.63	10.27
1907	5.18	6.25	6.66
1920	6.02	5.37	7.50
1929	4.11	4.85	5.85

Source: Sidney Homer, *A History of Interest Rates*, Rutgers University Press, 1963.

*Tight money hurts city people more than farmers; US population was moving to cities (farm % of GDP today = 1%).

Vineer Bhansali, PIMCO "Tail Risk Management"

Discussant: Jesse L. Phillips, University of California, Office of the Treasurer of the Regents

The presentation will focus on the practical approaches to managing tail risk of investment portfolios. With the observation that tail risks that arise from deleveraging or illiquidity episodes are accompanied by increasing correlations, we suggest using macro market instruments, strategies

and scenario shocks for hedging portfolios. We will discuss why traditional pricing methods severely misprice such hedges.

Joseph Cherian, Cornell University "Trading Agents and Liquidity Risk"

Discussant: Ahmet Kocagil, Fitch Solutions

A recent area of concern and analysis in both financial economics and capital markets has been liquidity. Broadly speaking, liquidity is the ease with which a financial asset can be traded. Liquidity risk, on the other hand, can be defined as the uncertainty associated with the measure of liquidity. Using a simple information-based model of liquidity, we define, develop, and empirically test some measures of liquidity risk, both at the stock and market-levels. In this model, trading agents are characterized as being driven by superior information, liquidity needs, or hedging requirements. The bid-ask spreads derived from this model have the desired historical properties, and the ability to forecast future liquidity. We also provide empirical evidence that validates the notion that liquidity affects financial market performance. Finally some live case studies illustrate how the investment manager can take liquidity explicitly into account to both enhance portfolio performance and mitigate portfolio risk.

Lisa Goldberg, MSCI Barra "Is There a Green Factor?"

Discussant: Rodney Sullivan, CFA Institute

We look at the controversial topic of environmental change and its impact on markets through the lens of the Barra Global Equity Model. We find statistically significant risk factors associated with environmental capital and renewable energy firms. The first of the two factors had a substantial return during the period January 2004 -December 2008, and it was uncorrelated with the overall market and changes in oil price.

Robert Hendershott, Santa Clara University
“**The Housing Bubble and Resulting Mortgage Crisis**”

Discussant: Jeffrey Bohn, Shinsei Bank, Ltd.

In the late 1990s United States house prices began a long boom that peaked in mid 2006. The subsequent reversal of the housing boom has spawned a major crisis in the credit markets. This talk reviews the financial developments that stimulated the house price bubble and the financial repercussions of it bursting.

Francis Longstaff, Anderson School at UCLA
“**Systemic Credit Risk: What is the Market Telling Us?**”

Discussant: Jing Zhang, Moody's KMV

The ongoing subprime crisis raises many concerns about the possibility of much broader credit shocks in the economy. We use a simple linear version of the Longstaff and Rajan (2007) model to extract the information about macroeconomic credit risk embedded in the prices of tranches on the most-liquid credit indexes. Three types of credit risk appear to be priced by the market: idiosyncratic risks at the level of individual firms, sector wide risk at the level of correlated firms within the same industry group, and economy-wide or systemic risk. We apply the model to the recent behavior of tranches in the U.S. and European credit derivatives markets and show that the current credit crisis has more than twice the systemic risk of the May 2005 auto-downgrade credit crisis.

Lasse H. Pedersen, NYU Stern School of Business
“**Dynamic Trading with Predictable Returns and Transaction Costs**”

Discussant: Ananth Madhavan, Barclays Global Investors

This paper derives a closed-form solution of the optimal dynamic portfolio policy when trading is

costly and security returns are predictable by signals with different mean reversions. The optimal new portfolio is a linear combination of the existing portfolio, the optimal current portfolio absent trading costs, and the optimal portfolio capturing future expected returns. We show explicitly how predictors with slower mean reversion (alpha decay) get more weight since they lead to a favorable positioning both now and in the future. We implement the optimal policy for commodity futures and show that the resulting portfolio has superior returns net of trading costs relative to more naive benchmarks. The optimal portfolio tracks smoothly a frictionless benchmark that is tilted towards slow-mean-reversion signals and has interesting impulse-response dynamics. Finally, we derive natural equilibrium implications of trading costs.

Anna Scherbina, University of California, Davis
“**Analyst Disagreement, Mispricing, and Liquidity**”

Discussant: James D. Peterson, Charles Schwab & Co., Inc.

We document a close link between mispricing and liquidity by investigating stocks with high analyst disagreement. Previous research finds that these stocks tend to be overpriced, but that prices correct downwards as uncertainty about earnings is resolved. Our analysis suggests that one reason mispricing has persisted through the years is that analyst disagreement coincides with high trading costs. We also show that in the cross-section, the less liquid stocks tend to be more severely overpriced. Additionally, increases in aggregate market liquidity accelerate the convergence of prices to fundamentals. As a result, returns of the initially overpriced stocks are negatively correlated with the time series of innovations in aggregate market liquidity.

Fan Yu, Claremont McKenna College
“**The Determinants of Operational Risk in U.S. Financial Institutions**”

Discussant: Rong Fan, Gifford Fong Associates

The recently finalized Basel II Accord requires financial institutions to calculate regulatory capital charges for market risk, credit risk, and operational risk. To better understand the nature of operational risk, we examine the incidence of operational risk events among U.S. financial institutions using publicly reported loss data from 1980 to 2005. We find that firms suffering from operational risk events

tend to be younger, more complex, and have elevated credit risk. They are also associated with more antitakeover provisions, fewer auditors on the board, and CEOs with higher in-the-money stock option holdings and bonuses relative to salary. These findings underscore the importance of better corporate governance and proper managerial incentives in mitigating operational risk.