TAKING STOCK

GOOD BEHAVIOR

INVESTOR PREFERENCES: NICE, ROUND NUMBERS

ASSESSING THE QUALITY OF FINANCIAL REPORTING

MSF PROGRAM: PRACTICAL, POSITIVE PRACTICUM
Dean’s Message

In a recent survey of 1,200 adults, 69 percent of respondents who were 25-49 years old and 49 percent over the age of 50 reported that they owned stock, either directly or indirectly.* Clearly “the market” is important to average Americans as never before. In this issue of Perspectives, we take a look at this important segment of the American economy from a research and a teaching viewpoint.

Our faculty researches a range of issues related to stocks and the stock market, and the results are often taken straight into business practice and the classroom. Josef Lakonishok, Karnes Professor of Finance, is a perfect example. This leading investment money manager’s work was recently featured in Barron’s, and we are pleased to reprint that article here. Our 4 for 4 feature is an interview with Anju Seth, professor in business administration, who comments on stock options in executive compensation. We also take a look at Accountancy PhD student Sam Han’s timely and thought-provoking work analyzing the quality of corporate financial reporting.

Our graduate and undergraduate students learn through personal experience with the market. Investment competitions whet their appetites for investing in the stock market, and a graduate practicum program offers a variety of experiential learning opportunities. One of our students took a semester off to work in a stock brokerage in the Czech Republic and returned with an understanding of how the financial market works in this emerging market economy. The interview with alumnus Mark Vonnahme, retired CEO of CNA Surety and currently visiting professor at the College of Business, further demonstrates how practice and learning converge to give Illinois students an active, engaging educational experience.

I invite you to learn more about our stock in trade — research and learning at the College of Business.

Sincerely,

Avijit Ghosh
Dean, College of Business

* research.aarp.org/general/fifty_plus_2004.html
Insight into investor conduct helps scholarly money manager beat the averages

It’s sometimes said that “those who can’t do — teach.” But that’s one adage you can’t apply to Josef Lakonishok. He does both.

Currently a finance professor at the University of Illinois in Champaign-Urbana and an academic for 26 years, Lakonishok’s credentials as a scholar and a teacher are impressive. A frequent lecturer at investment symposiums and conferences, the 57-year-old scholar has published more than 80 high-brow articles and papers on stock-market characteristics and anomalies, was co-author of a groundbreaking book on the “January Effect” (stocks that were beaten down at the end of the year tend to bounce back the following January) and established himself as an expert in the field of behavioral finance, which studies how people make judgment errors when handling their money.
But when he’s not in his Ivory Tower, Lakonishok can be found prowling the mean streets of money management. Since the late 1980s, he has been acting as a financial adviser and consultant for companies and institutions, and in 1994 he went into business full time with two other finance academics, Andrei Shleifer of Harvard and Robert Vishny of the University of Chicago. Each man provided the first letter of his last name to form LSV Asset Management, a Chicago-based money manager with $14 billion under its wing, including LSV Value Equity, the company’s only mutual fund.

Although he continues to teach, “doing” the business of money management consumes most of Lakonishok’s time these days. Keeping in close touch with his colleagues (though Shleifer bowed out in June to pursue academic interests), Lakonishok spends most of his time applying his behavioral theories to managing pension accounts and other money for institutional and individual clients, including Caterpillar, John Deere, BASF, Royal Dutch Shell, National Geographic and the MacArthur Foundation. He numbers several state governments (Illinois, Virginia and Louisiana) and university endowments (Stanford, Northwestern and Columbia) among his 200 accounts.

His university experience has been a help in providing the theoretical background and discipline needed to make the transition from classroom to the boardroom, he says, “but it hasn’t been easy.”

“The worlds of finance and academia are very different and moving between the two is not a transition every academic can make,” says Lakonishok.

Lakonishok (pronounced “luh KONN uh SHOCK”) has built a lifetime of transitions. He was born in Lithuania, raised in Israel and received advanced degrees at Cornell University. He holds dual American-Israeli citizenship.

The bulk of the $14 billion under management by LSV is spread out over 10 separate value investment strategies, including small-, mid- and large-cap funds as well as an international portfolio.

Lakonishok’s oldest fund, devoted to large-cap-value plays, has returned 14.3% since inception in 1993 (through the end of July), compared with 10.9% for his benchmark Russell 1000 Value index and 10.2% for the S&P 500. Over the past five years, the fund has returned 5.4%, compared with the Russell’s 1.7% and S&P’s minus 1.1%.

In April 1999, Lakonishok plunged into the world of mutual funds, establishing LSV Value Equity to provide smaller institutions, friends, associates and individual investors access to his trading strategies. The fund is up 15% so far this year, or about 1.5% ahead of the fund’s two benchmarks, and since inception, it is up an average of 4.7% a year, compared with a negative 0.5% by the Russell index and a minus 4.5% by the S&P.

“The fund has been able to outperform the S&P roughly by more than 9% per year,” say Lakonishok. “And we were able to do it with considerably less volatility than the index.”

At the core of Lakonishok’s strategy is his belief that the stock market is essentially and irrevocably inefficient, subject to mood swings.

“That’s because it is about people and their behavior, sometimes erratic and occasionally rational but always unpredictable,” he explains. The market’s direction and discipline are dominated by human frailties, such as greed, fear and excitement, which often result in unrealistic expectations and the mispricing of stocks.

These “behavioral biases” frequently cause investors to give up on companies that have done poorly in the past “because they extrapolate from their poor past performance and assume that these companies will continue to disappoint going forward,” says Lakonishok, who characterizes himself as a “deep-value investor.”

Over time, “value trumps growth,” he says, adding: “All academic studies have shown that as you become more valuable, your chances of outperforming improve because you actually end up with stocks that investors are probably not very optimistic about, which is why we definitely try to take a contrarian, deep-value position. As you go to more extremes, the chances of outperforming are bigger.”

Lakonishok uses computer models programmed with valuation measures and screening devices to sort through the 1,500 companies in his investment universe before deciding on 90 to 110 to keep in his portfolio. He typically will hold a stock for about three years, turning over about a third of his portfolio in a year.

Continued on page 7
Investor preference for certain numbers confirmed by analysis of stock trades

Throughout the stock market boom of the 1990s and the economic downturn that followed, investors became more aware of stock prices than ever before. Yet many market participants probably do not know about some unexpected trading patterns that have been identified in data that are part of a recent study at the University of Illinois.

David Ikenberry is chair of the Department of Finance. He earned his BS degree from the Pennsylvania State University and MM from the Kellogg Graduate School of Management at Northwestern University. After receiving his PhD from the University of Illinois, Ikenberry joined the faculty at the Jones Graduate School of Management at Rice University. In 2002, he returned to Illinois, where he teaches investment and corporate finance to both graduate and executive students. Ikenberry’s research concerns a broad array of empirical issues in corporate finance including, most notably, corporate stock repurchase programs. He speaks to many organizations, and his work is frequently cited in the popular press.
$.05 \times 30 = $1.50. But $.13 \times 27 = ?

Theory suggests that, in the absence of any bias, transaction prices should be uniformly distributed across all possible price ticks. Under a decimal pricing regime, it would be easy and cheap for investors to avoid cluster points in pricing by changing their bid or ask price by a mere penny. Imagine standing at the back of the line to enter a theater where, by simply paying one penny more per ticket, you could move straight to the front of the line for immediate seating. In this type of world, stock prices would be spread out and thus be uniformly distributed.

Despite this logic, Ikenberry and Weston found that investors seem determined to head to the back of the queue. They noted that for many stocks, close to half of all trades occurred at only 20 percent of the available price intervals. This tendency is illustrated in Figure 1, which shows that the last digit of most trades falls on either a zero (a dime) or a five (a nickel). This pattern is seemingly robust and is evident at each nickel and dime interval between zero and 99 cents (Figure 2).

Ikenberry and Weston found that investors have strong price preferences even after decimalization. In fact, they found a statistically significant increase in clustering after the switch to decimal pricing as compared with 1996 data. They found that prices tend to cluster at the “prominent” increments of five and ten cents. Data from December 2002 showed that trades that occurred in increments of five or ten cents accounted for over 45 percent of all dollar trading and volume. The overall degree of the clustering they report is difficult to explain and appears to indicate a general psychological bias or attraction of investors for trading in prominent numbers.

Continued on page 6
A Crash Course in Clustering

Research done before decimalization has established that when there are market frictions and uncertainty, prices may cluster at particular focal points. For example, if valuation is uncertain, prices may cluster at particular points to reduce search costs. The tendency for prices to cluster depends on such characteristics of the transaction as the size of the target firm, liquidity of the stock, and the spread between bid and ask prices — attributes that can be said to be related to uncertainty about firm value and the difficulty of executing trades. Clustering may also reflect an effort to reduce the costs of negotiation. Because the cost that traders perceive from any rounding error decreases with price, clustering should also be more prevalent in high-priced stocks.

Ikenberry and Weston did find that price clustering decreases with the intensity of trading and increases with firm size, share price, volatility, and bid-ask spreads, but not to the extent one might expect following conventional hypotheses. For example, price clustering does not change in the periods before, during, or after earnings announcements, when one might expect changes in price uncertainty. Furthermore, while share price should be an important determinant of price clustering, they found almost no change in clustering around stock splits. Even in the case of well-known and widely followed stocks for which the costs of trading are low, they saw a surprising degree of price clustering. The overall level of clustering suggests that market participants share a common bias for prominent prices that psychologists have identified as natural cluster points.

The Psychology of Simplification

A collective preference by investors may lead them to trade at particular price levels in order to simplify the trading process. They choose to simplify the price grid to particular prominent numbers in order to minimize the cognitive processing cost, that is, to reduce effort. Ikenberry and Weston note that there is evidence in psychology literature that some numbers are easier to process than others. Some psychologists have found that the “even-ness” and “odd-ness” of numbers affects the time or energy required to process the number. Others report results that indicate people show a bias for rounding to numbers ending in zero or five, and this tendency increases with the size of the numbers involved. Another study found that in experimental settings subjects frequently round answers to simple calculations and that the degree of rounding increases with the difficulty of the calculation. Ikenberry and Weston believe these findings suggest that, while clustering may indeed vary with value, uncertainty, and search costs, price clustering may also stem from a more fundamental desire to simplify the trading process, thus increasing the observed frequency of particular price points.

Impact? Minimal

Taken as a whole, the evidence of the Ikenberry-Weston study suggests that psychology may play some role in why prices cluster. Investors appear to be naturally drawn to certain prominent numbers when faced with making decisions in situations of uncertainty. Given the preference of investors to trade at certain prominent numbers, Ikenberry and Weston’s results highlight the importance of considering psychological effects and investor biases in the design and structure of optimal trading environments.

Overall, in light of the results of their study, Ikenberry and Weston suggest that if the SEC does move from decimalization to a pricing regime with a tick size of five cents, as has been discussed, the change should produce only minor differences in transactions prices from the ones prevailing now under price decimalization. Such a change should have no deleterious effects on prices or trading.

— Janet Fitch
Good Behavior: Continued from page 3

He looks for companies that are relatively cheap because they generate “a lot of earnings, cash, sales, dividends, and have assets.” And he finds smaller companies generally more appealing than larger ones.

“We search for companies that have had poor performance and have disappointed investors in the past,” says Lakonishok.

“But we also try not to fall into the value trap by buying a cheap company that becomes cheaper over time. So we look at all sorts of catalysts to see if the company is recovering and turning the corner.”

Lakonishok currently favors financials, largely for technical reasons. “Financials are a very big weight in our benchmark,” he explains. “We are not overweighted in financials but we do own a lot of J.P. Morgan, Washington Mutual, Lincoln National and Bank of America.”

“If you look at Bank of America, it is not so expensive,” he explains. “Many other banks look more expensive, but Bank of America is trading at around 80, which is 11.9 times forward earnings, which we think is actually cheap. Add to that a 4% dividend, a share-buyback program, and you might see why it holds the top spot in our portfolio.”

Washington Mutual is also cheap by Lakonishok’s model. It currently trades at around 39, or 8.8 times forecast 2003 earnings of $4.43 a share and 8.1 times estimated 2004 earnings of $4.82.

“It pays a nice dividend, yielding 4.1%,” he adds, and is aggressively buying back its shares. “It’s cheap by all our measures and has some positive earnings momentum.”

An active share-buyback program is an important factor in Lakonishok’s evaluation of a stock.

“We have found that many companies actively buying back their shares on average perform well subsequently,” he says. “That’s especially true of value companies, which seem to generate high returns after the repurchase. They are typically buying back their shares because they are trading at bargain price levels. Whereas, if a company which is trading at a very high multiple is buying back shares, the true motive is really not clear. Buybacks say a lot about a company’s financial health and management attitude.”

In the energy sector, Lakonishok favors oil producers such as ChevronTexaco, Occidental Petroleum and Marathon Oil because of their valuations, dividends and earnings and price momentum.

Occidental, priced at around 33, trades at just over nine times forecast ’03 earnings of $3.63 and pays a 3.1% dividend, the fund manager notes. He likes Marathon despite a mediocre past performance, he confesses. “There are a lot of signs that positive things are starting to happen,” he says, pointing to a dividend of 3.7% and a price/earnings ratio of 8.3.

Here again, Lakonishok finds the behavior of investors a good guide for his own management.

“We have found that most investors have some reference point regarding a stock, which is usually the price they bought it at,” Lakonishok explains. “So if the price goes up by a lot they will sell and realize a gain. However, if the price drops they tend not to sell. Typically, as a lot of studies have shown, investors sit on their losses way too long. That’s because to realize a loss is to admit that you made a mistake. So wishful thinking takes over. But we rank all companies by their attractiveness. We don’t care about the price we paid. Therefore, a loser can be attractive and a winner can be attractive, as well.”

If a stock performs exceptionally well, Lakonishok might scale back his funds’ holding and become more diversified. He trimmed their exposure to homebuilders Centex, Ryland Homes, KB Homes, Pulte and others whose stocks have been propelled by the low mortgage interest rates of the past two years. But he continues to hold some of those companies because “they remain attractive.”

“But the most important thing in this business is to be conservative and to be diversified,” he adds. “And when a company becomes too big a part of the portfolio, we look at it as having too many eggs in one basket and we will reduce our holdings in those cases.”

Other recent purchases include warehouse chain BJ’s Wholesale Club, independent oil producer Stone Energy, oil major Sunoco, banking giant Wachovia and book retailer Barnes & Noble.

Lakonishok believes interest in behavioral finance is rising as measured by the growing number of conferences dedicated to the topic.

“But, you know,” he sighs, “behavioral finance is not a clear-cut recipe of how to outperform the market. People tend to think there is sort of one strategy common to everybody that believes in behavioral finance. But there isn’t.”

So in the end, it may just boil down to luck, right?

Lakonishok waves his hand and says with a sly smile, “Maybe.”

— By Neil A. Martin, September 1, 2003

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For Barron’s subscription information call 1-800-BARRONS ext. 685 or inquire online at http://www.barronsmag.com/subscription/subscription.html.
alk about accounting for your time. Virtually every Friday for the past four years, Sam Han has gotten input about his research ideas from the University of Illinois accountancy research forum, a group of senior Department of Accountancy faculty. And as he delves further into his dissertation subject, he’s uncovered some interesting trends regarding how companies report their financial information to shareholders.
Shedding a Bright Light

Specifically, Han, a PhD candidate in accountancy, is investigating how the ownership patterns of publicly traded companies might affect the transparency of financial reporting. Transparency refers to the absence of closed-door deals. In a fully transparent market all participants are completely and rapidly informed. The more rapid and widespread the dissemination of information, the less likely that profit can be made through access to private information.

Large, institutional, or private investors mine publicly available data such as SEC 10K and 10Q filings to see how well a company is performing. Han’s research shows that “large managerial shareholdings are associated with lower quality financial information, after controlling for the monitoring role of large outside shareholders.” The data reveal that managers internalize the proprietary costs of disclosure as their ownership grows in size.

But does it really matter if a company’s managers are keen on keeping a lid on poor performance? Han thinks so.

Why Transparency Matters

“This behavior is bothersome for investors because they want more accurate and specific financial information on a company in making investment decisions. But if the company does not fully disclose its financial position, then the decision based on that information might be disastrous to investors,” Han said. “The competing tensions between the monitoring effect of sophisticated investors and the entrenched effect of managers play a significant role in determining the transparency of financial reporting.”

A. Rashad Abdel-khalik agrees. In talking about the significance of Han’s research, Abdel-khalik, Han’s advisor and a professor of accountancy, said, “At Illinois, we view accounting as an information system that generates data about all the functions of the business firm.” He noted that Han’s dissertation data confirm that institutional arrangements of business do influence the production and use of information. “Sam’s research is concerned with issues related to corporate governance, which has come to the spotlight after the debacles at Enron and WorldCom.”

Young Kwon, a professor of accountancy and the department’s PhD program director, concurs with Abdel-khalik about the importance of Han’s research. “Efficient allocation of capital to worthy projects depends on the amount and transparency of information available to investors,” said Kwon. “Given that a firm’s financial statement quality critically depends on management disclosure, the determinants of voluntary information disclosure by management are not only interesting in their own right, but also important from the societal perspective. Sam’s dissertation investigates a possible link between the size of managerial equity ownership and the firm’s financial information quality.”

Han, who received his MBA in accountancy from Seoul National University in 1998, has been aided by Abdel-khalik, Kwon, and a host of other faculty in the department. He says their feedback is crucial to his success.

“I think the research idea itself is very important. It should be interesting to readers, but you also need good guidance,” Han said. “That is critical, because even if you have a good idea, you have to fully develop interesting motivation for that idea. And the good guidance you need comes from support from good people.”

Han, a native of Korea who selected Illinois for his graduate work because of the international reputation of the accountancy department, plans to finish his dissertation by the end of the spring 2004 semester and hopes to move on to a professorial position by the fall.

— Christopher Boyce
Not everyone would embrace this change of pace, but Pradeep Kalla, Tyler Brough, Denny Tu, and Hsiao Yu Chien considered the new MSF Practicum an opportunity not to be missed. Accompanied by PhD student Brandon Julio, the two teams of students lived and worked in Chicago learning QAI software packages and applying them to a theoretical problem. QAI was one of ten companies (see page 12) hosting students from the MSF and MBA programs during January.

"The practicum gives me an opportunity to see applications of the concepts I’m learning in school,” Kalla said before he left for Chicago. “Specifically, Quantitative Analytics works in the field of quantitative finance, my area of interest. Also, I think the practicum can be a potential networking opportunity because we will be working with people who are in a field that interests us.”

Getting It Started
The MSF Practicum was established when Illinois’ David Ikenberry, finance department chair and professor, approached QAI President Bill Aronin about modifying a program the company has participated in with several other universities, including Harvard, Yale, MIT, Vanderbilt, and the Illinois Institute of Technology. The group from Illinois was the first to participate on-site and work with professional consultation from QAI staff.

“We thought it would be very beneficial to work with these bright students and establish a relationship with Illinois,” said Aronin. “We see an opportunity to bring our products into the university for the students to use and, if there is a potential fit, we might hire some of them in the future.”
Roger Cannaday, director of the MSF program and associate professor of finance, believes the practicums help overcome a disadvantage of a one-year program. The twelve-month cycle does not allow time for a two- to three-month summer internship. “The practicums are like a mini-internship,” said Cannaday. “In addition to giving the students some practical experience, it is a great networking opportunity. The hope is that some of these students will make such an impression that they will ultimately get job offers from the practicum host firm. There is some early indication that this might happen for one or two of this year’s students.”

**Student Experience: Positive**

For the practicum, Louis Chan, an Illinois finance professor, gave each of the two teams a financial problem to solve using QAI software. Brandon Julio, the PhD student, accompanied the teams and guided their efforts during the first week of the project. Among the problems the teams looked at was a study of the relationship between the divergence in security analysts’ forecasts of earnings and future stock performance.

While they had several weeks to consider the problem on their own before they left for Chicago, when the students sat down with the people at QAI, the problem took a different shape.

“They were pretty helpful because they knew we hadn’t used the packages before,” said MSF student Kalla of his supervisors at QAI. “They didn’t have any problems walking us through the steps. The biggest part of the learning curve came when we sat down to apply the software to the actual problem.”

On the Corporate Side: Positive

“Having them learn the language of our software gives QAI a real advantage,” Gits said. “Down the road it could help us to choose some employees, and we have a generated pool of people we can recommend to our clients as quantitative portfolio managers. I would have liked to have had this opportunity coming out of school, but it wasn’t available at the time.”

Aronin said that no matter how good of an education a student has received, many of America’s most talented graduates will struggle with the challenge of turning theories and concepts into tangible skills when entering the workforce.

“What we’ve pinpointed is that once they’ve graduated, it takes (employees) six to eight months to become really productive in their environment, because they don’t have a lot of practical skills with the tools that they will be using,” said Aronin. “This practicum gives Illinois students a huge edge over graduates from other schools. The MSF Practicum will help enhance Illinois’ reputation for master’s-level work in finance because students can graduate with skills and knowledge being used in corporate America today.”

**New Initiatives in the MSF Program**

The seven-year-old company produces four software packages that allow quantitative portfolio managers to produce financial models, produce reports, and aggregate and capture data. More than 150 financial institutions use the packages. Overseeing the work of the student teams was Joe Gits, QAI’s executive vice president, who often works with the company’s professional clients as they are training with the software. Gits said that although the students’ work was not something that QAI expects to benefit from directly, their newly developed knowledge of this software could be an advantage for both the students and their employers.

**Residents Component**

Living and learning together. That was the rationale for establishing the new residential option offered to MSF students. Just off campus and a ten-minute walk from the College of Business, a tall, modern apartment building called Presidential Tower is home to 15 students who enjoy turnkey apartment living with a lease schedule that matches the 12-month program calendar (June through May). The arrangements garner rave reviews from students.

**Finance Resource Center**

24/7/365. That is the schedule for the Finance Resource Center located in the Presidential Tower. The Resource Center is equipped with computers, peripherals, and internet connections, a Bloomberg terminal, and study space. PhD candidates in the Department of Finance serve as academic advisors and assist with coursework. What more could a serious, focused graduate student want?

For more information, consult www.business.uiuc.edu/msf.
Thirty-one years. That’s how much insurance experience Mark Vonnahme brought to the College of Business when he walked into his Property and Liability Insurance class this spring. The value of that experience? Priceless. “I’ve been around insurance products my entire career,” said Vonnahme (von-ah-MEE), who retired as CEO of CNA Surety in 2003. “In the class, we’re talking about marketing distribution systems, underwriting, claims, the reinsurance business, and the like. But in every piece I want to make sure I’m bringing in some real-life examples and what that’s meant in my own career.”

Feedback from the ten sponsoring companies was equally strong. Paul Hagy, the AON Corporation practicum coordinator, emailed Lins with his view on MSF candidate Tyler Shaffer and MBA student Ellen Chung who, he reported, “did a great job” in putting together a white paper on hedging foreign exchange exposure resulting from the translation of foreign income.

MBA students Noam Hirschberger and Ramunas Lygis worked at the Federal Reserve Bank of Chicago for their practicum project, which produced a research paper exploring factors that facilitate and impede automated clearinghouse cross-border payments. Carol Clark, the practicum coordinator for the Fed, and her colleagues found the paper very useful and thanked Lins for sending them “these two fine students.”

Lins is already thinking about the practicum experience in 2005. He wants to expand the program by signing on additional corporate sponsors so that more students can participate. “This is a rewarding educational experience for the students and for the sponsors,” he said. “We’re expecting even more interest next year.”

— Christopher Boyce & Ginny Hudak-David
An Ancient Industry with Modern Revenue

Surety is a $3.8 billion industry and is part of the property-casualty industry, so for that reason alone Vonnahme was a logical choice to fill in while Stephen D’Arcy, professor of finance, is on sabbatical. And because Vonnahme has a BA and MS from Illinois, both in finance, he had personal reasons for sharing his knowledge of the surety industry with College of Business students.

Surety is an ancient process with references in the Bible and other historical documents warning about the hazards of taking on someone else’s responsibility. Today an insurer guarantees the performance of another’s obligation to a third party. If, for example, the City of Champaign builds a new street, the construction company that gets the job would have to post a bond from a surety company that protects the city in case the contractor is unable to complete the project.

CNA Surety is the largest publicly traded surety company in the country. This means that, in addition to talking about the insurance industry, Vonnahme can talk about what it takes to run a public company — using examples from his own experience. While at CNA Surety, Vonnahme and his chief financial officer met regularly with various investment houses, like American Century, Fidelity, and Vanguard. In one three-and-a-half-week “road show” for a secondary offering of stock, Vonnahme and his CFO gave 75 one-hour presentations to potential investors.

“The Boardroom and the Classroom

Vonnahme is a natural-born teacher, which also makes him a good choice to teach at the College. His boundless enthusiasm and communications skills serve him well in the classroom, as they have in the boardroom. In the course of his career, Vonnahme has spoken to groups of all sizes.

And, while the College of Business is lucky that someone of Vonnahme’s stature and experience is teaching, Vonnahme is equally thrilled to be in the classroom.

“If you have a good story, the selling comes easy.”

— Deb Aronson
Joseph Schagemann was checking websites last fall when he looked out a window at a centuries-old building and realized things were quite different in his new home. Learning that his coworkers routinely picked stocks without analyzing how they might perform in the future solidified his belief that he was, indeed, in a very different place.

For three months, Schagemann, a senior in finance, worked for Afin Brokers, a Czech stock brokerage firm with three branches and approximately 70 employees. Each day he worked side-by-side with the six Afin employees in Brno, the second-largest city in the Czech Republic. Afin staff help Czech firms—and a few individual investors—purchase US stocks. Schagemann’s responsibilities included making notes on the US market that were posted to the Afin website, creating portfolios of US stocks for the company’s Czech clients, and researching US Securities and Exchange Commission rules and regulations to ensure that Afin was in compliance with SEC mandates. Because he speaks no Czech, his work was translated by one of the Afin supervisors whose English skills, Schagemann noted, are quite good.

Schagemann, who spent the fall 2003 semester in the Czech Republic, never realized how little he knew about how the citizens of other countries think and what influences their choices, until his semester abroad. His experience forced him to step outside the boundaries he had created in his mind and see another culture up-close. “I thought that I had a global mindset and understood other countries,” he said, “but actually I knew very little.”

Take a stock brokerage. Schagemann had a US-centric vision of how stocks are evaluated for clients. Research, data crunching, and earnings and value projections are the norm in the US and what he learned in his finance classes on the subject. In the Czech Republic, things are different.

MARKET ANALYZED? ✔
KNOWLEDGE SHARED? ✔
HORIZONS BROADENED? ✔

A semester in the Czech Republic helped one senior in finance understand the challenges and opportunities of foreign business ventures.
A New Perspective on Investing

“The most unexpected aspect of working with the Czech firm was how little they considered the value of a company when investing in it,” he said. He was surprised to discover that staff generally looked at a chart of prices per share of individual stocks within the previous 12-month period and tried to predict the future performance based on that data. The Afin staff didn’t perform an analysis of the future prospects of a company or its intrinsic value.

“The brokers did not have an understanding of the other factors you can consider because they don’t get the kind of training US brokers get,” he commented. “Most receive their training on the job.” And because most of the US corporate publications are not written in Czech, reading annual reports and searching for data on the Internet are difficult and time consuming.

In hindsight, he understands that, no matter where you live, all investment is, to some degree, a guessing game. American investors, he noted, “have a little more information to work with.”

Sharing His Education, Learning in the Process

Schagemann credits knowledge from core finance courses as being particularly helpful during his internship at Afin Brokers. Some of what he learned in corporate finance (FIN 254), financial markets (FIN 300), and investments (FIN 361) — determining the value of a company and creating diversified portfolios by checking websites that offer easy access to company financial information — he shared with the Afin brokers, most of whom were under the age of 30. “They are still behind when it comes to breaking news about individual stocks, though,” he said.

Schagemann’s supervisor at Afin was Radim Kadlček, an entrepreneur who has an ambitious total of five start-ups — including Afin, an accounting company, and a web design firm — to his credit. Schagemann pointed out that unlike Kadlček, many Czech citizens appear to retain a Communist mindset that the government will provide for them throughout their lives and have not adopted a free-market way of thinking that looks for and capitalizes on opportunities. Kadlček’s successes, which leverage the high-speed network connections available in larger cities in the Czech Republic, made Schagemann realize how many entrepreneurial opportunities exist outside the US. Said Schagemann: “Anyone who understands this can create a business.”

His travels throughout Europe and the immersive, focused work environment he had at Afin gave Joseph Schagemann an appreciation for international business and the global community. “I learned more than I could have imagined,” he said. “My career goal is to analyze stocks for a mutual fund company. Now I am more interested in less-developed economies and the opportunities that exist in those countries. Ideally I can combine the two.”

—Ginny Hudak-David

Funding, Support Key to Gaining International Experience

Joseph Schagemann’s internship to the Czech Republic was underwritten in part by the Center for International Business Education and Research (CIBER), which supports a variety of programs for undergraduate and graduate students with the goal of increasing awareness and providing career advancement opportunities in international business. Funded by the US Department of Education, CIBER is advancing the study and teaching of international business and supporting research on global competitiveness. www.ciber.uiuc.edu

AIESEC, the largest student-run exchange organization in the world, helped Schagemann find his work experience site, obtain his visa, and locate housing in the Czech Republic. AIESEC Illinois was founded on the U of I campus in 1971. AIESEC’s primary activity is facilitation of work abroad exchange programs between its member countries. www.business.uiuc.edu/aiesec
In the aftermath of the terrorist attacks on the World Trade Center and the Pentagon on September 11, 2001, there was widespread speculation that the terrorists or their associates had used advanced knowledge of the attacks to profit in financial markets. Much of the attention focused on options trading in the airlines involved in the attacks, American Airlines (AMR) and United Airlines (UAL).

Many observers maintained that activity in AMR and UAL options during the days leading up to September 11 constituted evidence that there had been trading on advance knowledge of the attacks. CBS Evening News (September 19, 2001) reported, “Now US investigators want to know whether Osama bin Laden was the ultimate inside trader; profiting from a tragedy he’s suspected of masterminding to finance his operations.” Many academics expressed similar views, including University of Chicago Finance Professor George Constantinides, who opined that the options market trading was “so striking that it’s hard to attribute it to chance. So something is definitely going on.” In addition, sophisticated options market participants like Jon Najarian, founder of options specialist Mercury Trading, also concluded from the trading that someone knew ahead of time that the attacks would occur, and that he turned that knowledge into profit.
**Award-winning Poteshman Research**
A working paper by Allen Poteshman and MIT collaborator Jun Pan entitled “The Information in Option Volume for Stock Prices” won the first place award at the Chicago Quantitative Alliance meeting held in late 2003. Using a dataset from the Chicago Board Options Exchange for 1990-2001, they found strong evidence that option trading volume contains information about future stock price movements.

Allen Poteshman joined the Department of Finance in 1999. He holds a PhD in finance from the University of Chicago. At Illinois he teaches futures and options to undergraduate and master’s students as well as PhD-level courses in investments and behavioral finance.

The full text of his paper “Unusual Options Market Activity and the Terrorist Attacks of September 11, 2001,” on which this article is based, and other research papers are available online: www.business.uiuc.edu/poteshma/WorkingPapers/WorkingPapers.htm

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**It’s Not that Simple**

Allen Poteshman, assistant professor of finance, was intrigued by the possibility that terrorists had traded in the options markets, and he set about trying to shed some light on the question. He believed that despite some of the views expressed by the media, leading academics, and options market professionals, there were reasons to question the decisiveness of the evidence that terrorists traded on advance knowledge of the attacks. One was the crash of an American Airlines plane in November of the same year. Options trading of AMR before that crash seemed to resemble activity just before September 11, but terrorism was all but ruled out in the November case. So the pre-September 11 trades were an uncertain sign of terrorist trading on advance information.

Other evidence was cited in an October 8, 2001, article in Barron’s that noted the heaviest trading in the AMR options was not in the cheapest, shortest-dated puts, which would have provided the largest profits to someone who knew of the coming attacks. Furthermore, an analyst had issued a “sell” recommendation on AMR during the week before September 11, which may have led investors to buy AMR puts. Similarly, the stock price of UAL had recently declined enough to concern technical traders and may have influenced investors to buy UAL puts.

Finally, market traders in the options did not raise the ask price at the time the orders arrived — as they would have done if they had believed the orders were based on adverse non-public information. Therefore, they did not seem to consider the activity “unusual” at the time that it occurred.

**Consider the Puts and Calls**

A quick refresher course: a put is an option to sell a stock at a certain price, and a call is an option to buy a stock at a certain price, before a fixed date in the future. Consequently, the value of a put increases and the value of call decreases when the underlying stock price declines. The put-call volume ratio is a common measure of the extent to which positions entered in options market trading will profit if the underlying stock price falls rather than rises. Poteshman computed the historical distributions of certain options market volume ratios similar to the put-call volume ratio as well as of indicators of put and call trading. He computed the overall distribution of these ratios and indicators and the distributions after taking into account the level of options activity, the return and trading volume on the underlying stocks, and the return on the overall market. These distributions can be used as benchmarks to determine whether the options market trading associated with any event is unusual.

**The Results**

In his paper, “Unusual Options Market Activity and the Terrorist Attacks of September 11, 2001,” Poteshman used these distributions to judge whether trading in the options market in the days leading up to September 11 was, in fact, unusual. By comparing the maximum daily value that a measure such as the standard put-call ratio for AMR or UAL obtained during the four trading days leading up to September 11 to the total daily distribution of the measure, he came to the conclusion that there had been an unusually large quantity of options market positions established that would be profitable if the prices of these airline stocks declined.

However, he realized that this comparison was suspect for two reasons. First, the standard put-call ratio counts both buys and sells of puts and calls in the same way. But buying and selling a call represent opposite bets about the future price movement of the underlying stock. The same is true for puts. Therefore, Poteshman constructed another measure that avoids this problem. Once that was done, the maximum value in the days leading up to September 11 does not suggest that options market trading was especially negative. Second, the maximum value of a statistic over a four-day trading period should be compared with the distribution of its daily maximum over four-day trading periods, not its daily distribution. When Poteshman made this comparison, the options market trading leading up to September 11 could not have looked more ordinary.

The options market volume ratios, however, are constructed of both long and short put and call volume. Simply buying puts, however, would have been the most straightforward way for someone to have traded in the options market based on foreknowledge of the attacks. Therefore, Poteshman also examined a measure of abnormal long put volume.

The maximum daily value that it reached during the four trading days leading up to September 11 indicated that put buying was highly elevated. Since abnormal volume of long put options is a direct measure of option positions that would be profitable if the underlying stock price fell in value, Poteshman concludes that there is evidence of unusual option market activity in the days leading up to September 11, evidence that is consistent with investors trading on advance knowledge of the attacks. Therefore, it seems quite possible that terrorists used their advance knowledge of the attacks to profit in the options markets.

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**CALL** n. an option to buy a stock at a certain price before a fixed date in the future  
**PUT** n. an option to sell a stock at a certain price before a fixed date in the future

—Janet Fitch
The controversy surrounding whether corporations should immediately expense the stock options they grant to employees has raged for several years and has yet to be resolved by federal regulators. However, several College of Business faculty say those who concentrate on that debate may be missing more significant issues.

Rather than focusing solely on the accounting treatment of options, these faculty believe the goal should be to encourage proper use of stock options as employee incentives, while assuring investors can understand how those options impact the value of the issuing company’s stock.

“What is really being debated in the controversy over expensing options is whether the information should be in a footnote or moved to page one of the annual report,” said Michael Weisbach, professor and Golder Distinguished Chair in Finance. According to Weisbach and Scott Weisbenner, an assistant professor and Weisbach’s colleague in the department, those who argue against the immediate expensing of options contend that such a step could negatively affect the ability of start-up firms to attract capital because expensing options would reduce earnings.

Weisbach and Weisbenner don’t see that as a problem because the value of a company’s traded stock depends primarily on the cash flow of the company, which is unaffected by accounting for options. They believe that if investors are rational and look at all the data, whether or not options are expensed should have no real effect on investment decisions because all relevant information is reported in either case.
“Venture capital investors are sophisticated enough to understand that alternative approaches to accounting for options are just different ways of looking at the same set of numbers,” said Weisbach. “It would be easy for a company to keep two sets of books. One for tax purposes in which options are expensed, and another set in which options are not expensed. The bottom line is that there would be no real difference in performance.”

What we shouldn’t do, Weisbach and Weisbenner insist, is take steps that encourage corporations to replace stock option grants with other, more complex transactions that are fertile grounds for abusive behavior.

One trend emerging from the controversy, noted Weisbenner, is that some companies are moving away from using stock options to compensate lower-paid workers, while retaining that tool for higher-paid employees. The result, he said, may be higher wages for some employees as a way to compensate for the absence of options.

### Weighing the Options

Professor Anju Seth of the Department of Business Administration observed that many businesses are actively taking sides in the options debate, dividing corporate America into two camps. “Companies that feel it is important to use options as a major part of their compensation plan (like Intel and Cisco) oppose the rule to expense option grants. In contrast, companies that are moving away from the use of options (like Microsoft) have voluntarily adopted the practice of expensing option grants,” she said.

The split, noted Seth, stems from the fact that, while some companies believe that stock options continue to be a critical means to attract and retain key talent to build and maintain their competitive advantage, others are concluding that there are more effective ways to compensate their employees in the present economic environment. “The opponents of expensing voice serious concerns about the inability to accurately value their option grants. Mandatory expensing could lead to misleading accounting statements and create disincentives to use a powerful motivator.”

Seth cautions that the prevailing sentiment that stock options are the root of all evil in corporate America is misplaced. “It is true that options can and have been misused in the past decade, but the real problem is one of inadequate corporate governance. Companies are rethinking the value of options in their compensation packages, and this is entirely appropriate. But it also appears that the pendulum may be swinging too far in the opposite direction.”

According to Seth, stock options can be a powerful tool to make managers think like shareholders. “The key is to encourage appropriate managerial decision making that will potentially provide big benefits to shareholders — and company executives — while reflecting the natural vagaries of the stock market. A company needs to look at its individual circumstances to make a thoughtful and informed decision about the costs and benefits of stock options.”

[For more on Seth’s views on the use of stock options, see 4 for 4 on page 22.]

### Indexing and Exercising

For options to function properly as incentives, expensing or not expensing isn’t the real issue, agreed Professor A. Rashad Abdel-khalik of the Department of Accountancy. “My more basic concern is that option grants do not achieve the intended goal of aligning owner/manager incentives because they are not indexed either to employee performance or to market-wide conditions,” he said.

Abdel-khalik believes options are better incentives if their exercise price is indexed to the broader stock market, using a measure such as the S&P 500 index. “That way, if the whole market rises or falls, the exercise price of the options goes up or down accordingly so that the value of an employee’s options doesn’t benefit or suffer from broad market trends. Managers would be rewarded for the added value arising from their efforts,” he said. “Several companies are already doing this.”

As for the current trend among corporations to expense options when they are granted, Abdel-khalik expects to study the results. He observed that approximately 200 companies have announced plans to expense options when they are granted, and he will be watching to see how the markets respond. Given that the information previously has been disclosed in footnotes, Abdel-khalik doesn’t know why the market would respond to the change.

He said that although he once agreed with the idea of immediately expensing options, he has changed his mind. “At the time a company grants options, the real cost is unpredictable because you can’t know the price at which they will be exercised or if they will be exercised at all. For that reason, I have concluded that the vesting date is more appropriate than the grant date for expensing options,” he said.

Weisbenner notes that much of the negative reaction to stock options incentives results from the fact that many options transactions lack transparency. [See related story on page 8.]

“Shareholders and regulators become understandably uncomfortable with some types of option transactions, but we don’t want to throw the incentive ‘baby’ out with the bathwater,” Weisbenner said. “What we ought to be concerned about is making sure we achieve a greater degree of transparency in reporting the use of options for compensation. Employees should have incentives, but there also should be tight enforcement of shareholder rights and applicable laws.”

—James Nathan
Buy long? Sell short? Ah, the challenges of investing money – or pretending to. How can you add the element of risk, but not a casual attitude, when you’re investing using a sophisticated computer program and not real money? Faculty in the Department of Finance have an answer: make it a competition.

Competition makes the stakes higher – on the line is your investment strategy and financial know-how and your standing with your peers. Understanding that fundamental drive of humans to be the best is what fuels the competitions organized around the University of Illinois Securities Exchange Simulation (UISES), a web-based, state-of-the-art investment simulation program that lets students manage a portfolio by buying and selling US equities, American Depository Receipts and American Depository Shares, and closed-end and exchange-traded funds. UISES was developed by faculty and staff in the College of Business.

MSF Teams Jockey for Winning Position
Master of Science in Finance (MSF) students had an opportunity to demonstrate their investment expertise in a UISES portfolio management simulation during the 2003 MSF Investment Challenge that ran from September 2003 through January 2004. The challenge was open to all MSF students, and prizes were awarded on the basis of rates of return realized during the competition.

MSF students assembled teams, called Investment Management Companies, with one or two managing partners and an initial balance of $1 million. A team had to make at least five trades by the end of November 2003 and could “borrow” up to $500,000 at reasonable rates of interest for the simulation. Final standings were based on the market value of assets on a non-accrued basis in the portfolio at the close of the challenge. Team standings were posted to the web daily.

The winning team was Gator Bite with a five-month return rate of 17.48%. Team members Peter Lee and Yi-Hsuan Wu worked hard to gain the upper hand, making a total of 122 trades. Team members Vivek Choudhary and Fatima Hamad of F&V Investments made 34 trades for a final rate of return of 14.31%, which earned them second place. Chia-Wei Su operated solo as Home Growing Investments and generated a return of 3.34% with 42 trades.

Kevin Conroy, who, along with Grace Chen made up the Whitefish Trading team, is a full-time options trader as well as a graduate student in the MSF program. Conroy, who knows his way around a trading floor, says UISES is a realistic program for simulating portfolio theory based on an investment position and longer term investments. As an options trader he may make multiple trades in any ten-minute period, something UISES discourages by imposing a higher-than-average commission figure. Conroy’s professional experience didn’t help Whitefish finish in the top three. “We made some mistakes,” he admitted of the team’s fourth-place finish.
Elisabeth Oltheten, assistant professor of finance who administered the fall 2003 competition, is finding the spring 2004 semester equally exciting. Illinois MSF students are matching their investment savvy against graduate students at Boston College who are enrolled in the graduate investment class taught by Peter DiCarlo, a professor of finance at BC’s Carroll School of Management. BC students used UISES in the fall 2003 semester for another class, which served as good preparation for the intercollegiate competition and honed their competitive spirit.

“We’re neck and neck at this point,” Oltheten noted at press time. “Student interest is high because we want to claim this victory for the Midwest.”

The Illinois-Boston challenge ends in May. Results are posted frequently to the web at uises.cba.uiuc.edu/results.htm.

### Teams Tackle Three Strategies

Undergraduates in Finance 361, Investments, were involved in an innovative, in-class competition during the fall 2003 semester. Teams of students were tasked with the goal of maximizing their portfolio based on three fundamental financial investment concepts – value, momentum, and size (see story below). The competition was not only among the student teams – with clever names like Cha-Ching Inc., Sharpe Investment, and Money Makers Inc. – but between the instructors of the two sections of FIN 361, Virginia France and Zoran Ivkovich, both assistant professors of finance.

At the end of the semester, the collected returns from Ivkovich’s teams nosed out France’s, 7.89% to 7.81%. The best strategy? Based on the closing figures for the collected teams, the rate of return for investments by size was 8.30% with value returning 7.81% and momentum lagging at 7.44%. The top four teams, however, were evenly divided between those instructed by France and by Ivkovich. Interestingly, three of the top four teams had invested by momentum, and seven teams had rates of return over 20%.

### Final returns from the FIN 361 competition

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>STRATEGY</th>
<th>TEAM</th>
<th>RATE OF RETURN</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulls and Bears</td>
<td>Momentum</td>
<td>Ivkovich</td>
<td>34.12%</td>
</tr>
<tr>
<td>Frenchees</td>
<td>Size</td>
<td>France</td>
<td>29.99%</td>
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<tr>
<td>Investors</td>
<td>Momentum</td>
<td>France</td>
<td>28.09%</td>
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<tr>
<td>Cobras</td>
<td>Momentum</td>
<td>Ivkovich</td>
<td>28.11%</td>
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<tr>
<td>Illini Investments</td>
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<td>France</td>
<td>24.76%</td>
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<tr>
<td>TNJI Investments</td>
<td>Value</td>
<td>France</td>
<td>20.95%</td>
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</tbody>
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### Competition Heightens Realism

UISES is one tool used by Business faculty to complement traditional classroom instruction by providing a team-based experience with a hands-on application of traditional business skills. The intra-class and interstate competitions increase the excitement for students and better simulate the investment world outside academe.

— Ginny Hudak-David

### Finance Faculty Leaders in Strategy Research

The “Strategy Challenge” was set up to focus on three stock-picking strategies: size (or market-cap), value, and return momentum. “It’s particularly appropriate to be teaching these strategies. Much of the work in these areas was done here by Illinois faculty. Josef Lakonishok, Louis Chan, Narasimhan Jegadeesh, Tim Loughran, Inmoo Lee, Jay Ritter – they all did seminal work at Illinois,” said David Ikenberry, professor and chair of the Department of Finance. The size-based strategy exploits a recurring finding that smaller capitalization firms tend to outperform larger firms. The momentum strategy involves buying firms that have done well in the recent past (e.g., over the last year), in the hopes that they will continue to outperform. A value-based strategy focuses on firms whose market price is low relative to common accounting measures.

A rich body of research from both the U of I and other institutions is in agreement that these strategies show long-term excess performance, even after correcting for market risk. The puzzling question, and one that Illinois researchers continue to struggle with, is why.

One school of thought says that these strategies do well either because of a statistical fluke or perhaps because of a peculiar type of risk that has not been controlled for. For example, if the problem were motivated by an unknown risk factor, the higher returns to these strategies might simply be driven by a risk exposure.

Researchers at Illinois, however, have pioneered another school of thought. Their conclusions suggest that despite the competitive and noisy nature of markets, stocks may become mis-priced at various points in time. “Whether we are looking at size effects, momentum effects, or book-to-market effects, the work of many Illinois researchers seemingly reaches a conclusion that investors are prone at times to mistakes,” said Ikenberry.

He noted that papers at Illinois have not only been at the crux of the more general debate, but have gone much further to show that company managers seem to react to these pricing discrepancies. “Whether the work deals with initial or seasoned equity offerings, stock repurchases, insider trading, or a host of other events, work coming out of Illinois has played a huge role in shaping our understanding of financial markets.”

— Virginia France
Q & A with Anju Seth: Recent trends in the use of options in compensation packages and what the future might hold

Anju Seth, a professor in the Department of Business Administration, researches corporate governance, strategic alliances, corporate and competitive strategies, and globalization/new market entry. She teaches graduate courses on strategy and on competitive analysis. Named to the campus Incomplete List of Excellent Instructors numerous times and awarded the Executive and Professional Development Award from the College of Business, Seth holds a PhD from the University of Michigan, an MBA from the Indian Institute of Management, Calcutta, and a BA from Delhi University.

What trends have influenced the declining use of options in compensation packages?

Several years ago we saw a high demand for qualified executives in a tight labor market. This led to the widespread use (and perhaps overuse) of options to attract senior executives to a firm. An executive who creates value for shareholders deserves more money, and options can be a good way to compensate executives and focus their attention on creating shareholder value. But when the entire market or a whole industry experiences a large stock price change, it’s unlikely that a specific executive’s decisions had anything to do with that change. Even executives with mediocre performance can and did become wealthy merely because of the rising stock market. So companies and commentators began to question whether options reward employees for superior performance (as is desirable to create shareholder wealth) or whether they merely reflect good luck.

When the market surges upward, as a practical matter it is infeasible to reprice or take options away. However, when the market falls, firms can reprice options or grant new options to neutralize the change. Many companies undertook wholesale repricing of their existing option grants when the market price fell below the option exercise price during the recent stock market decline. The rationale was to boost the morale of employees who perceived their options to be worthless. Investors are concerned that this asymmetry defeats the intended incentive effects of stock options and so represents a net cost to shareholders.

Major failures of corporate governance in companies like Enron, Tyco, and Nortel focused public attention on the potential for egregious misuse of stock options to transfer wealth from shareholders to managers. For example, heavy use of options in their compensation plans is cited as an explanation for why Enron’s management manipulated the accounts to boost up the company’s stock price.
Have we been overzealous in our quest to eliminate stock options as part of executive compensation?

Since the excesses of the 1990s have been identified, the inappropriate use of stock options has become the whipping boy for wider failures in corporate governance. The backlash against stock options has been fueled by scandals, such as those at Enron. However, research has shown that under the right circumstances, granting stock options can be a powerful tool to make managers think like shareholders.

If used appropriately, options are a form of risk-sharing between stockholders and employees. Equally important, options with delayed vesting can delay the voluntary departure of those executives who create the most shareholder value.

If a company decides to use stock options, how should the compensation package be structured?

Option packages should be designed in line with the firm’s strategic objectives. The idea is to devise option plans that make it expensive for key employees to leave and to align their interests with shareholders in the specific context of the strategic imperatives faced by the firm.

Companies often want to encourage employees to make the kind of risky decisions that could cost them their jobs if they fail but that carry big potential benefits for shareholders. Without these incentives, employees might not make such decisions and take those risks. In the early 1990s, for example, risk-taking behavior encouraged by at-the-money stock options grants (i.e., with an exercise price equal to the market price of the company’s stock on the grant date) played an important role in General Dynamics’ corporate turnaround. High technology firms with an uncertain future often use options to attract talented employees.

However, in mature industries, such as paper products or commodity chemicals, a reasonably well-run company should continue to generate solid profits without taking major risks. Even in these companies, it is important to create incentives for executives to make decisions to benefit shareholders and to retain key executives. Underwater option grants (i.e., with an exercise price above the market price of the company’s stock on the grant date) with delayed vesting periods can accomplish these objectives. But, if in such situations you give executives at-the-money options that vest quickly, you can instead end up overcompensating them at the expense of shareholders.

Even option repricing in a declining stock market can sometimes be consistent with creating shareholder value. Employees with unique skills that are in high demand can effectively reprice their underwater options by switching jobs and getting new options from a new employer. Companies must weigh the potential negative effects of employee turnover on shareholder value against the potential negative incentive effect of rewarding employees for stock price declines in deciding whether or not to reprice options.

How can optioning excesses be curbed?

Ultimately, the perceived benefits of option-based compensation must exceed the costs for options to create shareholder value. A judicious and informed approach to these costs and benefits is necessary, with appropriate oversight over the use of option plans. Today the use of options has become much more measured than in the past, and this clearly is a step in the right direction.

One critical issue is that investors must be able to decide whether options are used appropriately in compensation packages. [See related article on page 18.] So, option grants, their potential dilution effects on existing shareholder interests, and the sale or disposition of stocks acquired by exercising options must be disclosed in an understandable, transparent, and timely manner. If such information is available to investors and analysts for valuation purposes, it is likely to deter the misuse of options. A second issue relates to bringing about symmetry vis-à-vis the effects of a rising or falling stock market. Executives should be subject to both the upside gains and the downside risks of stock ownership. Like my colleague A. Rashad Abdel-khalik, I believe that indexing options could be a valuable step towards neutralizing market effects and strengthening the link between pay and performance.

At present, such “performance-based options” are required to be expensed although standard at-the-money options are not. A persuasive argument in favor of expensing standard options is that different forms of stock-based compensation receive consistent treatment. On the other hand, it is also possible that if we make expensing of standard options mandatory in the specific fashion that FASB (Financial Accounting Standards Board) now recommends, we can discourage their use even when appropriate or encourage gaming in reporting the value of option grants. Ultimately, accounting rules should represent balanced incentives for companies to use any and all the different forms of stock-based compensation as appropriate while yielding reliable, accurate, and comparable data to investors and analysts.

Another potentially beneficial change would be to require that stock acquired by exercising options be held for a significant period of time. This likely would deter executives from manipulating the stock market to realize quick gains at the expense of shareholders. But options are not unique; any form of compensation may be subject to abuse in the absence of controls. We need stronger corporate governance that makes it costly to misreport or manipulate.

Editor’s Note: 4 for 4 is a regular feature of Perspectives, allowing us to catch up with College newsmakers. We pose four questions and share the answers here.
Brown Awarded Grant to Study Long-term Care Insurance Market

Jeffrey Brown, assistant professor of finance, was awarded a $275,000 grant in January from the Robert Wood Johnson Foundation health policy program to study the long-term care insurance market in the United States. Brown will conduct the study with Amy Finkelstein of Harvard University. The three-year grant is the maximum amount awarded by the foundation.

At approximately $100 billion per year, long-term care expenditures represent one of the largest financial risks facing the elderly in the United States, and yet only 5 percent of such expenditures are covered by private insurance. The primary objective of Brown and Finkelstein’s research project is to understand how public policy can or cannot be used to influence private long-term care insurance coverage. The researchers expect to pay special attention to the structure of Medicaid, which currently pays for long-term care only after an individual has exhausted most of his or her financial wealth, and to tax subsidies.

“Most state governments already face severe short-term budget crunches,” said Brown. “They are looking down the road and seeing a potential fiscal disaster on the horizon because of rapidly rising Medicaid expenditures that are primarily driven by expenditures on nursing homes and other long-term care for the elderly.” He noted that states are beginning to experiment with tax subsidies and changes to Medicaid rules to promote private insurance coverage but are doing so without research to guide their efforts. “We hope that our study will be useful in determining which policies will be effective for altering private insurance coverage,” he said, “and which ones will not.”

The Robert Wood Johnson Foundation Investigator Awards in Health Policy Research support broad studies of the most challenging issues in health, health care, and health policy facing the US.

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Kauffman Foundation Awards Grant for Academy

In December 2003, the E. Marion Kauffman Foundation announced a $4.5 million, multi-year grant to the College of Business to establish an academy to build entrepreneurial capacity and culture at the University of Illinois and extend those initiatives to other doctoral-granting institutions. The Academy for Entrepreneurial Leadership Development will develop courses, internships, and other activities for almost 10,000 graduate students and the Illinois faculty.

Paul Magelli, director of OSBI Consulting, led the team that developed the proposal for the Academy and said the funding “is a remarkable opportunity to provide national and international leadership in entrepreneurship.”

The Illinois grant was the largest of eight awards from the Kauffman Foundation. Illinois is matching the Kauffman grant two to one, ultimately directing more than $13 million to the creation of new, interdisciplinary entrepreneurship education programs on campus. The primary objectives of the Illinois proposal are to build institutional and instructional capacity in entrepreneurship, conduct scholarly research, and offer the skills sets and practical training critical to the success of entrepreneurs.

Urbana-Champaign Chancellor Nancy Cantor called the Academy “an ambitious, interdisciplinary initiative we hope will be a national model in a new and exciting field.”

The E. Marion Kauffman Foundation works with partners to encourage entrepreneurship across America and improve the education of children and youth.

Entrepreneurial Portal Announced by CED

An online repository of information for the aspiring entrepreneur was announced in February by the Center for Entrepreneurial Development (CED), a unit of the College of Business.

The Startup Portal specifically targets early-stage entrepreneurs who do not come from a business background. The links contained on the portal site cover the business plan, raising financing, human resources, budgeting and financial planning, accounting and financial statements, sales, marketing, and franchising. Each of the eight main categories has three to five subtopics that link to specific, non-proprietary web-based information.

MBA students researched each topic and searched the web for the most appropriate and timely information on the subject. Dinesh Ahluwalia, director of CED, said that the portal was an outstanding research project for the students and a project that moved CED a step closer to “being a world-class resource for entrepreneurial development.”

The portal is available at ced.business.uiuc.edu/startup.
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