Chair of the Board
Laurence D. Fink (MBA ’76)

Founding Members
David (MBA ’82) and Charlotte Ackert
Robert D. Beyer (MBA ’83)
David G. Booth
Richard R. Crowell (MBA ’80)
Charles E. Davidson (MBA ’77)
Joel P. Fried (MBA ’86)
George A. Froley, III (MBA ’61)
B. Kipling Hagopian (MBA ’66)
Timothy D. Jensen (MBA ’88)
Richard A. Kayne (MBA ’68)
Martin C. Murrer (MBA ’81)
Ben Nickoll
Timothy M. Pennington, III (MBA ’66)
Edward W. Wedbush (MBA ’57)
Richard S. Wiley (MBA ’80)

Advisory Members
Matthew Barrett (MBA ’86)
John R. Casaudoumecq (MBA ’85)
William L. Davis
Jeffrey S. Deutschman (MBA ’81)
William O. Grabe (MBA ’63)
Stephen A. Greene (MBA ’85) and Mary C. Don (MBA ’85)
David Hou (MBA ’92)
Christopher D. Jennings (MBA ’80)
Chris M. Kanoff (MBA ’84)
Dennis J. (MBA ’80) and Karen S. Keegan (MBA ’81)
Raymond Kennedy (MBA ’88)
O. Kit Lokey (MBA ’67)
Laurie R. (MBA ’81) and Thomas E. McCarthy (MBA ’80)
Chris Myers (MBA ’91)
Mitchell J. Milias
Karlheinz Muhr (MBA ’85)
Joan A. Payden
Robert W. Schult
Leland L. Sun (MBA ’86)
David Windreich (MBA ’83)
Art, science, or a bit of both? Academics and practitioners often disagree, not only with each other but among themselves. In this issue of the Bulletin, however, they seem to be in agreement that the capital structure decision is both art* and science.

Whether an optimal capital structure exists and if so, what drives firms to adhere to one is a fundamental question in finance. For decades, this topic has been researched extensively by academics. Yet the answer remains elusive.

For this issue’s academic perspective, I provide a general overview of the literature culminating with the latest evidence uncovered in a new empirical paper by Richard Roll (UCLA) and Harry DeAngelo (USC). Although there has been conflicting evidence on the stability of leverage ratios, the generally accepted view to date is that firms do indeed have target leverage ratios and seek to maintain them. Contrary to this view, Roll and DeAngelo find that “…capital structure stability is the exception, not the rule.”

Timothy Terrell, director of Capital Management at Kroger, offers an insightful view into the highly competitive supermarket industry. They provide the historical background that has helped shape Kroger’s capital structure decisions, as well as some guiding principles for their overall financial strategy that has helped them maintain success throughout the ever-changing market conditions.

*Disclaimer: It really ought not to be if we knew how to do it. The leverage decision is an art in the sense that it is a scientific question that has not yet been resolved.
The Myth of the Target Leverage Ratio

Pansy Yang | FCFI Executive Director, UCLA Anderson

What factors propel firms to choose one form of financing over another? How should firms make decisions on what proportions to put in debt, equity or alternatives? Does an optimal capital structure exist? This topic has been heavily researched and hotly debated by the academic finance community for over half a century, resulting in little consensus and a lot of controversy. Many consider the motivation for firms to issue debt one of the top 10 unsolved mysteries in modern finance.

The literature dates back to a paper by Modigliani and Miller (MM) in 1958, which contained the first rigorous theory of capital structure. MM states that a firm’s value is unaffected by its financing choices. In other words, capital structure is irrelevant to the market value of the firm. MM is logically valid in a perfect world without market frictions. But imperfections such as taxes, bankruptcy costs, transactions costs, agency conflicts, information asymmetry, to name a few, might compromise its MM irrelevancy conclusion. Some view MM as pure theory, but nonetheless important because it represents an idealized framework for examining real world reasons why capital structure is relevant to the value of the firm.

Miller and Modigliani (1963) specifically address the tax benefit of debt, which laid the groundwork for the trade-off theory. Trade-off theory states that there is benefit to financing with debt that arises from the corporate tax shield. This would imply 100% debt financing though, so there must be something to offset the benefit of debt. The answer lies in bankruptcy costs, that loom with ever greater probability as leverage increases. This implies that firms should establish a target determined by balancing the advantages of debt tax shields against the costs of financial distress and bankruptcy. If leverage is off target, firms should gradually move toward it. The optimal speed of adjustment to the target is an important empirical issue.

Miller’s seminal paper on debt and taxes in 1977 questions whether expected bankruptcy costs could be large enough to explain why firms do not take more advantage of the benefits of corporate debt. His skepticism led to his famous comment that “the supposed trade-off between tax gains and bankruptcy costs looks suspiciously like the recipe for the fabled horse-and-rabbit stew — one horse and one rabbit.” In his paper, Miller specifically argues that the corporate tax advantage of debt is offset by a personal tax disadvantage, so in equilibrium there might be no optimal leverage ratio except that very high leverage is excluded because of bankruptcy costs. In other words, the cost of capital is flat for a wide range of leverage ratios from zero to at least fifty percent.

Myers and Majluf (1984) offer an alternative explanation, called the pecking order theory. Pecking order theory postulates that firms prioritize their sources of financing, with an initial preference for internal financing, followed by debt financing when internal sources are depleted, followed lastly by issuing equity when it is no longer sensible to issue more debt. In other words, there exists a hierarchy in the various sources of capital. This model is based on asymmetric information, in which managers are assumed to possess more knowledge about the true value of the firm than investors. Thus, when firms issue new equity, investors believe that managers may consider the firm to be overvalued and therefore take advantage of the overvaluation (and investors). It follows that astute investors will assign a lower value to new equity issuance, which explains why equity is the least preferred form of financing.

From these models emerged a large number of papers, both theoretical and empirical. Theoretical papers include, but are not limited to, models with assumptions based on (1) asymmetric information (managers are assumed to have more valuable information than outside investors) (2) agency costs (costs due to conflicts of interest between managers and shareholders, or equity holders and debtholders) (3) product/input market interactions (a firm’s capital structure is related to its strategy when competing in the product market or related to the characteristics of its product or inputs) (4) takeover considerations (since debt and equityholders have different voting rights, the capital structure of a firm can be modified to affect the outcome of a takeover attempt).

Empirically, the data has been sliced many ways. Researchers have looked at differences in capital structure choices between small and large public firms, domestic and international firms, and have employed different empirical specifications as well as various definitions of debt. Empirical papers have sometimes been constrained by the availability of data and at other times, criticized for being unrelated to existing theories (which admittedly can be hard to test). Nonetheless, we do know a few things that have emerged from the vast empirical literature, including the following: leverage ratios and market-to-book ratios are negatively correlated, the aggregate market-based leverage ratio has been surprisingly stable and remained around 0.32 for decades, leverage is positively related to expected inflation and median industry leverage, and many small firms issue equity frequently.

Leverage stability for individual firms (as opposed to the market-wide average)
has been researched heavily, although much of the evidence is conflicting. For instance, Welch (2004) finds that leverage ratios at U.S. firms experience large changes that are induced by stock returns, and firms do little to counteract those changes. He states that “…corporate issuing motives remain largely a mystery.” On the other hand, Lemmon, Roberts, and Zender (2008) find that “…corporate capital structures are stable over long periods of time: Firms with relatively high (low) leverage tend to remain as such for over 20 years.” Frank and Goyal (2008) suggest to researchers that “a satisfactory theory must account for why firms keep leverage stationary.” Despite the puzzling evidence, the view that leverage ratios remain stable over time seems to be widely accepted.

However, recent evidence compiled by DeAngelo and Roll (DR) suggest that leverage ratios are in fact, remarkably unstable over time. Their new paper “How Stable are Corporate Capital Structures?” concludes that “…capital structure stability is the exception, not the rule.” DR analyze data from 1950-2008, as well as hand-collected leverage data dating back to the early 1900s for a subsample of 24 firms. This subsample includes General Motors, General Electric, IBM, Exxon, U.S. Steel, DuPont, Proctor & Gamble, Eastman Kodak and Coca-Cola — all firms that were in the Dow Jones Industrial Average by the 1930s. The evidence indicates that “…leverage takes on such a wide range of values at so many firms that it is difficult to believe there are significant benefits from adhering even loosely to a leverage target. Given the pervasive and substantial time-series variation in leverage, the most plausible view is that the choice of a leverage ratio per se is just not that important for firm valuation. And this, in turn, suggests that the main

![Figure 1](leverage-ratios-general-motors-ibm-eastman-kodak-1926-to-2008.jpg)

**Figure 1**

Leverage Ratios of General Motors, IBM and Eastman Kodak: 1926 to 2008

Book leverage is the ratio of total book debt to total assets. Market leverage is total book debt divided by the sum of total book debt and the market value of common stock. Leverage data are from company annual reports, Moody’s manuals, and Compustat. Market values are from CRSP.
drivers of the time path of leverage are likely to be funding needs for investment and other considerations that have little or nothing to do with rebalancing toward a target."

WHAT? Is it possible that firms actually may NOT HAVE A SPECIFIC TARGET LEVERAGE RATIO in mind? Let’s take a look at the empirical results presented in the DR paper. Figure 1 plots leverage ratios for GM, IBM and Kodak from 1926 to 2008. The time-series variation in leverage is substantial for all three firms, with book leverage ratios equal to or approaching zero at low points and exceeding 0.4 at high points for IBM and Kodak. There is an even greater spread for GM, with book leverage ratios varying between zero and 0.6. Not surprisingly, market leverage ratios vary more widely than book leverage at all three firms, but overall the market and book measures track each other quite closely. The relatively unpredictable pattern of leverage is fairly representative of all U.S. industrial firms; leverage stability is actually quite uncommon.

DR report that the “range in book leverage (debt/assets), market leverage, and the net debt ratio exceeds 0.500 at, respectively, 29.8%, 57.4%, and 66.2% of firms listed 20-plus years.” Leverage stability at individual firms occurs only infrequently and when it does, is almost always temporary. Periods of stability occur mostly when firms have low leverage.

DR conclude that the evidence is consistent with theories in which firms have target leverage zones, provided that the zone boundaries are very wide. Most firms are behaving as MM postulated more than 50 years ago; i.e., “leverage takes on such a wide range of values at so many firms that it is difficult to believe there are significant benefits from having a particular leverage ratio. It seems more plausible that, over a reasonably wide range, leverage per se is not that important for firm valuation, so that factors other than adhering to a target ratio are likely the main drivers of the time path of leverage.”

DR also provide some evidence about what firms are doing with leverage. They are mainly using debt to finance capital expenditures, either on new investment projects or for takeovers. Debt is the preferred means of financing large capital expenditures, presumably because it has a smaller asymmetric information problem than equity. Typically, a firm will increase leverage to make an investment, then pay it down gradually in order to be in a position to finance the next investment with debt. Such behavior is inconsistent with a stable leverage target.

References
Myers, Stewart, and Nicholas Majluf, 1984, Corporate Financing and Investment Decisions when firms have information that investors do not have, Journal of Financial Economics 13, 187-221

Pansy Yang is the executive director of the Fink Center for Finance & Investments (FCFI). She joined UCLA Anderson in 2006 at the inception of the Center for Finance & Investments and has overseen the growth of the center through its naming, raising over $15 million in the process. She helps build relationships between faculty, students, alumni, donors and the local business community and facilitates communication between academics and practitioners in the field of finance. Previously, she was an assistant professor at the University of Washington and taught MBA corporate finance and options and futures. She received her Ph.D. in finance from UCLA Anderson (’00) and B.S. in management science from MIT (’95).
The supermarket industry in the United States is highly competitive, has relatively low barriers to entry and is characterized by paper thin net income margins. Recent history also demonstrates that capital structure decisions are a critical factor to long-term survival. Public companies with high yield or declining credit ratings lack the financial flexibility to weather economic cycles, combat competitive threats, or have been forced to merge, sell or liquidate. The listing in Table 1 reveals that only two of the Top 10 U.S. grocers in 1983 were still on the list in 2010.

Table 1: Top 10 U.S. Grocery Retailers

<table>
<thead>
<tr>
<th>1983</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Safeway</td>
<td>Wal-Mart</td>
</tr>
<tr>
<td>Kroger</td>
<td>Kroger</td>
</tr>
<tr>
<td>American Stores</td>
<td>Costco</td>
</tr>
<tr>
<td>Winn-Dixie</td>
<td>Safeway</td>
</tr>
<tr>
<td>The Southland Corp.</td>
<td>SUPERVALU</td>
</tr>
<tr>
<td>Lucky Stores</td>
<td>Publix</td>
</tr>
<tr>
<td>A&amp;P</td>
<td>Ahold USA</td>
</tr>
<tr>
<td>Albertson's</td>
<td>Delhaize America</td>
</tr>
<tr>
<td>Grand Union</td>
<td>HEB</td>
</tr>
<tr>
<td>Jewel Companies</td>
<td>Meijer</td>
</tr>
</tbody>
</table>

The Kroger Co. is one of the largest traditional grocers in the U.S. We operate more than 2,400 supermarkets and multi-department stores in 31 states, plus over 1,000 supermarket fuel locations. Approximately 44% of these supermarkets were operated in company-owned facilities, including some company-owned buildings on leased land. Our current strategy emphasizes self-development and ownership of store real estate. In addition to the supermarkets, we operate approximately 780 convenience stores, 360 fine jewelry stores and 40 manufacturing plants. Total sales exceed $82 billion. We hold the #1 or #2 market share in 38 of our 42 major markets. And we offer a personalized approach to each customer based on proprietary consumer insights that help us grow the total households that shop with us.

Among other responsibilities, the mission statement of The Kroger Co. includes a commitment to deliver a consistent return to our shareholders equal to or above overall market returns. The connection between capital structure decisions and our mission statement lies in our past. The finance team at Kroger has inherited a culture shaped by dramatic structural events, including a major recapitalization in 1988, the industry's largest merger in 1998, and the industry's most expensive work stoppage in 2003. These events helped shape our belief that a solid, investment grade capital structure best supports the operating strategies we employ to meet our responsibilities.

We define “solid” as maintaining a BBB/Baa2 rating on our public debt. We believe this rating provides us with the lowest cost of capital, access to liquid capital markets and significant financial flexibility. To maintain this rating, we employ a financial strategy designed to meet the needs of both equity and fixed income investors.

We also maintain a constant dialogue with ratings agencies and allocate free cash flow to produce a consistent net debt to EBITDA ratio. (Leverage takes many forms and we assess operating lease commitments and Taft Hartley, Multi-Employer pension obligations in our overall capital structure.) Our public debt portfolio is designed to produce a smooth and sufficiently staggered maturity schedule. Finally, our revolving credit facility provides cost effective and immediate access to bank capital.

The true value of our financial strategies was clearly revealed during the financial crisis of 2008. During this time our finance team proactively managed the situation by slowing down share repurchases, temporarily borrowing under our revolver, and subsequently issuing debt (even though there was negative carry) to bring the revolver back down. Looking back, the greatest risk we faced was the culture shock and resulting impact on customer service that would have occurred had we been unable to fund a weekly payroll or meet vendor payment terms. Our stable cash flows from operations and ability to access liquid credit markets during the crisis gave our associates the confidence to focus on customers’ needs first.

Maintaining a solid investment grade rating, however, is just part of our overall financial strategy. Decisions regarding changes to our capital structure are considered within the broader scope of our free cash flow principles. These principles include:

- Executing a strong capital plan that supports growing market share
- Funding a significant, increasing dividend
- Repurchasing stock when appropriate
- Reducing debt over time, if necessary

We start our evaluation with a three-to-five-year forecast of free cash flow and allocate it among various priorities in a manner that we believe is in the best long-term interest of stakeholders. Since we are currently at our ideal capital structure, we generally expect to allocate about 60-75% of our free cash flow toward capital expenditures with the remaining dollars spent on shareholder return and maintaining our leverage ratio. In any one-to-three year period the allocations could be materially different for a variety of reasons.

Increasing shareholder value starts with earning a return on assets that exceeds our cost of capital. As mentioned earlier, we believe that our targeted capital structure offers us the lowest cost of capital. Based on this cost of capital we set an 11.3% “hurdle rate” for our capital project returns. This internal hurdle rate is...
higher than our cost of capital to ensure that maintenance and defensive projects with little or no return and an occasional failure can be covered by growth investments.

We establish the total company capital expenditure budget three years out and allocate it to divisions and infrastructure teams (i.e., information systems and logistics) based on historical returns and specific opportunities or objectives. Investments in new stores and expansions are determined on a company-wide basis. All projects are vetted thoroughly and significant investments must be approved by a capital committee comprising most of our senior officers. Additionally, we perform reanalysis on major projects to ensure that if we are missing our returns, we know where and why, and most importantly, avoid repeating mistakes. Since we began tracking actual project returns in 1986 (1,900 major investments), we have not had a single year where our returns for projects in that year were below our cost of capital.

Company specific events, market inefficiencies and industry developments have caused us to deviate in either the short or long-term from our targeted capital structure. Table 2 illustrates that over the last 30 years we have met or been close to achieving our desired capital structure in only half of those years. The remaining years from 1988 – 2004 are characterized by slow and steady improvement toward our goal after the initial shock of the recapitalization.

While acquisitions are not required for us to hit our goal of delivering consistent earnings per share growth equal to or above overall market returns, we strive to ensure our capital structure is in a position to take advantage of industry consolidation. Kroger’s acquisition strategy focuses primarily on existing markets with leading market shares. Such “in-market” acquisitions have lower risk and generally produce a higher incremental return because they require little investment in overhead, advertising and distribution.

Summary:
We operate in a dynamic and sometimes dysfunctional business environment. This may cause us to deviate from any one performance or financial goal, including our ideal capital structure, for the purpose of delivering on long-term commitments to our customers, shareholders and the communities we serve. We believe that our capital structure should provide both the strength and flexibility necessary for our company to grow and survive.

Tim Terrell is director of Capital Management at The Kroger Co., one of the nation’s largest grocery retailers. Tim joined Kroger in 1999 as manager of SEC Reporting. Before being promoted to his current position in October 2010, he held roles as director of Finance and Process Change, assistant corporate controller, and controller of Kroger’s Michigan Division. Tim worked as an auditor at PricewaterhouseCoopers prior to joining Kroger. He is a graduate of Miami University with a B.S. in accountancy and holds an MBA from Xavier University. Tim is a certified public accountant and sits on the Investment Board of Beech Acres Foundation.
Recent Events

Join the UCLA Anderson finance faculty, ranked #1 in intellectual capital by BusinessWeek, 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 from 11:00 a.m. – 12:15 p.m.

Finance Seminar Series

<table>
<thead>
<tr>
<th>Date</th>
<th>Speaker</th>
<th>University</th>
<th>Topic</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 18</td>
<td>Jeremy Stein</td>
<td>Harvard University</td>
<td>“A Comparative-Advantage Approach to Government Debt Maturity”</td>
</tr>
<tr>
<td>April 1</td>
<td>Dean Karlan</td>
<td>Yale University</td>
<td>“Getting to the Top of Mind: How Reminders Increase Saving”</td>
</tr>
<tr>
<td>April 8</td>
<td>Fernando Ferreira</td>
<td>The Wharton School</td>
<td>“Anatomy of the Housing Boom in U.S. Neighborhoods and Metropolitan Areas, 1993-2009”</td>
</tr>
<tr>
<td>April 15</td>
<td>Steve Ross</td>
<td>MIT</td>
<td>“Notes from the Vol Surface”</td>
</tr>
<tr>
<td>May 6</td>
<td>Adriano Rampini</td>
<td>Duke</td>
<td>“Dynamic Risk Management”</td>
</tr>
<tr>
<td>May 13</td>
<td>Vojislav Maksimovic</td>
<td>University of Maryland</td>
<td>“Redefining Financial Constraints: a Text-Based Analysis”</td>
</tr>
<tr>
<td>May 20</td>
<td>Christine Parlour</td>
<td>UC Berkeley</td>
<td>“Competition, Quality and Managerial Slack”</td>
</tr>
<tr>
<td>June 3</td>
<td>Kai Li</td>
<td>University of British Columbia</td>
<td>“Determinants of Corporate Cash Policy: A Comparison of Public and Private Firms”</td>
</tr>
</tbody>
</table>

Special Guest Speakers

David Windreich (’83) visited Professor Hanno Lustig’s Securities Analysis and Investment Management class on Monday, May 23rd. David is the head of U.S. Investing and Executive Managing Director at Och Ziff Capital Management Group and a Fink Center board member. He started his talk with an outline of the fundamental economics of the hedge fund industry. David emphasized the absence of significant barriers to entry in the hedge fund industry and the importance of human capital (identification and retention). After that, there was a lively Q&A session. Students asked a variety of questions about the future of the hedge fund industry, the challenges of adequately measuring value added in investment management and the lessons learned from the recent financial crisis.
Upcoming Events

Save the Date

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>September 15, 2011</td>
<td>MBA Orientation Breakfast</td>
</tr>
<tr>
<td>November 17, 2011</td>
<td>Conversation with Larry Fink (BlackRock) and Bill Gross (PIMCO)</td>
</tr>
<tr>
<td>February 10, 2012</td>
<td>2nd Annual Private Equity Summit</td>
</tr>
<tr>
<td>March 14-16, 2012</td>
<td>Young Presidents’ Organization (YPO) Raising Capital Seminar</td>
</tr>
</tbody>
</table>

For more information about any of the above events, please contact us at fink.center@anderson.ucla.edu.

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.
Overview
The past year has been memorable, to say the least, for the ASAM Class of 2011. We have seen turbulence in not only the U.S. financial markets, but in the global political and socio-economic environment as well. Since inheriting the ASAM portfolio in May 2010, the current ASAM class has managed the portfolio amidst major macroeconomic headwinds, ranging from the ramifications of the Deepwater Horizon oil spill in the Gulf of Mexico, sovereign bailouts in the European Union, escalation of tensions on the Korean peninsula, social unrest and upheaval in the Middle East and North Africa, a devastating earthquake and tsunami in Japan, and fiscal deficits in the U.S. at the federal, state and municipal level. May 2010 was also noteworthy in that we witnessed an intraday decline, the Flash Crash, of over 900 points (9%) on the Dow, the largest intraday point decline in the history of the Dow Jones Industrial Average.

Despite these macroeconomic headwinds, the S&P 500 rallied about 15% over the past year, buoyed by unprecedented monetary stimulus (QE1 and QE2) by the Federal Reserve. The 30% market rally since August 2010 was broad and mostly beta driven. Since February 2011, however, the S&P 500 has returned just over 1% in choppy trading, signaling the end of the beta trade and marking the beginning of a period in which investors will have to rely increasingly on stock selection to drive returns. In this environment, the FSCORE and EAR stock selection strategies should perform well, particularly given enhancements by this year’s class regarding stock selection, sell discipline and risk management. Additionally, this year’s class implemented a new strategy (BCD) based on a variation of the Gordon growth model, which has shown promise in back-testing as a strong alpha generation tool.

Purpose of Fund
Anderson Student Asset Management is a student-run investment fund that aims to:
1. Enhance the educational and professional development of the student-managers through experiential learning in strategy development and fund management
2. 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
For the 12 months ended April 2011, the aggregate ASAM portfolio returned 16.13%, trailing the S&P 500 by 109 basis points, which returned 17.22% over the same period. Performance by strategy is broken out in Table 1.

The Table 1 performance figures are inclusive of cash balances held over the course of the year, which served to dampen performance relative to the broad market indices, particularly for EAR and FSCORE. Returns on invested cash, which remove the effect of cash holdings, are in Table 2.

### Table 1

<table>
<thead>
<tr>
<th>Portfolio</th>
<th>ASAM Returns</th>
<th>Benchmark Returns</th>
<th>Difference</th>
<th>Benchmark Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>EAR</td>
<td>16.40%</td>
<td>18.35%</td>
<td>-1.95%</td>
<td>Russell 3000</td>
</tr>
<tr>
<td>FSCORE</td>
<td>17.97%</td>
<td>18.35%</td>
<td>-0.38%</td>
<td>Russell 3000</td>
</tr>
<tr>
<td>TAA</td>
<td>13.78%</td>
<td>17.22%</td>
<td>-3.44%</td>
<td>S&amp;P 500</td>
</tr>
<tr>
<td>Aggregate</td>
<td>16.13%</td>
<td>17.22%</td>
<td>-1.09%</td>
<td>S&amp;P 500</td>
</tr>
</tbody>
</table>

### Table 2

<table>
<thead>
<tr>
<th>Portfolio</th>
<th>Return on Invested Cash</th>
<th>Returns Inclusive of Cash Balances</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>EAR</td>
<td>19.45%</td>
<td>16.40%</td>
<td>3.05%</td>
</tr>
<tr>
<td>FSCORE</td>
<td>22.85%</td>
<td>17.97%</td>
<td>4.88%</td>
</tr>
<tr>
<td>TAA</td>
<td>11.59%</td>
<td>13.78%</td>
<td>-2.19%</td>
</tr>
<tr>
<td>Aggregate</td>
<td>17.62%</td>
<td>16.13%</td>
<td>1.49%</td>
</tr>
</tbody>
</table>
As EAR was a recently developed strategy, the current student managers inherited a portfolio that was only 44% invested, and have since done a wonderful job sourcing new investment opportunities to put their cash to work, and are now close to 94% invested. FSCORE, which is a more established strategy as compared to EAR, had to sell legacy positions over the past 12 months that did not fit the strategy criteria, and as a result, was left with a bigger than desirable allocation to cash. TAA remained fully invested over the past 12 months.

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 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 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, Runee Kishore, and Mohan Venkatachalam.

**BCD**
BCD strategy is based on two academic research papers: (1) “Stock Valuation in Dynamic Economies” by Bakshi and Chen (1998) and (2) “A General Model of Stock Valuation” by Ming Dong (1998). It is worth noting the adoption of the BCD model by a Wall Street research firm, ValueEngine. BCD Model derives a stock valuation formula that explicitly relates the stock’s fair value to the observable fundamental variables such as stock’s historical market prices, term structure of interest rates, historical earnings and analyst estimates for future earnings.

**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 2011:

- Allianz Global Investors
- Analytic Investors
- Ares Management
- Bradford and Marzec
- BlackRock
- Canyon Capital Advisors
- Causeway Capital
- Criterion Capital Partners
- Crosslink Capital
- Dodge & Cox
- DoubleLine Capital
- Franklin Templeton
- Frontier Asset Management
- GMO
- Graham Investment Management
- Guggenheim Partners
- Los Angeles Capital Management
- Oaktree Capital
- MSCI Barra
- PAAMCO
- Pacific Life Asset Management
- PIMCO
- PRIMECAP Management Company
- Relational Investors
- Research Affiliates
- Weintraub Capital Management
- Wells Capital Management
- Western Asset Management Company

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.

The ASAM Class of 2011 would like to thank the managers and employees of the investment management firms that we visited during our tenure. The lessons learned during these visits could not have been replaced by classroom experience.
Professor Bruce Carlin Promoted to Associate Professor with Tenure
Professor Bruce Carlin has been promoted to associate professor with tenure. Carlin joined the finance faculty at UCLA Anderson in 2007. Carlin's primary research interests are in the areas of theoretical corporate finance and consumer finance. He has published in leading journals, including the Journal of Finance, Journal of Financial Economics and Review of Financial Studies. He is a dedicated teacher, and was awarded the 2008 Dean W. Robbins Award for teaching excellence. He has been recognized previously for his teaching acumen at both Duke University and the University of North Carolina. Please join us in congratulating Bruce!

Professor Mark Garmaise Selected 2011 Outstanding Teacher of the Year by MBA Students
Our MBA students selected Professor Mark Garmaise as the 2011 Outstanding Teacher of the Year. Garmaise teaches the core Corporate Finance course, as well as the Venture Capital and Private Equity course. His primary research interests are in the areas of corporate finance, real estate, entrepreneurship and banking. This honor is additional to Garmaise's many prior awards. He has received 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 also published in the Review of Financial Studies, Journal of Finance and Quarterly Journal of Economics.

Professor Bhagwan Chowdhry is Panelist at the Israeli Presidential Conference
Facing Tomorrow 2011, the third annual conference under the auspices of the president of the State of Israel, Mr. Shimon Peres, took place in Jerusalem from June 21-23. The Israeli Presidential Conference was held for the first time in May 2008, one week following the 60 year anniversary of the State of Israel. It was defined by many as the most impressive event that took place in honor of the 60th celebration. Conferences have been privileged with the presence of global leaders, international scholars and activists, poets and scientists, artists, clergy, entrepreneurs, economists and industrialists. The 2011 Conference focused on the vital issues, initiatives and decisions that must be implemented today in order to guarantee a better tomorrow for the world, the Jewish people, and the State of Israel.

Professor Bhagwan Chowdhry is an invited panelist at the Israeli Presidential Conference. Chowdhry is a professor of finance, and faculty director of the Master of Financial Engineering program. His research interests, on which he has published several papers in finance and economics journals, are in international finance and corporate finance strategy. He has been on the editorial board of a number of finance journals. Microfinance has been his recent teaching, research and applied interest.

Professor Avanidhar Subrahmanyam is Keynote Speaker for European Financial Management Annual Meeting
Professor Avanidhar Subrahmanyam (“Subra”) is the invited keynote speaker at the European Financial Management Association’s (EFMA) 21st Annual Meeting in Barcelona, Spain from June 27-30. The EFMA was founded in 1994 to encourage research and disseminate knowledge about financial decision making in all areas of finance as it relates to European corporations, financial institutions and capital markets. Members consist of academics, practitioners and students from Europe and the rest of the world who are interested in the practice of sound financial management techniques and are dedicated to understanding and solving financial problems. Over 500 people attend the meetings. Subrahmanyam is an expert in behavioral finance and economics, known for his path-breaking research in the use of psychological principles to explain stock price movements. Co-editor of the Journal of Financial Markets, Subrahmanyam is the author or co-author of numerous refereed journal articles in leading finance and economics journals. For his scholarly efforts, he has received best paper awards at the Western Finance Association meetings and the International Conference of Finance in Taiwan and was honored with the Fama-DFA prize for the best paper in investments published in the Journal of Financial Economics (2000) and the Smith Breeden Prize for the best paper published in the Journal of Finance (1999).
Two Finance Chair Transitions

Richard Roll will become the first Joel Fried Chair in Applied Finance, a new endowed chair created thanks to the generosity of alumnus and Fink Center board member Joel Fried (’86) to recognize excellence in applied finance teaching and research. Mark Grinblatt, the J. Clayburn LaForce Professor of Finance, has been named to the Japan Alumni Chair in International Finance, the chair held previously by Richard Roll, created in 1997 thanks to the collective generosity of over 130 Japan alumni.

Richard Roll, a distinguished member of our faculty since 1976, is among the leading finance scholars in the world, having contributed seminal works on asset pricing, portfolio theory and interest rates. He was president of the American Finance Association, and has led the Fink Center for Finance and Investments since its founding in 2006. He has worked for the Boeing Company and Goldman Sachs, and consulted with many firms in the financial services industry. Richard has been the recipient of some of the most prestigious prizes in the field, including the Graham and Dodd award for financial writing three times, and the Leo Melamed Award for the best financial research.

Mark Grinblatt, who has been on our faculty since 1981, is senior associate dean of the UCLA Anderson Ph.D. Program. He is a former president of the Western Finance Association and a founding member of the Foundation for the Advancement of Research in Financial Economics. His research focuses on asset pricing, corporate finance and investor behavior. His recent work on IQ and investor performance won the 2010 Goldman Sachs international prize for best paper. He currently serves as advisory editor to both the Journal of Finance and the Journal of Financial and Quantitative Analysis, on the executive committee of the National Bureau of Economic Research, and on the board of Citi Swapco, Inc. He formerly was vice president at Salomon Brothers, a board member of the American Finance Association, and the keynote speaker at several major academic conferences.

Professor Bhagwan Chowdhry Makes Special Appearance on “Entourage”

Professor Bhagwan Chowdhry was approached by “Entourage’s” casting director Susan Abramson and Executive Producer Doug Ellin to make a cameo appearance on the show for his Financial Access at Birth (FAB) initiative. FAB is trying to convince world leaders as well as private donors to open a $100 savings account for every child born in the world. He plays himself, a professor in finance at UCLA Anderson School. The show will air on Episode 6 during the upcoming and last season on Sunday, August 28th.

Bhagwan, second from left, on set with “Entourage” cast members, his children, and Professor Bruce Carlin.
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
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

Contact us

Laurence and Lori Fink Center for Finance & Investments
UCLA Anderson School of Management
110 Westwood Plaza
Entrepreneurs Hall, C424
Los Angeles, CA 90095-1481
fink.center@anderson.ucla.edu
310.825.3867

For more information about the Center, please visit us at www.finkcenter.anderson.ucla.edu

The opinions expressed 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.