

Abstracts of Papers to be presented at the USC-UCLA-UCI Finance Day, May 9, 2014

1) "Dynamic Agency and Real Options"

Authors: Sebastian Gryglewicz (Erasmus University) and **Barney Hartman-Glaser** (UCLA)
http://www.usc.edu/schools/business/FBE/seminars/papers/FinDay_5-9-14_HARTMAN-GLASER.pdf

Abstract:

We present a model integrating dynamic moral hazard and real options. A risk averse manager can exert costly hidden effort to increase productivity growth of a firm. In addition, the risk neutral owners of the firm can irreversibly increase the firm's capital stock. In contrast to the literature, moral hazard may accelerate or delay investment relative to the first best depending on the severity of the moral hazard problem. When the agency problem is more severe, the firm will invest at a lower threshold than in the first best case because investment acts as substitute for effort. This mechanism provides an explanation for over-investment that does not rely on "empire building" preferences. Effort decreases after investment, however pay performance sensitivity increases after investment when the agency problem is less severe and the growth option is large.

2) "Being Surprised by the Unsurprising: Earnings Seasonality and Stock Returns"

Authors: **Tom Chang** (USC), **Samuel Hartzmark** (Chicago), **David Solomon** (USC), and Eugene Soltes (HBS)
http://www.usc.edu/schools/business/FBE/seminars/papers/FinDay_5-9-14_SOLOMON.pdf

Abstract:

We present evidence consistent with markets failing to properly price information contained in seasonal earnings patterns. Firms whose earnings are historically larger in a given quarter each year ("high seasonality months") experience higher stock returns for predicted earnings announcements that month. Analyst forecast errors are also more positive in high seasonality months, consistent with the returns being driven by mistaken estimates of earnings rather than just announcement risk. Earnings seasonality returns appear to be related to the tendency of investors to overweight the recent lower earnings that follow a highly seasonal quarter, leading to pessimistic forecasts when the high seasonal quarter arrives again. The effect is not explained by firm-specific information, increases in trading volume, greater earnings management, or calendar effects.

3) "Analysts' Forecast Bias and the Overpricing of High Credit Risk Stocks"

Authors: **Mark Grinblatt** (UCLA), Gergana Jostova (George Washington University), and Alexander Philipov (George Mason University)
http://www.usc.edu/schools/business/FBE/seminars/papers/FinDay_5-9-14_GRINBLATT.pdf

Abstract:

This paper investigates whether financial analysts' power to move prices arises from investors' tendency to blindly follow analyst earnings estimates. Analyst forecasts are often overly optimistic. This optimism is predictable and many generate temporarily inflated stock prices. In addition, for high credit risk stocks, the quintile predicted to have the most optimistic forecasts outperforms the quintile with the least optimistic forecasts by about 19% per year. Certain types of firms attract significantly more analyst optimism than others—namely those with poor credit quality. For these firms, the price distortions caused by analyst optimism are so large and frequent that they account for the negative credit risk-return relation observed in the cross section of the U.S. stocks.

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4) "What We Talk about When We Talk about Mutual Fund's Reputation"

Authors: **Huang Chong** (UCI) and Fei Li (UNC-Chapel Hill)

http://www.usc.edu/schools/business/FBE/seminars/papers/FinDay_5-9-14_CHONG.pdf

Abstract:

The term reputation appears in our everyday discussions about mutual funds. However, few studies have been done to explore how the mutual fund's reputation forms and evolves. In this paper, we model fund's reputation as the market's belief whether the fund has the information to make profitable investment. We then propose an infinite-horizon model, in which the fund's reputation can be invested by costly information acquisition but may depreciate due to exogenous economic shocks. Reputation has significant effects on the fund's information acquisition decision, performance, and flows. Our results provide theoretical explanations to several empirical observations.

5) "Local Risk, Local Factors, and Asset Prices"

Authors: **Selale Tuzel** (USC) and Miao (Ben) Zhang (UT-Austin)

http://www.usc.edu/schools/business/FBE/seminars/papers/FinDay_5-9-14_TUZEL.pdf

Abstract:

This article provides a new link between firm location and stock returns. We show that the industrial composition of the local economy, in particular, how cyclical its industries are, affects firm risk. We propose a metric of this cyclicity, labeled "local beta", and demonstrate that local factor prices such as wages and real estate prices are more sensitive to aggregate shocks in areas with high local beta. While procyclical wages should lead to lower firm risk due to risk sharing with labor, procyclical prices of real estate, which is part of firm's assets, should increase firm risk. We confirm that firms located in higher beta areas have lower industry-adjusted returns and lower conditional betas, and show that the effect is stronger among firms with low real estate holdings. A production-based equilibrium model explains these empirical findings.