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The Future of the MBA

Dr. Pansy L. Yang | Executive Director
Fink Center for Finance & Investments

With the number of layoffs on all corners of Wall Street hitting record highs, many question the judgment, character, and training of the business leaders at the helm in seeking to understand how we ended up in the calamitous financial crisis we are in today. Most CEOs of major failed institutions have one degree in common, the MBA. Several key business leaders were even star students in business school. This has led to the reevaluation of business school curriculum, and the open discussion in the popular press over the last few months serve as the inspiration of this issue of the bulletin.

Critics of what is taught in business school have suggested that “business schools have actively freed their students from any sense of moral responsibility”¹, and that the MBA “prepares people to manage nothing”². Defenders of business schools assert that the crisis is partially due to personal greed, and that “personal greed reflects personal values, and you can't blame business schools for determining personal value systems.”³ In this issue of the bulletin, we highlight two distinct views on the direction business schools should be headed.

The academic perspective is provided by UCLA Anderson’s very own Dean Judy Olian. In addition to her role as Dean, Judy is the John E. Anderson Chair in Management, and has been widely published in journals on human resource management and business alignment of management systems. With her unique experience as Dean, she shares with us her broad vision of the future of management education.

Stewart Resnick, chairman and owner of Roll International Corporation, is the industry contributor. Stewart has developed and owns a number of successful companies including Paramount Agribusiness, POM Wonderful, Teleflora, FIJI Water, as well as Suterra. An accomplished businessman and entrepreneur, in a recent interview he divulges his strong views on what can and cannot be taught effectively in business schools.

¹ Sumantra Ghoshal, *The Economist*, May 29, 2009
² Henry Mintzberg, *The Economist*, January 16, 2009
³ “Training Managers to Behave”, *Time* Magazine, May 14, 2009
The Future of Management Education

Judy D. Olian  |  Dean, UCLA Anderson

The Challenge

“How Business Schools have failed Business” in the Wall Street Journal, or “Is it time to retrain B-Schools?” in the New York Times, are just a few examples of some of the recent press that has greeted deans of business schools. If you listen to critics, especially after the recent financial crisis, you might wonder if management education has any future. The argument goes like this: The economic meltdown occurred because of an absence of leadership among top executives and boards. Business schools train business leaders. It follows, then, that the dismal performance of business leaders is the fault of their management education. By that logic, schools of management should also get the credit for the economic successes of the previous years. What do you think?

In other quarters, management education is simply ignored. The National Science Foundation’s 2007 analysis of the future determinants of US prosperity issued an urgent call for investment in the country’s human, financial and knowledge capital. The report resulted in a 592 page book, ‘Rising above the Gathering Storm: Energizing and Employing America for a Brighter Economic Future’. It includes a careful review of the number of current and projected graduates in various science and technology fields, and it recommends substantial national investment in STEM education – science, technology, engineering and mathematics. Not once in this lengthy report is the need mentioned for management education.

Whether management education is considered irrelevant, or responsible for the ills of the global economy, the world is changing around us and the value proposition of management education is being challenged. We, too, must change. Why, and how? That’s what I’ll contemplate next.

Changes Impacting Management Education

The changing global landscape will continue to have dramatic impact on the content of management education, on learning approaches, and on the composition of the student body. The much read ‘Dreaming with BRICs’ report issued by Goldman Sachs in 2003 projected radical shifts in the order of global economic powers between 1980 and 2050, with only two of the top five economic superpowers -- US and Japan -- retaining their position though falling from the top two spots. By 2050, China, India and Brazil are expected to replace Germany, France and the UK in the top five. Population changes across the globe are also very uneven, with declines or, at best, modest population growth in developed regions that are the traditional focus for management education (see Figure 1). Contrast that with the largest population growth in Africa, a continent which management education misses almost entirely either as a focus for learning or for education delivery.

Here’s another major transformation. Other than speaking, our future students will communicate and consume information almost entirely through new media and social networking tools. The 15 – 24 year old age group is already using the Internet more heavily than the total population in many countries (see Figure 2). Traditional books and print materials will be a thing of the past, and face to face interactions will become just one of many channels for communication. Much of the information will be consumed free, and not because it is pirated. Best in class teachers, business people, and global leaders will share their insights in many formats and channels in a manner that is readily available and intimate to consumers, and customizable to their needs. Users of the information will be able to connect with online global communities to share their reactions and to collaborate. These students of the future will not be satisfied with the current model of one-way teaching and learning,

Figure 1: Projected Changes in Population: 2005-2020

Source: U.S. Department of Census and Global Foundation for Management Education
and they will be less inclined to view schools of management as the necessary destination for learning about management.

Another evolving change concerns the ultimate outcome for management education. Management education is a breeding ground for future leaders, and increasingly not just business leaders. Whether serving as CEO of a large organization, launching a start up, leading a local charity, an NGO, government unit, or an arts organization, these individuals need to learn the fundamentals of management, finance, marketing, accounting and operations to function effectively as organizational, community and government leaders. In preparing for leadership, they need to learn to formulate and execute strategies for a broad range of organizations – business and non-business -- and to be aware of their own leadership disposition and impact, before they can become effective leaders. That kind of preparation is foundational for a variety of leadership careers.

That's a much broader agenda for management education than is true for most schools today. It also calls into question the typical rankings of success for schools of management – those that reflect earnings or progression in traditional business careers. And, as Joel Podolny points out in the recent Harvard Business Review, it requires an integrated view of leadership, one that is not isolated from the actual functions of management or addressed – as it typically is in business schools – as a stand-alone set of skills and behaviors.

Management Education in the Future

To prepare our graduates to practice business globally and to serve in leadership roles in all parts of the world, management education must do more than present global case studies or touch on business practices abroad. Our students need to experience the challenges and opportunities of doing business in countries where the language and cultural norms are entirely unfamiliar, where the law of contracts shares little with Western traditions, or where there is an entirely different set of business development opportunities. Students might learn these differences in innovative courses that are able to bring them to life, but they should also conduct meaningful projects and spend time studying abroad in foreign cultures outside of their zone of comfort, where they are humbled by the human differences or living conditions. The Internet has not yet been exploited for the full power of global collaboration opportunities that it offers.

We must also provide welcoming environments to students from abroad, despite increasing competition from new foreign business schools and barriers for international students to study in the US. Otherwise, we’ll lose the advantages of a learning community that serves as a ‘United Nations’, where global immersions happen right there.

Another imperative for management education, magnified by the global economic crisis, is to help graduates better understand and prepare for systemic, global risk across all functions of business. This is true for business and non-business organizations. The crisis has demonstrated how global interconnectedness of risk impacts all types of organization when risk is not anticipated and mismanaged. Such risk, and appropriate counter measures, needs to be studied in realistic and deep learning scenarios.

As we welcome the net generation into our programs, we must adapt to the way they acquire information and to the many opportunities for access to a richer array of learning opportunities. Younger students learn through conversation, collaboration and engagement in issues that matter to them, and are less stimulated when they are subject to the traditional teacher talking ‘at’ them. There’s no doubt that management education has been evolving and compared to traditional disciplines, involves students in case studies, practicums, internships and learning through community engagement. But we have an opportunity to improve engagement in learning by recognizing

Figure 2: Wired Youth – Percent Internet Users: 2002-2007

Source: United Nations International Telecommunications Union
students’ needs to be simultaneously stimulated through multiple channels. Think of a class session on entrepreneurship in China, with four screens simultaneously showing an entrepreneur’s interview on YouTube, her Facebook page summarizing her track record, a couple of tweets from a collaborator in China with his photos and one line assessments of the entrepreneur’s products, and the budgeting model displayed in Excel. That’s how students learn, but that’s not how instructors teach. We will need to adapt, or students will go elsewhere to customize programs of learning to their needs from all that they can access so adeptly from the Internet.

Management education wasn’t mentioned in “Rising above the Gathering Storm” because we haven’t made a strong case for our role in the knowledge economy. The management of the innovation process, and the success of inventors and entrepreneurs, are both key to the growth of the knowledge economy and to the future competitiveness of this country. Hence, our critical contribution is in improving future leaders’ effectiveness in managing innovation, and in teaching entrepreneurs the requisite skills to increase the odds of entrepreneurial survival and success. Yet, in schools of management we are still fixated on large corporations as the dominant model for management examples and applications. We’ll need to change to become more relevant to the growth segments of the nation’s and world’s economies.

We also must prepare our graduates for the leadership requirements in today’s world -- in communities, profit and non-profit organizations around the globe with cultures and missions that vary widely. The flight away from the large corporate model has eroded also the shape of hierarchy. Technology, changing demographics, and globalization have vaporized the walls around imperial leaders, requiring them to be more accessible, communicative, transparent, collaborative, adaptive, and open to ideas and feedback from every constituency. We can help prepare our graduates for such leadership imperatives by first creating self awareness of their style in groups, and then coaching them in areas where improvements are warranted. Leadership must be considered, also, as part of every function in schools of management, for multiple organizational types, and no longer as a stand-alone set of behaviors modeled after a corporate hierarchy.

Some of the requirements for leaders are timeless -- that they need to lead by example with a capacity to identify opportunities, set clear priorities and then execute the priorities, resist the temptation of short term goals, build for the medium to long term, inspire others in tough times, share recognition generously, and guard against insulation from those who challenge the leader. Above all, graduates must have unyielding integrity that guides their behavior when they are in the midst of conflicted ethical dilemmas. That’s when their sixth sense must engage, steering them in a course that is right. That takes courage, character, and a rock-solid set of values.

As I’ve said elsewhere, the career path to leadership is curious and indirect. Our graduates start first through a functional track and only then mature into leadership. Along that journey they encounter organizations with a range of values – some to be admired, others to be derided. Organizational cultures can be quite powerful and corrosive to a future leader’s value system by reinforcing unprincipled behaviors through perverted incentive systems, lax controls, inexcusable risk taking, poor governance, and lack of self-discipline despite what we teach in schools of management.

Schools of management must strive to develop within graduates an ethical compass that steers them to stay the course, even when they encounter forceful winds attempting to sweep them off the ethical cliff. That’s an argument for requiring refresher study by all MBA graduates, similar to medical or legal professionals for whom lifelong education is compulsory. In the case of MBA refreshers, this would be a recurring opportunity to recalibrate values, provoke questions, examine and challenge ethical choices, as well as to stay current with technologies and evolving practices in the functions of business. If management were a profession with ongoing certification requirements, as some have advocated, these refreshers would be mandatory.

As we ponder management education for the future, I am certain that many of us in schools of management will be very focused on developing learning experiences that have an enduring impact on our graduates’ character, that builds in them the wisdom and courage to withstand ethical compromise, and equips them to grow organizations with resilient value.

Is UCLA Anderson ready?

There are certainly many areas where UCLA Anderson’s management education programs are looking forward, rather than in the rear view mirror. Our global reach has expanded dramatically into emerging economies like India, China, and to some degree into Africa and Latin America. Study abroad programs and student immersion experiences through Applied Management Review (AMR) and Global Access Program (GAP) projects provide incomparable opportunities for our students to roll up their sleeves and learn on the ground about business, management and cultures.
Leadership preparation is achieved through a variety of courses, activities, and one-on-one coaching that are designed to have lasting impact. Students have quite a number of course options in which they hear personal accounts from an array of business leaders who discuss ethical dilemmas and the painstaking choices they had to make. They analyze leadership models in the earliest part of their program, and then again in the context of several discipline based courses — from finance to strategy to organizational behavior. Most importantly, students’ own leadership style is assessed through the lens of different team activities. As a result of that assessment they develop awareness of how they impact others, and then work on improving their leadership behaviors, if indicated.

Social entrepreneurship — application of business entrepreneurial thinking and models to social and community transformation — has been a longstanding interest among faculty and students at UCLA Anderson. Students are involved in numerous non-profit and community projects in the region and around the world to learn by applying their business skills to improve critical financial and management capabilities in these client organizations. We recently added a new program titled “Leaders in Sustainability.” In partnership with the UCLA Institute for the Environment, we have expanded our portfolio of courses to include business models for environmental sustainability, non-profit organizational strategies, and venture initiation for non-traditional businesses.

Although risk management and control systems have been an important subject of teaching by various finance, accounting, global economics, strategy, management, and real estate faculty, there is no doubt that the economic crisis has prompted us to devote greater attention to the topic across the entire curriculum. There is also more to be done in exploiting the power of global learning collaborations through the Internet, and in adapting to the learning styles of the net generation. There, we are still a mirror of the technology tools which we use, though not necessarily what our students use and from which they learn. In that area, we will need quickly to become the students, and they the teachers.

Judy D. Olian, Ph.D., is the eighth dean of UCLA Anderson School of Management where she has launched a comprehensive strategic plan to expand the school’s global presence and partnerships. Prior to this, she was dean and professor of management at the Smeal College of Business Administration at Pennsylvania State University. Olian served as chairwoman of the Association to Advance Collegiate Schools of Business (AACSB International), the premier business accrediting and management thought leadership organization in the world. She has been widely published in journals on human resource management and business alignment of management systems, wrote a weekly syndicated newspaper column and hosted a monthly television show on current topics in business. Olian’s honors include the American Council on Education Fellowship and the Maryland Association for Higher Education Award for Innovation.

Olian holds a B.S. degree in psychology from the Hebrew University, Jerusalem; and M.S. and Ph.D. degrees in industrial relations from the University of Wisconsin, Madison.
The Fink Center: Do you think that business schools had a role in the current crisis?

Stewart Resnick: I think that business schools had a huge impact on the meltdown. I think that we have become a country of financial people. Finance is a support, not an end in itself and we've created an end in itself. People had high expectations of making lots of money. They went out into the market and created a whole infrastructure of nonsense that didn't do anybody any good, except the people who were involved in inventing it. There are way too many people going into law and into finance who have no reason to do it other than for the money. And they don't want to work hard for it.

The Fink Center: In your opinion, what questions should business schools be asking themselves? What should they be teaching more of?

Stewart Resnick: Business schools can teach more about long-term vision. I gave a talk during the dot-com boom about working hard and the whole class had no interest. If you can't tell me how to make $5 million in three years, I have no interest. Three years later they were much more receptive. There's the classic story about Walmart. He spent a huge amount of time on building the appropriate infrastructure – 20 years roughly – before really starting to expand. It's a good lesson. You can't do it overnight!

The Fink Center: One criticism is that schools have become too scientific with a focus on the use of complex models and not focused enough on relevant, real-world issues. What are your thoughts on this?

Stewart Resnick: Formulas and models are all about the assumptions, and the assumptions are all about understanding risk and those are judgments, those aren't RULES. So the rules work for a short period of time because everyone believes in them, but to measure risk, looking backwards doesn't work.

The Fink Center: Some would argue that the takeaway from the crisis would be that we need to build our risk management curriculum and departments within firms to better understand risk. It sounds like you don't think that's the right direction?

Stewart Resnick: I don't think you can really teach risk. Look, the problem is this: the incentive system is such that the more money you lent out, the more leverage you had, the better you did even if you were totally wrong. The incentive is that people are going to do that when they have short-term money and no long-term responsibility and I think that you disengage “making the risk” from “taking the risk”. And that doesn't work because people will always assume that there is no risk if they're making money, and if they're selling to someone who is willing to take the risk!

The Fink Center: This brings us to bad incentives, for example large bonuses based on short-term performance, contributing to the current economic state. Any thoughts on how to remedy this situation?

Stewart Resnick: I think there has to be regulation. I'm an entrepreneur so I'm not terribly pro-regulation. On the one hand, you don't want over-regulation but people will not self-regulate. People are not honest! They think: if it's good for you, it's right.

The Fink Center: Some critics argue that schools give students a limited view of their role in business — that they graduate with a focus on maximizing shareholder value and only a limited understanding of ethical and social considerations essential to business leadership. Can ethics be taught, and if so, how can it be taught effectively?

Stewart Resnick: You ain't going to be ethical. Students are all sitting around in the classroom with these good ideas and then they're going to go out in the industry, and forget it! You can't do it. You're going to work for Coca-Cola and you're going to tell them “You have this high-fructose corn syrup and there is information that shows this is harmful – we should change it.” They're going to say “It's going to cost us $100 million.” Do you think they're going to listen to you? Tell me how you think you can be ethical. We're suing all these companies right now because they're totally dishonest about labeling. So you need regulation.

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The Fink Center:
So not only can ethics not be taught effectively, you’re saying that the system neither allows nor encourage ethical behavior. How about leadership? How can this skill be taught effectively?

Stewart Resnick:
Business schools don’t teach enough about leadership and management. I think you can teach how to manage people and the practical aspects of that much more effectively than you can teach someone how to be an entrepreneur. I guess you can teach the basic skills of how to build a business, but I think most entrepreneurs didn’t go to business school. There just has to be a knack and some good fortune.

The Fink Center:
With corporate corruption and greed, how does a firm, for example yours, manage to stay financially successful and ethical?

Stewart Resnick:
We created the pomegranate juice industry. We spent a fortune on research and have been able to create a large interest in their health effects. Yet, our financial returns are still in the future even though we have been investing in the business for over six years. But we don’t need an immediate return because our other businesses (i.e. almonds, pistachios, Fiji water) are profitable. But no one else would have done this. We took this huge risk. And I don’t have any stockholders so I can make less money.

If I did this as a public company and invested in the pomegranate business as I have and we weren’t making a large return, what would be the pressure? It would be to look to see what the other companies do, and not spend the money on real research. What does everyone else do? Put in 40% pomegranate juice initially, find that they can get away with 30%, then 20%, and realize that they can’t compete with the prices of someone who is putting in 10% or less. Everyone else is doing same thing. Tropicana and Minute Maid then stamp it and label it 100% real pomegranate juice.

So we’re doing it as a public good. But that’s a unique situation. Who else is going to do it?

The Fink Center:
Unfortunately, it sounds like it’s very expensive to be ethical.

Stewart Resnick:
Very expensive, and there’s a big movement against it, and the competition pushes you.

The Fink Center:
Do you think we are at the end of the free-fall in markets?

Stewart Resnick:
I was not surprised when all this happened, and I think we’re nowhere through this. Everybody says we’re coming out of it. We’re not even in it yet as far as I’m concerned.

Interview conducted, condensed, and edited by Pansy Yang

Stewart A. Resnick is chairman and owner of Roll International Corporation, a Los Angeles-based holding company. Resnick has developed and owns a number of successful companies including Paramount Agribusiness, the largest farming operation of tree crops in the world, which includes Paramount Citrus, Paramount Farming and Paramount Farms, growers, processors and marketers of citrus, almonds and pistachios; POM Wonderful, grower of pomegranates and maker of the all-natural POM Wonderful pomegranate juice; Teleflora, the largest floral wire service in the world; FIJI Water, the largest imported bottle water brand in the United States; and Suterra, the largest biorational pest control company in the United States.

Resnick is a member of the Executive Board of the UCLA Medical Sciences; member of the Board of Trustees of Bard College, Annandale-on-Hudson, NY; member of the Board of Trustees of the J. Paul Getty Trust; member of the Board of Conservation International; and trustee of the California Institute of Technology. He is also a member of the Advisory Board of UCLA Anderson School Management.

Resnick holds a Bachelor of Science degree in business administration from the University of California, Los Angeles (UCLA) and Juris Doctorate from UCLA Law School.
That meet the fundamental and technical specifications adopted and developed by the managers. The managers believe that security prices sometimes violate sensible risk/return boundaries. Each portfolio seeks to identify and exploit these opportunities through large-sample quantitative techniques. Fund managers leverage research and analytical capabilities within the Anderson finance faculty, other academic resources, and investment management profession.

The managers, along with the faculty advisor, determine an optimal mix of equity, fixed income and cash investments.

Overall Performance Review
The aggregate fund outperformed the S&P 500 by approximately 18% from 4/30/2008 to 4/30/2009 (see Figure 1). Student managers from both the 2009 and 2008 classes determined that it would be prudent to move two of the ASAM portfolios, TAA and EDS, primarily into cash for the entire year. These decisions were judgment calls based on the fact that the DAA model and AFG View, the precursors to TAA and EDS, respectively, were no longer reliable.

Relative Strategy Performance
The graph in Figure 2 shows the relative performance of all of the different ASAM portfolios. Cash portfolios outperformed equity for the past year. A brief summary of each of the four portfolios (TAA, F-Score, Parametric and EDS) follow.

Tactical Asset Allocation
Overview
Objective: Tactical asset allocation (TAA) attempts to maximize risk-adjusted returns by using economic indicators to forecast asset classes that will outperform in the future.


Indicators: Yield Curve, Credit Spread, US CPI, ISM PMI, oil, S&P P/E Ratios, F/X vs. Broad Index, GDP, VIX

F-Score
Overview
The FSCORE strategy is based on the academic paper: “Value Investing: The Use
of Historical Financial Statement Information to Separate Winners from Losers” (2002) by Joseph Piotroski. In this paper, Piotroski concludes that financially healthy, small, low price-to-book “value” companies with minimal analyst coverage garner abnormally high returns in the US equity market. He evaluates the financial health of a firm using ratios to measure profitability, changes in capital structure and operating efficiency as explained below.

**Profitability**
- Positive: return on assets (ROA), year over year change in ROA, cash flow from operations, and cash flow from operations minus net income

**Changes in capital structure**
- Increase in liquidity ratio
- Decrease in leverage ratio and shares outstanding

**Operating efficiency**
- Increase in gross profit margin and turnover ratio

### Parametric Optimization Strategy

**Overview**

ASAM’s Parametric Optimization Strategy is based on the working paper “Parametric Portfolio Policies: Exploiting Characteristics in the Cross-Section of Equity Returns” by Michael W. Brandt, Pedro Santa-Clara, and Rossen Valkanov. The strategy optimizes the weights of stocks within a portfolio on the basis of each stock’s size, value, and momentum. Each characteristic is associated with a documented market anomaly. The original paper determines a long or short weight for each security in a market portfolio consisting of the top 600 largest market capitalization equities worldwide. This method contrasts with the Markowitz approach, which attempts to optimize a portfolio on the basis of an estimated joint distribution of stock returns.

Major limitations on the ASAM fund require modifications to the strategy. First, the ASAM guidelines disallow individual short positions. Since the strategy achieves its highest level of abnormal returns by taking short positions in individual securities, this is a major constraint. In addition, the supporting research assumes that the strategy buys or sells short all stocks in the market. Finally, transaction costs and the small size of the portfolio make it impractical to hold a portfolio of all securities. We back-tested the strategy using a long portfolio of 40 stocks to address these limitations and constraints on shorting individual positions.

### Earnings Drift Strategy

**Overview**

The Earnings Drift Strategy (EDS) was selected to replace the AFG View strategy. In contrast to the other ASAM strategies, EDS is event-driven. The strategy is based on the premise that companies often release additional information with earnings announcements and that this information can be captured by excess returns around earnings announcements. Firms in the highest quintile of excess returns around earnings announcements subsequently had average returns of 4.61% over the 12 months following the announcement while those in the lowest quintile had average excess returns of -2.94% over 12 months.

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1 “Earnings Announcements are Full of Surprises” by Prof. Pedro Santa Clara, Prof. Michael Brandt, Prof. Runeet Kishore and Prof. Mohan Venkatachalam
On January 9, 2009, members of Anderson Student Asset Management (ASAM) and the Student Investment Fund (SIF) visited Omaha to meet with Warren Buffett. The day started with a tour of Nebraska Furniture Mart, one of the many Berkshire Hathaway companies. The Mart in Omaha has a sprawling facility with over 420,000 square foot of retail space and attracts customers from different states. The tour was led by Bob Batt, a member of the founding family of Nebraska Furniture Mart and included stops at the different retail departments within the store, ranging from consumer electronics to carpets. During the tour, Mr. Batt shared some of the key management principles and customer oriented values that guide the company to this day.

The next stop was the Kiewit Building, where the headquarters of Berkshire Hathaway is located. The meeting was held jointly with Anderson students and about 100 other students from universities such as Dartmouth, USC, and the University of Texas. At the front of the room was a table with Mr. Buffett's favorite Cherry Coke and a Moody's manual. Mr. Buffett entered the room and immediately started to take questions from the students on any topic the students were interested in. Over the next two hours, Mr. Buffett shared his thoughts and words of wisdom on several topics such as the economy, executive compensation, investing, career and life in general. It was a highly rewarding learning experience for the students to see one of the greatest investors in the world address questions on different topics with high levels of energy and humor. A key piece of advice he gave to the students was to identify your circle of competence, stick to it, and not make any decisions.

The final stop for the trip was Piccolo Pete’s, where Mr. Buffett treated the entire group of students to steaks and root beer floats. Following the meal, Mr. Buffett patiently took several group photos and individual pictures with each of the students. Overall, this was a once in a lifetime opportunity for the group to meet with and learn from Mr. Buffett, the Sage of Omaha.
The Obama administration’s plan to replace a majority of the General Motors board casts a light on boards of other companies that have accepted bailout money, and there is at least one similarity at GM (GM), American International Group (AIG), Citigroup (C) and others that have so veered into financial straits.

Troubled Asset Relief Program, or TARP, recipient companies were much more likely than the average company to have had independent directors on the board with social or professional ties to the CEO.

Independent directors aren’t employed at the company, and shareholders rely on them to speak up if they see it heading for disaster. New research finds that many of those independent directors have connections to the CEO, including memberships at the same country clubs, attendance at a college at the same time, or volunteerism with the same charitable or non-profit organizations.

For example, among all large, publicly traded banks, 14% of independent directors have social and professional connections with the CEO, similar to the 15% at all companies. But at banks that later accepted bailout money, 39% of independent directors had such ties.

The study by finance professor Geoffrey Tate and doctoral candidate Cesare Fracassi was done at UCLA Anderson School of Management. It examined 20,000 board members of 2,080 firms year by year from 1999 to 2007 to identify connections. It found that when connections increased, so did earnings restatements and the likelihood of mergers that hurt a company’s performance.

At USA TODAY’s request, Tate re-examined his data to focus on the smaller universe of 24 publicly traded companies that later accepted TARP money.

Tate says 30% of the independent directors at GM had ties to now-former CEO Rick Wagoner, who was forced out on Monday. GM is the only publicly traded auto company to have accepted government bailout funds. Throughout the auto industry, just 2% of independent directors have social and professional connections with the CEO, Tate says.

In 2006, independent directors included John Bryan, who was chairman of Catalyst, where Wagoner was also a director, as was GM independent director Karen Katen. Independent director Eckhard Pfeiffer and Wagoner were both council members of the Business Council.

“Membership in groups like the Business Council, an association of chief executive officers of major companies, and Catalyst, a group that works to promote the interests of women in business, is vital for keeping our board members informed and engaged with the broader issues of our time,” GM’s Julie Gibson says. If more than one GM board member “is involved with such worthwhile organizations, we don’t consider it a problem to be addressed, but rather a very positive practice."

Bryan, the former CEO of Sara Lee who is on the GM board, says something as minor as a Catalyst directorship with Wagoner would not create a lack of independence in fulfilling his board duties at GM.

“I suppose (relationships) create a lack of independence, but it’s understood that board members have a high responsibility to the shareholder, and I have not seen any evidence of people making judgments otherwise,” Bryan says.

No company has sparked more public ire of late than AIG, and Tate said he was surprised to find that there were zero ties in 2006 between the company’s independent directors and Martin Sullivan, who was AIG’s CEO from 2005 to 2008. The insurance industry as a whole had 20% of independent directors with such ties.

But the board that served when Sullivan was CEO had been formed in 2004 when Hank Greenberg was CEO. With Greenberg in charge, two-thirds of independent directors had ties to him. AIG spokeswoman Christina Pretto declined to comment.

When former Citigroup CEO Sandy Weill was building a financial supermarket through acquisitions more than five years ago, he had ties to eight independent directors. “Citigroup’s extensive list of connections is far above the norm,” Tate says.

Citi spokeswoman Shannon Bell says six of the independent directors at the time are gone. Citi Chairman Richard Parsons has said the board will be reconstituted. Of the 15 current board members, three won’t stand for election at the April annual meeting, and two others will retire.
This year’s Fink Center Research Grant recipients are: Avanidhar Subrahmanyam, Geoffrey Tate and Bruce Carlin.

Research projects funded by the Fink Center for Finance & Investments must be related to its mission; that is, they must advance both the theory and application of finance. The selected award winners have demonstrated how their research and subsequent research will meet this standard. A summary of each recipients’ proposed research follows.

**Avanidhar Subrahmanyam**

A number of characteristics such as the book/market ratio, accounting accruals, and past return performance, have been shown to explain return performance differentials across stocks. A significant section of practitioners and academics believe that this predictability emanates from pricing inefficiencies. We are testing to see if the level of predictability has diminished in recent years due to the dramatic decreases in costs of trading on financial markets. In particular, institutional trading commissions and bid-ask spreads have declined sharply over the past decade, and technology such as algorithmic trading and online brokerage has allowed trades to be conducted more cheaply.

We test the premises that pricing inefficiencies should have weakened on average, and should have weakened the most in stocks with the biggest decline in trading costs. An ancillary hypothesis relates to the notion that certain financial institutions that have recently proliferated, such as hedge funds, are active short-sellers of stocks, unlike traditional institutions like mutual funds. Thus, we propose that with an increase in hedge fund activity, abnormal returns to strategies that call for shorting should have declined in recent years. We expect the results will have implications for finance education because they will shift our priors on whether it is actually possible to earn supernormal profits on anomalies documented by academics in the current low trading cost regime. Further, we expect that if the anomalies are found to be persistent, the field of behavioral finance may take on stronger impetus.

**Geoff Tate**

External links between independent directors and CEOs – through employment or education networks as well professional, charitable, and leisure organizations – appear to undermine the quality of board monitoring. We find that firms with many such links do more and worse acquisitions and generally perform poorly compared to firms with few or no such links. We will build on this evidence by measuring explicitly the relation between individual director incentives to monitor management and major corporate policy decisions. In particular, CEOs in the U.S. have enjoyed a surge in compensation over the past two decades, but the efficiency of those pay increases remains a subject of debate. Moreover, U.S. firms make frequent acquisitions (>12,000 worth $3.4 trillion between 1980 and 2001) despite a preponderance of evidence suggesting that they may not benefit acquiring shareholders.

We will study the link between these corporate decisions and the future career paths and compensation of individual directors. We will identify policy changes which increase the likelihood that a director will add additional board seats in the future, focusing on CEO compensation decisions and acquisition choices. We will also measure the value implications of these additional board seats to the individual director and compare them to internal incentives to maximize firm value. Finally, we will ask whether alternative governance mechanisms – like strong shareholder rights or the presence of large institutional shareholders – can counteract weak (or absent) director incentives to monitor management.

**Bruce Carlin**

According to the NASD Literacy Survey of 2003, households who participate in financial markets routinely do not clearly understand what they are purchasing or the price they are paying. Moreover, people often employ systematic biases when they make financial decisions, which degrade personal welfare and may impact the market as a whole. To study how such biases evolve, we will systematically study how newcomers to financial markets learn and behave by examining how young adults in Junior Achievement learn and interact in the Finance Park in Los Angeles, CA. The Junior Achievement Finance Park is an interactive venue in which students between the ages of 13-18 years old receive didactic training as well as participate in a simulated business environment. The students are from a broad cross-section of LAUSD middle and high schools, all of which participate as part of their class requirements.

We will attempt to address questions such as whether newcomers to financial markets exhibit the same behavioral biases as previously documented, or if such biases are the result of more experience, the consumption-investment decisions for newcomers to the market, how girls and boys differ when they are making financial decisions for newcomers to financial decisions, such as whether newcomers first participate and save money, if they invest in the stock market save in the bank.
Finance Area Faculty

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Michael Brennan, Professor Emeritus
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