

Bridge the Gap: Fruitful Contacts Between Finance Professionals and Academics Are Needed

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ABSTRACT

In a maturing industry innovation brings competitive edge and growth. Scientific research offers new ideas and contradicts former beliefs. The aftermath of the burst of the bubble and new regulations raise new questions to the financial industry. This paper outlines some of the questions which academic research may help answering too. In the new context of “open innovation” the many efforts done to foster the dialogue between researchers and practitioners must be developed.

Keywords: Research ; Innovation ; Banking industry ; Financial services ; Regulations ; Research organization

I. INTRODUCTION

Innovation brings every day, bit by bit, or with breakthrough changes, more comfort, more efficiency, more pleasure, more security in our real lives. Behind innovation there is often a long process of research, fundamental and applied, plus another process of marketing, which in the end “creates” new products and services that seem only remotely related to fundamental research. Yet, without all the investments in research and marketing no innovation would foster growth in our economies. If everyone agrees on these steps the thinking on how to manage innovation has really changed since the glorious days of the Bell Labs in the United States or the Centre d’Etude Atomique in France twenty years ago.

The trend says H. Chesbrough from Harvard is: “open innovation” rather than “closed innovation”. The success of in house secretive teams was built on an environment that has dramatically changed. Nowadays knowledge and creativity is more widespread on earth among the populations and socially. Small firms turn out to be adapt quicker and to promote more genuinely the new ideas and technologies. Lastly people move from one company to another but nevertheless keep their knowledge.

If the positive role of research on company profits and at the macroeconomic level on growth is proven the ways to deal with the process of applying research remains to be discussed in the present environment. Finance cannot be treated as an isolated field. Innovation is a key driver in bank strategies. It is a sure way to attract investors’ attention and help finance new projects. Options, funds and securitisation have transformed the market place for corporations as well as for people’s savings and access to credit. The purpose of this paper, presented at AFFI conference in Tunis, is precisely to discuss, from a practitioner point of view, the questions that today wait for better answers. I would like first to stress what is the current state of mind after the burst of the TMT bubble. Then I draw a list of subjects of interests. Finally a selection of private initiatives to foster the contacts between practitioners and academic researchers are described. The dialogue that comes along will create a favourable climate for innovation and let a rich field for our kids. To me, open research contributes to a sustainable growth.

II. AFTER THE KRACH

In the aftermath of the TMT bubble krach all financial professionals have had to restate their credentials, if not their attitudes. Reputation of the whole industry has been damage. Action has been taken to restore confidence and if possible, clear the market place from wrongdoers. But the scars of these “fabulous years” will certainly not disappear from our minds, touching on very fundamental issues that research can hopefully solve.

In my opinion nothing illustrates better the craziness of the whole market place than the story told in “A rose.com by any other name”, a paper published in 2002 in the “Journal of Finance”. That paper rests on empirical research done on stock performances of the 140 quoted companies that decided to change their name during the year ending in July 1999. About one hundred of these firms change their name to

become “.com”, hence the title of paper. The authors report that in this sample, a quarter of the firms were changing their strategy to become an Internet firm, whatever this could actually mean. The remaining firms had at best, intention to change their strategy, which was loosely related to the web; worse, among them, 20% of the firms had activities with no visible relation to Internet. The authors then look at stock performance (more precisely relative performance to various market indices) around the announcement of the name change. The (true) story goes that the week after the stock returns were on average around 50%. Six months later, their price tripled on average. The best performers are the less related to internet; also in sizeable number of cases, the stock started to performed a bit earlier, fact which the authors attribute to chat rooms and rumours. The final words of that paper are a marvel, when one knows that, it was submitted end of 1999, before the first krach in April 2000. Indeed in their conclusion the authors wonder if this superior performance will last (we have paid to see) and if this performance reveals superior forecasting ability of the investors or this is all but plain speculation. Because of the referee process and queuing file for publication in the “Journal of Finance”, the paper was published two years later. France Telecom stock which had topped at 225 euros was worth less than 10 euros. How could the all thing happen?

III. NEW CONTEXT AND OLD QUESTIONS

As the previous story shows, market valuations are questionable. The first question is indeed to price equities. Firstly, we have read various arguments on the equity premium: for some it had decreased (Arnold and Berstein 2001) and even vanished. Although three years of bear market have probably brought more confidence on such an important number, more research is needed. Secondly, valuation of start-up with real option approaches has been also put to a by test. Here a survey would be very useful.

The role and means of watchdogs must be reassessed: up to me the attention should focus more on the efficiency rather than on the quantity. All these elements could be summarised in a better micro economic analysis of the incentives of the various market participants, from the financial analyst to the seller of mutual funds. Commissions related to prices increase with prices. We knew that when inflation was high during the 80's, we should look at all these aspects first because the benefits for the clients are, of course, net of fees; second, incentives may guide the intermediaries who often have duties in client advice. As behavioral finance studies have shown, human beings in charge of financial services, in brokerage firm or an asset management companies for example have understandable attitudes, sometimes well predicted by the classical theory, sometimes not.

A better understanding on the effects on prices would be of great interest, either to modify our valuation tools or to limit these effects by various means, when they are socially or economically undesirable.

As always during financial crisis, innovative techniques are criticised and unfortunately taken as scapegoats. Derivatives have been described as “weapon of mass destruction.” Is this a wise quote? Is this from a wise man? In the financial industry nowadays everyone knows that derivatives are useful and cheap. Wrong uses of good

tools must be controlled and if mishandling of these instruments create unnecessary risks, then in my opinion, rules should be designed.

A more positive approach of the problem would be better understand if the introduction of new instruments on the market equilibrium. Control of human competence in dealing with new financial instruments could be an answer. It is often said that the greatest risk is the one that is not identified by the person who bears it. Knowledge risk in a highly specialised world could be better controlled. More research on derivatives is definitely better than uncontrolled tips form individuals, whose influence on the opinion of the man in the street is dangerous when uncontrolled. I don't agree with Warren Buffet. What has been done in the area of alternative investments is a good example of a gradual introduction of innovation.

Even if more research must be made on this growing field, the analysis done by a number of academics, Shieh, Lo, Argawal or Lhabitant have shed new light on the particular risks and sources of added values of the myriad of alternative strategies. With a better understanding of their process regulations like COB in France, were able to put a framework on their activity as far as mutual funds (at this stage fund of alternative funds) are concerned.

Finally, a number of asset management practices were questioned. Are index funds destabilising the market? Should benchmarking be avoided? A debate on issues related to strategic allocation is clearly needed. Because, in the end, these allocations mean capital to finance the economy, such problems require more research. Three years of bear market have also forced a lot of investors, institutional (insurance companies or pension funds) and individuals, to reduce their equity exposure. What a better argument for portfolio insurance? The anglo-saxon would often disregard such strategies because they entail some costs. A more pragmatic approach on utility functions that take investor's regret into account is needed. Risk aversion is a concept that is much more difficult to use in practice than simple limits on losses that everybody understand. On the other hand, long-term investor could sell this short-term protection... for a premium as dealers or hedge fund do.

IV. NEW CONTEXT AND NEW QUESTIONS

Financial institutions face nowadays a hectic agenda of reforms. Some of these reforms rest on research, others not. Such ideas sometimes end in poor adaptation; that is why, these various reforms merit also the attention of academics who can offer an independent (but expert) view on how to put them in place.

Basles II will be the industry achievement of the decade. Credit risk management and therefore, credit market will be deeply influenced by the enforcement of this reform, especially because of IRB (model based) methods of calculating capital requirement. The same is true for operational risk, which is a quite common topic seen by an actuary but forces the industry to better measure the operational losses induces by their activities. This round does not impose capital requirement to bank balance sheet interest rate risk. Such asset and liability management issues are rightly more and more looked at by academics.

Similarly solvency rules for insurance companies and pension fund are analysed. The controversial smoothing mechanisms to achieve right funding or release of benefits to customers are another interesting subject, addressed by S. Haberman for example with interesting results.

Finally, enforcement of international accounting standards face fierce resistance of a number of banks especially in continental Europe. The debate on fair value has been fierce in the recent years; certainly more transparency and better information can benefit to all market participants: less uncertainty for investors may indeed reduce the required cost of capital, in theory at least. But if fair values are given by a market that is prone to bubbles, what is the benefit? Moreover only a small fraction of assets (and liabilities) can be valued by financial markets. What to do with the rest? Comparison of the pro and con of the various approaches must be assessed and balanced. Applied research is needed!

V. PRIVATE INITIATIVES TO ENHANCE USAGE OF RESEARCH

Financial services are predominantly a people business. That is why financial centres have developed in the past. A need for enhanced relations between this group in Europe and academics in finance has been perceived by some market participants who have brought time and money to ease the process of transforming new research to better practices. Their initiatives are associated with the reaction of technical journals, with the birth of dedicated organisations, with more and more seminars.

Like the popular *Journal of Portfolio Management* or *Financial Analyst Journal*, referred journal of targeting practitioners have been put in place. *Banque et Marchés*, of the French Finance association (AFFI) was created 11 years ago. The *European Investment Review* was launched two years ago. *Journal of Asset Management* and several publications related to *Risk Magazine* related to operational and credit risks have been introduced.

Seminars, of course, are a popular way to disseminate research and for practitioners and for academic to get contacts. *Frontieres en finance*, *Finance sur Seine*, the *Bachelier seminar* are just few examples of what exists in Paris. Associations like *Institut des Actuaire*s or *Association Française de Gestion*, the asset manager corporate association invite regularly their members to listen to and to debate with academics.

Finally and more importantly, private organisations intend to fund scientific research on topics closely related to specific activities. The *Institute for Quantitative Investment Research (INQUIRE Europe)* created in 1990 provides funding to projects in asset management (and related topics). Less important funding is brought by the *Association Française des Gestionnaires Actif Passif* to research in ALM. More recently the *Eurolplace Institute of Finance* was set up with a more ambitious funding policy with a particular interest of research in risk measurement and management.

VI. BRIDGING THE GAP IS A REALITY

Closer relationships driven by mutual interests are the signs of a more open approach to financial technology development that is under way in financial services. Resistance

exists nevertheless. But the benefits for the market participants, the regulations and in the end to the clients are large enough. Therefore the trend accelerates. Idealistic or not, this view is shared by a growing number of active people. How a sustainable innovation can exist without their efforts?