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The Fallout from Bernie Madoff

Hedge funds have been under tight scrutiny since Bernard Madoff was accused of using his fund to front a $50 billion Ponzi scheme. Two recent papers from EDHEC Business School in France take a closer look at hedge funds and the Madoff scandal. One surveys the industry's perceptions of hedge fund reporting. Another details the red flags that should have sounded alarms about Madoff's fund—but didn't.

In the summer of 2008, the EDHEC Hedge Fund Reporting Survey questioned 214 people who managed or invested in hedge funds. The researchers found that 80 percent of respondents felt liquidity risk was not sufficiently captured in hedge fund reporting. Most also said that a key signal of a hedge fund's excellence is the quality of its reporting.

The survey also found that investors desire even more disclosure than fund managers think they do. Managers said that they believe investors most value information on risk-adjusted returns. Investors, however, rated this information least important—instead, they stressed the relevance of information about extreme risk and past returns.

Felix Goltz and David Schroeder of the EDHEC Risk and Asset Management Research Centre conducted the survey. They write that fund managers "use many risk and performance measures without disclosing them to investors, believing that their investors are uninterested in these additional indicators." This kind of nondisclosure, they add, "is an obstacle to hedge fund investment."

The authors of a second paper, "Madoff: A Riot of Red Flags," suggest that a lack of proper disclosure wasn't the only reason Madoff was able to run his Ponzi scheme for decades. François-Serge Lhabitant, associate professor at EDHEC, and Greg Gregoriou, finance professor at State University of New York at Plattsburgh, note that investors let Madoff's reputation overshadow their need for due diligence. As a result, they missed obvious signs of wrongdoing.

Lhabitant and Gregoriou write that the fund lacked third-party oversight, had too many family members in top positions, and employed too few staff to handle the number of transactions Madoff's operation would require. They note that Madoff's reported trading strategy was also baffling. He explained that he converted holdings to cash each quarter to avoid disclosure with the SEC—and yet, there was no evidence of such large transactions.

Another red flag: The auditor of Madoff's fund was listed as Friehling and Horowitz, an obscure three-person firm operating from a 550-square-foot office in New York City. If the idea of such a tiny firm auditing a multibillion-dollar hedge fund wasn't enough to arouse suspicions, another fact certainly should have. Every year since 1993, Friehling and Horowitz reported to the American Institute of Certified Public Accountants that it had conducted no audits.

Lhabitant and Gregoriou write that the collapse of Madoff's fund "should serve as a reminder that the reputation and track record of a manager, no matter how lengthy or impressive, cannot be the sole justification for investment."

Both papers are available online at www.edhec.edu under the site's research publications section.

The Pitfalls of Frequent Trading

If some investors haven't learned that frequent stock trades hurt returns, a recent study might hit the point home. It shows that individual Taiwanese investors collectively lost $32 billion in the stock market between 1995 and 1999, largely due to frequent trading.

The study was conducted by Brad Barber of the Graduate School of Management at the University

STUDY BRIEFS

EYES ON THE PRIZE

Two marketing professors advise companies to rethink their approaches to promotional sweepstakes and prizes. Mengze Shi of the University of Toronto's Rotman School of Management and Ajay Kalra of Rice University's Jones Graduate School of Management argue that companies should note carefully whether they are targeting current or potential customers and structure contests accordingly. To attract new customers, companies should design a contest with a variety of smaller prizes; to maintain an existing customer base, companies will be more successful if they offer a few grand prizes. The paper, "Consumer Value-Maximizing Sweepstakes & Contests," is forthcoming in the *Journal of Marketing Research.* Full text of the study is available at www.rotman.utoronto.ca/newthinking/sweepstakes.pdf.

UNDERSTANDING CHINA

James Sebenius and research associate Cheng (Jason) Qian of Harvard Business School are examining negotiations and business etiquette in China in two working papers. In "Cultural Notes on Chinese Negotiating Behavior," available online at www.hbs.edu/research/pdf/09-076.pdf, the writers outline the history, philosophy, cultural influences, and current practice of Chinese business behaviors. In "Etiquette and Process Puzzles of Negotiating Business in China: A Questionnaire," available at www.hbs.edu/research/pdf/09-077.pdf, they present 36 multiple-choice questions designed to evaluate test-takers' understanding of Chinese culture and negotiation practices. Sebenius and Qian will use the questionnaire to collect data from people with various levels of experience negotiating in China.

THE RULES OF OFFSHORING

Phanish Puranam and Kannan Srikanth of London Business School studied 130 business processes and found that the transfer of knowledge from onshore to offshore operations was not the key driver to successful offshoring. What does drive success, the authors found, is ongoing coordination between onshore and offshore sites. Businesses "tend to place disproportionate emphasis on incentives and not enough on coordination," says Puranam. Instead, businesses should rely on low-tech methods such as teaming up people from both sites who have worked together in the past and who understand both working environments well. The paper, "Coordination in Distributed Organizations," can be downloaded at ssrn.com/abstract_id=939786.

of California, Davis; Yi-Tsung Lee of National Chengchi University in Taipei, Taiwan; and Yu-Jane Liu of Peking University in Beijing. They focused on Taiwan, which has the world's twelfth largest financial market, because it gave them access to complete transaction data, underlying order data, and the identity of each trader.

They found that stock turnover in Taiwan during this period was two to three times the turnover in the U.S. The researchers suggest that Taiwanese investors may have been so bullish because they were overestimating their trading prowess or trading stocks as a form of entertainment.

The data show not only that individual investors suffered huge losses during this period, but also that institutional investors enjoyed gains. While individual investors saw a 3.8 percent annual decrease in their portfolios during the study period, the performance of financial institutions increased by 1.5 percent. Frequent trading, the authors say, resulted in a transfer of wealth from Taiwanese individual investors to foreign firms.

"Just How Much Do Individual Investors Lose by Trading?" appeared in the February issue of the *Review of Financial Studies.*

Star Power Doesn't Hurt

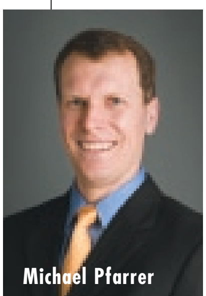
Companies with strong reputations or celebrity status benefit more when they report positive earnings surprises and are punished less for negative earnings surprises, say Michael Pfarrer, assistant professor at the University of Denver's Daniels College of Business in Colorado; Timothy Pollock, professor of management at Pennsylvania State University's Smeal College of Business in University Park; and Violina Rindova, associate professor of management at the University of Texas at Austin's McCombs School of Business.

The authors examined the performance of 291 public companies from 1991 to 2005. They matched 80 high-reputation firms listed among *Fortune* magazine's "most admired companies" and *The Wall Street Journal's* top 25 companies with other similar but low-reputation firms. They chose celebrity firms based on the number of emotionally positive articles written about them in *BusinessWeek*.

They noted Berkshire Hathaway, Toyota, and Xerox as examples of high-reputation companies; Amazon, Apple, eBay, and Starbucks were among those with celebrity status.

The researchers studied annual financial information and examined the biggest positive and negative earning surprises for these companies. They found that celebrity firms outperformed high-reputation firms by 1.02 percent in the three-day window around earnings announcements. In addition, high-reputation firms were 32 percent less likely to produce positive earnings surprises than celebrity or low-reputation firms.


Violina Rindova


Michael Pfarrer


Timothy Pollock

The reason, the authors say, is that investors are often excited by and emotionally connected to celebrity companies. Investors have enough good will toward these companies to stick with them through hard times.

The information in the study may prove important to stock analysts, whose jobs depend on forecasting market behavior, says Pfarrer. "Earnings surprises interfere with the expectations of the market," he says. When surprises do occur, he adds, "how the firm is perceived can affect how the market responds."

The study, "Does Noblesse Oblige? The Effects of Firm Reputation and Celebrity on Earnings Surprises and Investors' Reactions," was recognized in the Academy of Management's 2008 Best Paper proceedings.

Payday Loans Don't Bankrupt Consumers

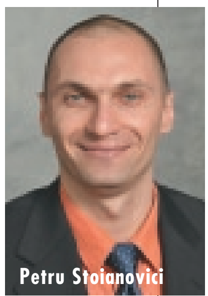
Payday lending, often thought to be the road to financial ruin, may have gotten a bad rap. After studying the relationship between payday lending and bankruptcy filings from 1990 to 2006, two economists have found no correlation.

Michael Maloney of Clemson University's John E. Walker Department of Economics in South Carolina and Petru Stoianovici of The Brattle Group, an economic and financial consulting firm in Cambridge, Massachusetts, studied payday-lending legislation and the number of payday loan stores in a state. Then, they examined personal bankruptcy filings in subsequent years.

The two found that neither legislation nor a greater number of loan stores increased rates of consumer bankruptcies. In fact, they found that the presence of payday loan stores in a state actually led to a slight decrease in Chapter 7 bankruptcies—by one filing per one million persons.

These findings are consistent with other studies that have shown that access to high-interest-rate consumer credit actually correlates with improved household financial situations, say the authors.


Michael Maloney


Petru Stoianovici

"This study has important policy implications for legislators considering restrictions on consumer credit, including the interest-rate limitations put forth by President Obama in his economic stimulus proposal," says Maloney. "Despite their high cost, payday loans appear to increase the welfare of consumers by enabling them to survive unexpected expenses or interruptions in income."

"Restrictions on Credit: A Public Policy Analysis of Payday Lending" can be read online at ssrn.com/abstract=1291278.

Imitation—Better Than Innovation?

Businesses often credit a country's economic growth and technological progress to innovation—and the investment in research and development that comes with it. But imitation may be just as important to some countries' economic prosperity, say Maria Minniti, a professor at Southern Methodist University's Cox School of Business in Dallas, Texas, and Moren Lévesque, the Canada Research Chair in Innovation and Technical Entrepreneurship at the University of Waterloo in Ontario, Canada.

Minniti and Lévesque looked at two types of entrepreneurship: research-based, which emphasizes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I've seen the world, studied the cultures of nine foreign countries and found my calling. Soon I'll use my degree to pursue this passion — founding an orphanage in a developing country.
- Rachel Haney
Senior - Management and Spanish

Moren Lévesque

Maria Minniti

spending on R&D to develop new commercial products and services; and imitative, which focuses on products or services that already exist. The researchers found that a country achieves higher economic growth when it backs the style of entrepreneurship that best fits its culture and competitive environment.

China, for example, has experienced exceptional growth over the last few years, even though it spends very little on R&D and emphasizes imitation more than invention. On the other hand, the economies in Japan and Sweden have grown very little even though these countries invest heavily in R&D.

A reason for this discrepancy, say the researchers, is that Japan and Sweden may be less willing to back truly innovative ideas—especially those that may seem "crazy." In the U.S., for example, "those crazy ideas get financed," says Minniti. Moreover, those investments often pay off because innovation "has no bearing on economic growth unless it is commercialized."

Minniti and Lévesque studied Africa, where the World Bank has poured billions of dollars with little to show for it. The researchers speculate that the World Bank may have backed the wrong type of entrepreneurship. Technological innovation means little in countries that most need entrepreneurs to focus on agricultural innovation to boost crop yields and produce clean water.

Governmental leaders must learn to understand the roles of innovative and imitative entrepreneurship, say these researchers. Rather than spend indiscriminately on R&D, a government should direct entrepreneurial activity in ways that match its country's competitive characteristics.

The paper "Entrepreneurial Types and Economic Growth" is forthcoming in the *Journal of Business Venturing*.

Trans-Atlantic Academic Alliances Are on the Rise

A survey of 180 higher education institutions in the United States and European Union finds that more universities are establishing trans-Atlantic joint and dual degree programs. However, the extent of these partnerships varies widely from institution to institution and country to country.

The survey, conducted by the New York City-based Institute of International Education and Freie Universität Berlin, finds that European campuses currently offer twice as many collaborative degrees as their U.S. counterparts, and U.S. students are less likely than European students to participate in collaborative degree programs. The most popular academic disciplines to establish collaborative degree programs are business and engineering.

European schools cite curriculum design and credit transfer recognition as obstacles they face in starting joint and dual degree programs. U.S. schools face challenges such as securing institutional support and recruiting students. The biggest challenges for both? Securing adequate funding and ensuring the sustainability of collaborative programs.

The complete survey is online at www.iie.org/researchpublications or www.tdp-project.de.

Experience Isn't Always a Good Thing

Employers may look far and wide to hire people with just the right previous experience—experience that supposedly will help new hires hit the ground running. But that's not necessarily the case, say Steffanie Wilk of The Ohio State University's Fisher College of Business in Columbus, Gina Dokko of New York University's Stern School of Business, and Nancy Rothbard from The Wharton School at the University of Pennsylvania in Philadelphia.

The three looked at data from 771 employees and job applicants at two call centers for a large U.S. insurance firm. They examined employees' job performance evaluations and studied ratings of the employees' work-related skills and knowledge. Then, they compared these evaluations with employees' prior work histories and experience.

They found that prior work experience did lead to better skill sets and more knowledge. As a result, these employees often received better performance reviews. But the authors argue that many of these workers also bring with them rigid procedures and processes that may not suit their new company's policies. "Such baggage," the authors write, "may actually have a negative effect on performance,

Nancy Rothbard

Steffanie Wilk

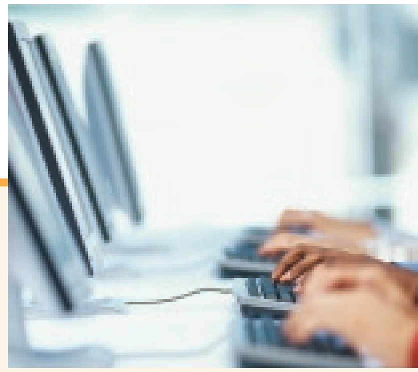
resulting in a negative direct relationship between prior related experience and performance once the benefits of knowledge and skill are accounted for."

For example, a claims adjuster used to haggling claims at his old firm may find it difficult to change his approach at a new firm that values customer service. One manager quoted in the study notes that, because of their "baggage," employees hired from other insurance companies were the "least successful" employees in the firm.

The authors believe future research should focus on whether prior experience has a similar negative effect on managers and other high-level positions. Such analysis will become increasingly important as workers become more mobile. "If organizations understand how applicants' work histories affect their performance," the authors write, "they might consider the effects of prior experience in designing selection, training, or socialization processes."

"Unpacking Prior Experience: How Career History Affects Job Performance" was published in a recent issue of *Organization Science*.

RESEARCH RECOGNITIONS



■ An adjunct professor at the Haas School of Business at the University of California, Berkeley, has been named one of the top 50 authors in the field of technology and information management. **Henry Chesbrough** received the honor from the International Association of Management of Technology based on its analysis of his published research between 2003 and 2007. Chesbrough studies topics such as open innovation, processes of industrial research and development, management of intellectual property, and services innovation.

■ **Shouhong Wang,** professor of management information systems at the Charlton College of Business at the University of Massachusetts Dartmouth, is the first to receive a $5,000 Chalk & Wire Scholars Grant for encouraging research on electronic portfolios, data collection, and reporting tools in K–12 and higher education. Wang's winning research proposal, "Designing Structures of E-Portfolios for Teaching and Learning Higher-Order Thinking," will explore the design and development of effective electronic tools for today's classrooms.

■ The Computer History Museum has named Harvard Business School's **Richard Tedlow** as its first resident scholar. The appointment is part of the museum's long-term plan to establish a permanent research center to support the study of computer history and the impact of the information age on the human experience. As the museum's resident scholar, Tedlow will produce written materials, give public lectures, and collaborate with the exhibitions team on content for its forthcoming permanent exhibit, "Computer History: The First 2,000 Years."

Getting Real About Predictions

Whether it's how long it will take them to complete a home remodeling project or how many times a week they plan to exercise, people are notorious about making unrealistic predictions. Now there might be a way to make them get real, say Kurt Carlson of Duke University's Fuqua School of Business in Durham, North Carolina, and Robin Tanner of the University of Wisconsin-Madison School of Business.

Carlson and Tanner asked study participants how often they planned to exercise over the next two weeks. On average, participants predicted they would exercise 4.48 times. Two weeks later, they reported they had exercised only 3.38 times.

However, the researchers obtained different results when they asked subjects to make two predictions about how long it would take them to complete a task: one that reflected ideal conditions and one that reflected less ideal conditions. In this case, participants offered inflated ideal-world predictions but more modest real-world predictions.

"We've known for a long time that people underestimate how long it will take them to complete a project—look at the Big Dig in Boston. What we have not known is how to fix the problem," says Carlson. "Now we do."

"Unrealistically Optimistic Consumers: A Selective Hypothesis Testing Account for Optimism in Predictions of Future Behavior" was published in the February 2009 issue of the *Journal of Consumer Research*.

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Dr. Maria Schutte, Michigan Technological University and Dr. Vaneesha Boney, University of Denver after the capping ceremony at The PhD Project Annual Conference!

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