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Press report

The Swiss Finance Institute after 10 months: Full steam ahead!

Ten months after its inauguration, the Swiss Finance Institute is moving ahead on all fronts. Established at the initiative of the Swiss Bankers Association, the Swiss Finance Institute is a private foundation funded by the Swiss banks and SWX. With its university partners, the Swiss Finance Institute pursues the objective of forming a competence center in banking and finance commensurate to the importance of the Swiss financial center.

At the institutional level, we are happy to note that all governing bodies are complete and operational and that the legal merger operations between FAME and the Swiss Banking School have been completed. Cooperation agreements with the Universities of Geneva, Lausanne, Lugano and Zurich have been signed. These agreements have led to the creation of the Swiss Finance Institute's regional centers in Léman, Lugano and one soon to be opened in Zurich. An important cooperation agreement with the Swiss National Science Foundation and NCCR FINRISK has also been signed.

At the research and PhD levels, the Swiss Finance Institute PhD program was officially launched with 18 new PhD students admitted for the 2006-2007 academic year under full financing by the Swiss Finance Institute. Three professors were hired over the first part of 2006 by partner universities with the help of the Swiss Finance Institute. Two full professor positions (one at the University of Zurich, the other at the University of Lugano) are currently open and recruitment is in full swing. Planned recruiting for the fall of 2007 by partner universities calls for up to six junior and three senior positions to be filled. Two new research programs have been approved under co-financing with the NCCR FINRISK; the first call for a proposal for a project to be financed by the Swiss Finance Institute was made this month for project start on January 1, 2007.

With respect to knowledge transfer activities the Swiss Finance Institute organized a lecture on **Neuro-Finance and how the Brain Perceives Financial Risk** by the Swiss Finance Institute visiting professor Peter Bossaerts in Geneva in October, as well as the **1st Annual Meeting** in Zurich on November 14, 2006, in which Federal Councilor Pascal Couchepin participated. In addition the Swiss Finance Institute sponsored a conference on **Corporate Governance in Family/Unlisted Firms** in June, and helped organize the 2nd **ZURICH WEALTH FORUM** in September 2006.

On the level of executive education, the Swiss Finance Institute has successfully offered its **Executive Program** to 75 participants from Switzerland, the five-week **Certificate in Financial Asset Management and Engineering** (FAME) with participation from 17 countries, the first nine modules of the Swiss Finance Institute **Advanced Executive Program**, the 8th **International Private Banking and Wealth Management Retreat**, 15 modules of the **Geneva Executive Courses in Finance** with participants from 37 countries and the last module of the fourth cycle of the **International Wealth Management Executive MBA**.

The 2006 Annual Meeting of the Swiss Finance Institute

Fundamental Research

The first fundamental research session is devoted to recent theoretical and empirical developments in asset allocation.

In his talk «Behavioral Finance and Wealth Management», Professor Thorsten Hens, University of Zurich and Swiss Finance Institute, first reviews the range of psychological biases exhibited in human decision-making. Next, he derives the risk-reward trade-off for a utility function with loss aversion, an approach based on prospect theory (PT). The paper proves that for this PT approach, two-fund separation holds if and only if the reference point is the risk-free rate. In the context of wealth management, the paper presents an example with data for five asset classes (money, bonds, stocks, commodities and hedge funds) which concludes that this PT approach leads to better portfolio outcomes than mean-variance optimization.

In his talk «1/N», Professor Raman Uppal, London Business School, explores how well the naïve 1/N portfolio method performs relative to 14 popular portfolio optimization methods. The 1/N portfolio rule involves no parameter estimation and no optimization. The paper calculates three performance measures (Sharpe ratio, certainty equivalent and portfolio turnover) using out-of-sample data from seven very different datasets. The results are surprising. First, none of the other 14 methods consistently outperforms the 1/N method across performance measures and across datasets. Second, an extremely long estimation window is necessary for the sample-based mean-variance strategy to outperform the 1/N rule. Uppal concludes that more precise estimation of expected returns is probably the best way to improve the performance of portfolio optimization methods.

In his talk «Correlation Hedging», Professor Fabio Trojani, University of St. Gallen, first shows that asset return correlations vary significantly over time. While the effect of stochastic variance on asset allocation has been well researched, the effect of stochastic correlation has not. Trojani proposes a dynamic asset allocation model that accounts for both (stochastic) time-varying variance and correlation for multiple assets. Model calibrations show that the risk of changing correlation is economically significant, that correlation hedging demand can be larger than volatility hedging demand and that indirect utilities are more sensitive to correlation changes than to volatility changes.

The second fundamental research session is devoted to three topics on the frontiers of finance research.

In his talk «Stock Returns and Irrational Investor Behavior», Professor Bernard Dumas, Swiss Finance Institute Professor at the University of Lausanne, argues that excess stock market return volatility is caused by fluctuations in the «sentiment» of irrational investors. However, if the stock return volatility is excessive relative to economic fundamentals volatility then there must be a profitable strategy for rational, inter-temporally optimizing investors. The paper proposes a general-equilibrium heterogeneous-agents model that specifies the optimal strategy for the rational investors and defines the impact of this strategy on the irrational investors who are responsible for the excess volatility. An important implication is that it takes a very long time for the rational investors to drive the irrational ones out of the market.

In his talk «Risk Management and Corporate Financing», Professor Jean-Charles Rochet, Toulouse University, argues that risk management should be seen as a way to reduce the cost of future financing, in particular at times of financial distress. Using a simple model of a firm with random cash flows, debt and stock, he shows that risk management has no value in the absence of financial frictions (i.e. the cost of issuing new equity). Using increasingly realistic models, the paper develops a Shareholder Risk Measure (SRM) of the risk of a loss which is the monetary equivalent of the shareholders' expected loss. SRM is a function of firm specific characteristics (liquidity, solvency, profitability, etc.) and complements coherent risk measures. Finally, the implications of the proposed risk management valuation model on the practice of risk management and the behavior of stock prices are discussed.

In his talk «Fairness in Finance», Professor Ernst Fehr, University of Zurich, argues that people care about fair outcomes, about being treated fairly and about treating others fairly. Nevertheless, academic finance has neglected fairness motives and concentrated on rational individual behavior in modeling risk and uncertainty. At the core of financial relationships, those who lend or invest money face a moral hazard problem. The paper argues that, in such moral hazard problems, moral and fairness concerns play a positive role in the enforcement of contracts. Moreover, the impact of fairness concerns on contract enforcement is amplified by reputation concerns.

Knowledge Transfer

Why is it that the financial market for real estate is currently so under-developed despite the fact that the value of real estate exceeds the value of all companies listed on the SWX many times over? What current developments could lead to a solvent market for real estate? These questions are analysed and discussed in the knowledge transfer session

Fredy Hasenmaile of Credit Suisse presents the specific characteristics of real estate as goods. Strong regulation and limited land resources are examples of causes that lead to an insolvent real estate market and a high price to income ratio. Trends in connection with the importance of demographic and income development and human preferences are shown as drivers of demand. These factors lead to an increasing demand in living space per individual, to an exodus from cities due to prices being kept high and to a trend towards condominiums.

Helmuth Aberer, UBS AG, analyses direct and indirect investments in real estate. The advantages of direct investments – solvency, diversification and management experience – are used to illustrate strategies for indirect investments. It is shown that the REITs (Real Estate Investment Trust) have advantages over direct investments and non-listed funds: they are more solvent, there is less risk than with non-listed closed-end funds. Finally he presented the next step in product innovation: making real estate synthetic, that is the creation of real estate indices and the design of derivatives on the indices.

Jürg Syz and Paolo Vanini, both from the ZKB, showed how a qualitatively high-standing real estate index could be constructed. Derivatives show which investor preferences can be covered by such products. In addition to derivatives for trade, real estate indices also allow completely new types of mortgage and savings products to be defined: index mortgages are the most recent example of mortgages whose underlying value is a real estate index and no longer an interest rate. This type of product innovation allows the mortgagee to protect him or herself from a possible fall in the value of real estate.

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Executive Education

What are the current key trends in finance and banking? What are the main theories and how are they being applied in reality? The session executive education addresses these questions on a level for executives, with a focus on asset management, structured products and corporate banking.

Andreas Schlatter, UBS AG, describes the trends in asset management. He introduces the separation between Alpha, i.e. risk-neutral out-performance, and Beta, i.e. out-performance achieved by taking higher risks. This separation has implications on the portfolio structure. Risk management is the third aspect of his talk, where demands on risk models and differences between the modeling of traditional assets versus hedge funds are discussed. He concludes with a review of the so-called quantitative approaches which are applied more and more in modern portfolio management.

Steffen Tolle, Bank Wegelin, describes the trends in structured products. He discusses the basics and the definition of structured products, the current trends, and the environment for structured products. The presentation concludes with a summary of the most important conclusions from the viewpoint of an expert.

Urs Peter Gauch, Credit Suisse, describes the trends in corporate banking which are multifaceted and complex. He discusses the modern financial thinking of today's companies, which tries to combine longer-term scenarios with immediate opportunities. The ability to balance standardized solutions and individual adaptations is a necessary skill for successful corporate banking. At the same time the convergence of the different methods available for the financing of corporates poses a considerable challenge for banks.

Panel

The final plenary session will begin promptly at 17:00 at SWX. The session will be chaired by Olivier Steimer, the chairman of the Swiss Finance Institute Foundation Board who will say a few words of welcome, report briefly on the current state of the Swiss Finance Institute and then present the winners of the 2006 Swiss Finance Institute Publication Awards and Doctoral Prize.

The floor will then be given to Federal Councilor Pascal Couchepin who will address the audience on the theme Finance, Research and Culture.

A panel discussion will close the event. The theme of the discussion is «Catching Up with the Leaders in Financial Research». The underlying question for the forum is whether the Swiss Finance Institute can reach its objective of becoming one of the top three financial research centers in Europe? Does it have the blueprint and the financial means? The question will first be phrased with a broader perspective in mind: in general, can Europe catch up with the leaders in scientific research and what does it take to do so? Professor Ernst Hafen will provide a concrete perspective from the viewpoint of a major European institution and in the Swiss context (meaning with a set of constraints that is similar to those of the Swiss Finance Institute). Professor Rolf M. Zinkernagel will further the debate taking the perspective of an individual researcher who has made it in Europe! Professor Michael C. Jensen will bring the discussion back to finance by adopting an American perspective.

Among the corollary issues that will be addressed are the following three questions:

1. The centralized model vs. the decentralized model. Top American finance research groups are part of the same university department often living on the same floor of one building. The European MIT project is guided by this standard vision of a research institution. The Swiss Finance Institute is decentralized on three (possibly four campuses). We want each of them to be strong research centers in their own right. But the smallest one (Lugano) will have a maximum of 10 professors and the largest will have no more than 25. Altogether the Swiss Finance Institute will count more than 50 full time researchers (and some 80 PhD students) but in different locations. Can it work? Is there a chance a structure such as this one will one day be recognized on the same level as a top American finance department?

2. The motivation for the decentralized model is two-fold: to be able to build on existing institutions because it is less costly than to begin everything from scratch; but also to help these existing institutions change and increase in strength. This guarantees important externalities: all our professors will also be teaching at the undergraduate and master levels and our improved recruiting will have important spill-over effects even at levels where we do not aim to be present. The flip side of the approach is that we cannot totally free ourselves from the rules of the Swiss university system. There are constraints in recruiting processes, in tailoring teaching loads and other duties attributed to professors and in remuneration of researchers. A key question is: is this flip side too expensive to bear? If so, what should be the priorities for change?

3. Can there be a specific European agenda in research? In finance the three undisputed major journals are all US-based. European researchers often regard the editors of these journals (who are of course also US-based) as setting a research agenda which is

strongly influenced by what is considered as interesting in the top US departments. Additionally, the dominant networks (where most referees are recruited) are all US-based. As a result it often seems that there is a strong disadvantage in starting a research career in Europe which of course makes it hard for European institutions to recruit rising stars. This leads to a list of questions. What is the best strategy for an ambitious European research center in the set-up phase? Is there any other choice than copying what is done by US departments? Is there any room for agenda setting? Should we refrain from hiring on a junior level?

More information about the Swiss Finance Institute is available on www.SwissFinanceInstitute.ch or at

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