

MIND | WORK

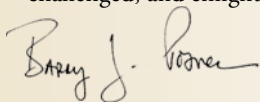
LEADING SCHOLARSHIP FROM SANTA CLARA UNIVERSITY SCHOOL OF BUSINESS

You are holding the inaugural issue of *Mind|Work*, a quarterly digest of faculty research from the Leavey School of Business, Santa Clara University, focusing on knowledge and practices which serve to make corporations and communities better.

As can be expected from the Business School located in the heart of Silicon Valley, and one built on an historic Jesuit foundation, our scholarship explores innovation, entrepreneurial practice, global ethical concerns, and the meaning of justice in enterprises around the world.

This issue highlights the work of our Finance faculty, examining ideas ranging from global implications of financial ethics to multi-dimensional risk models being used on Wall Street today. These scholars are some of the most widely cited, providing a legacy of thought leadership that will shape how we think and work.

We hope you are intrigued, surprised, challenged, and enlightened by *Mind|Work*.



Barry Z. Posner

Dean and Professor of Leadership

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SITUATIONAL ETHICS: Professor Meir Statman has demonstrated that what's considered ethical in business can vary from country to country.

Is It Right to Do That?

It Depends on Where You Ask, but Investors are Watching

Paul Bond is an attorney whose law firm is advising one company on the takeover of another. Though Bond is not involved in that project himself, he overhears a colleague say that the offer for the target company will be \$120 a share. Based on this knowledge, he buys 1,000 shares at \$70, expecting to turn a quick and substantial profit.

Is Bond's behavior ethical?

It turns out there's a wide range of opinions, depending on the country where the question is asked and whether it's asked of college students or finance professionals, according to research done by Meir Statman, Glenn Klimek Professor of Finance at Santa Clara University.

Statman published the results of his study ("Local Ethics in a Global World") in the May/June 2007 issue of the *Financial Analysts Journal*. ▷

is it right to do that?

Statman has been awarded the Finance Research Excellence Award by the University of Notre Dame and will present an expanded version of his paper this fall at its Ethical Dimensions in Business conference. He hopes his findings will stimulate deeper and more practical discussions on business ethics and how to improve it.

“Conversations about ethics in business tend to be sterile and based on abstract principles drawn from philosophy,” Statman said. “There’s too much preaching, too much self-righteousness and hypocrisy, and too little knowledge of actual perceptions of ethics and how they vary among countries and within them.”

Working with colleagues abroad over several months, Statman posed the Paul Bond question and others to finance professionals and college students in the United States, Australia, India, Israel, Italy, the Netherlands, Turkey and Tunisia. Cultural adjustments were made by location, so that, in India for instance, Paul Bond became Pesi Bhabba.

In the U.S. and the Netherlands, only five percent of finance professionals said Bond’s

behavior was acceptable. That rose to 16 percent in Australia and Israel, and then jumped to percentages in the forties in Italy, Tunisia and India and to 56 percent in Turkey.

In every country surveyed, students were more likely, often by wide margins, to approve of Bond’s behavior. In the U.S., 36 percent of students found Bond’s behavior completely fair or acceptable, and in India and Turkey the percentage approving was in the seventies. Statman said he can’t say for sure why students are more tolerant of such behavior but suspects that, unlike the professionals, they haven’t yet been fully schooled on the law prohibiting insider trading.

The law, however, is not a sufficient solution to the insider trading problem, he said. Insider trading is illegal in all the surveyed countries, but it is widely perceived as acceptable in many countries. Norms of fairness as well as levels of trust and freedom from corruption are part of “social capital,” and that capital varies from country to country. “In a society where people cheat where they can,” said Statman, “business enterprises are often limited to family because others are not trusted.”

Social capital does accumulate and ethical standards can be improved. Globalization promotes social capital and so do income, education, and law enforcement.

Tainted food and lead in paint are not new in China, where social capital is low and trust is rarely extended beyond family. But China is learning quickly that its businesses must improve their behavior if they are to sell their products globally.

Corruption tends to be higher where incomes are lower. In his surveys Statman found that insider trading is more acceptable in countries where incomes are lower. Ethics, it seems, is a luxury. It is relatively easy for us in our wealthy country to return \$5 paid in error by a store clerk since the warm glow of ethical behavior is worth more than \$5 to many of us. But it is not as easy to do so when \$5 is what one can earn in a day or a week.

“If you want to raise ethical standards, raise income first,” he said. “Once you make people prosperous, they want cleaner air, safer food, and higher ethical standards in business and government.”



AN ANTIDOTE TO EXCESSIVE OPTIMISM: Professor Hersh Shefrin’s new book, *Ending the Illusion of Management*, discusses the ways companies can avoid mistakes due to illusionary thinking.

The People Factor Structuring Businesses to Compensate for Human Error

Businesses are run by people who have their own personality quirks and a capacity for self-delusion. Yet the way this fact affects business decisions has been largely ignored or downplayed over the years by most business schools.

Hersh Shefrin, Mario L. Belotti Professor at SCU’s Leavey School of Business, has been a pioneer in the area of behavioral finance, which examines the role the human factor plays in the business world. In a new book, *Ending the Illusion of Management*, he talks about how companies can avoid bad decisions by making structural changes to take the human element into account.

“I’ve tried to take a look at the classic financial mistakes which people make, both as individuals and in groups and relate these to

corporate culture and process — particularly when it comes to a bias toward overconfidence and optimism,” he said. “This book is not going to solve all those problems, but it can be the beginning of a conversation between managers and those of us who teach them.”

Shefrin has written an earlier book, *Beyond Greed and Fear*, that provided an overview of these issues for financial practitioners. *Ending the Illusion of Management* is written for corporate managers. The tone is conversational, and the reader can almost imagine Shefrin using the text as a lecture, which he said he plans to do.

Too often, he said, managers plan only for the best-case situation and don’t rigorously identify the things that can go wrong and what the best response would be if they do. They tend to suffer from “the illusion of control,” which makes them overconfident about their ability to generate the outcome they want and reluctant to plan for possible setbacks.

“The book is not about ending management,” Shefrin said. “It’s about improving management through the use of better financial and accounting processes which are built into the culture of the organization.”

For a company to function effectively and correct its own bad impulses, there are four business processes that need to be woven into the fabric of a company’s culture. These involve accounting, planning, incentives, and information sharing. Among other things, these processes induce managers to engage in contingency planning and think through a variety of potential scenarios.

One company that integrates those four very well, he said, is Southwest Airlines. That company “manages around the numbers” and has strict accounting standards so that managers continuously track what’s going on financially. When Southwest was considering setting up at the Denver airport, its team asked so many good contingency-based questions of airport management that the airport managers realized there were some issues they themselves needed to address.

In his book, Shefrin also addresses how the human tendency to succumb to illusions has affected the debate about the environment, a conspicuous example being the denial in some quarters of the reality of global warming. That affects both the political debate and the actions businesses take on environmental issues.

“We’re on a dangerous trajectory for this planet,” he said. “Business is part of the solution as well as the problem. But ending the illusion of management will help companies develop solutions. However, if managers continue in their illusions, their companies are more likely to end up being part of the problem than part of the solution.”

When Shefrin got into the field of behavioral finance three decades ago, “my professional colleagues’ reaction . . . lay somewhere between rejection and outright hostility,” he writes in his book. Today, it’s a different story.

“A paradigm shift is taking place,” he said. “Behavioral finance is now in the mainstream of economic thought, and financial practitioners are starting to pay attention.” ▶



A NEW CHALLENGE: Professor Atulya Sarin brought years of international financial experience to his latest effort, co-authoring the text of *Foundations of Multinational Financial Management*.

Passing It on to the Students

Professor Sarin Co-Authors Revised Financial Textbook

Atulya Sarin has served on the editorial board of the *Journal of Financial Research* and has written more than 25 articles for leading journals in the fields of finance, economics and management. This year he adds a different writing credit to his portfolio: co-author of a textbook that is considered “the gold standard” in its field.

Foundations of Multinational Financial Management came out in its sixth edition in January 2008 with Sarin, Professor of Finance at SCU’s Leavey School of Business, collaborating with Alan C. Shapiro of the University of Southern California, the book’s original author.

“The level of writing is different because you can’t assume the understanding of a peer group that you have with research papers,” Sarin said. “It’s a juggling and balancing act trying to reach a diverse audience with different perspectives. You have to provide enough depth to satisfy the advanced reader while being clear enough for a beginner in the field.”

Aimed at an undergraduate audience but suitable for masters-level classes, the book, published by Wiley, aims to teach students how to analyze key financial decisions in multinational firms in the context of what they have learned in more basic financial management courses. Sarin said he would be using the book in the graduate classes he teaches at SCU.

Shapiro and Sarin have known each other for years and have previously worked together on research papers and business consulting assignments. The collaboration on the most recent edition of the text was a logical outgrowth of that, and they are also co-authoring a new book on business valuation.

His work on the textbook drew heavily on his experience doing consulting and litigation support in the areas of transfer pricing, corporate valuation, stock and bond prices and derivatives. Pulling it all together, he said, was a different experience from his previous writing.

“Writing a textbook, you have to be disciplined and work in a steadier manner than with shorter research papers. There’s also a lot of detail work — for instance, I spent nearly three months doing and redoing the instructors’ manual and slides,” he said.

“But there’s also a freedom in how and what you can write, and you can write it the way you see it more so than in research articles with peer review. It was a very rewarding experience.” ▶

Beware of the Hype It Can Actually Be a Harbinger of Sub-par Performance

When a company is approaching the date of an equity offering, it's not unusual to see the firm's publicity machine go into high gear. But that shift could in itself be a red flag for investors, because it often correlates with disappointing performance afterwards.

Hoje Jo, associate professor of finance and Yongtae Kim, assistant professor of accounting at SCU's Leavey School of Business, reached that conclusion after examining 1,431 seasoned equity offerings and connecting them with over 103,000 press releases generated by the companies doing the offerings. Their paper, "Disclosure Frequency and Earnings Management," appeared in 2007 *Journal of Financial Economics* 84, 561-590.

They found that increased publicity around the time of an offering was often connected to earnings management aimed at making the investment look better than it really was. On the other hand, companies that routinely and consistently had a high level of public disclosure tended to fare better after the public offering.

"If disclosure is persistent, there's an information pattern available to investors," Jo said. "When a company is transparent, it's tough to manipulate earnings."

Jo and Kim decided to use press releases as a way of measuring disclosure because they are available for a large group of firms. They believe it is important to obtain a sufficient number of cross-sectional observations to ensure enough variation in earnings management among the sample firms.

Using the date of the offering announcement as the starting point, they worked back two years and forward two years, breaking each two-year period into six-month sections and counting the number of press releases in each six-month section.

A company that was transparent in its disclosure would be issuing a similar number of press releases in each six-month period and maintain high disclosure frequency. A company that was more opaque in its disclosure would issue a lower number of releases well before the offering, show a significant spike in press releases just prior to the offering, then revert to lower numbers in the periods afterward.

association between accruals and financial performance is suspected.

One of their key findings, which differs from the conventional wisdom, is that earnings management tends to be more acute immediately after the offering announcement, presumably because the company managers are concerned about lawsuits and agreements with the underwriters of the offering.



LOOKING BEYOND THE PR: Professor Hoje Jo and colleague Yongtae Kim have documented how some companies use public announcements to help stock prices.

Jo said this could likely be an indication of hyping behavior, in which the company is engaging in a pattern of aggressive disclosure.

This sort of corporate behavior has been known in financial circles, but Jo and Kim carried it to another level by then following up on the companies to see how they did after the offering. The study covered offerings made between 1990 and 1997, so the results were on the record.

In order to measure earnings management, Jo and Kim looked at performance-adjusted discretionary total accruals (ADTA), which Jo said is the better measure when mechanical

Jo said he hopes the results of his research will help financial analysts do a better job over time by recognizing the value of consistent corporate disclosure and factoring it into their analysis. But there's still going to be a temptation for a company to hype its stock, pre-offering, for short-term gain.

"It's relatively easy to deceive a certain group for a short period of time," he said, "but it's tough to deceive a lot of people over a long period of time." ▶



LOOKING AT THE WORST CASE: Professor Sanjiv Das has developed a formula that helps investors take into account a company's prospect of defaulting on debt.

The Risk Factor

Formula Works Default Prospects into Security Prices

The dot-com crash that hit at the beginning of the century exposed a gap in the financial analysis of security prices. The dot-com start-ups had been running on credit (often publicly traded convertible bonds), but the prospect of default wasn't adequately factored into these bond prices.

"There are three sources of risk for a hybrid security such as a convertible bond," said Sanjiv R. Das, Professor of Finance at the Levey School of Business at SCU. "Those are equity, interest rate and credit risk. There was no complete model in place to deal with all these, since credit risk wasn't adequately factored in."

The fallout was a number of distressed convertible bond funds whose shareholders claimed that portfolio managers hadn't properly valued these securities. Das decided to create a value-analysis model that would give credit risk its full due.

Working with his long-time collaborator Rangarajan K. Sundaram of New York University's Stern School of Business, Das began to develop a "hybrid" model for valuing these complex

bonds and quickly had an early version. They would spend the next five years improving this model and coming up with a formula that would capture the whole picture better than it had been painted to this point.

"As with any theory," he said, "you posit a theoretically rigorous mathematical structure you believe represents the real world, it's a physical embodiment at which you throw data to see if it works. A model should give consistent results or it isn't any good. Like a good car, it needs to perform well on the road conditions for which it is designed."

The models that Das and Sundaram came up with evolved over the next five years ("It was a long journey," he said). The model is a dense, multi-lined equation linked to a larger algorithm that they feel makes a significant inroad into addressing the credit risk question. A useful feature of the class of models is that they rely only on information readily available in the public markets.

Wall Street was definitely interested and gave the researchers a helping hand by road-testing the models and developing variants of

the same. Working papers were put out part way into the process to get comments and criticism, and a securities firm that is a household name invited Das to its trading room and showed him their implementation of the model.

"The model is pretty sound, and traders do like its intuitive nature," Das said, "but we're still very early in the life cycle of the idea. Our approach is much more a framework than a specific formula."

"The model is sound and traders like its intuitive nature."

Sanjiv R. Das

Professor of Finance and Chair, SCU

Das and Sundaram published their findings in the September 2007 issue of *Management Science*. The formula applies to hybrid securities trading such as convertible arbitrage, and any form of defaultable debt. It is also useful for trading credit risk, an area that has been burgeoning in the last five years as investors try to hedge their credit exposure in a volatile and rapidly changing market.

"It's not uncommon to see firms trading on small differences in price," Das said. "It's become a real high-tech business. The difference in value between the market price and what our formula shows may be as little as a tenth of a percent," he said. "But when you're talking about hundreds of millions of dollars in bond face value, that's enough of a spread to drive a tank through." ▶



PICKING THE WINNERS: Professor Robert Hendershott has looked into how much of a record investors need to identify a high-performing fund manager.

Looking at the Record

How Soon Can You Spot a Top-Notch Fund Manager?

Past performance may not be indicative of future results. Every investor has heard that one, yet almost everybody believes there's some connection. Robert J. Hendershott, Associate Professor of Finance at SCU's Leavey School of Business, is working on bringing that connection into sharper focus.

"In investing, we know there's a spread in outcomes," he said. "The question is how much of that is due to luck and how much to skill."

Hendershott is close to completion on a paper tentatively titled "Using Past Performance to Infer Investment Manager Ability." His research suggests that past performance can be a guide to the ability of an investment manager, but that a proper evaluation takes time — longer, in some cases, than investors might be willing to wait.

He directed his attention toward private equity funds for several reasons: They're smaller than, say, mutual funds; they offer the investment manager more discretion and allow for greater risk; and the bottom lines can be dramatically different. The performance gap between a fund in the 25th percentile and one in the 75th percentile can be as much as 20 percent annually.

Because of that, investors want to back funds that finish in the top 25 percent. Fund managers who are in the top 25 percent rated by ability are more likely to get them there, but luck still plays a significant part. Even a crackerjack fund manager can be taken down by something like the sudden death of a powerful CEO or by backing a good company just as its industry goes into a slump, dragging down the good and bad alike.

Hendershott was able to calculate that if you took 1,000 private equity funds and looked at the top quarter (the best 250), you would expect to find that 146 of them, or 58.4 percent, were managed by top-quarter managers. That still leaves 41.6 percent of the good funds managed by the 13.9 percent of ordinary managers who happened to be lucky.

Time and additional experience are the compensators for this phenomenon. Winnowing the data down to get a practical handle on it, Hendershott determined that when a manager has had three consecutive top-quartile private equity funds, potential investors can conclude with 80 percent or greater confidence that the manager is exceptional.

Yet that raises practical problems. By the time a manager's 1995 fund has been

proved successful, it's too late to invest in that manager's 1997 fund. Once a manager has had three straight proven funds, everybody wants to jump on the bandwagon. That could create problems by reducing the allocation available to new investors or by causing the fund to grow larger and move away from the strategies that made it successful in the first place.

In other words, Hendershott said, by the time past performance can be used as an effective screening device for fund managers, investors might be better off looking for the funds run by good but unlucky managers who didn't meet the strict screening criteria.

And in the end, while past performance can help identify the top managers, it still can't identify what it is that makes the top-rank managers really good. Hendershott used a sports analogy to make the point:

"What made Michael Jordan such a great basketball player?" he asked. "He was tall, but others were taller. He was fast, but others were faster. We know that there are Michael Jordans of the investment world who aren't just lucky. They have something the other people don't have." ▶

"We know there's a spread in outcomes; how much is due to luck and how much to skill?"

Robert J. Hendershott

Associate Professor of Finance, SCU

The Cost of Having It Now

Formula Determines What a Quick Deal Is Really Worth

In today's markets when an investor wants to buy or sell, the deal will go through right away. That's because intermediary organizations, such as banks and brokerage houses, are willing to hold securities or other financial instruments until they can be turned around so there's always an immediate buyer or seller.



REPLACING HUNCH AND EXPERIENCE: Professor George Chacko has come up with a formula to replace the guesswork on what a quick and easy deal is worth to a customer. ▶

There's a cost to this service, of course, and it can be a very lucrative business for those who provide it. Now George Chacko, Professor of Finance at SCU's Leavey School of Business, has come up with a model to determine what the service is worth.

"Everybody understands what's going on in this sort of transaction," he said, "but nobody's modeled it before. That's what we've tried to do." Chacko is first author of a paper, along with two colleagues from Harvard Business School, Jakub W. Jurek and Erik Stafford, about the model. Called "The Price of Immediacy," it has been accepted for publication in the *Journal of Finance*.

The concept of business intermediaries extends through all of commerce, he said. An example everyone can understand is the grocery store. "If you go to the store to buy a tube of toothpaste," he said, "you're paying a premium to the store for buying the toothpaste and holding it until you come in for it." Customers are willing to pay that premium because of how inconvenient it would be for them to deal directly with the manufacturer and wait for delivery.

But it's hard to place an objective value on that premium, which is one of the reasons the same tube of toothpaste sells for different prices at different stores.

Several years ago, when he was at Harvard Business School and working at State Street Bank, a leading Boston-area financial institution, Chacko got to thinking about the lack of a formula to determine what the intermediary holding service is worth. It's a question he's still very much interested in as managing partner of a hedge fund, 6S Capital, based in Zurich.

"This was something that has always been done by hunch and experience, but I wanted a more formal and rigorous way of doing it," he said.

Chacko and his associates focused their research on the financial markets because of their transparency. "You can see all the prices

and know exactly what the buyers and sellers are doing," he said. However, the formula they came up with can be used in a far broader range of businesses.

Developing the formula took years and involved a number of dead-end investigations. There are two risk factors involved — how long is the product held and how much does its price fluctuate — but those had to be weighed against a number of other considerations in varying degrees to come up with something that works.

In the end, the formula they developed yields similar results to those generated by experienced professionals who are relying on hunch and experience. The value of that to companies in this line of work is that they can rely more on the formula and not have to pay high-priced professionals to do the educated guesswork. Chacko said the formula could be put to wide use in the financial industry.

"I think it can be used by financial institutions — banks, insurance companies, brokerages, hedge funds — that are involved in buying and selling," he said. "Everyone can make use of this process to run the business more quantitatively and have more accurate financial measurements." ▶

When the Boss Comes Back It Happens Fairly Often and Generally Works Out

When a CEO retires from a company, that's supposed to be the end of the story. But surprisingly often it isn't. If the executive remains on the Board of Directors, there's a fairly good chance he or she will come back if the successor falters.

Carrie H. Pan, Assistant Professor of Finance at SCU's Leavey School of Business, has been looking into that phenomenon, trying to get a better understanding of when it's likely to happen and what it's likely to mean for the company and its market valuation.

"We realized when we started looking into it that there were many more cases than previously realized of CEOs coming back," Pan said. "This is consistent with the notion that there's a short supply of qualified CEOs, particularly in industries where managerial human capital is essential to the success of a firm."

Pan has been looking into the issue with two colleagues from The Ohio State University, Rudiger Fahlenbrach and Bernadette A. Minton. Their paper, tentatively titled "The Market for Comeback CEOs," is still being revised, but some of the findings seem fairly clear.

One of their key conclusions is that firms rehiring their former CEOs often hire the best available candidate, given the circumstances.

"Sometimes having the former CEO come back can be a good thing," Pan said. "It can be a lifesaver to a firm in really deep trouble where a quick turnaround is necessary. In all the cases we study, former CEOs come back when their former employers experience a sharp decline in ▶

[continued from page 7]

when the boss comes back

performance under the management of their successors.”

The research indicated that a company’s stock value tends to take a temporary hit for around two weeks when it’s announced that



REVOLVING-DOOR

LEADERSHIP: Professor Carrie Pan and her colleagues examine the frequency and effect of former CEOs returning to run their companies after they’d retired.

the former CEO is returning, but that carried out over a slightly longer period, the firm’s stock performs as well as that of a firm in a similar situation that did not rehire a former CEO. The large negative-announcement return could indicate that the real situation is even worse than the market had anticipated.

Using computer databases on publicly traded firms from 1993 to 2005, Pan and her associates looked at 275 companies where the CEO resigned, but remained on the Board of Directors. A surprisingly high number of these businesses — 24 percent — later rehired their CEO for an average period of two and a half years.

It happened most commonly in companies where the CEO had been replaced by an internal candidate, in industries where human capital (as evidenced by high R&D expenses and levels of intangible assets) was high, and in businesses where the CEO had been the founder of the company.

Having the former CEO on the Board and, in effect, waiting in the wings, raises the

question of whether the CEO returns to the job owing to his or her entrenched power or whether the decision is simply what was best for the shareholders. Pan and her co-authors concluded that it’s generally the latter. The firm that brings back its former CEO is typically in serious trouble, and the former CEO knows its operations and doesn’t have to spend as much time as an outsider learning the ins and outs of the business.

One of the things the research suggests is that companies that keep a recently departed CEO on the Board of Directors might inadvertently be setting themselves up for that CEO’s return. Having that former CEO on the board might scare off potential outside candidates as successors and could hinder the new CEO in making changes.

“There’s some anecdotal evidence that keeping the former CEO around can have a stifling influence on the successor and put pressure on someone who is trying to implement a new strategy,” Pan said. That subject is grist for further research. ▶

FL-07266 2/2008 23,000

Mind|Work is produced by the Leavey School of Business Marketing and Communications Office, 500 El Camino Real, Santa Clara, CA 95053.

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