ASIAN BUREAU OF FINANCE AND ECONOMIC RESEARCH

October 2014

A Message from the President and Executive Committee of ABFER

Dear readers,

Welcome to the 2nd annual edition of the ABFER Research Digest. ABFER's 2nd Annual Conference was held in May 2014 at the Shangri - La Hotel, Singapore. This Digest summarizes selected papers presented in conference. More information on the conference can be found here.

Please feel free to share this Digest with your friends and colleagues. We hope to see you at our next edition.

If you have any feedback and suggestions, please email them to: info@abfer.org

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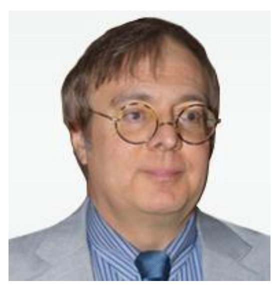

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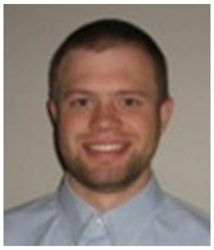
Who are the Sentiment Traders? Evidence from the Cross-section of Stock Returns and Demand



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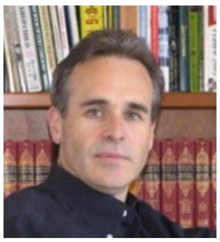

Richard Sias

Prof Richard Sias has been a Professor, Department Head, and Tyler Family Chair in Finance at the University of Arizona since 2011.

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Prof Laura Starks is the Charles E. and Sarah M. Seay Regents Chair of Finance, Associate Dean for Research and Director of the AIM Investment Center in the McCombs School of Business at the University of Texas at Austin.

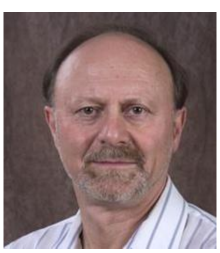
Research suggests that investor sentiment affects share prices. But are the price effects coming from the sentiment trading of individual investors, as assumed by many, or from the trading of professional, institutional investors? In **Who are the Sentiment Traders? Evidence from the Cross-section of Stock Returns and Demand,** authors **Luke DeVault, Richard Sias,** and **Laura Starks** seek to shed light on whether institutional traders could also be affected by sentiment and whether they are the investors responsible for the documented sentiment effects. This question is important as institutional investors own a large percentage of U.S. equities and account for 70-96% of the trading volume. If sentiment affects their trading, the impact on the mispricing of securities could be high.

Baker and Wurgler (2007) develop a metric to gauge sentiment and show that sentiment traders usually buy speculative (high volatility) stocks when sentiment is high and sell them when sentiment is low. Since each trade needs a party on the other side, liquidity traders absorb the volatility in demand caused by sentiment traders. With the Baker and Wurgler sentiment metric or consumer confidence measures, the authors find increased demand (and increased levels of ownership) by institutions of speculative (high volatility) stocks than safe securities when sentiment levels are higher and vice versa. This evidence suggests that institutional, rather than individual, investors are indeed the traders causing sentiment-based mispricing.

The authors also find that out of some 5,368 institutions in their data, including hedge funds and mutual funds, 57.3% of the institutional investors appear to be sentiment traders, while the remaining 42.7% are liquidity traders. The authors examine several potential explanations of their results: that hedge funds trade on sentiment to ride bubbles in asset prices; that institutions trade on sentiment due to reputational concerns; and that the sentiment trading comes from the underlying investors. The tests of these explanations provide no evidence that hedge funds ride bubbles, but they do show that institutional sentiment may have ensued, at least in part, from the reputational concerns of institutions and that managers' decisions play the primary role in sentiment trading, rather than the underlying investors.

The results have implications not only for understanding investor sentiment, but also for any study using sentiment metrics.

China's Growth, Stability, and Use of International Reserves



Joshua Aizenman

Prof Joshua Aizenman joined the faculty at the University of California in 2001 following 11 years at Dartmouth College, where he served as the Champion Professor of International Economics.

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Dr Yothin Jinjarak joined the Research Department of ADBI in 2013. His areas of research include international development, trade, finance, and macroeconomics. He is Reader in Banking and Finance at DeFiMS, SOAS, University of London.

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Prof Nancy P. Marion is the George J. Records 1956 Professor of Economics at Dartmouth College. Her research is focused on macroeconomic and international finance issues. She has also been a frequent lecturer at the IMF Institute on a range of topics related to emerging markets.

In the years prior to the 2007-8 global financial crisis, economies around the world faced enormous current-account imbalances. Some believed such large imbalances were likely to persist. Dooley, Folkerts-Landau and Garber (2003, 2005) argued that Asia's emerging markets, and China in particular, could pursue a strategy of export-driven growth, supported by low, favourable exchange rates and capital controls, for many years to come. This strategy was beneficial to the United States, as a virtually unlimited demand for its financial assets would enable it to sustain its large current-account deficit, effectively allowing the U.S. to live beyond its means for years.

In **China's Growth, Stability, and Use of International Reserves**, authors **Joshua Aizenman, Yothin Jinjarak, Nancy P. Marion** focus on how East-West global imbalances, in particularly those between China and the United States, have evolved after the financial crisis. Both China and the U.S. have rebalanced. As a share of GDP, their current-account imbalances are now less than half their pre-crisis levels.

The authors suggest that structural changes in China may have contributed to the fall in its current-account surplus post-crisis. These changes may have moderated the pattern of international reserve hoarding as well. Reserve hoarding will be reduced further as China increases its outward Foreign Direct Investment.

The authors analyze panel regressions for a sample of almost 100 countries over a 30-year period (1983-2013) to provide evidence that the relationship between current-account balances and economic variables such as structure, performance, wealth and the exchange rate have changed in important ways after the financial crisis.

Busted! Now What? Effects of Cartel Enforcement on Firm Value and Policies

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In an effort to combat collusive behavior of firms, a number of countries have recently implemented leniency laws that offer companies within a cartel either total immunity or a reduction in the fines if they self-report and hand over evidence to antitrust authorities. Although theoretical literature largely agrees that leniency legislation makes cartels more easily detectable and harder to exist, empirical support for its effectiveness has been lacking so far.

In their paper **Busted! Now What? Effects of Cartel Enforcement on Firm Value and Policies**, authors **Ailin Dong, Massimo Massa and Alminas Žaldokas** provide empirical evidence on the effect of leniency laws on cartels and firm policies. Based on a wide sample of firms from 63 countries over 1990-2012, the authors find that the passage of leniency laws led to an increase in the number of convicted cartels by 154%. In addition to the observed convictions, the authors also examine the unobservable effects of cartel enforcement, i.e. breakups of existing cartels or changes in their propensity of their formation. They find that leniency legislation led to an average drop of 3%-4% in firm gross margins.

The authors further study how firms strategically react to the changes in their boundaries. As a result, the firms affected have re-organized their activities by pursuing more mergers and acquisitions (M&A) transactions, especially those in the same industry. The authors show leniency laws increase M&A activity in a given country by up to 5%-6% after their passage. There was no evidence that the firms affected resorted to strategic alliances or pursued greenfield investments by increasing capital expenditure.

The authors argue that firms pursue more M&A to achieve economies of scale and exploit cost synergy. The alternative interpretation of regaining market share by increasing M&A transactions is not consistent with the authors' finding that customer industries react positively to cartel-induced mergers, which indicates that the efficiency gains of M&As after cartel prohibition are also passed to customers.

The authors conclude that the results demonstrate that leniency laws are effective in detecting existing cartels. Moreover, after drops in profitability firms tend to redefine their boundaries.

When Real Estate is the Only Game in Town

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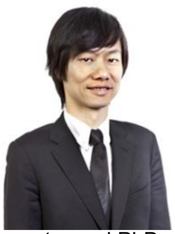

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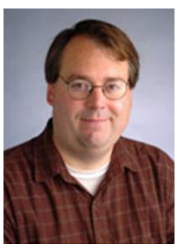

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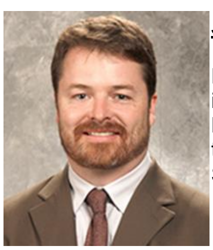

Jeffrey P. Thompson

Dr Jeffrey P. Thompson is an Economist on the Board of Governors of the Federal Reserve System since 2012.

The housing boom of 2007 and crash thereafter have generated interest in the study of the residential real estate market and identifying the factors driving the fluctuations of home prices. There are some who believe that prolonged lower interest rates, easy credit for subprime borrowers and agency problems in the screening, documentation and monitoring of mortgages by banks and loan houses might have contributed significantly to the boom and subsequent bust. Others argue that sentiments such as investor over-confidence and trend chasing may be more important.

In **When Real Estate is the Only Game in Town**, authors **Hyun-Soo Choi, Harrison Hong, Jeffrey Kubik and Jeffrey Thompson** study the factors of home purchases for investment purposes from 1995 to 2010, and suggest that an “only game in town effect” might also be important for understanding real estate price cycles.

Residential properties can be classified as primary, vacation, and investment residences. In the United States, investment residences, defined as homes bought for investment, as opposed to occupation by the owner, make up a sizeable part of the residential real estate market. From 2002 to 2007, demand for investment homes increased to 28% from 17% of the market for residential sales. After the financial crisis, investment homes still represented around 22% of the residential sales market.

Investment residences are similar to stocks, in that they are bought for investment or speculation, and generate dividends and capital gains. Banks also put in place more stringent collateral requirements for investment home mortgages, because these mortgages are viewed as speculative investments. There are good reasons to believe that households in the market for investment homes would show local or home biases. Owners have local knowledge about residences close to their own neighborhoods, and it is easier and cheaper to commute to such properties. However, such investors could also choose to invest in the shares of firms that have their headquarters nearby. The authors conclude that the availability of such alternative investment opportunities would compete for the attention of households, leading to reduced ownership of investment homes.

Using public data on household investments, the authors find that in a city where fewer publicly-traded firms are headquartered, households are 15% more likely to own an investment home nearby, while simultaneously less likely to own stocks. This phenomenon is called the “only game in town” effect: if there are few publicly-listed firms with headquarters nearby, investors with local or home biases have little opportunity to invest in stocks, and buy nearby investment homes instead. The authors also show that this effect is more pronounced for households in high credit-quality areas, which have easier access to financing for investment homes. The effect also becomes pronounced for households in low credit-quality areas after 2002, when mortgage securitization made financing easier. Finally, the authors suggest that due to the “only game in town” effect, cities with few local stocks tend to have higher price-to-rent ratios.

In conclusion, the authors provide new evidence of the existence of the “only game in town” effect, showing that households in areas with few local stocks are much more likely to purchase local investment homes. This suggests that investments in the stock market and residential real estate are likely to be inter-related.

Investing Like China

Chong-En Bai

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The authors **Chong-En Bai**, **Qing Liu** and **Wen Yao** looks at several puzzling facts in the Chinese economy: firstly the private lending rate is very high, while the returns is much lower; secondly the combined investment rate in China is almost as high as 50%, even though the private lending rate is high and marginal return to capital is lower; thirdly it seems that demand for skilled labor is falling over these year, while demand for unskilled worker is rising. As a result, the wage difference between skilled and unskilled workers are declining in recent years, driven by a faster rise in the wage of unskilled worker and a slower rise in the wage of skilled worker.

In their paper **Investing Like China**, the authors attempt to explain the above unique features of capital and labor markets in the Chinese economy using a two-sector model. They assume that the economy has two production sectors; an infrastructure sector and a general good sector.

The authors suggest that these puzzling facts are likely to be the result of the government subsidies in the infrastructure sector through a lower loan rate. Assuming that the infrastructure sector uses more unskilled worker, government subsidies in this sector drive up the demand for unskilled worker and increase in the wages for the unskilled workers compared to the skilled workers. At the same time, the subsidy in the infrastructure sector drive up the demand for capital in the market and hence the market interest rate increase for the general good sector. This leads to reduction in the investment and demand for skilled workers, and in turn pushes down the wage rate of skilled workers. Hence the two-sector model proposed in the paper is able to explain the declining wage premium, high investment, high interest rates in the private sector and low return on capital. The authors built a two sector growth model with government policy biased towards the infrastructure sector and the resulting model is consistent with the above facts.

The authors conclude that there are several important policy implications. There is a limit to intervention on subsidizing investment. When the rural area has excess supply of labor, subsidizing infrastructure sector could increase total productivity and welfare. However, when the migration is finished, the intervention could only increase output while reduces welfare. This model also has implication on the education policy. The expansion of college enrollment is not the main driving force for the declining wage premium, because the skilled labor intensive sector shrinks due the government subsidizes in unskilled labor intensive sector.

CEO Turnover and Earnings Management in Banks: Evidence Using Age-based Retirement Policies

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Managerial incentives in banks have been blamed as the cause for excessive risk taking, as well as earnings management, seen during the 2008 global financial meltdown. Earnings management concerns the use of accounting techniques to produce financial reports that may paint an overly positive picture of a company's position.

Earnings management may occur when there is either an outgoing or incoming CEO, or both. The "finite horizon" hypothesis suggests that the outgoing CEO tries to shore up earnings towards the end of his tenure to finish on a high note. In contrast, the "big bath" hypothesis predicts that the incoming CEO may try to make poor earnings look worse at the beginning of his tenure to create "room" for a subsequent stronger performance . Given the relatively opaque nature of banks' operations compared with those of non-financial firms, the "big bath" effect tends to occur in banks rather than non-banking firms. The "coaching" hypothesis suggests that both the outgoing and incoming CEOs collude to manufacture a smooth transition.

Authors **Arkodipta Sarkar, Krishnamurthy Subramanian and Prasanna Tantri** suggest in their paper, **CEO Turnover and Earnings Management in Banks: Evidence Using Age-based Retirement Policies** that CEO turnover leads to earnings management in banks with the "big bath" effect occurring.

During a leadership change, the incoming CEO is likely to be concerned about the quality of the bank assets created during his predecessor's tenure. Such fears are particularly strong especially when the incoming CEO could be held personally liable for the bank's poor performance. Given this, the authors argue that to avoid such risks, the incoming CEO may choose to manage the bank's earnings by creating excessive loan-loss provisions.

According to the researchers, publicly-held banks in India provide an ideal setting to study whether earnings management occurs when there is CEO turnover. First, employees of such banks face skewed incentives as these institutions are owned and controlled by the government, and are publicly traded. In these banks, good performance is not rewarded and prosecution is a continual threat to senior managers. Second, the retirement of a bank CEO occurs when he reaches 60; it is not on the basis of performance. Bank CEOs will only leave their positions when they reach the tenure requirement.

The authors also compare the effects of CEO turnover in Indian public banks versus non-financial firms. Compared to banks where there was no CEO turnover, banks experiencing a change in leadership reported 23% lower profit-to-sales and 22% lower return-on-assets. In the corresponding non-financial sector, the authors did not find any significant difference in the net profit-to-sales ratio between the CEO transition quarter and subsequent quarters.

The authors also observe that the decrease in earnings was mainly driven by provisions for bad and doubtful debts. There were more loan-loss provisions during the transition quarter, some of which were reversed in subsequent quarters.

They also found that shorter tenure increases the earnings management of the incoming CEO. In particular, the effect of a turnover on earnings management was double that of a CEO with a longer tenure period.

Further, there were also real effects associated with CEO turnover. As the incoming CEO may not be privy to soft information about loans provided during the incumbent's tenure, the former is likely to be more cautious about the quality of bank assets. Hence, the authors found that lending was lower with a corresponding decline in stock price.

Finally, the authors also observed that CEOs with lower accounting earnings had a great likelihood of being prosecuted for corruption during their tenure or after retirement. The authors concluded that, at least in the context of Indian public banks, there is evidence that CEO turnover leads to earnings management. In particular, the "big bath" hypothesis is supported. The opaque information prevalent in banks is also likely to have resulted in incoming CEOs managing earnings. There was evidence of earnings management in public banks, but not in non-banking firms where information is more transparent. Further, the lack of over-provisions in the last quarter of the outgoing CEO's tenure suggests that the "finite horizon" hypothesis does not hold. Finally, the "coaching" hypothesis is unlikely in the case of Indian public banks as the incumbent does not have the opportunity to collude with the incoming CEO, given the short notice period of the identity of the new appointee.

The Information Value of Credit Rating Reports

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Do credit rating reports contain new information value beyond the credit ratings themselves? While many prior studies have focused on the hard information contained in the rating reports such as rating changes, there are no studies that have examined the soft information contained in the credit rating reports. Rating agencies usually express their rationale and opinions about the creditworthiness of rated firms or products in these concurrently released rating reports.

In **The Information Value of Credit Rating Reports**, authors **Sumit Agarwal, Vincent Chen, Weina Zhang** abstracted one type of soft information – linguistic tone – from 1,137 rating reports issued by one major rating agency - Standard & Poor's. Linguistic tone refers to the number of positive words and negative words employed in the report which are modified in the financial context. For example, the popular negative words include "challenge", "concern", "decline", "deteriorate", "suffering", and "weakness" etc. The popular positive words include "improve", "gain", "outperform", and "strengthen" etc.

The authors found that the positive (negative) tone is significantly and positively (negatively) related to stock returns. Moreover, they found that credit rating reports do provide valuable information that investors can use to better predict future rating changes. Their results are very robust with respect to other contemporaneous news releases from stock analysts, CreditWatch and Outlook news.

The authors took another step further to examine the incentives of rating agencies when they provide the credit rating reports. Are they more concerned about their reputation or are they more affected by the conflict of interest faced? The conventional wisdom about rating agencies usually focuses on the conflict of interest due to their issuer-paid business model. Conflict of interest implies that rating agencies are struggling between providing truthful credit ratings and keeping their rating business with their rated clients since they are the payees of the rating services. Their findings reveal that rating agencies are less concerned about the conflict of interest in writing these reports, while investors are still worried about the conflict of interest.

Based on their findings, the authors concluded that credit rating reports do contain new information beyond the credit rating itself. Conflict of interest matters more to investors, even though the real motivation of credit agencies in providing credit rating reports is not likely driven by the conflict of interest. Instead, the rating reports seem to be a placeholder for rating agencies to accumulate their reputational capital. Hence a more careful reading of these credit rating reports can be fruitful for both investors and regulators.

Lehman Sisters

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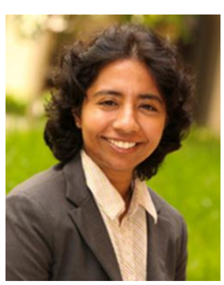

Vanitha Ragunathan

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At a recent World Economic Forum in Davos, outgoing European Union Commissioner for Competition, Neelie Kroes, declared: "If Lehman Brothers had been Lehman Sisters, we might now sit in a different world", a reference to the collapse of Lehman Brothers that marked the beginning of the global financial crisis. Her remark was based on the belief that women are more risk-averse than men, and that their under-representation on bank boards may have accounted for the financial risks taken that led to the financial crisis.

However, anecdotally, there are reports of female bankers who have undertaken risky strategies. The creator of credit default swaps, which some blame for the onset of the global financial crisis, was a woman – Blythe Masters. Ina Drew, then chief investment officer at JPMorgan Chase who was later fired for a six billion dollar trading loss, was famously described as "bold" by its CEO, Jamie Dimon.

It is possible that women on boards of publicly-listed firms or banks are different from women in the general population. In their paper, Lehman Sisters, authors Renée B. Adams and Vanitha Ragunathan support this argument by showing that women in finance are not only less risk-averse than other women, but also exhibit similar levels of risk appetite as their male colleagues. They also demonstrate that gender diversity enhances the value of banks.

The authors studied major US-listed bank-holding companies and commercial banks from 2006 to 2009. They found little evidence to suggest that board gender diversity led to less risk-taking during the crisis. For example, in banks with more women on their boards, the issuance of mortgage-backed securities was not significantly lower and hedging was not higher.

However, this does not imply that gender diversity does not matter at all. On the contrary, the authors find evidence that during the crisis a bank's value is enhanced by having more female directors. Banks with more women on their boards reported higher Tobin's Q (a measure of a firm's assets in relation to a firm's market value) and ROA (return on assets) during a crisis. The better performance may be due to fewer complacency issues in decision-making for firms with gender-diverse boards. The presence of female directors, and hence diversity in backgrounds and values, may have encouraged the board to spend more time deliberating on optimal strategies. This aspect of diversity may be particularly valuable in a crisis.

Consistent with the idea that diversity may matter, the authors found that female directors behaved quite differently from male directors in ways that could enhance corporate operation, governance and performance, especially during a crisis. Banks with more female directors performed better than other banks in the following ways. Male directors were less likely to have attendance problems in banks with more women on the board. Female directors served different committee duties from their male counterparts, and were more likely to serve on monitoring committees. They also exhibited different resignation behaviours. Specifically, they were less likely to resign in banks that eventually delist.

Based on their findings, the authors conclude that more board gender diversity is not necessarily associated with less risk-taking behaviour. However, diversity may be valuable in crisis situations.

Till Death Do Us Part: Marital Events and Hedge Funds

Melvyn Teo

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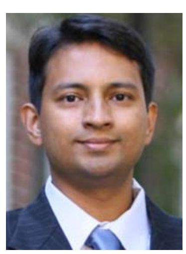

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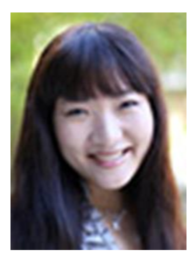

Yan Lu

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Hedge fund managers are human beings, and therefore influenced by emotions. As the founder of a flagship hedge fund, Paul Tudor Jones II, once stated, "one of my number one rules as an investor is, as soon as … I find out that [a] manager is going through divorce, [I] redeem immediately. Because the emotional distraction that comes from divorce is so overwhelming … You can automatically subtract 10 to 20 percent from any manager if he is going through divorce."

Emotional distractions at the personal level include marriage and divorce. The process of either can be time-consuming and emotionally distracting. The performance of fund managers, especially those engaged in high-paced strategies, may be adversely affected by the emotional distractions associated with these events.

In **Till Death Do Us Part: Marital Events and Hedge Funds**, authors **Yan Lu, Sugata Ray and Melvyn Teo** explore whether emotional distractions at the personal level affect professional investment decision-making. Using publicly-available, court-reported marriage and divorce data, while tracking hedge fund performance, the paper documents the relationship between fund managers' marital events and their investment performance.

In line with Jones' statement, the authors found evidence that fund managers significantly underperform during a divorce. During a six-month divorce period, fund managers underperformed by 4.33% per annum, versus the pre-divorce period. This gap increases to 7.79% per annum after adjusting for other factors. The detrimental effects of a divorce last beyond the six-month event window; fund managers continue to underperform by 2.29% per annum up to two years post-divorce.

Since divorce has a negative effect on performance, one might expect that marriage would have a positive effect. However, this is not the case. The authors found that marriage has similar, although weaker, effects on fund performance. During the six-month period around the time of the divorce, fund managers underperform by 3.13% per annum relative to the pre-marriage period, or 5.10% after controlling for other factors. As with divorce, a long-lasting effect is observed; for the two-year period after marriage, fund managers continue to underperform by 3.16% per annum.

The authors also found other interesting results. For example, the effect of marriage is more detrimental to the investment performance of high-paced and liquid hedge funds run by older managers. This result is consistent with the intuition that older managers who are running liquid, higher-paced strategies that trade frequently have little surplus emotional capacity to cope with the additional demands of a marriage. On the other hand, younger managers who are running illiquid, lower-paced strategies seem more able to cope with the emotional distractions associated with marriage.

However, this finding is the opposite in the case of divorce. The performance of younger fund managers drops by 15.68% per annum during a divorce, while that of older fund managers only drops by 4.10% per annum. The authors argue that older fund managers, presumably calmer and less emotional, are more able to manage the stress associated with a divorce than younger, presumably more emotional, fund managers.

The authors support the view that, since fund managers are human beings, emotional distractions at the personal level can affect their professional investment decision-making. During a marital event, fund managers are less likely to deliver the same performance they used to achieve.

About Abfer

The Asian Bureau of Finance and Economic Research is a new institute founded by academics from Asia, North America, and Europe. The Bureau intends to create a virtual and independent network of high-quality academics akin to the NBER/CEPR, as well as conferences and workshops. The objects of the Bureau include:

- *to promote Asia-Pacific oriented financial and economic research at local, regional and international levels;*
- *to connect globally prominent academic researchers, practitioners and public policy decision-makers on Asia-Pacific related financial and economic issues; and*
- *to enhance the research capabilities and development of strong clusters of finance and economic research groups in academic institutions and other institutions in Singapore and Asia-Pacific.*