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The disparity in salary between the average employee and executive has only widened in the last decade, and the hefty CEO payouts that have accompanied major financial firms while collapsing have once again launched the topic of executive compensation into the limelight. As public outcry reaches a crescendo, regulators have scrambled to come up with measures to rein in practices such as exorbitant pay packages and guaranteed bonuses regardless of how an employee performs. Partial solutions include salary caps, shareholder voting rights on executive pay, as well as additional government legislation. They all seek to address the same question that we examine in this issue of the bulletin: How should the optimal compensation package be structured so that managers act in the best interest of the firm and not engage in excessive risk-taking behavior?

Richard Roll, Japan Alumni Chair in Finance at UCLA Anderson, contributes the academic perspective with his research on the relationship between option and equity-based compensation and long-term IPO operating performance. Based on a theoretical framework and rigorous empirical tests, his paper finds that performance is better when managers receive a balanced form of compensation, a mixture of equity ownership and stock option grants.

Insight into industry practices is provided by George Paulin, Chairman and CEO of Frederic W. Cook & Co. George is an expert consultant specializing in executive and employee compensation. With more than 25 years of experience, he has witnessed the continuing evolution and trends in executive compensation over many market cycles. In this issue, we include a reprint of an interview with George that appeared in the Financial Times in June 2009, and augment it with a few questions of our own.

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

In This Issue

Academic Perspective
How Employee Stock Options and Executive Equity Ownership Affect Long-term IPO Operating Performance
Richard Roll

Industry Perspective
Changes and Trends in Executive Compensation
Interview with George Paulin

Faculty Highlights
Richard Roll receives IAFE Financial Engineer of the Year Award
Mark Grinblatt is Keynote at Two Major Finance Conferences
Hanno Lustig wins Terker Family Prize in Investment Research

Announcements

Events
How Employee Stock Options and Executive Equity Ownership Affect Long-term IPO Operating Performance*

Richard Roll  | Japan Alumni Chair in Finance, UCLA Anderson

In the United States, equity-based compensation represents a substantial and increasing fraction of the total remuneration received by top corporate executives (Conyon and Murphy, 1999). Equity-based compensation comes in a variety of forms, but the two most common are undoubtedly awards of shares and grants of options on the firm’s stock; both of which are commonly subject to various restrictions on reselling, vesting, etc.

Agency theory suggests that firms endow employees with equity to create incentives and align the interests of managers and owners.1 Stock-based compensation plans can also assist a firm in bringing talented new staff on board (Oyer, 2004; Oyer and Schaefer, 2004) or in retaining that staff (Carter and Lynch, 2001; Callaghan et al., 2003; Subramanian et al., 2007). Stock options might be a particularly effective form of compensation when cash availability is limited in cashpoor start-up firms (Inderst and Müller, 2005). This might be especially important for high technology firms that have intangible assets but little cash (Yermack, 1995; Dechow et al., 1995; Core and Guay, 2001).

In recent years, however, stock option plans have drawn the attention of many critics who claim that they have become too costly, that their costs are not properly reported under current GAAP rules, and that they provide employees with an incentive to abuse the system.2 But despite recent publicity about supposed backdating and corporate scandals involving such high-profile firms as WorldCom, Enron, and Adelphia Communications, the use of employee stock options is still widespread, particularly by high-technology firms.

The scholarly literature about compensation arrangements and their specific features has also blossomed in recent years.3 But although the very prevalence of equity-based compensation argues for its efficacy, there has not been much hard empirical evidence about costs nor about incentives, risk taking, and other managerial behavior presumably influenced by the form of compensation.

Our purpose is to augment the evidence by studying equity and option usage by new public companies. After an IPO, insider holdings are diluted and the secondary market makes it easier for insiders to sell their ownership shares; yet the use of equity-based compensation such as stock options increases significantly (Frye, 2002). For several reasons, IPOs represent a particularly fertile laboratory for studying managerial compensation; top managers often hold substantial equity positions and the success of start-up firms is undoubtedly more sensitive to good managerial practices. Consequently, if the form of managerial compensation really does play a role in fostering success, it seems likely to be more easily and quickly discernable among IPOs.

Does the long-term performance of IPOs depend on the form of managerial compensation? We study the form of equity compensation and operating performance for 5 years after an IPO using a comprehensive sample of 897 firm-commitment IPOs filed between January 1997 and December 1999. We find that a particular compensation form is associated with superior performance for at least 3 years.4

The pattern in Figure 1 typifies most of the operating performance measures for at least the first 3 years after IPOs (as might be expected, the pattern becomes attenuated in later years as the firm matures). The figure shows a sharply non-linear relation between compensation arrangements and performance. When equity compensation is high, performance improves with option compensation. When equity compensation is low, performance falls with option compensation. For medium levels of equity compensation, the relation is humped so that medium levels

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1 See also Jensen and Meckling (1976), Haugen and Senbet (1981), Smith and Stulz (1985), Lambert (1986), Copeland and Weston (1988), Lambert et al. (1991), Hirshleifer and Suh (1992), and Hemmer et al. (1999). Other researchers such as Demsetz and Lehn (1985), Himmelberg et al. (1999), Core and Guay (1999), Rajgopal and Shevlin (2002), and Hanlon et al. (2003) base their analyses on the premise that option granting is consistent with firm value maximization.

2 Murphy (2002, 2003) proposes that compensation policies are based on the “perceived cost” of options rather than their true economic cost. Until the recent FAS123 ruling by the Financial Accounting Standards Board (FASB), option grants involved no accounting charges. Also, they resulted in no direct cash outlay. Consequently, many firms may have perceived that option compensation was a low cost alternative to cash compensation.


of option compensation are associated with the best performance. Over the nine categories of compensation arrangements, the highest performance is for medium levels of both options and equity though high levels of options and equity are almost as effective. Not surprisingly, there is a general tendency for improved performance with higher levels of compensation in general, presumably because managers with larger stakes in the firm have interests that are more aligned with shareholder interests. However, the worst performance occurs when options and equity ownership are unbalanced; i.e., for combinations of high options and low equity and vice versa.

Thus, performance is better when there is a balanced compensation scheme, a mix of equity and options as opposed to unbalanced scheme i.e. high equity ownership and few option grants or many option grants and low equity ownership. This result is consistent with our theory that the two forms of compensation must be balanced if managerial decisions are to be compatible with stockholders' perceptions of optimal decisions.

Equity ownership and stock options have different risk properties. Returns on options are more volatile than returns on the underlying equity; thus, holding an undiversified position in options is more risky than holding an equal dollar amount of the equity. On the other hand, adopting more risky investment projects increases the value of option grants, though it will not increase the value of equity grants and could even decrease their value. This suggests that investors should favor a combination of options and equity grants to different levels of employees. All employees are motivated to exert extra effort by options, but top decision makers must be restrained from taking on too many risky projects; such a restraint is effectuated when top executives hold significant equity positions.

For a given level of managerial compensation in the form of stock ownership, there is an ideal option grant that induces a top manager to choose the firm's overall level of non-diversifiable risk commensurate with the desires of shareholders. This translates cross-sectionally into improved long-term performance for firms that have selected balanced compensation arrangements for senior executives.

We also find that not all balanced arrangements produce the same operating results. Not surprisingly, managers who receive few options and little equity do not produce good performance. Less surprisingly, managers who receive many options and a lot of stock, though they do better than poorly compensated managers, do less well than managers who receive both forms of compensation in the middle range. This is a result certainly worthy of further study.

Professor Richard Roll holds the Japan Alumni Chair in Finance at UCLA Anderson. He is also a principal of the consulting firm, Compensation Valuation, Inc. Other business experience includes the Boeing Company where, in the early 1960’s, he worked on the 727 and wrote the operating manual for the first stage booster of the Saturn moon rocket. During 1985-87, he was a vice-president of Goldman, Sachs & Co., where he founded and directed the mortgage securities research group. He has been a consultant for many corporations, law firms, and government agencies, and has served on several boards.


He has published two books and more than seventy articles in technical journals. His 1968 doctoral thesis won the Irving Fisher Prize as the best American dissertation in economics. He has won the Graham and Dodd Award for financial writing three times and the Leo Melamed Award for the best financial research by an American business school professor. Roll is the past president of the American Finance Association and is a fellow of the Econometric Society. He has been an associate editor of eleven different journals in finance and economics.

Roll received his Ph.D. in economics, finance, and statistics from the University of Chicago, an MBA in business from the University of Washington, and a B.A.E. in aeronautical engineering from Auburn University.
Changes and Trends in Executive Compensation

Interview with George Paulin  |  Chairman and CEO of Frederic W. Cook & Co., Inc.

The following interview with George Paulin, CEO of one of the leading executive compensation consultancy firms, Frederic W. Cook and Co., consists of two parts. The first is a reprint of an interview with the Financial Times (FT) performed by Josh Martin in June 2009; the second part is an exclusive interview with the Fink Center that includes some follow-up questions.

FT: Are caps on executive compensation here to stay?

GP: No, they are temporary. How much a company pays for the services of executives is an economic transaction.

Applied over time, caps on executive compensation would distort the market, causing talent to move between industries, countries, and types of organisations (privately versus publicly-owned) based on where their services were most valued by market forces.

FT: In this environment, how have corporations designed compensation packages that attract, retain, and motivate the most talented executives?

GP: I find that companies with the greatest success in this environment have “balanced” executive compensation programmes, where they have found the right trade-offs between cash versus equity, reward versus risk, short-term versus long-term performance focus, and external competitiveness versus internal equitability.

There is no one-size-fits-all formula. Every company is unique, based on its business and human-resources objectives, cost structure, culture, history, and decision-maker bias.

FT: What changes are emerging in compensation structure?

GP: Long-term incentives include variable pay arrangements where determination of the earned amounts and/or the vesting is for a period in excess of a year.

For executives of publicly traded US companies, long-term incentives are the largest single element of total compensation – commonly half or more of annualised total compensation value for large-company CEOs, although that amount has been fluctuating downwards.

At the start of this decade, about 90 per cent of long-term incentive value for US executives was in the form of stock options. Now, it is less than 50 per cent. The difference has shifted to additional time-vested restricted stock and multi-year performance stock and cash arrangements.

The result is better balance in the long-term incentive component of total pay, with less tied directly to increases in stock price, and more to strategic business goals and executive retention.

Other structural changes are the trend toward downsizing non-business-related perquisites and supplemental executive pension plans to focus on performance-based pay, and of severance benefits to avoid high pay for failure.

FT: To what extent does this come from an HR division rather than a board compensation committee?

GP: Government actions have a direct impact on how it is handled. Sarbanes-Oxley [the US corporate-governance reform legislation enacted in 2002] aimed in part at creating more independent board compensation committees.

In 2006, rules were introduced [the so-called Securities and Exchange Commission’s disclosure regulations] to expand the disclosure of both the size of executive compensation and the process by which they are determined, to increase transparency.

The result is that board compensation committees are better positioned to drive positive change. In more and more cases they are doing this effectively, although bad practices have not disappeared and the debate over how-much-is-too-much continues.

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**FT:** What can US corporations learn from British and European experiences (and vice versa)?

**GP:** Our firm works primarily with companies based in the US and Canada, so we have limited direct experience of practices elsewhere. But the answer is probably in how to use equity incentives and ownership most effectively.

In the US, equity — and options in particular — was often used too aggressively in terms of award values and resulting shareholder dilution. Meanwhile, the opposite occurred in Britain and Europe, where equity award values generally have not been for significant amounts, and non-performance-based pensions and perks continue to predominate.

**Fink Center:** How do firms compensate for maximizing the long-run value of the firm over short-term gains?

**GP:** In the design of executive compensation programs, we try to balance the performance focus in terms of the goals and the time periods. Most companies have short-term bonus or incentive plans and long-term incentives, anything beyond one year, and firms try to balance the two generally through restricted stock, performance stock (3-4 years) and stock options (10 year term exercisability, vested over 3-4 years). The long-term compensation is by far, the largest factor in total compensation for executives. If you look at the typical mix, 60% is in the form of long-term.

In addition, there are meaningful ownership guidelines that provide an additional long-term perspective. Executives are required to hold shares and accumulate more by holding them over period of time.

A decade ago, competitive practice has been for the majority of long-term grants to be in options, now that’s declined to about 45%.

**Fink Center:** What are the reasons for this decline?

**GP:** Part of it was due to accounting changes. Part of it was that options were perceived not to be aligned with the interests of long-term investors, which is different with long-term value creation, because of all the speculative volatility in the stock market.

As a result, there has been significant movement into full-value shares (restricted and performance stock). In terms of restricted shares, shares the firm gives you if you work for a certain period of time, versus performance shares which if the firm performs well you get more, the firm performs poorly, you get less, the preference is for performance shares.

**Fink Center:** Any differences across industries?

**GP:** Pretty much the same.

**Fink Center:** How should compensation packages be structured so that managers will choose the right risk profile for the company (i.e. so that managers will behave the way you’d like them to, in the best interest of the firm)?

**GP:** What’s best for the firm is the economic return to long-term investors. How you achieve that takes a number of factors into account. Have you been able to attract, retain, and motivate the best people to run business? What is your strategy for running the business?
Should these be a primary design consideration? This has become more complicated over the years, elevating the importance of executive compensation in a broader societal way because of what happened to the financial institutions.

The SEC has put in new disclosure requirements at the end of last year which apply to this year, that essentially say that boards have to determine whether or not there is material risk and if so, they have to disclose it. Material risk is defined as something there in the way we are paying people that would encourage behavior that is risky to company. Now we are in the process of risk assessments with big companies to determine if there is material risk related to compensation programs that have never been done.

Fink Center: Given the current economic and regulatory environment, do you expect clawbacks to increase? If so, what form might they take on?

GP: Five years ago the only clawback was if you left to go work for a competitor, and after you left you still had compensation coming to you, you would lose it. But now the majority of big companies have formal clawbacks; if there is management fraud/misconduct, the board has the discretion to take away compensation. Provisions have become almost universal in the last 3-4 years, and continues to evolve. This practice started with larger companies and is moving to smaller firms, mid-caps. The expectation is that there will be legislative clawback requirements.

George Paulin is Chairman and CEO of Frederic W. Cook & Co., Inc. He has been a consultant specializing in the areas of executive and employee compensation for more than 25 years, and is nationally known as an advisor to board compensation committees and management.

Paulin joined Frederic W. Cook & Company in 1982. He was named president of the firm in 1994, and assumed his current responsibilities in 2001. He opened the firm’s Chicago office in 1983, and in 1987 he opened the office in Los Angeles where he currently resides. During the past two years, the Cook firm has served more than 50% of the current Fortune 200 companies, and over 1,800 major U.S. companies since the firm was founded as an independent organization owned by its principal consultants in 1973.

Paulin has ongoing advisory relationships with a diverse list of companies. Examples of those where he is retained as the independent board compensation committee advisor include Apple Computer, Baxter, Cisco Systems, Gap, Hewlett-Packard, 3M, Northrop Grumman, Pfizer, Pritzker Trust, Procter&Gamble, Qualcomm, Starbucks, Wells Fargo and Yahoo.

Paulin has a master’s degree from the Institute of Labor and Industrial Relations at the University of Illinois, where he has been active in alumni affairs and received their Distinguished Alumni Award in 1990.
Professor Richard Roll, Japan Alumni Chair in International Finance, has been selected as the recipient of the 2009 IAFE/SunGard Financial Engineer of the Year (FEOY). Renowned for his extensive academic and professional achievements, Roll was presented with the 2009 FEOY Award on February 4, 2010 at the New York Stock Exchange. The IAFE/SunGard FEOY Award recognizes individual contributions to the advancement of financial engineering technology.

In 1968, Roll's doctoral thesis won the Irving Fisher Prize as the best American dissertation in economics. In addition to serving as a Professor and the Japan Alumni Chair in Finance at UCLA Anderson, he has served on the faculty at Carnegie-Mellon University, The European Institute for Advanced Study of Management in Brussels, and the French business school, Hautes Études Commerciales, near Paris. Roll has published more than ninety articles in technical journals; he has won the Graham and Dodd Award for financial writing three times and the Leo Melamed Award for the best financial research by an American business school professor.

Nominations for the annual IAFE/SunGard FEOY Award are submitted by a nominating committee of approximately 100 people, consisting of all the IAFE governing boards. They are then reviewed in a two step process by a selection committee of 25 members, including the IAFE board of directors and senior fellows.

“"It is extremely gratifying to receive this award, which has been given before without exception to financial scholars that I greatly admire,” said Roll. “I am truly honored to be included in their company.”"
Stuart Rosenthal, Karlheinz Muhr (MBA ’85), Richard Roll, Marty Murrer (MBA ’81) at the NYSE podium

Kent Daniel (MBA ’87, Ph.D. ’92) and Professor Bhagwan Chowdhry, MFE Director
Hanno Lustig wins Terker Family Prize in Investment Research

Professor Hanno Lustig, Nick Roussanov and Adrien Verdelhan were awarded first prize in the 2009 Terker Family Prizes in Investment Research from the Rodney L. White Center for Financial Research at the Wharton School, for their working paper “Common Risk Factors in Currency Markets”.

The present version of the paper can be found at http://ssrn.com/abstract=1139447.

Mark Grinblatt is Keynote at Two Major Finance Conferences

Professor Mark Grinblatt, J. Clayburn LaForce Professor of Finance, is the invited keynote speaker at the European Winter Finance Summit 2010, to be held from March 21-24, 2010 at Saalbach Hinterglemm, Salzburg, Austria. The European Finance Winter Summit is a joint initiative of financial economists from Copenhagen Business School (CBS), Norwegian School of Economics and Business Administration (NHH), and Vienna University of Economics and Business. There is attendance by a substantial number of noted academics from around the world.

Grinblatt is also the invited keynote at the Western Finance Association (WFA) 2010 meeting to be held from June 20 - 23, 2010 at the Fairmont Empress in Victoria, British Columbia. This is a major meeting of financial economists, which has over 1000 paper submissions.

Grinblatt has been on the faculty at UCLA Anderson since 1981. His current research interests include asset pricing, rational expectations equilibria, performance evaluation, stock market anomalies, corporate finance, derivatives valuation, and investor behavior.
Welcome to five new doctoral students entering the finance Ph.D. program this year.

**Yaron Levi** graduated with a B.A. in Economics (2008) from Haifa University. He is from Tel Aviv, Israel.

**Aurelien Philippot** received his M.Sc. in Management (2007), majoring in finance from the HEC School of Management in Paris. His research interests include corporate finance, behavioral finance, market anomalies and firm valuation. His publications include “Corporate raiders et transformation d'entreprises familiales en multinationales”, Club Finance-Les Etudes du Club, December 2007. He is originally from Auxerre, France.

**Florian Schulz** earned a M.Sc. Finance (2008) from the London Business School, MBA (2006) from the University of Iowa and Diploma program (B.Sc. Equiv.) in Economics (2005) from Goethe University Frankfurt. His research interests include corporate finance, incentives, financial contracting, credit risk, and market regulation. He is a native of Berlin, Germany.

**Brian Waters** graduated with a B.S. in Economics (2007) and Human and Organizational Development from Vanderbilt University. He served as a Staff Economist in the White House Council of Economic Advisers from 2007-2009. He grew up in Coral Springs, Florida.

**Xiaolan Zhang** received her M.A. in Economics (2009) from Peking University and B.A. in Financial Engineering (2006) from Renmin University of China. Her research interests include corporate finance and financial intermediation. She is originally from Ningde, China.

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**Ways To Support the Fink Center**

- Serve as a guest speaker at a Fink Center conference or event.
- Sponsor a student scholarship.
- Volunteer to speak to a student organization (e.g., Investment Finance Club, Anderson Student Asset Management, Student Investment Fund).
- Hire an Anderson MBA or MFE as an intern.
- Serve as a guest lecturer for a finance class at Anderson.
- Contribute financially to the Fink Center and the Anderson finance program.
Upcoming Events

Future of Financial Regulation: Balancing Risk and Reward

Date: Wednesday, April 14
Time: Noon to 1:30
Location: UCLA Anderson Korn Hall, Reception to follow panel discussion

A discussion on how to balance financial risk and reward in an atmosphere of a near market meltdown that has caused an erosion of trust in financial institutions and the federal government. Representatives from industry, academia, and government will have a dialogue on the future of new regulations for Wall Street and whether or not this type of financial crisis could happen again.

Panelists:
Lynn A. Stout, Paul Hastings Professor of Corporate and Securities Law
Greg Berman SEC Senior Policy Advisor to the Director,
Division of Risk, Strategy and Financial Innovation
Judy Posnikoff, Founding Member and Managing Director,
Pacific Alternative Asset Management Company, PAAMCO

Moderator:
Professor Emeritus Michael Brennan, UCLA Anderson

Finance Seminar Series

Join the UCLA Anderson finance faculty, rated #1 in intellectual capital, for a weekly seminar given by renowned academics visiting from leading universities all over the world. Seminars are open to the public and held at UCLA Anderson Cornell Hall D301, from 11:00 a.m. – 12:15 p.m.

<table>
<thead>
<tr>
<th>Date</th>
<th>Speaker</th>
<th>Areas of Expertise</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 5</td>
<td>Martin Oehmke (Columbia)</td>
<td>Financial economics, asset pricing, financial intermediation</td>
</tr>
<tr>
<td>March 12</td>
<td>Markus Brunnermeier (Princeton)</td>
<td>Macroeconomics, institutional frictions, behavioral trading</td>
</tr>
<tr>
<td>April 2</td>
<td>Harrison Hong (Princeton)</td>
<td>Behavioral finance, stock market efficiency, asset pricing and trading</td>
</tr>
<tr>
<td>April 9</td>
<td>Monika Piazzesi (Stanford)</td>
<td>Macroeconomics, asset pricing, housing market trading</td>
</tr>
<tr>
<td>April 16</td>
<td>Joost Driessen (Tilburg)</td>
<td>Liquidity risk, the empirical analysis of derivatives, corporate bonds and credit risk, optimal portfolio choice, and private equity</td>
</tr>
<tr>
<td>April 19</td>
<td>Ivo Welch (Brown)</td>
<td>Financial markets, executive compensation, capital structure</td>
</tr>
<tr>
<td>April 23</td>
<td>Vish Vishawathan (Duke)</td>
<td>Corporate finance and asset pricing, especially to issues related to collateral and market liquidity</td>
</tr>
<tr>
<td>May 7</td>
<td>Jonathan Berk (Stanford)</td>
<td>Delegated money management, asset pricing</td>
</tr>
<tr>
<td>May 14</td>
<td>Russ Wermers</td>
<td>Securities markets, mutual funds, pension funds, hedge funds.</td>
</tr>
<tr>
<td>May 28</td>
<td>Dean Karlan (Yale)</td>
<td>Microfinance programs focused on poverty</td>
</tr>
</tbody>
</table>
Finance Area Faculty

Antonio Bernardo, Professor
Michael Brennan, Professor Emeritus
Bruce Carlin, Assistant Professor
Bhagwan Chowdhry, Professor
William Cockrum, Adjunct Professor
Stuart Gabriel, Arden Realty Chair
Mark Garmaise, Associate Professor
Robert Geske, Associate Professor
Mark Grinblatt, J. Clayburn LaForce Chair in Management
Francis Longstaff, Allstate Professor of Insurance and Finance
Hanno Lustig, Assistant Professor
Marc Martos-Vila, Assistant Professor
Richard Roll, Japan Alumni Chair in Finance
Pedro Santa-Clara, Professor
Jan Schneider, Assistant Professor
Eduardo Schwartz, California Chair in Real Estate and Land Economics, Finance Area Chair
Avanidhar Subrahmanyam, Goldyne and Irwin Hearsh Chair in Money and Banking
Geoffrey Tate, Assistant Professor
Walter Torous, Lee and Seymour Graff Professor
Liu Yang, Assistant Professor

The opinions are solely those of our contributors and not necessarily those of anyone else associated with the Fink Center, including the staff, directors, board, and supporters. We welcome letters to the editor (fink.center@anderson.ucla.edu) to be published in the next Bulletin.
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