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Microfinance

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

Microfinance is the practice of lending small amounts to those who have traditionally lacked access to banking and other forms of credit. Microloans can help start or expand businesses in the most impoverished places that banks shun, such as in the rural parts of India, China, Africa, as well as within the US.

Microfinance has been internationally recognized over the last decade. Muhammad Yunus received the 2006 Nobel Peace Prize for his efforts to create economic and social development. The John Bates Clark Medal, which has been awarded biennially from 1947 on to the best American economist under 40, was given this year to Esther Duflo for her work in microfinance. It has even made its way to Congress, sparking debate on whether some institutions are overcharging the poor. And yet despite the giant advances made over the last 30 years, there still remains a lot to be uncovered.

Mark Garmaise, Associate Professor in Finance at UCLA Anderson, provides the academic perspective this issue. His paper postulates that lending terms in the microfinance industry are often influenced by non-market political considerations, and that microfinance institutions (MFIs) that reside in host nations who improve their relationships with the nations of their lenders benefit from reduced borrowing costs.

Elisabeth Rhyne, Managing Director of the Center for Finance Inclusion at ACCION, discusses the evolution of microfinance from merely lending to a financial inclusion vision that encompasses savings, insurance, payments, as well as addresses the quality of services, such as convenience and affordability, to name a couple. She explores the challenges that arise from the expansion of microfinance and the important questions that are raised.
In this paper, we investigate the effects of providing credit to financial institutions at below-market interest rates on the operational efficiency and lending activities of microfinance institutions (MFIs) around the world. We employ an instrumental variable approach based on the international relations between the host country of an MFI and the nations of its lenders. We show that improvements in these relations lead to the supply of politically-motivated subsidized financing that is plausibly unrelated to the characteristics of an individual MFI. In this sense, shifting political relationships may be viewed as an exogenous source of variation in the provision of cheap credit.

We use these political shocks to the supply of subsidized financing to study three questions. First, does cheap credit affect the efficiency of an MFI’s operations? Second, do MFIs that receive below-market financing expand their lending? Third, does low cost financing have a special impact on young, entrepreneurial MFIs, potentially altering their medium-term growth path?

We first demonstrate that an increased similarity in the voting patterns of two countries in the U.N. General Assembly is strongly associated with reduced interest rates for loans between lenders and MFIs in those countries in the following year. Specifically, we make use of a well-known bilateral measure from the political science literature that captures the ‘macro’ affinity between countries in regressions explaining ‘micro’ interest rates at the loan and MFI level.

We find that the interest rate a lender charges an MFI falls when the lender’s nation and the MFI’s host country become politically closer. Similarly, when their host nations move apart politically, a lender charges MFIs higher interest rates. A graphical illustration of this result, that the cost of financing can be influenced by international political relationships, can be found in Graph 1. This graph shows the broadly negative correlation between the international affinity of Venezuela and Peru, as measured using UN General Assembly voting, and the interest rate premium (in U.S. dollar equivalent over maturity matched U.S. treasuries) that a Venezuelan lender charges a Peruvian MFI over time.

We then aggregate across all of an MFI’s current borrowing relationships and consider the weighted change in its political affinity across its full set of lenders. We find that MFIs with improved political affinities pay a lower average cost of funding. A one standard deviation increase in its average political affinity leads to a 91 basis point decrease in the average weighted cost of financing for an MFI.

We study the implications of low interest rates for the operations of an MFI and find that MFIs operate less efficiently immediately after they obtain cheap credit: these MFIs have both reduced loans per credit officer and higher administrative expenses. We also find

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1 Signorino and Ritter (1999), Tau-b or Not Tau-b: Measuring the Similarity of Foreign Policy Positions. International Studies Quarterly 43: 115-144.


Graph 1
that the net profitability of MFIs (i.e., net income over equity) decreases immediately after receiving cheap credit. This evidence suggests that the immediate impact of below-market financing is to allow financial institutions to operate with greater slack, as agency theory predicts. Subsidized financing in this sense frees an MFI from the discipline of being forced to seek credit on terms determined by the market, at least in the short term.

When measuring the influence of subsidized funding three years into the future, we find that loans per credit officer, administrative expenses, and net profitability are insignificantly affected by cheap credit. This suggests that there is a gradual return to efficiency over time.

We also consider the impact of cheap credit on the investment activities of an MFI. For MFIs investment takes the form of lending, so we are able to analyze whether subsidized funding to a financial institution leads to more loan-making. In other words, we can test the effectiveness and timing of the bank lending mechanism of the credit channel of monetary policy.

We find that the provision of subsidized financing does not lead to a significant increase in lending by the affected MFIs in the same year. MFIs that receive cheap credit, do, however, expand their lending two to three years after a positive political shock, indicating that there is a significant time lag in the effect of the bank lending credit channel. This suggests that the bank lending mechanism, in general, may not offer a quick option for regulators seeking to inject liquidity into the broad economy, though bank lending does expand.

We further find no significant effect of below-market financing on the portfolio quality of MFIs; subsidized MFIs do not lend recklessly. The results suggest that cheap credit leads to an immediate decrease in the internal efficiency of financial institutions and a gradual increase in loan supply achieved without a deterioration in lending quality. The lagged response of investment to the provision of subsidized financing suggests that MFIs require time to build the organizational capital necessary to extend their lending operations. The short-term reduction in internal efficiency that can be interpreted as the adjustment cost necessary for enabling a credit expansion.

Having found clear evidence that subsidized financing has substantial real effects, we investigate whether young and old MFIs differ in their reaction to low interest rates. We do find that both the efficiency and lending effects of cheap financing are very pronounced for young MFIs, while old MFIs do not show any significant change. More broadly, we show that financial subsidies have a medium-term impact on entrepreneurial MFIs, changing both their financial strength and internal organization. Subsidized young MFIs are able to increase both the maturity of the loans they obtain and the share of their financing that is provided in local currency. Young MFIs receiving cheap credit also gradually experience lower employee turnover and switch to more incentive-based pay for their credit officers.

Our results have broad implications for the economics of financial institutions. They suggest that subsidized credit to financial institutions is a somewhat slow and costly mechanism for increasing loan making. The availability of subsidized financing can lead to changes within firms in their efficiency, target clienteles, employee relations and compensation schemes. The transformation of these firms may have a longer-term impact that extends far beyond the credit expansion.

*Condensed version from working paper with Gabriel Natividad

Mark Garmaise's primary research interests are in the areas of corporate finance, real estate, entrepreneurship and banking. With his co-author Tobias Moskowitz, he received the 2004 BGI Brennan Award for the best paper published in the Review of Financial Studies and the 2005 BGI Brennan Runner-up Award for the best paper published in the Review of Financial Studies.

Dr. Garmaise teaches the core corporate finance course and an elective on venture capital and private equity. He was awarded the 2005 Dean George W. Robbins Assistant Professor Teaching Award, the 2006 Eric and "E" Juline Excellence in Research Award, the 2007 Citibank Teaching Award for most outstanding MBA teacher and the 2009 Fully Employed MBA Teaching Excellence Award. He has published in the Review of Financial Studies, the Journal of Finance and the Quarterly Journal of Economics. Dr. Garmaise taught at the University of Chicago Graduate School of Business before joining the faculty at UCLA Anderson.
A spotlight on microfinance a decade ago would have illuminated a small grassroots movement, financed mainly by charities and foreign assistance agencies. That was then.

Today, microfinance has become a global force with the audacious goal of opening financial systems to serve the low income majority of the world’s population. Microfinance demonstrated that the poor are bankable and can be served profitably and at scale. By 2008, the 1,100 microfinance institutions (MFIs) reporting to the Microenterprise Information Exchange (MIX), a data service, were reaching 86 million clients with loans and 96 million with deposits. Most of clients had no prior access to formal financial services. The global microfinance loan portfolio was about $40 billion, with total deposits of about $25 billion. These numbers are all the more impressive when considering that the median loan was only $525 and the median savings account was $145. It has taken more than two decades of dedicated industry-building by microfinance pioneers like ACCION International, Opportunity International, Grameen Foundation and others to bring this about.

Today’s microfinance industry is increasingly commercial, both in operations and in funding. MFIs structured as commercial banks or finance companies serve 60 percent of all borrowing clients, while NGOs continue serving about 35 percent (credit unions and rural banks serve the remainder).

Microfinance has been resilient through the global financial crisis, especially in comparison to first-world banks. For a time, financing for MFIs was scarce, but it is now flowing again. A larger problem is that the worldwide recession, coupled with continued high food and fuel prices, has slowed client demand. Before the crisis, microfinance grew at 25 percent annually (2000 to 2007). This growth slowed substantially in 2008 — in Latin America to 11 percent and in Africa to 14 percent. However, looking forward, prospects are that the microfinance industry will emerge from the crisis in good health.

Despite the pause for consolidation, the longer term story is that microfinance is emerging into the mainstream financial sector. The industry is developing a comprehensive vision to reach everyone on the planet with financial services. This financial inclusion vision goes well beyond microloans. It encompasses savings, insurance, and payments, as well as specialized forms of credit. And with momentum for scale assured, more attention is turning to quality: convenience, affordability, safety, dignity and client protection are all receiving increasing priority. At the same time, microfinance reaches out to population segments that remain unserved: very poor, rural, and disadvantaged groups (e.g., women, ethnic minorities, disabled). And on top of these changes, the industry is being turned around by private sector players from telecoms companies to big box retailers coming onto the scene with game-changing new technologies like mobile banking.

The move from microfinance to financial inclusion challenges raises many important questions. Here are two of the most important: What are the changing roles of public and private capital in this situation? How can microfinance keep its social mission alive as it becomes more mainstream?

Public vs. Private Capital. Microfinance now reaches over 100 million people largely because it learned to finance itself from commercial sources. Starting with the creation of BancoSol in 1992, as the first commercial bank devoted to microfinance, the industry has shed its initial donor dependency. In the late 1980s the US Agency for International Development (USAID) and the InterAmerican Development Bank together invested something less than $5 million to help ACCION launch BancoSol. Today BancoSol is a commercial bank with a loan portfolio of $340 million, serving 127,000 borrowers and 254,000 savers – the same informal sector clients it first targeted. This is a major development success and a highly leveraged use of foreign assistance.

USAID would not today give BancoSol a grant for operating expense or loan capital. In response to the changing frontier, donor support has also evolved. When more MFIs became profitable and regulated financial institutions, most public sector support changed from grants to loans and equity investments in microfinance. Organizations like the International Finance Corporation laid the groundwork for attracting private and commercial finance, for example in creating the first equity fund, ProFund, in 1994. Once success was demonstrated, private capital entered, at first mostly from social investors, but later purely commercial players began to enter at the very top end. A milestone for this process was the highly successful initial public offering (IPO) of ACCION’s Mexican partner, Compartamos Banco. The IPO showed that microfinance could attract investors interested in business success. It was also one of the most controversial events in microfinance, raising questions about how to maintain a double bottom line while swimming in the mainstream.

Public funders face a clear decision rule: Find the frontier and push it out. The public sector must continually re-deploy public monies to riskier uses and away from any activity that can be financed privately. Today’s challenge is to figure out where today’s industry frontiers actually are. When
ACCION International sold stock in Compartamos to mainstream investors through IPO, its resources were freed for redeployment to MFIs in locations where microfinance is just beginning, including the Amazon region of Brazil, Inner Mongolia in China, the poverty-stricken state of Bihar in India and Cameroon in central Africa.

Today, at the absolute frontier, grant funding is needed to reach marginal groups including rural populations, the extreme poor and the disabled. BRAC and Grameen Bank offer loans to urban beggars. CARE and Oxfam develop savings groups in remote, sparsely populated parts of Africa. Grants are needed for R&D for new product development (think of microinsurance or loans for renewable energy) and to apply new technologies for delivery (such as mobile banking). And the industry still needs to build the industry “ecosystem”, such as credit bureaus and regulatory policy reform.

At the risk frontier, public-sector investment capital is needed to overcome private risk aversion to finance equity and some debt investment in smaller, emerging MFIs, especially in riskier countries. The public sector still plays a role as emergency lender. In early 2009 when credit markets froze, the international finance organizations stepped in and kept financing flowing to many MFIs during the leanest months.

As the frontier expands, the scope for market-based, commercial funding grows larger and larger. The market can now provide the funding and equity needed by the top tier MFIs that serve the overwhelming majority of all clients.

Maintaining social mission. The non-profit roots of microfinance gave it a social purpose: to help clients build their businesses and improve their quality of life. As for-profits take the lead, and especially as new entrants come in with purely commercial origins, this social purpose may be endangered. Given the vulnerability of the low income people microfinance serves, it is important that their welfare remain at the core of the industry, starting with client protection.

Financial service providers have a responsibility to treat clients with transparency and dignity and to avoid selling products that could cause harm. The prevalence of practices like teaser rate mortgages in the U.S. sub-prime market revealed a massive failure to respect basic client protection principles. The sub-prime debacle shocked microfinance industry actors into putting client protection near the top of their agenda. It created an opportunity to rally the entire microfinance industry around a set of client protection principles. The Center for Financial Inclusion is working throughout the industry in The Smart Campaign to promote client protection, backed up with tools, resources and structures to assist MFIs in implementing good practices. The Campaign has over 1,000 endorsers, including about 250 of the leading MFIs. It aims to embed client protection deep in the fabric of the industry.

Most of the private capital flowing into microfinance comes from socially responsible investors who seek double bottom line returns – financial and social. Such investors can help keep microfinance focused on the social mission over the long term. The socially responsible investment sector is growing rapidly. Social investors increasingly want more than the traditional “negative screen” applied to stock portfolios. Current vehicles for social investment are not very supportive of “positive-screen” investments. New structures for social investment would benefit not only the microfinance industry, but could also facilitate investment in health, education, and environment. In the mean time, microfinance industry will continue to need investors who are willing to take a long term perspective and give explicit value to social aims.

Elisabeth Rhyne is Managing Director of the Center for Financial Inclusion at ACCION International and the author of Microfinance for Bankers and Investors (McGraw-Hill, 2009).

About ACCION International and the Center for Financial Inclusion

ACCION International (www.accion.org) is a U.S. non-profit institution founded in 1961. It works through partner banks and microfinance institutions in Latin America, Africa, India and China to provide financial services to low-income people in 20 countries, including the United States. At the end of 2009, ACCION’s affiliates and partners were reaching 3 million clients, with a total loan portfolio of $3 billion. Most of ACCION’s partners are regulated commercial banks and finance companies that pursue a double bottom line of financial performance and social mission. ACCION has been a pioneer in developing commercial microfinance, having founded the first commercial bank devoted to microfinance (BancoSol in Bolivia, 1992). Most recently, ACCION was party to the initial public offering (IPO) of its Mexican partner, Compartamos Banco. The IPO was one of the most significant – and controversial – events in the history of microfinance.

ACCION established the Center for Financial Inclusion (CFI) in September 2008 as a “think and action tank” to address industry-wide issues through research and collaborative action, especially as the industry moves from microfinance to the broader sphere of financial inclusion.
Laurence D. (Larry) Fink ('76), BlackRock's chairman and CEO, returned to the UCLA campus Thursday, April 22 and offered a sobering view of the country's financial industry as well as prescriptions for restoring its vitality and the confidence of the nation.

Fink, the namesake (along with his wife Lori) of Anderson's Fink Center for Finance and Investments, joined UCLA Anderson Dean Judy Olian on the Korn Convocation Hall stage for a wide-ranging conversation before a standing-room-only audience. In her opening remarks, Olian described Fink, whose company manages over three trillion dollars in assets as "a giant on Wall Street" whose advice is sought by other CEOs and governments. She reminded the mostly-student crowd that Fink's success was "all because of UCLA Anderson."

"We were a society, from the president to the individual, that allowed us to lived way beyond our means, and we had a financial system that encouraged it, and we encouraged it to a point where we had a cataclysmic fall," Fink said. "We were very close to ... going into another depression. We were almost at the cusp of a severe breakdown where society as we know it would have changed. It is time now for us to rebuild a system in which we are not allowing ourselves to be in that position again."

Fink said he believes "financial reform is necessary," comparing the need to changes in traffic regulations when cars replaced horses "and the country needed stop lights and curbs on the roads."

"That cost a lot of money," Fink said. "Now we need better curbs in the roads, better stop lights to regulate our system, making sure that we have a system that is sounder, safe but more importantly, a system in which we as investors can feel comfortable that we're more protected and a greater opportunity to win."

Alluding to regulations proposed by President Barack Obama, Fink said BlackRock was entirely supportive, noting that he had conveyed the same point of view to members of congress and others in the administration as well.

Several times throughout the evening, Fink stressed the dangers posed by highly-leveraged institutions and the need to protect society against over-leveraging. He said he believes that more structure of leveraged institutions will lead to greater dependency on capital markets.

"We're going to see more capital-raising in the financial markets, whether it's the
bond market or the equity market,” Fink said, a reference to the record amounts of bond issuance worldwide and record numbers of IPOs in China and other parts of the world. “We’re actually seeing the capital markets play a much more significant role not just here in the United States but in Asia and in Europe and now that societies are more dependent on these capital markets, now we need to put more structure in the capital markets.”

Olian reminded Fink that he last addressed an Anderson gathering in September 2008 as major Wall Street institutions were collapsing, an appearance in which he expressed concerns about the financial industry and the country’s future at that time. Nineteen months later, Fink said he is much more optimistic.

“We have done more ‘construction destruction’ than any Western country,” Fink said, citing as one example, the auto industry where bankruptcies and reforms have significantly reduced the cost of producing cars.

Fink applauded the strength of U.S. corporations, which, despite loss of business, were not irreparably harmed by the credit crises. “Business dropped a lot, but they were strong going into (the crisis) and they’re stronger now. We are the country that created Google and Apple ... we are a dynamic force.

“We’re a much improved country,” he said. “I’m very bullish on the United States.”

### UPCOMING EVENT

**Title: Private Equity Summit**  
**Date: October 21-22, 2010**  
**Location: UCLA Anderson**

This summit will bring together key players in the private equity space to discuss today’s most pressing issues, featuring cutting-edge academic research as well as lively panel discussions with heavy emphasis on audience participation. Confirmed panelists include Morten Sorensen (Columbia Business School), Per Stromberg (Stockholm School of Economics, University of Chicago Booth School of Business) and Richard Henkel (Arizona State Retirement System).

### 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 Association, 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.
On April 23, 2010, a group of twenty-four senior law, economics, finance and accounting faculty and business practitioners was jointly convened by The Aspen Institute, the UCLA School of Law and the UCLA Anderson School of Management for an off-the-record roundtable discussion on the topic of short-termism in business and the capital markets.

The resulting discussion was wide-ranging. Participants were united in their concern for the healthy functioning of the U.S. financial system, and their interest in helping to create solutions for economic recovery in the wake of an unprecedented financial crisis. BlackRock CEO Laurence Fink opened the day with cogent remarks on the state of the financial system and the broader economy.

The expertise of the participants was deep and varied, and their opinions were diverse both on the nature and extent of short-termism in business and the markets, and also about whether and to what degree short-termism is problematic. The purpose of the roundtable was to generate interest in and dialogue around the topic of short-termism rather than to yield a single consensus or coherent set of recommendations. However, the discussion circled around several key elements that recurred throughout the discussion.

**Refining Vocabulary**

Many participants expressed a concern that the term "short-termism," while widely used, may not be well-enough defined. Two major reasons were given for this concern.

First, a number of participants pointed out that the term can be used to describe many different business and market phenomena, some of which may be related to one another and some of which may not. Phenomena named ranged from the broad and systemic to the specific. They included high turnover in investment portfolios, the creation of derivatives with a set termination date, the short tenure of CEOs and board members, the moral hazard created by contracts that give rewards even to CEOs whose companies do poorly, the spread of mark to market accounting, a high discount rate, the misaligned incentives of financial intermediaries, and inherent human behavioral biases.

Participants questioned whether "short-termism" was useful as an umbrella term to describe all of these and other phenomena, or whether these behaviors and phenomena might be better addressed by describing and discussing them individually.

In addition to a concern that the term "short-termism" may be so broad as not to be a particularly meaningful descriptor, participants also pointed out that in many cases a broader ideological point of view is implied in the use of the term, in ways that may be misplaced. Specifically, participants noted that discussions of short vs. long-term behavior are often conflated with discussions of business sustainability and stakeholder impact. While both of these are legitimate topics for discussion, they are not the same topic. Participants also noted that the term "short-termism" is frequently used to suggest that short-term behavior is always and inherently irrational and that long-term behavior is inherently rational. Participants asserted that while this may sometimes be the case, it is not always so—for example, short-term behavior may in some cases be a rational reaction either to a lack of information or to others’ irrational behavior.

**Defined Contribution vs. Defined Benefit Saving**

A second major recurring theme of the day’s conversation centered around changes in the market that result from the increase in retirement saving through defined contribution plans and a shift away from defined benefit plans.

Discussion participants were relatively united in a concern that this change may not be best for the broader economy, in large part because it has caused individual investors to be a more significant force in the markets. Participants expressed concern that the average individual investor does not have the knowledge, expertise or time to make good investing choices. Individual investors may focus their attention on quarterly statements, which may lead the institutional investors that manage those funds to engage in destructive short-term behavior, in turn affecting the broader market.

Participants also pointed to the potential for wider negative effects for society that may be brought on by the shift away from defined benefit contribution plans. They expressed concern that many baby boomers may wind up with inadequate funds to retire, even as they age and become unable to work. A number of participants were vocal in their assertion that a return to defined benefit plans would have positive effects for the markets and the economy, and for society at large. They asserted that defined benefit plans are less costly for firms to manage, and that presence of fewer unskilled investors in the market would reduce the "noise" in the system. Some also argued that a return to defined benefit would be a boon to economic growth because such savings plans can serve as a powerful mechanism to attract...
employees, thus contributing to a strong labor base.

**Ambivalence about Policy Intervention**

Discussion participants expressed ambivalence about the possibility of using public policy to drive individual and company behavior. While the majority of those present agreed that the interventions taken by the Bush and Obama administrations to offset the effects of the financial crisis were necessary and appropriate, a number of participants (including those who supported the bailout and a strong regulatory regime in general) also cautioned that policy and regulation should not be viewed as an economic panacea.

Some participants were quite vocal in defense of the usefulness of broader regulation, arguing that when society bears the cost of the bad decisions of a small number of people or institutions that the government has a responsibility to intervene to stop those decisions. These participants asserted that strong regulation is necessary to safeguard the integrity of the U.S. and global financial system, and that there should be international cooperation in developing this regulation so as to prevent arbitrage among different regimes.

Participants also named several specific concerns about the potential negative consequences of regulatory policy. Some expressed the belief that law and policy are a “blunt instrument” that is ill-suited to navigating the vagaries and complexities of the markets and economy. Some noted that even well-intentioned policy decisions can have unintended negative consequences.

Others suggested that bailing out financial institutions creates moral hazard that in the future may disincentivize these institutions from performing their fiduciary duties. Finally, a number of participants expressed the concern that policy and regulation can be a form of paternalism.

**Participants**

- **Iman Anabtawi**, Professor of Law, UCLA School of Law
- **Steven A. Bank**, Vice Dean and Professor of Law, UCLA School of Law
- **Sanjai Bhagat**, Professor of Finance, Leeds School of Business, University of Colorado at Boulder
- **Sanjeev Bhojraj**, Associate Professor of Accounting, S.C. Johnson Graduate School of Management, Cornell University
- **Margaret Blair**, Professor of Law, Vanderbilt University Law School
- **Joseph Boateng**, Chief Investment Officer, Casey Family Programs
- **Stephan Brown**, Director & Associate General Counsel, Corporate Governance, TIAA-CREF
- **Colin Camerer**, Robert Kirby Professor of Behavioral Finance and Economics, California Institute of Technology
- **Roger Farmer**, Distinguished Professor of Economics, UCLA
- **Laurence Fink**, Chairman & CEO, BlackRock
- **Mark Grinblatt**, J. Clayburn LaForce Endowed Chair in Management, UCLA Anderson School of Management
- **B. Kipling Hagopian**, Managing Partner, Apple Oaks Partners
- **Carla Hayn**, Senior Associate Dean for the Fully Employed MBA and Executive MBA Programs, Professor of Accounting, UCLA Anderson School of Management
- **Henry T. C. Hu**, Director, Division of Risk, Strategy, and Financial Innovation, U.S. Securities and Exchange Commission; Alan Shivers Chair in the Law of Banking and Finance, University of Texas at Austin School of Law
- **Mats Isaksson**, Head of Corporate Affairs at the Organization for Economic Co-operation and Development (OECD); Visiting Scholar, Stanford University
- **Sanford Jacoby**, Howard Noble Professor of Management, UCLA Anderson School of Management
- **Terrance Odean**, Rudd Family Foundation Professor of Finance, Haas School of Business, University of California, Berkeley
- **Judy D. Oliani**, Dean and John D. Anderson Chair in Management, UCLA Anderson School of Management
- **Jeffrey Pfeffer**, Thomas D. Dee II Professor of Organizational Behavior, Stanford Graduate School of Business
- **Richard Roll**, Professor and Japan Alumni Chair in Finance, UCLA Anderson School of Management
- **Judith Samuelson**, Executive Director, Aspen Institute Business and Society Program
- **Lynn Stout**, Paul Hastings Professor of Corporate Securities Law, UCLA School of Law
- **Avanidhar Subrahmanyam**, Goldyne and Irwin Hearsch Chair in Money and Banking, UCLA Anderson School of Management
- **Adam Winkler**, Professor of Law, UCLA School of Law
- **Eric Zolt**, Michael H. Schill Professor of Law, UCLA School of Law
Overview

The ASAM class of 2010 began the year with three strategies: F-Score, Earning Announcement Return (EAR), & Tactical Asset Allocation (TAA). While the F-Score strategy has a long successful history as an ASAM strategy, both EAR and TAA were new at the beginning of the year and were in various stages of development throughout the year. The incoming class chose to dissolve the Parametric strategy due to student interest in other quantitative strategies.

The recovery in global capital markets provided impressive results for the value-based F-Score strategy, while hurting the active return of the developing strategies, which were mainly in cash throughout the year. The aggregate ASAM fund underperformed relative to all equity benchmarks. Despite the large allocation to cash, both the EAR and the TAA strategies made huge progress during the year and are now both fully implemented and actively trading.

Purpose Of Fund

Anderson Student Asset Management (ASAM) is a student-run investment fund that aims to:

- Enhance the educational and professional development of the student-managers through experiential learning in strategy development and fund management
- Provide competitive risk-adjusted returns

A portion of the Fund’s long-term profits will be donated to the UCLA Anderson School for student scholarships and research in finance.

Investment Philosophy

ASAM's objective is to preserve capital while pursuing favorable risk-adjusted returns. The student-managers adhere to stated investment policies established by the UCLA Anderson School and the ASAM faculty advisor, Professor Robert Geske.

The Fund seeks to achieve its objectives through a diversified portfolio of securities 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 professionals.

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

Overall Performance Review

The aggregate fund underperformed the Wilshire 5000 by approximately 30.5% from 4/30/2009 to 4/30/2010. While such a large underperformance is not desirable, this can largely be attributed to the large cash positions held throughout most of the year while the broader equity market experienced one of the steepest sustained rallies in recorded history. Holding large cash positions while transitioning to new strategies has been the modus operandi at ASAM, but perhaps this procedure should be revisited. Cash is an asset class and therefore an investment in and of itself. For the 2009 class, holding a large cash balance proved advantageous, while for the 2010 class, it proved detrimental to overall performance. Future classes might want to consider more carefully in what asset classes sidelined funds be placed.

Despite underperformance during the 2009-2010 academic year, ASAM fellows made significant advancements in developing and implementing their individual strategies.
A brief description of each of the three investment strategies follows.

**Tactical Asset Allocation (TAA)**

Tactical Asset Allocation (TAA) is a strategy where a portfolio manager rebalances his asset mix away from a Strategic Asset Allocation (SAA) in order to take advantage of market pricing anomalies. The goal of a TAA strategy would be to produce returns in excess of the SAA benchmark.

**FSCORE**

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 the paper, Piotroski concludes that small, high book-to-market companies that are financially healthy measured by nine metrics, generate abnormally high returns between 1976 and 1996. Piotroski argues that high book-to-market companies are “value” names that tend to be neglected by investors as well as the analyst community can be “financially distressed.” Piotroski measures the financial health of a firm by evaluating nine factors which measure a firm’s profitability, changes in capital structure and operating efficiency.

**Earnings Announcement Return (EAR)**

EAR is a variation of an earnings drift strategy, which seeks to exploit the earnings drift anomaly. The basic premise of the earnings drift anomaly is that when a company beats market participants’ expectations of quarterly earnings, the stock price of that company has a tendency to drift higher over the subsequent 12 months. The opposite is true when a company reports quarterly company earnings that disappoint expectations; the price of the company stock tends to drift lower over the subsequent 12 months. The EAR strategy is based on the academic research paper “Earnings Announcements are Full of Surprises” by Professors Pedro Santa Clara, Michael Brandt, Runeet Kishore, and Mohan Venkatachalam.

**Distinguished Speaker Series**

ASAM coordinates the Distinguished Money Manager Speaker Series at UCLA Anderson. Through the speaker series, investment management practitioners come to ASAM meetings to share their knowledge with the Anderson community. The sessions are interactive; students are encouraged to ask questions that extend their knowledge of finance beyond academia.

The 2010 Distinguished Speaker Series included the following prominent speakers:

- Bill Reynolds – Previous Head of Fixed Income at T. Rowe Price
- Professor Francis Longstaff
- Mark Perry – Associate at Centinela Capital Partners and ASAM Alum
- Philip Lee – Portfolio Analyst at Analytic Investors and ASAM Alum
- Professor Robert Geske
- John Brynjolfsson, CFA – Managing Director at Armored Wolf
- Jeff Hoo – Transamerica Investment Management
- Bill Simon
- Jay Wong – Principal at Payden & Rygel
- Arthur Hovsepian – Vice President/ Emerging Market Strategist at Payden & Rygel
- Professor Richard Roll

**Firm Visits**

Each year, ASAM student managers visit respected money management firms, most of which are in the Southern California area, to learn empirical lessons from practitioners. The following firms generously donated the time of their top managers to meet with the ASAM Fellows of 2010.

- Berkshire Hathaway
- Research Affiliates
- Western Asset Management
- PIMCO
- Sterling Johnston Capital Management
- Dodge and Cox
- Wells Capital Management
- Capital Group
- Oaktree Capital Management
- Dimensional Fund Advisors
- Dalton Investments
- Los Angeles Capital Management
- Causeway Capital Management
- Wilshire Associates
- Brandes Investment Partners
- Nicholas Applegate
- Harlingwood
- Relational Investors
- MetWest Asset Management

The firm visits were extremely beneficial and gave the ASAM Fellows a more complete view of the industry. During firm visits, ASAM fellows learned about the organizational structure and strategic goals of the firms, their investment strategies and processes, and in some cases, their outlook for future market conditions. Career advice and interview tips given by the firms’ managers were also of tremendous value.
On the morning of Friday, January 8th, nine fellows of UCLA Anderson’s quantitative investment group (ASAM) were greeted in Omaha, Nebraska by bone-chilling record low temperatures. However, the weather was far from everyone’s mind. This would be a day to remember – the day that the ASAM fellows would meet the legendary investor, Warren Buffett.

After taking a brief tour of Nebraska Furniture Mart (a Berkshire Hathaway Company), the ASAM bus set out for the big meeting. On the way, we cruised through an unassuming upper-middle class neighborhood, when suddenly the bus came to crawl. “See that house to the right? That’s where Mr. Buffett lives,” the bus driver informed us. Apparently he purchased the house 35 years ago and lives there to this day. It wasn’t a small house, but it wasn’t at all a house where you’d expect a billionaire to live either. Buffett’s philosophy for living was apparent and congruent in every aspect of his life. This was only the beginning.

Our first impressions of Berkshire Hathaway were no different. The largest holding company in the United States occupied a mere two floors in an average downtown building. It was unbelievable. Then, following signs that led us through a corridor, the ASAM group came face-to-face with the Oracle of Omaha himself, Warren Buffett. He was smiling and speaking with students from other prestigious business schools. Following Mr. Buffett’s instructions, we grabbed a Cola-Cola soft drink (a Berkshire Hathaway holding), and took our seats in the very first rows of the small conference hall.

After some small talk, Mr. Buffett opened up the Q&A session. When responding to complicated macro-economic questions concerning the direction of the dollar, unemployment, or the future of energy, Buffett simply replied that he preferred to invest in businesses that would flourish and grow regardless of fluctuations in the economy, citing their investment in Coca-Cola as a perfect example.

Everyone was surprised to learn how down-to-earth and humorous the world’s second richest man really was. According to Mr. Buffett, his ability to allocate capital proved to be lucrative, but he postulated that different times in human development called for different skills. 10,000 years ago, it paid to be a warrior and a hunter; hence, someone with his skills probably would have wound up in the mouth of a tiger. As the session went on, the conversation topics focused more on family and social responsibility, and Mr. Buffett spoke of his strong beliefs in philanthropy.

After the incredible two hour conversation, the ASAM team followed Mr. Buffett, driving a 2002 Cadillac, to his favorite lunch restaurant in Omaha – Piccolo Pete’s. Of course it was Mr. Buffett’s favorite because there was nothing obviously special about it. During lunch, the ASAM team sat a few tables away from Mr. Buffett and observed how he still had the energy to speak with students in an entertaining fashion.

After lunch came time for pictures. This was definitely a critical moment because this would be the proof – the physical evidence that this day really existed and that we did indeed meet Mr. Warren Buffet.

It was an amazing day that the fellows of ASAM will never forget.

Before coming to UCLA Anderson, Wade Hickok was a Sergeant in the United States Marine Corps and an Operations Manager for Halliburton in Russia. Wade’s passion for investing compelled him to switch careers during his FEMBA experience and he now works as freelance analyst with Stonebridge Capital Management.
We are delighted to inform you that Hanno Lustig has been promoted to Associate Professor with tenure. Hanno started his career at the University of Chicago and later was part of the Department of Economics at UCLA, before joining our Finance faculty in 2008. Hanno’s expertise lies at the intersection of macro-economics and finance, including studying the linkages between the housing markets and financial markets, clearly a very important research area. He is a dedicated and very flexible teacher, and an outstanding citizen within the school and in his profession.

Professor Hanno Lustig Receives NASDAQ OMX Award for the Best Paper in Asset Pricing

Hanno Lustig along with co-authors Yi-Li Chien (Purdue University) and Harold Cole (University of Pennsylvania) were awarded the NASDAQ OMX Award for Best Paper in Asset pricing for their working paper titled "Is the Volatility of the Market Price of Risk due to Intermittent Portfolio Re-balancing?"

The present version of the paper can be found at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1473520

Professor Bhagwan Chowdhry launches Financial Access at Birth Campaign

Professor Chowdhry recently proposed a Financial Access at Birth (FAB) Campaign in which every child born in the world is given an initial deposit of $100 in an online bank account to guarantee that everyone in the world will have access to financial services in a few decades. The goal of the FAB Campaign is to bring governments, banks, insurance companies, technology and telecom companies, microfinance organizations, charitable foundations, health-care organizations, educational organizations and academics together to devise best strategies for implementing the plan of providing Financial Access at Birth for every child born in the world. The campaign has recently received attention from the press, including The Economist, The Huffington Post, and Smart Money.

For more information, please visit http://www.fabcampaign.org/.
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, Associate Professor
Marc Martos-Vila, Assistant Professor
Richard Roll, Japan Alumni Chair in Finance
Pedro Santa-Clara, Professor
Eduardo Schwartz, California Chair in Real Estate and Land Economics, Finance Area Chair
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