



CANADIAN
SECURITIES
INSTITUTE
RESEARCH
FOUNDATION

JOURNAL | VOLUME I

ANNIVERSARY EDITION • 2012

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JOURNAL | VOLUME I

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The findings, interpretations and conclusions expressed in the articles herein are those of the authors and do not necessarily reflect the views of the Canadian Securities Institute Research Foundation or its Board of Directors. The **Canadian Securities Institute Research Foundation** does not guarantee the accuracy of the data cited in the articles.

EDITORIAL



As president, I am pleased that we have been able to launch our first publication, the **Canadian Securities Institute Research Foundation Journal**, highlighting the work of academics across Canada. The articles present two types of research: technical research that seeks to explain how the capital markets work, or research that explores the more human side of investing.

In this publication, two authors approached the more technical side. Dr. Wang explores the effects of ETFs on the value of the underlying stocks. Dr. Thompson describes credit default swaps.

Six of the authors explore the human factor. Investing and financial results are all driven by people: people who invest their money, people who advise investors, people who manage the money and people who work in enterprises that create value in the market. Dr. Kramer investigates how investing is influenced by the seasons. Dr. Durnev shows how elections impact investors. Dr. Phillips (with co-author Kaul) explores investment tendencies following a major crisis such as the collapse of the World Trade Centre. Dr. Gokul explains the psychological biases that cause investors to make poor investment decisions. Dr. Simutin studies the value of active mutual fund management by looking at how fund managers invest within families of funds. Dr. Christoffersen outlines the results of her research looking at the performance of fund managers and compensation issues.

One of the main objectives of the Foundation is to create a bridge between the financial services industry and academia. By funding the grounded research, the Foundation ensures that practical research is being supported in Canadian universities. The research presented here provides some perspective on the vast number of topics deserving of academic attention. The research presents divergent views and it will require much more research to properly understand the dynamics of the capital markets and investors. Through this publication, the Foundation begins its work to connect academics to the industry by ensuring the dissemination of their work. I extend a heartfelt thanks to the academics who were able to contribute to this journal.

A handwritten signature in black ink that reads "Marie Muldowney". The signature is fluid and cursive.

Marie Muldowney

President
Canadian Securities Institute Research Foundation

HISTORY & BACKGROUND

The CSIRF was founded in 1996 as the Investor Learning Centre of Canada (ILC) with a grant of six million dollars from the Canadian Securities Institute (now CSI Global Education). The mandate of the ILC was to bring capital markets education to the public with a “store front” on King Street in the heart of Toronto’s financial district.

In 2003, the board of the Investor Learning Centre decided to refocus the mandate of the Centre from investor education to the funding of applied and relevant research in the areas of investing, capital markets and financial planning and to change the name of the ILC to the Canadian Securities Institute Research Foundation (www.csifoundation.com).

The Foundation has been supporting applied research in the capital markets since 2005. Over the years, the Foundation awarded a Limited-Term Chair (a three year scholarship of \$150,000) supporting a researcher undertaking a significant body of grounded work focused on the capital markets, an Academic Award (one-year scholarship of \$35,000) granted to a researcher who is undertaking a new career in the capital markets research, and Ph.D. Awards (one-year scholarships of \$25,000) generally awarded to students who are well advanced in their Ph.D. research. In all, more than \$700,000 has been granted as scholarships to worthy candidates in universities across Canada:

2010-2011	▶ \$100,000 one Limited-Term Chair, two Ph.D. awards
2009-2010	▶ \$110,000 one Limited-Term Chair, one academic award, one Ph.D. scholarship
2008-2009	▶ \$170,000 one Limited-Term Chair, two academic awards, two Ph.D. scholarships
2007-2008	▶ \$125,000 one Limited-Term Chair, three Ph.D. scholarships
2006-2007	▶ \$100,000 one Limited-Term Chair, two Ph.D. scholarships
2005-2006	▶ \$100,000 one Limited-Term Chair, two Ph.D. scholarships

In addition, the Canadian Securities Institute Research Foundation has just completed a major research project to identify research topics that would be of interest to the industry in the area of the client–advisor relationship.

Ultimately the Canadian Securities Institute Research Foundation aims to fund grounded research on the capital markets and to better bridge research work in academia with the needs of the investment industry and investors in Canada. This journal is the culmination of the work of the Foundation over the last 15 years in supporting Canadian researchers, and the well-being of the capital markets and investors.

HEATHER-ANNE IRWIN



Over the last ten years, the Canadian Securities Institute Research Foundation has granted scholarships and awards to both graduate students and academics at universities across Canada. I have had the privilege of structuring the awards and then working with the Foundation to execute the mandate. I work with the award recipients and the universities to ensure that the grant money awarded by the Foundation is properly channelled through the university to the designated researcher. Over time, I have been presented with many interesting research proposals which have been evaluated by our Canadian Securities Institute Research Foundation Award Selection Committee.

I have dealt with all the Foundation award recipients and their respective universities since the inception of the award. I am convinced that the Canadian Securities Institute Research Foundation is contributing to encourage applied research in the capital markets. The grants are generous and have contributed to the work of each and every recipient. I am pleased to see that so many of the recipients have accepted to present some of their work in this [Canadian Securities Institute Research Foundation Journal](#).


A handwritten signature in black ink that reads "Heather-Anne Irwin". The signature is fluid and cursive, with a long, sweeping tail on the final letter.

Heather-Anne Irwin

Executive Director
Canadian Securities Institute Research Foundation

FRED KETCHEN



 In behalf of the Board of the Canadian Securities Institute Research Foundation, I am very pleased to present the first **Canadian Securities Institute Research Foundation Journal** marking the 15th anniversary of the Foundation. I am proud to have been associated with the Foundation and its work both with investor education and in support research since its founding in 1996.

The Foundation funds realistic and creative ideas for research of issues pertaining to the Canadian capital markets to benefit investors and other participants. It is supporting important work. This journal presents a selection of articles by academics who have been funded by the Foundation and who have made it their life's work to conduct research in the capital markets. The research presented casts a light on several areas that are important to the industry. Clearly, there is much work to be done to better understand the functioning of the capital markets and the actions of investors.

This is the first time that the Foundation is publishing articles on the work it funds. Through this journal, the Foundation takes a huge step towards knowledge mobilization helping to connect the world of capital markets with the research world. Congratulations to the Canadian Securities Institute Research Foundation for its 15 years of work. I also extend my deep gratitude to the academics who took the time to present articles for the journal.

A handwritten signature in black ink, appearing to be 'Fred Ketchen', written in a cursive style.

Fred Ketchen

Chairman of the Board
Canadian Securities Institute Research Foundation



LISA KRAMER

SEASONAL VARIATION IN DEPRESSION & IN MARKETS

A collection of recent studies in finance strongly suggests human emotions play a profound role in financial markets. The view promoted by this body of work has become increasingly accepted by the investing public in the wake of extreme market volatility over the past few years. Certainly fundamental economic factors are the biggest determinant of security prices, but evidence is increasingly arising that basic human psychology also plays a pivotal role.

For example, with diminished daylight in the fall and winter, a substantial fraction of the population suffers annually from seasonal depression (commonly known as seasonal affective disorder, or SAD). Up to ten percent of people in North America suffer severely, and clinical evidence shows that most of the rest of us experience winter blues to a milder degree. Importantly, careful research has established that depressed people are more averse to financial risk. Consequently, as an investing public we are collectively less willing to bear financial risk in the fall and winter. Combine this human tendency with a bit of bad economic news, such as we have seen come out of Europe recently, and the result can be plummeting stock markets, much more so than if the same news had emerged in the spring or summer, when daylight is more abundant and our moods are more buoyant.

My co-authors Mark Kamstra, Maurice Levi, and I showed the impact this human characteristic has on stock markets around the world.¹ We found prices for risky securities tend to be lower in the fall when individuals start shunning risk, leading to a relatively higher expected reward for investors



“ A COLLECTION OF RECENT STUDIES IN FINANCE STRONGLY SUGGEST HUMAN EMOTIONS PLAY A PROFOUND ROLE IN FINANCIAL MARKETS. ”

who are willing to bear risk through the fall and winter seasons. Then, as daylight increases in the spring, prices tend to rebound, leading to lower expected returns for investors who hold risky securities during the spring and winter. (All of this is consistent with the old adage "Sell in May and go away.")

We found that in countries located at more extreme latitudes, such as Sweden and the UK, where daylight fluctuates more dramatically through the seasons

relative to North America, seasonal stock market fluctuations are relatively more dramatic. And in southern hemisphere countries such as Australia and New Zealand, where the seasons are six months out of phase, so are the seasonal effects in markets.

In follow-up studies that build on that finding, my co-authors and I have been examining the impact this human characteristic has on other aspects of

financial markets. We are finding that the expected return on safe financial assets, such as US government bonds, in a sense mirrors that of risky assets, with expected returns being lower in the fall and winter than the spring and summer.² Furthermore, we are finding that investor flows of capital into and out of mutual funds reflect this characteristic too: investors tend to move from risky to safe mutual fund categories in the fall and from safe to risky categories in the spring.³ To date, most of the evidence regarding the influence of seasonal depression on financial risk tolerance has been at the level of aggregate financial markets, with the implications for individual investor behavior being inferred rather than definitively shown. My recent work with co-author Mark Weber addresses that gap.⁴ In that study, we examined the financial risk preferences and other characteristics of hundreds of faculty and staff at a large North American University. We found strong, statistically significant evidence that individuals who suffer from seasonal depression become significantly more averse to financial risk in the winter. Moreover, they tend to be more risk averse than non-depressed individuals all year. This finding helps solidify our understanding of the influence human emotion has on risk preferences at the level of the individual, and aggregate price fluctuations at the level of the market. Additional work in progress will continue to build on this finding, contributing to the growing body of research that relates human psychology to the discipline of finance.

BIOGRAPHY

DR.

LISA KRAMER

is an Associate Professor of finance in the University of Toronto's Rotman School of Management. She recently spent a sabbatical as a Visiting Scholar in the Psychology Department at Stanford University. Her Ph.D. in finance is from the

Sauder School of Business at the University of British Columbia. During the years 2008 to 2011 she was the CSIRF Limited Term Professor.

Professor Kramer is an expert on behavioural finance, with interests in neuroeconomics, investments, capital market seasonality, human decisions, and emotions. Some of her best-known and most provocative research is based on identifying instances where investors' psychological tendencies lead to widespread movements in financial markets. She has delivered research seminars at universities and government agencies around the world, and she is a regular presenter at top international conferences including the meetings of the American Finance Association, the Western Finance Association, and the European Finance Association. Her work has been published in prestigious journals including the *American Economic Review* and the *Journal of Financial and Quantitative Analysis*. Her studies have been extensively covered by the popular media, in outlets including *The Wall Street Journal*, *US News and World Reports*, *The Washington Post*, *The Daily Telegraph*, *Business Week*, *SmartMoney Magazine*, *The National Post*, *The Globe and Mail*, CBC Television, and CBC Radio.

TESTIMONIAL

IT HAS BEEN AN IMMENSE HONOUR TO RECEIVE FUNDING FROM THE CSIRF.

The funding has permitted me to conduct research that would not have been feasible otherwise. Specifically, I have been able to conduct costly but extremely illuminating research based on studying the risk preferences of over a thousand individuals. Additionally, I was able to spend a year-long sabbatical at Stanford University collaborating with other researchers who study the influence of emotions on risk preferences. The fruits of the Foundation's support have already begun to emerge in the form of publications, and will continue to be produced based on the datasets I have been assembling. Collectively, the findings that are emerging from my Foundation-supported work are helping to shape the finance profession's understanding of the interaction between emotion and individuals' financial risk preferences.

¹ ["Winter Blues: A SAD Stock Market Cycle," 2003, *American Economic Review* 93(1), 324-343.] <http://www.jstor.org/pss/3132178>

² [Work-in-progress with Mark Kamstra and Maurice Levi, "Seasonal Variation in Treasury Returns."] <http://ssrn.com/abstract=1076644>

³ [Work-in-progress with Mark Kamstra, Maurice Levi, and Russ Wermers, "Seasonal Asset Allocation: Evidence from Mutual Fund Flows."] <http://ssrn.com/abstract=1907904>

⁴ [Seasonal Affective Disorder and Risk Aversion in Financial Decision Making, forthcoming, *Social Psychological and Personality Science*.] <http://spp.sagepub.com/content/early/2011/07/15/1948550611415694>

SUSAN CHRISTOFFERSEN

RESEARCH IN MUTUAL FUNDS

The increasing complexity of mutual funds makes it difficult for unsophisticated investors to navigate where to invest. Consequently many rely on broker intermediaries to provide advice. The recent regulatory reform in the Dodd-Frank Act (in the US) calls for better alignment of incentives between brokers and mutual fund investors where regulators are concerned that payment incentives to the broker may skew advice. Consistent with this, we find that third-party brokers will direct more money towards mutual funds paying them a larger portion of the one-time upfront load, and even more concerning, the resulting performance for these investors is worse than the benchmark. The findings also suggest that the relation between payment and flows is more aggravated in third-party brokerage channels rather than in-house brokers since funds compete so aggressively for investor attention when they are compared directly with other mutual fund families offered by the same third-party broker.

While the relation between upfront loads and flows confirms regulatory concerns, there is some positive news in that a change in the structure of compensation may help to align incentives. Numerous fund families have moved to paying brokers on an ongoing basis, through trailer fees or revenue-sharing arrangements, where brokers are paid a percent of the assets each year rather than a one-time upfront commission. Although the practice of revenue-sharing is less transparent than upfront loads, the ongoing nature of the payment implies that brokers are exposed to the long-term performance outcomes of investors. Consequently,



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while higher on-going payments to the broker serve to attract more dollars to the fund, the resulting returns are at least on par with (and not worse than) the benchmark.

Aside from relying on intermediaries to attract flows, funds also need to build size through better performance, based on trades and securities lending programs to implement profitable strategies. In this regard, the research support from the CSIRF

was instrumental in helping to create a unique database on Canadian mutual fund trades where we see that active managers deliver both cheaper trades and better subsequent performance than index managers. Given index managers are often considered uninformed, the lower trading costs of active managers is somewhat surprising. Our research points to the ability of active managers to more patiently wait to build positions as a key contributing

factor to their lower costs, while index funds are forced to trade to maintain small tracking errors with their index. The trade-by-trade nature of the data provides important insights that cannot easily be picked up when comparing aggregate fund returns. Most importantly, the analysis enables us to separate the positive effect of skilled active management on performance from the negative drag on performance of higher trading costs amongst larger funds. Aggregate fund returns mix these two effects and often interpret the effects of large fund size as unskilled active management.

While there is a benefit to active management, investors often have difficulty choosing an active manager and the reliance on a third party broker, as shown above, can result in investors being directed to funds which pay more to the broker rather than ones which are best for the investor. For this reason, index funds are attractive and their ability to engage in securities lending programs can significantly help these funds boost their returns to overcome trading costs. In addition to improving performance through lending fees, securities lending is also an effective tool to manage tax inefficiencies amongst its investors.

Unlike Canada, the US mixes retirement and taxable money in the same mutual fund and this leads to severe tax inefficiencies which can be mitigated by securities lending. Take, for example, an international index fund. The fund invests in cross-border assets whose dividends are subject to a withholding tax—15% seems to be the norm—so, for example,

DR. BIOGRAPHY SUSAN CHRISTOFFERSEN

joined the
Rotman

School of Management in 2010. Prior to joining, she was an Associate Professor at the Desautels Faculty of Management at McGill and has over twelve years of experience teaching courses on capital markets and corporate finance at the undergraduate and graduate level. In recognition of teaching excellence, she received the Desautels Faculty of Management Teaching Award for Graduate Teaching in 2006. Professor Christoffersen's research focuses on mutual funds and more generally on the role of financial institutions in capital markets. Given the topical nature of her research, it has been published in top finance publications such as the *Journal of Finance*, *Journal of Financial Economics*, and the *Review of Financial Studies* and has been cited in well-known media outlets such as the *New York Times*, *International Herald Tribune*, *Bloomberg News Service*, *CBS Marketwatch*, and the *Wall Street Journal*. In recognition of her work, Susan has received several grants from SSHRC, IFM2, and FQRSC and numerous paper awards from various international agencies (Q-Group, Bank of Canada, BSI Gamma Foundation, INQUIRE, and the Swiss Finance Institute). In 2005, Susan was awarded the Limited Term Professorship by the CSIRF for her work on mutual fund trading and trading execution.

TESTIMONIAL

THE SUPPORT FROM THE CSIRF was fundamental to my continued research on mutual funds and instrumental in providing the necessary resources to create a unique database on Canadian mutual fund trades. The CSIRF's generous investment in Ph.D.s and academic researchers help ensure we have excellent research in Canada on topics which are important and relevant to practitioners, enabling researchers to compete with the very best in the US. The Limited Term Professorship is one of the largest academic prizes offered in Canada and carries with it considerable recognition in bridging the gap between academics and practitioners.

only \$0.85 of a \$1 dividend paid from a Canadian company would reach a US mutual fund investor. To offset this loss and encourage foreign investment, taxable investors receive a tax credit and non-taxable investors (like pension plans) can apply for exemption from the withholding tax. However, the mixed tax-base of mutual funds is excluded from exemption so without securities lending, the retirement money in these funds simply loses the 15% of foreign dividends, or in other words, a typical retiree in these funds would lose about 4% of their consumption at retirement.

To get around this, US mutual fund managers can engage in dividend arbitrage where the securities are lent temporarily to a Canadian entity, not subject to withholding. The 15% savings is split between the US mutual fund and Canadian entity through lending fees and we estimate that about 10% is recaptured by the US mutual fund. Therefore through arbitrage, the US mutual fund is able to return a \$0.95 dividend to retirees rather than \$0.85 without arbitrage. Another way to help the non-taxable retirees would be to avoid dividends and withholding tax all together and in fact we find more evidence of both dividend arbitrage and avoidance as the pool of retirement money in the fund increases, suggesting managers try to maximize the after-tax returns of their investors.

Two important lessons for Canada arise from this research. First, the separation of RRSP from taxable money in Canadian mutual funds makes our mutual funds better able to manage the tax needs of their constituents. Second, the withholding tax discourages foreign mutual funds from investing in Canadian stocks paying high dividends, an outcome with important implications for corporate policy.



JAMES R. THOMPSON

CREDIT DEFAULT SWAPS: WHAT ARE THEY?

After the fall of Lehman Brothers and AIG, credit default swaps (CDS) became a household term. AIG in particular sold massive amounts of credit default swaps that essentially became worthless to the buyer before the US government stepped in. In this article I will demystify and discuss some relevant issues related to credit default swaps, and focus mainly on the potential problems of CDS contracts. It is important to point out, however, that there are many potential benefits of CDS investment, so one should not look at this article as advocating for their ban.

The notional size of the CDS market grew from 180 billion dollars in 1996 to 41 trillion in 2008.¹ CDS contracts have traditionally traded in over-the-counter markets, dominated by a handful of large dealers. Regulation of these contracts has been relatively light; however, that is fast changing.

Credit default swaps resemble insurance contracts. The buyer purchases protection against default of an underlying debt from a seller. A CDS contract can be compared to a standard insurance contract where the buyer is like a home owner, the seller like an insurance company, and the default of an underlying debt like that associated with a house fire. There are, however, differences. There is no stipulation that the buyer of a CDS contract must own the underlying debt. Fitch Ratings Agency finds through survey data that roughly half of all buyers use the contracts purely for speculation. We can draw an analogy to insurance in 18th century England. For a period of time, insurers allowed people to purchase policies on many things, with no restriction that the buyer must own the



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underlying risk (in insurance jargon: have an insurable interest). A particularly perverse contract at that time was for merchants to purchase an insurance policy on another merchant's ship. Not surprisingly, insurers started to realize that there were more ships sinking than pure chance would allow. Imagine the situation from the perspective of the policy owners. They could profit from sinking the ship referenced in the policy in two ways: first, through a claim to

the insurer, and second, by knocking out one of their competitors. It is this type of reasoning that has been used by Germany and France in an attempt to ban the practice of purchasing any CDS, written on sovereign debt without being an owner of that debt.²

The differences between the CDS and insurance can be taken even further. Contrary to ordinary insurance, many CDS contracts can be traded in a very

active secondary market. It is this fact that has led many players to speculate on CDS investments, as opposed to speculating on the underlying bonds. The lack of liquidity in many bonds can make the CDS a low priced way to bet on the credit worthiness of a firm. A very important difference of CDS lies with the seller. In ordinary insurance, one usually thinks of an insurance company as well diversified, able to cede risk to re-insurers when necessary. In the CDS market, banks, insurers and hedge funds are the most active players on the sell side. The latter group can be particularly troublesome as many of them are undiversified by choice. This can make counterparty risk considerably more important in the CDS than in insurance. When a person purchases auto insurance for example, it is unlikely that they think too hard about the probability that their insurer will not be able to pay them. Although many CDS contracts are collateralized, they are rarely completely collateralized with risk-free assets and so buyers must consider counterparty risk, or they may find themselves on the wrong end of a deal gone bad.

To drive the point home about CDS sellers not performing the traditional role of insurers, the Wall Street Journal (June 12, 2009) reported an over-the-top story on a trade gone horribly wrong for many major banks at the hands of a small brokerage firm.³ The assets were mortgages on homes located mainly in California that, as of March 2009, were

BIOGRAPHY

DR.

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is an Assistant Professor of Finance

at the University of Waterloo where he has taught Managerial Finance since 2009. Currently he is a visiting Assistant Professor of Finance at the Wharton School, University of Pennsylvania where he teaches corporate finance in the MBA program. His research is centered on the issue of counterparty risk, with particular focus on credit default swaps. He has published his work in the Quarterly Journal of Economics and has presented his research at many conferences, Universities and Central Banks/Government institutions including the Bank of England, the German Bundesbank, the Bank of Canada and the Federal Deposit Insurance Corporation. He holds a Ph.D. degree from Queen's University.

TESTIMONIAL

THE FUNDING I RECEIVED FROM THE CSIRF WAS INSTRUMENTAL TO MY WORK.

My research requires interaction with many academics, government agencies and industry practitioners around the world. It is important to interact with these individuals so that my papers are relevant both inside and outside of academia. The CSI grant allowed me to do such traveling. In addition, my work requires me to seek assistance from graduate students to help keep on top of the literature and media coverage of such issues. The CSI grant allowed me to hire two Ph.D. students to assist me.

becoming quickly worthless. Anticipating this, the big banks were actively buying insurance in the form of CDS contracts which were to pay off as the housing market sank. One of the firms from which they purchased protection was Amherst Holdings, a relatively small brokerage house. The protection was written on a bundle of pre-defined mortgages. Precisely as the banks had predicted, the housing market deteriorated further and their contracts quickly became in the money. However, they were shocked to learn that the mortgages that were referenced in the CDS contracts with Amherst had all been paid off in full by another company which appeared to have a relationship with Amherst. The problem was that the banks did not own the mortgages in which they insured, so they had nothing to gain when they were paid off, and thus they were left holding worthless contracts.

Stories like the one above might give us pause as we try to uncover the true economic role that CDS contracts play in the economy. In their infancy, there was little doubt that they were used mainly as a tool for banks to hedge credit risk. With the market size growing every year, it is clear that speculation plays an important role in the modern CDS market. Although these instruments have received considerable bad press since the credit crisis, we cannot correct inefficiency until we understand what that inefficiency is. This requires a deeper understanding of CDS contracts; an understanding which we currently lack.

¹Stulz, Rene M. "Credit Default Swaps and the Credit Crisis," Finance Working Paper N. 264, ECGI (2009)

²<http://dealbook.nytimes.com/2010/05/19/germany-bans-naked-shorts-and-c-d-s-s/>

³<http://online.wsj.com/article/SB124468148614104619.html>

ART DURNEV

PRECARIOUS POLITICS & RETURN VOLATILITY

Elections are great for democracies, but my new study finds they may not be so good for business. My co-authors and I find that countries with national elections have more volatile economies because businesses don't like political uncertainty. The study also found economic volatility increases during political campaigns. Autocracies, however, demonstrate no such volatility, as they have less political risk and so investors are more easily able to make business decisions in those countries. The study measured volatility as the returns on stocks for companies based in each country, or companies based elsewhere that do significant business in a country. We looked at 50 countries, both developed and developing, and observed stock market volatility during the six months leading up to an election and for the year after the election.

The study found that in general, more mature democracies saw increased market volatility in the six months prior to an election. The markets in autocracies did not exhibit that volatility. This doesn't mean that autocracies face no market uncertainty. Dictatorships often experience revolutions, destabilizing the economy by throwing out the dictator, and increasing market volatility. The death of a dictator while still in office also causes increased market volatility because investors are unsure how the country's citizens will react and new leadership will govern.

But the volatility in democracies was more frequent and clearly tied to the election. The study did not quantify each country's market volatility because that level depended on factors unique to each country and each election. For instance, Russian markets might



“ELECTIONS ARE GREAT FOR DEMOCRACIES, BUT MY NEW STUDY FINDS THEY MAY NOT BE SO GOOD FOR BUSINESS.”

experience little volatility in the run-up to the presidential elections there if the markets expect that Vladimir Putin will win re-election to a third tenure in office. However, Egypt's already destabilized economy will likely become even more so because nobody knows who will win the coming elections.

But the study found that markets don't necessarily settle down in the year after an election. Sometimes the election

brings political stability that leads to economic stability. But sometimes, the election only creates more instability, increasing political risk and doing nothing to smooth a country's economy.

The study found that export-oriented industries, industries dependent on contract enforcement, and labor-intensive industries exhibit higher volatility when political risks are higher. Labor-intensive industries also display

higher volatility when governments from the political left lead a country or when labor laws are stricter. Autocratic regimes, on the other hand, reduce volatility, especially in industries that are more dependent on trade or contract enforcement.

The study sheds light on what's happening in the U.S. economy right now. Political uncertainty is high and so businesses respond by putting off expansions, investments, and new hires, slowing the economic recovery. I expect businesses to continue sitting on their cash until after the next election, when they have a clearer idea of who our new leaders will be. But even then they may hold back because the perceived polarized nature of American politics will create an ongoing uncertainty no matter who wins.

The results of the study have several theoretical and practical implications. For example, this paper has implications for corporate financial decision-making, as we show that choices to engage in trade with international partners or invest in lines of business with greater input or labor dependence can increase volatility and, thereby, can affect the cost of capital.

"Precarious Politics & Return Volatility," is a paper co-authored with:

Maria Boutchkova, University of Leicester
Hitesh Doshi, University of Houston
Alexander Molchanov, Massey University

It is forthcoming in the *Review of Financial Studies*.

BIOGRAPHY

DR. ART DURNEV is Assistant Professor of Finance at the Henry B. Tippie College of Business at the University of Iowa. He joined Iowa in 2011 after spending six years at the Desautels Faculty of Management at McGill University in Montreal, Canada. Art Durnev earned his Ph.D. in Finance from the University of Michigan Business School. He is a Canadian and Russian citizen.

Art Durnev's research interests are primarily focused on corporate finance, political cycles, governance, and financial markets development. His work involves empirical investigations of how political cycles affect corporate policies, firm governance structures, disclosure policies, insider trading regulation and idiosyncratic volatility. He has published this work in top academic and practitioner journals, such as the *Journal of Finance*, *Review of Financial Studies*, *Journal of Accounting Research*, *Journal of Applied Corporate Finance*, *Journal of International Business Studies*, *Michigan Law Review*, and *Economics of Transition*. Two of his *Journal of Finance* articles were nominated for the Brattle Prize (awarded to the best corporate finance articles).

TESTIMONIAL

THE STUDY WOULD NOT BE POSSIBLE WITHOUT A GENEROUS AWARD FROM THE CSIRF.

To complete the study, I had to hand-collect data on elections around the world. The award helped me recruit a team of qualified students who, under my guidance, collected the necessary data. To get necessary feedback from academic experts, I presented this study at several conferences around the world. The CSIRF award financed my travel costs. This project resulted in a paper that got accepted in a top finance academic journal, *Review of Financial Studies*.

A TYPOLOGY OF PSYCHOLOGICAL BIASES INFLUENCING INVESTMENT DECISION-MAKING

Recent studies in investment and finance find that individuals make flawed investment decisions due to various psychological biases which are considered deviations from rational decision-making. Based on their primary characteristics and impact on investment decisions, biases can be classified into three types: cognitive, affective, and conative. Decision Support Systems (DSS) are designed to counter these biases. In the following paragraphs, we describe the nature of these biases and how they influence investors, and conclude with some ways in which DSS counter these biases.

Cognitive biases are information-processing biases which motivate individuals to misjudge the true significance of new information. These biases are primarily triggered by the arrival of new information and are caused by the salience, order, patterns, and amount of information received by decision-makers. Some major cognitive biases in investment decision-making are: framing, representativeness, and ambiguity. A *framing* bias is said to occur when the manipulation of a decision frame changes the decision-maker's perspective about the problem. *Representativeness* refers to an individual's tendency to classify objects into different categories by observing only their representative or salient characteristics. The representativeness bias motivates people to ignore sample size, and mean reversion and become over-confident about the significance of the information received. For example, if a stock in the software industry is doing well, people may erroneously believe that all stocks in that industry are also doing well (sample size neglect)



“RECENT STUDIES IN INVESTMENT AND FINANCE FIND THAT INDIVIDUALS MAKE FLAWED INVESTMENT DECISIONS DUE TO VARIOUS PSYCHOLOGICAL BIASES...”

and if the price of a stock has been rising for some time, people believe it has entered an “increasing trend” (neglect of mean reversion). *Individuals* experience ambiguity and make contradictory decisions when they are faced with conflicting, incomplete, uncertain or excessive information. Several pension studies document that plan participants tend to make their choices based on the “path of least resistance” to cope with the information ambiguity.

Affective biases involve strong emotional elements such as pride, regret and fear, and are triggered by the arrival of new information. Emotion influences decision-making in a major way. For example, the quest for pride and the desire to avoid regret often result in demonstrably unwise investment decisions. The *house money* and *disposition effects* are major investment-related affective biases. The house money effect refers to an individual’s

tendency to take high risk under the influence of recent gains. Although people are risk averse in gains and risk seeking in losses in one-stage gambles, they may take high risks in multi-stage gambles such as investing if they have recently made some profits.

The disposition effect refers to an individual’s tendency to seek pleasure by realizing gains and avoid the pain of regret by avoiding the realization of losses. This is the exact opposite to what should be done due to tax consideration. Investors sell their rising stocks too early and hold their falling stocks too long due to the disposition effect.

Conative biases constitute general human tendencies (e.g., inertia) and are likely to exist in different cultures and across markets. The conative component in human judgment and decision-making is a metalevel process with strong developmental roots. Therefore, conative biases are persistent in nature and may exert their influences even in the absence of any new information. Major conative biases are *over-confidence*, *familiarity*, and *status quo*. Over-confidence, which refers to the systematic over-estimation of the accuracy and precision of one’s knowledge, has been observed in several contexts of judgment and decision-making. Previous studies have found that people generally over-rate their qualifications and judgment capacity, and investors exhibit over-confidence even in such difficult tasks as stock selection. Familiarity bias is an individual’s general tendency to prefer familiar objects or situations. Investors often invest major portions

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TESTIMONIAL

THE GENEROUS FUNDING FROM THE CSIRF

enabled me to design and develop a prototypical decision support system (DSS) in my doctoral study. The primary goal of the DSS was to assist individuals in overcoming their investment-related psychological biases. Without this financial support, it would have been very difficult for me to conduct the proposed experiment. Encouraged by the support of CSIRF, I continued working in the behavioural aspects of investment decision-making and I have had three journal publications in this area. Credit is also due to the CSIRF for my recent success in obtaining a SSHRC standard grant because the reviewers had such a high opinion of the CSIRF scholarship.

of their portfolio in companies that they are most familiar with. People may achieve familiarity due to geographical proximity or their industry knowledge and affiliation. Familiarity bias is a major cause of insufficiently diversified portfolios. Status quo bias is an individual’s tendency to do nothing or maintain one’s current or previous decision. Prior studies find that retirement plan participants do not change their portfolios and contribution rates for a long time due to the status quo bias, thereby forfeiting potential gains.

Based on our experimental study, we find evidence that properly designed computerized decision support tools can lower the impact of psychological biases on individuals’ investment decision-making. In order to overcome the influence of cognitive biases, decision support systems (DSS) may follow an introspective de-biasing strategy in which the investor’s assumptions and beliefs are challenged by the DSS by furnishing relevant and easy-to-understand information (e.g., providing a summary of critical data or changing their presentation format etc.). To overcome the impact of affective biases, DSS may follow a prospective de-biasing strategy in which investors are graphically shown the potential impact of their current investment decisions on their long-term investment goals with the objective of alerting them to any possible discrepancy. To ameliorate the effect of conative biases, DSS would follow a retrospective de-biasing strategy in which the investors are questioned about their past decisions and transactions with the goal of detecting persistent patterns of their behavioural biases, if any. We expect to see more research on this topic in the future.



BLAKE PHILLIPS & ADITYA KAUL*

ECONOMIC CONDITIONS, FLIGHT-TO-QUALITY & MUTUAL FUND FLOW

Collectively, mutual fund investors are major players in capital markets, with assets of 23 trillion USD worldwide at year-end 2009.¹ Canadian mutual funds manage over 600 billion CAD, which represents 30% of Canadian financial wealth.² At the fund level, research has shown that investor actions do not always have rational explanations. For example, mutual fund investors chase returns, relying on past performance as imperfect predictors of future returns and react to non-informative name changes and advertising campaigns.³ In this article, we study the aggregate allocation decisions of Canadian mutual fund investors across broad asset classes. Our goal is to assess the collective behavior of these, typically small, investors. Much as diversification minimizes the effects of idiosyncratic factors, aggregate investor allocation decisions may be quite different from fund-level evidence. Our focus on aggregate asset allocation decisions leads to new insights about the collective behavior of mutual fund investors.

Starting with monthly flow data for individual Canadian mutual funds over the period January 1991 through October 2005, we compute aggregate monthly allocations for seven major fund categories: Money Market; Bond; Balanced; Dividend and Income; Canadian Equity, U.S. Equity; and Foreign Equity. These categories individually account for at least 10% of overall monthly flow, on average, although each series shows considerable time-series variation. We then relate allocations to common proxies for economic conditions: the term spread (TERM), the default spread (DEF), the change



“ AT THE FUND LEVEL, RESEARCH HAS SHOWN THAT INVESTOR ACTIONS DO NOT ALWAYS HAVE RATIONAL EXPLANATIONS. ”

in the short-term interest rate (ΔTB), the Treasury-Eurodollar spread (TED), and volatility in the stock and bond markets (TSV and TBV).⁴

We find that, in aggregate, fund investors alter the riskiness of their portfolios in response to shifting economic conditions, increasing risk as the economy improves and reducing risk in anticipation of economic downturns. Thus, when the economy is expected

to perform favorably (i.e. $TERM$ is high, DEF is low, ΔTB is low, or TED is low), investors direct flow away from money market funds and towards equity funds. For example, a one standard deviation increase in the term spread (1.13%) results in an 84% increase in allocations to Canadian equity funds and a 74% decrease in allocations to money market funds, relative to the previous month. The coefficients on DEF and ΔTB paint a broadly similar picture. Moreover, the

sensitivity to $TERM$, DEF and ΔTB is, for the most part, lower for balanced or dividend/income funds than for equity funds; thus, flow to the riskiest assets is most sensitive to economic conditions. These results on the relation between aggregate flow and economic conditions are, to our knowledge, new.

In sum, our results point to rational motives behind the aggregate asset allocation decisions of mutual fund investors. Often derided as noise traders, small investors pay attention to economic signals while determining allocations. In general, fund managers are precluded from reallocating across asset classes as economic conditions change. Our results suggest that investors recognize this limitation and undertake such 'market-timing' type reallocations themselves. Further, the direction of the relation between aggregate allocations and the proxies for economic conditions suggests that the collective actions of fund investors do not disrupt price formation. Rather, they likely contribute to the well-documented relation between these proxy variables and asset prices (e.g. see Fama and French, 1989).

Despite the apparently rational foundations of these asset allocation decisions, we find limited evidence of associated wealth benefits. Comparing a buy-and-hold equity portfolio and a 'flight-to-quality' portfolio which switches between money market and equity funds based on the term spread, we find that both average return and risk (standard deviation) are lower for

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received a Bachelor of Science from the University of British Columbia in 1996, a Master of Forestry and Master of Business Administration from the University of Alberta in 2004 and a Ph.D. in

Finance also from the University of Alberta in 2009. Prior to commencing his doctoral studies, Blake was a Director and Managing Partner of Spectrum Resource Group Inc., a forestry consulting firm headquartered in British Columbia. Blake is currently an Assistant Professor of Finance at the University of Waterloo, School of Accounting and Finance and a Regular Member of the Waterloo Research Institute in Insurance, Securities and Quantitative Finance. Blake's research focuses on stock market efficiency, empirical asset pricing and mutual funds.

TESTIMONIAL

I RECEIVED THE CSIRF FUNDING IN THE FINAL YEAR OF MY Ph.D. AT THE UNIVERSITY OF ALBERTA. Ph.D. students often need to take on research assistantships or lecturer jobs to meet their financial needs. The CSIRF scholarship allowed me to focus my time on research, significantly increasing my productivity in my final year and contributing to my placement at the University of Waterloo.

the flight-to-quality portfolio. On a risk-adjusted (Sharpe ratio) basis, the buy-and-hold portfolio marginally outperforms the flight-to-quality portfolio.

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The authors are grateful for financial support from a National Research Program in Financial Services & Public Policy grant from the Schulich School of Business, York University, and for data provided by the Investment Funds Institute of Canada. We thank Dick Beason, Wolfgang Bessler, Susan Christoffersen, Mark Huson, Marty Luckert, Vikas Mehrotra, and session participants at the 2008 European Financial Management Association and 2008 North American Financial Management Association meetings and seminar participants at Hitotsubashi University and Kobe University for helpful comments.

¹ Investment Company Institute, Trends in mutual fund investing, 2010.

² The Investment Funds Institute of Canada, 2011.

³ See Gruber (1996), Sirri and Tufano (1998) and Lynch and Musto (2003) for evidence of return chasing. Jain and Wu (2000) and Cooper et al. (2005) report that investors direct flow at funds which advertise more and funds which undergo name changes to reflect current market trends.

⁴ Among other papers in this line of research, see Fama and Schwert (1977), Fama and French (1989), Schwert (1989) and Chen (1991).



JIN WANG

THE COSTS OF ETF MEMBERSHIP: VALUATION EFFECT OF ETFs ON UNDERLYING FIRMS

In spite of the explosive growth of the ETF market over the past two decades and its significant effects on the trading environment, we know little about the effects of ETFs on the value of underlying stocks and the channels through which such valuation effects take place. In my recent research (co-authored with Professor Kee-Hong Bae at York University and Professor Jun-Koo Kang at Nanyang Technological University), we seek to fill this gap in the literature by investigating whether and how ETFs affect the value of the stock issuers.

There are two competing views on the effect of ETFs on firm value, namely, the view that ETFs adversely affect the value of the stock issuers (the “negative view”) and the view that they have a positive effect on the issuer value (the “positive view”). According to the negative view, the significant rise in ETF trading increases systematic risk of the underlying stocks and both supply of and demand for underlying shares to sell short. In contrast, the positive view suggests that ETFs increase firm value through improvement in stock liquidity and increased demand by institutional investors for stocks that underlie the ETF.

Our results are largely consistent with the negative view of ETFs and inconsistent with the positive view. Specifically, using the proportion of shares outstanding held by all ETFs as the measure of the availability of ETF, we find that ETF holdings have a significantly negative impact on firm value during the eight-year sample period from the fourth quarter of 2002 to the third quarter of 2010. However, this negative impact exists only for firms



“ WE KNOW LITTLE ABOUT THE EFFECTS OF ETFs ON THE VALUE OF UNDERLYING STOCKS & THE CHANNELS THROUGH WHICH SUCH VALUATION EFFECTS TAKE PLACE. ”

with market capitalization below the sample median, suggesting that small firms suffer more from the rise of ETFs. The economic impact of ETF holdings on the value of small firms is substantial: For firms with market capitalization below the sample median, one standard deviation increase in ETF holdings leads to a decrease in Tobin's q by almost 13%.

To investigate the channels through which ETFs affect firm value, we

examine how ETF holdings affect key determinants of firm value, such as systematic risk, short interest, liquidity, and institutional ownership. We find that systematic risk of small firms increases with ETF holdings. We also find that ETF holdings significantly increase underlying firms' short interest, stock liquidity, and institutional ownership, especially for small firms.

We then examine how the changes

in these stock characteristics caused by the changes in ETF holdings affect firm value. We find that systematic risk and short-selling activities are the channels through which ETF holdings impact on firm value. Furthermore, we find that even though ETF holdings improve stock liquidity and increase institutional ownership, these seemingly desirable changes in stock characteristics actually do not contribute to firm value because they increase investors' short-selling activities in underlying stocks.

BIOGRAPHY

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is an Assistant Professor in Finance at Wilfrid Laurier University. He received his Ph.D. at Queen's University.

His research interests are in empirical corporate finance, corporate governance, and investment. His work spans several areas such as capital structure, payout

policy, corporate cash holdings, credit ratings, and ETFs. He studied how a firm's labor market affect its financial choice; investigated how a firm's relationships with its customers/suppliers affect its shareholders' income; examined why those firms that rely on principal customers/suppliers tend to hold more cash; investigated whether competition among rating agencies affects the quality of their ratings on corporate bonds; and examined how the rise of ETFs affect firm value of underlying stock issuers. Dr. Wang has presented his work at a variety of prestigious academic conferences around the world, such as Northern Financial Association and Financial Management Association annual meetings. His paper on how a firm's relationships with employees affect its capital structure has been published in the Journal of Financial Economics. He mainly teaches corporate finance courses.

Our research may be of interest to regulators and investors by providing new insights on a number of important issues. First, index inclusion has long been viewed by both academics and corporate managers as a desirable event for its positive effect on stock liquidity and demand by institutional investors. However, our results show that the rise of ETFs actually hurts firm value, suggesting that index inclusion is not always beneficial to firms. Second, our research sheds new light on the relation between institutional ownership and firm value. Our results suggest that the institutional demand effect could be detrimental to firm value if high ownership by institutional investors leads to high short-selling activities by short sellers. Third, our study identifies a conflict of interest that exists in the ETF industry. While ETF sponsors have strong incentives to lend underlying stocks to short sellers to make profits, ETF investors and shareholders of these stocks suffer from the increase in supply of their stocks for short sales because it decreases firm values. This conflict of interest causes a wealth transfer from shareholders of the underlying stocks and ETF investors to ETF sponsors and short sellers.

The proponents of ETFs argue that ETFs are a low-cost alternative to conventional mutual fund investments. However, our study uncovers a non-trivial hidden cost of ETFs and suggests the importance of re-evaluating the potential benefits and costs of the rise of ETFs. Finally, regulators are

TESTIMONIAL

I AM VERY HONoured TO BE A RECIPIENT OF THE CSIRF Ph.D. SCHOLARSHIP.

I received this scholarship in the last year of my Ph.D. program. My university provides funding for Ph.D. students up to four years; without this scholarship, I would have to spend much more time on activities such as teaching and research assistance. This scholarship helped me focus on my dissertation and complete my Ph.D. degree on time. In addition, the funding provided me with means to attend several major conferences and present my research. This was greatly helpful for both disseminating the knowledge from my research and increasing my visibility in the job market. Finally, as one of the most prestigious scholarships for Canadian scholars in the finance area, the scholarship increased my reputation and marketability in the job market.

increasingly concerned about the potential risks of having ETFs, particularly their impact on market volatility. By providing firm-level evidence that ETFs increase the systematic volatility and thereby decrease the value of the underlying firms, our paper provides direct evidence in support of this concern and calls for future research on the systemic risks of ETFs.



MIKHAIL SIMUTIN

ON INCENTIVES TO STAND OUT IN THE FAMILY: DEVIATION FROM A FAMILY PORTFOLIO & MUTUAL FUND PERFORMANCE

The mutual fund industry has grown tremendously over the past forty years. Mutual funds manage significant amounts of money on behalf of diverse groups of investors. According to the Investment Company Institute (U.S.) and the Investment Funds Institute of Canada, assets invested in mutual funds at the end of 2010 totaled \$636 billion in Canada alone and \$24.7 trillion worldwide. Given the amount of assets under management and the significant fees fund managers charge for their services, one of the important questions that both academics and practitioners have studied and debated is whether active management adds value. In one of my recent papers, I contribute to this literature by studying the behaviour of funds inside their fund family.

Family organization of the mutual fund industry is widely prevalent, with ninety percent of all actively managed equity funds belonging to a broader fund company (e.g., Fidelity, Vanguard). Family structure offers a number of advantages to family members including access to shared research and marketing resources. Yet, recent studies highlight that families often behave not as coordinated entities but as groups of competing funds that strive to dominate the family to enjoy benefits accruing to stand-out members. For example, researchers have documented evidence of favoritism in mutual fund families, highlighting that family members with the best recent performance benefit in the future at the expense of other family members. Among other things, they show that top funds receive higher inflows, enjoy better allocations of initial public offerings and get assigned more managers.



“ONE OF THE IMPORTANT QUESTIONS THAT BOTH ACADEMICS & PRACTITIONERS HAVE STUDIED AND DEBATED IS WHETHER ACTIVE MANAGEMENT ADDS VALUE.”

The key insight of my paper is that preferential treatment of best-performing family funds provides strong incentives for managers to take into account holdings of other family members when making their investment decisions. Deviating from the family portfolio can be very costly for a manager with inferior investment ability. By deviating, such a manager may be foregoing the valuable research done at the family level that other

managers rely on for their stock picking. Moreover, if the manager's portfolio decisions prove to be poor, he or she may be singled out and face the risk of being replaced and suffer low flows due to cuts in advertising exposure. By contrast, a skilled manager who can apply his abilities to obtain information superior to that gathered through centralized family research may prefer not to share this information with other family members but to act on it alone by

deviating from the family portfolio. Thus, skilled managers have a strong incentive to deviate from the family portfolio, whereas unskilled ones can benefit from closely mimicking investment decisions of the rest of the family.

I studied the 1981-2010 performance of actively managed U.S. equity funds conditional on their deviation from the family portfolio. I find that managers who actively deviate from the family portfolio perform considerably better in the future than do those who passively mimic investment decisions of their family peers. After controlling for differences in risk, I show that high deviation funds outperform the low deviation ones by a statistically and economically important 2% per year. The empirical results suggest that the exceptional performance of managers who deviate strongly from the family portfolio is due primarily to their superior stock selection abilities. For example, the difference in risk-adjusted returns of stocks purchased by high and low deviation funds reaches 2.5% per year. Thus, skilled managers deviate from the family portfolio by investing in stocks in which they have informational advantages.

Overall, this paper emphasizes the importance of viewing mutual funds not as individual entities but as parts of a larger fund family and of studying interactions among family members. It suggests that managerial skills are more pronounced among managers who hold portfolios that deviate from those of other family members. The results support the value of active mutual fund management.

BIOGRAPHY

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TESTIMONIAL

I RECEIVED THE SCHOLARSHIP FROM THE CSIRF WHILE I WAS PURSUING MY Ph.D. DEGREE AT THE UNIVERSITY OF BRITISH COLUMBIA. The scholarship helped alleviate my financial concerns and allowed me to spend considerably more time on research topics. I am convinced that the scholarship played a big and important role in facilitating my research efforts. During the award tenure, I worked on a number of projects, which have proved fruitful, and the results of which have been published in leading finance journals. I am very grateful to CSIRF for the generous support.



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Canadian Securities Institute Research Foundation Journal
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Journal Design: **Anie Kojarian**
Production & Distribution: **Maxine Lewis**
Printed By: **TPH**

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Research Foundation