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## PRACTITIONER'S DIGEST

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The “Practitioner’s Digest” emphasizes the practical significance of manuscripts featured in the “Insights” and “Articles” sections of the journal. Readers who are interested in extracting the practical value of an article, or who are simply looking for a summary, may look to this section.



### INSIGHTS

#### TROUBLE WITH CORPORATE DISCLOSURE

PAGE 6

*Jack L. Treynor*

Is it time to redraw the boundary between the provider of information about public companies and the user—to redefine the respective responsibilities? It won't be easy if it entails new concepts, new patterns of thinking. Is it time for us to rethink what we mean by *value*? by *finance*?

### ARTICLES

#### RESAMPLED FRONTIER VERSUS DIFFUSE BAYES: AN EXPERIMENT

PAGE 9

*Harry M. Markowitz and Nilufer Usmen*

This paper reports an experiment that tests two proposals for handling the fact that historical means, variances, and covariances, sometimes used as inputs to MPT portfolio analyses, are themselves noisy. One method is that of Michaud (1998). The other is an implementation of the diffuse Bayes approach widely discussed in texts and tracts on Bayesian inference.

The experiment contains a simulated referee and two simulated players, namely a Michaud player and a Bayes player. The referee selects a “true” probability distribution of returns on eight asset classes. Given this probability distribution, the referee generates 217 monthly observations for the eight asset classes. These observations are handed to each player who then proceeds in its prescribed manner. The object of each player is to pick a portfolio which maximizes a specified function of portfolio mean and variance. This process is repeated for three different objective functions, for 100 historical samples drawn from a given truth, and for 10 truths. One of the investor objectives is long run growth. The others are two other “utility functions.”

The two players, and therefore their methodologies, are evaluated in terms of their ability to provide portfolios which give greatest value to the objective function, and their ability to estimate how well they have done. The results of the experiment have implications for the relative merits of the two methodologies, and for probable weaknesses in other methods of estimating the inputs to an MPT portfolio analysis.

## PRICE DISCOVERY FOR CROSS-LISTED STOCKS

PAGE 26

*Cheol S. Eun and Sanjiv Sabherwal*

This study examines cross-market adjustments to price and exchange rate movements for non-US stocks cross-listed in the US. Using a sample of 38 Canadian stocks listed on the Toronto Stock Exchange (TSE) that are also listed on the NYSE, we find that price adjustments due to cross-market information flows take place not only on the NYSE but also on the TSE. Thus, the NYSE also contributes to price discovery. For a majority of the stocks, the NYSE prices adjust more to the TSE prices than vice-versa. The NYSE bears a greater burden of adjusting to changes in the C\$ to US\$ exchange rate.

The NYSE share of price discovery ranges from 0.4% to 98.1%, with an average (median) of 36% (35.3%). The evidence that there is a considerable price discovery for the US-listed Canadian stocks not only in their home market but also in the US has an interesting implication for order execution. The TSE has suggested that the US Securities and Exchange Commission (SEC) refine the interpretation of a US broker's best execution obligation for foreign stocks listed in the US. In particular, the TSE has suggested that for the US-listed Canadian firms, the US brokers should be obligated to check the Canadian prices also. Our finding that the TSE is the main price discovery mechanism for a majority of the US-listed Canadian stocks provides support for the suggested change. However, the finding that the NYSE serves as the primary price discovery mechanism for some Canadian stocks, while making a significant contribution to the price discovery of other stocks, suggests that the Canadian brokers should also be required to check the US prices of the Canadian stocks cross-listed in the US.

This study also examines the factors that affect the extent to which the NYSE contributes to price discovery. The results are consistent with the argument that the greater the competition offered by the NYSE, the greater is its contribution to price discovery. First, the NYSE contribution is more for stocks with a higher NYSE share of total trading. Second, the NYSE contribution is inversely related to the ratio of bid-ask spreads on the NYSE and the TSE. Third, consistent with the argument that the medium-size trades have a higher information content than small- and large-size trades, the NYSE contribution to price discovery increases as the proportion of medium-size trades on the NYSE relative to the TSE increases.

## LONG-RUN INVESTMENT MANAGEMENT FEE INCENTIVES AND DISCRIMINATING BETWEEN TALENTED AND UNTALENTED MANAGERS

PAGE 47

*Robert Ferguson and Dean Leistikow*

There are a variety of investment management fee structures and contract renewal arrangements employed in the industry. It is important to know if these fee structures and contract renewal arrangements motivate

investment managers to act in their clients' interest. Another consideration is whether the fee structures and contract renewal arrangements discriminate effectively among talented and untalented managers. They discriminate effectively if talented managers have significantly higher contract renewal probabilities than untalented managers.

This paper shows that talented and untalented managers often have different incentives and that some bull-spread and flat fee arrangements effectively discriminate among talented and untalented managers. It also shows that the volatility-dependent contract renewal structures introduced in this paper provide superior results to the volatility-independent structures discussed in the literature.

## INDEXATION OF MOMENTUM EFFECTS

PAGE 73

*Eugene Y. Lee*

Momentum effects have been consistently present in the US as well as foreign stock markets for more than three decades. As a result, both the academic circle and investment community now consider momentum effects as another factor of stock returns in addition to beta, market cap, and book-to-market ratio. Momentum effects have several applications to investment management. For example, individual investors can enhance the investment return by buying a portfolio of past winners instead of, say, an S&P 500 index fund. Since past winners represent a unique segment of the market, individual investors can also reduce investment risk by adding a portfolio of past winners to their current portfolio. Furthermore, individual investors can evaluate better the security-picking skills of actively-managed fund managers by separating momentum effects from fund performance. An efficient means for systematically measuring momentum effects, however, is needed first before the investment products based on momentum effects are developed. Indexation of momentum effects would pave the way for development of the investment products capturing momentum effects, and for improved performance evaluation of the actively-managed funds.