
PRACTITIONER'S DIGEST

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THE EVOLVING STRUCTURE OF THE PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

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Mark A. Wolfson

The standard endowment model fails to incorporate liquidity budgeting in an efficient manner. Portfolio managers also tend to rebalance portfolios to targeted asset allocations both too often as well as to the wrong allocations. This paper explains how and why these mistakes are made and points to how they can be avoided.

The paper also addresses how the traditional structure of private equity partnerships and the traditional relationship between limited partners and general partners might naturally evolve in the coming years. Such changes have been slower to develop in the private equity asset class than in other asset classes.

FINANCE PROFESSIONALS IN THE FINANCIAL CRISIS: VALUES, FAIRNESS, AND CULTURE

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Meir Statman

Finance professionals have expressed their views on values, fairness, and culture in the great debate about the global financial crisis and its aftermath. Yet their positions remain precarious because they stand accused of instigating the crisis, because their views on values, fairness, and culture are not widely shared in society, and because they fail to persuade that their work has social benefits.

Many finance professionals behave as if they live in a cocoon, where salaries, retention payments and bonuses in the hundreds of thousands or millions are perceived as ordinary and fair. Finance professionals often maintain the naïve belief that their views are shared by all. They are not. Policies and laws are an outcome of a process that involves the values, rules of fairness, and desired culture of the entire community, not finance professionals alone, and the views of many in the community are radically different from the views of finance professionals.

Finance professionals face both internal and external obstacles in relating to community values, rules of fairness, and desired culture. The internal obstacle is these professionals' adherence to a free-market notion of fairness, where the right to freedom from coercion is paramount and the right to equal bargaining power is overlooked or dismissed. The external obstacle is the difficulty in explaining the social benefits of the work of finance professionals, whereas it is easy to explain the social benefits of the work of physicians, engineers, or plumbers.

**WHAT DRIVES THE VALUE PREMIUM? RISK VERSUS MISPRICING:
EVIDENCE FROM INTERNATIONAL MARKETS**

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Denis B. Chaves, Jason Hsu, Vitali Kalesnik and Yoseop Shim

Value stocks outperform growth stocks. Do value strategies reward investors for bearing extra risk or cost-conscious investors for choosing attractive bargains? If the first option is true, stocks with high betas relative to some observable (or not) risk factor should outperform, even after taking into account other characteristics (high B/M, for instance). If the second option is true, stocks with more attractive characteristics (high B/M, for instance) should outperform, even after taking into account their risk exposures.

In this paper we recognize that the answer is not either-or, but a combination of both positions. Therefore, we use a large sample, spanning multiple countries and many years, to get more precise estimates of both effects. By sequentially measuring the importance of each argument while at the same time controlling for the other, we provide novel and extensive tests that shed new light on the sources of outperformance and quantify their relative impact. The key finding is that stock characteristics, not risk exposures, are responsible for the majority of the value premium. This leads us to conclude that mispricing is the main source of value premium.

Aside from satisfying intellectual curiosity, our results have practical implications that are relevant for investors. First, they affect how investment decisions are made and understood by managers and clients. Under the risk-based story, return and risk decisions cannot be separated: expected returns rise in lockstep with risk exposures. On the other hand, if one believes some securities are underpriced—relative to their riskiness—then it is possible to find investments with more attractive risk-return profiles. Second, if risk is not tightly linked to expected returns, performance measurement and attribution should be modified accordingly. Choosing benchmarks with the same characteristics provides a much better comparison than simply measuring factor betas and factor risk premiums. For instance, a mechanical strategy that chooses investments with low betas but high B/M might look incredibly sophisticated if it is evaluated under the lens of a risk-based framework.

STRESS-TESTING PORTFOLIO-SPECIFIC RISK

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Jason D. Fink, Kristin E. Fink and Hui H. Sono

Idiosyncratic risk (or firm-specific risk, if discussing equity-only portfolios) is a significant source of risk for almost all investors. This risk is primarily reduced through diversification. However recent studies, such as Bennett and Sias (2011), demonstrate that portfolio diversification alone may be insufficient to eliminate idiosyncratic risk, in contrast to classical finance theory. If this risk must be borne, responsible portfolio managers will want an assessment of the exposure of their portfolio.

However, idiosyncratic risk is stochastic, and difficult to forecast. Idiosyncratic risk appears to exhibit stochastic jumps. So, modern volatility forecasting methods such as GARCH methods work well under most circumstances, but fail during times of significant market turmoil, when practitioners are most in need of risk assessment.

Building on Bekaert *et al.* (2012), we show that the idiosyncratic risks in a portfolio may be described by a parsimonious group of market variables. Since we are able to effectively describe idiosyncratic risks in this way, we may construct a model that can effectively stress-test idiosyncratic risk. The results of such stress tests provide the portfolio manager with valuable information about the nature of their idiosyncratic risk exposure.

ANALYST FORECASTS: IT PAYS TO BE OFF!

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Gilles Hilary and Charles Hsu

Our study should be of use to practitioners in several ways. First, contrary to common sense, analysts who are not strictly as accurate as others but whose forecasts are off in a more predictable way are actually more useful, more informative, and more influential for at least some investors. This puts a number of important market behaviors in a new light. For example, it should also be of use to both investors and regulators to know that, for analysts, the key benefit of lowballing is not greater accuracy, as one might think, but rather greater consistency. Analyst performance does matter, but not always the way one might think it should.

Second, we offer what could be a more powerful measure of analyst performance, which in turn can help understanding whether some other factor—such as experience, boldness, or access to management—affects the quality of an analyst's forecasts and the success of his or her career.

Third, it should be of use to both investors and regulators to know that the more sophisticated investors there are in a market, the greater the effect of forecast consistency on forecast usefulness. In contrast, the fewer sophisticated investors there are in a market, the greater the effect of stated accuracy on forecast usefulness. This matters because, even though investors taken as a group may be sophisticated, retail investors in particular may not be. We also find that the more sophisticated investors there are in a market, the more consistent the forecasts are and the more lowballing there is. Our results suggest that, for most analysts, the dominant strategy is to collaborate with managers in order to get information that can be used to produce forecasts that are more informative but are systematically downward-biased. Because sophisticated investors are the ones who can identify and correct for such bias, they are the ones who find the forecasts more informative. However, when investors are not sophisticated enough to recognize the bias, analysts are penalized for issuing biased forecasts that are inaccurate, even if they are more consistent than other analysts' forecasts. Investors who fixate on the face value of the forecast will find the more consistently biased forecasts less useful, which often undermine those analysts' reputations. Our findings could therefore be valuable to regulators interested in understanding the trade-offs associated with biased forecasts. In particular, these findings can clarify the effect of legislation such as Regulation FD. Empirical results discussed in our study indicate that this regulation made it more difficult for analysts to use lowballing to improve their access to management.