ROTTERDAM SCHOOL OF MANAGEMENT
ERASMUS UNIVERSITY

CEGIST, LISBON, 8 OCTOBER 2015

LET'S CHANGE FINANCE

JAAP SPRONK

The business school that thinks
and lives in the future

RSM ERASMUS UNIVERSITY

LET’S CHANGE FINANCE: PROGRAM

Program

- Introduction
- Why change finance
- Towards change in academic finance

WHY CHANGE FINANCE

CAPITAL IDEAS (PETER BERNSTEIN)

"….Capital Ideas traces the origins of modern Wall Street, from the pioneering work of early scholars and the development of new theories in risk, valuation, and investment returns, to the actual implementation of these theories in the real world of investment management. Bernstein brings to life a variety of brilliant academics who have contributed to modern investment theory over the years: Louis Bachelier, Harry Markowitz, William Sharpe, Fischer Black, Myron Scholes, Robert Merton, Franco Modigliani, and Merton Miller. Filled with in-depth insights and timeless advice, Capital Ideas reveals how the unique contributions of these talented individuals profoundly changed the practice of investment management as we know it today….."

As a recommendation to Bernstein's 2007 book, shortly before the beginning of the financial crisis, John C. Bogle, founder of the Vanguard Group writes:

"….A lot has happened in the financial markets since 1992, when Peter Bernstein wrote his seminal Capital Ideas. Happily, Peter has taken up his facile pen again to describe these changes, a virtual revolution in the practice of investing that relies heavily on complex mathematics, derivatives, hedging, and hyperactive trading. This fine and eminently readable book is unlikely to be surpassed as the definitive chronicle of a truly historic era….."

"….Finance as a scientific discipline is the study of how to allocate scarce resources over time under conditions of uncertainty. There are three analytical "pillars to finance-optimization over time (the analysis of intertemporal tradeoffs, asset valuation, and risk management. At the core of each of these pillars are a few basic "laws" and principles that apply across all of the topical subfields…..)

As a teaser for potential buyers of the book, they say

"Our text encompasses all of the subfields of finance -corporate finance, investment, and financial institutions- within a single unifying conceptual framework.

CAPITAL IDEAS: CLAIMING TOO MUCH

The main purpose is to *describe* the way financial assets are priced.

But in the wording of Bodie and Merton and many others the descriptive theory becomes *prescriptive*. They use words like "*how to allocate* scarce resources over time, *optimization over time* and *risk management*. This prescriptive pretension is one big step too far:

The contribution of financial theory is (only) in the *valuation* of uncertain future cash flows in the market place, where value is the value *today*. (Value being a *relative value).*

Of course, this value can be used to compare the present value of for instance alternative investment policies or alternative risk management strategies. But that is generally not good enough to make a proper overall comparison in practice. (Context & Impact)

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ACADEMIA & CAPITAL IDEAS: OPM IN RESEACH AND ADVISE

For many years it was sexy to be a financial academic:

- *Many students*
- *A lot of interest from practice*
- *Research with lots of mathematics and statistics and enormous amounts of data.*

ACADEMIA & CAPITAL IDEAS: NEGLECTED ISSUES

Financial theory is *grosso modo* ***not able to say anything about the relative value of the same assets tomorrow or next week***. It is also not able to predict a financial crisis.

Then, explicitly or implicitly, ***the goal of shareholder value maximization is introduced as the only yard stick for all decisions, including risk management decisions***. Shareholder value should be fostered, but other values are important as well and are *not* automatically taken care of by a form of shareholder value maximization that ***essentially ignores the context of any decision.***

Rationality is defined in terms of financial-economic rationality and thus in terms of ***one dimension, money***.

The future and risk and estimated values are ***much less quantifiable than assumed*** in both research and education.

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IMPACT CAPITAL IDEAS

1. Asset management

2. Investment banking

3. Financial management

4. Financial way of thinking

CAPITAL IDEAS IN AN HISTORICAL PERSPECTIVE (I)

70ies *CR China, Brezhnev stagnation , two oil crises, Iran, worldwide recession*
Apple I,II CAPM, OPM, etc.

80ies *Thatcher, Reagan, China GDP*3, Berlin Wall USSR 1991*
Shareholder value back at the table *Finance*

90ies *World economy expanding, China GDP*3 once more, Central-East Europe*
Netscape, Google, Increased attention for external effects

CAPITAL IDEAS IN AN HISTORICAL PERSPECTIVE (II)

2000's *Financial crises: Asian (1997), Ruble& Latin American (1998), Dotcom (2001)*
LinkedIn, Facebook, Twitter, Blackberry and Iphone. Corporate Social Responsibility & High tide of Financial Way of Thinking

2007ff *Real Estate Crisis, Credit, Liquidity Crisis Banking Crisis, Never Ending EURO Crisis, EU Crisis*
TIME TO RETHINK OUR ASSUMPTIONS
>>>*ALSO IN ACADEMIC FINANCE*

RECENT DEVELOPMENTS

"… Banks are easy to hate, but they remain among the largest and most powerful companies on Earth. The FORBES Global 2000 is a comprehensive list of the world's largest, most powerful public companies, as measured by a composite score of revenues, profits, assets and market value. This year's Global 2000 companies hail from 61 countries and account for combined revenues of $39 trillion, profits of $3 trillion, with assets worth $162 trillion, and a market value of $48 trillion. This year, banks and diversified financials dominate with 434 spots — more than one fifth of the world's largest companies — representing the largest share of any industry. For the first time since our first ranking in 2003, China's "Big Four" banks took over the top 4 spots. Among the world's 100 largest banks, China houses the most with 13 banks in total, while the U.S. places second with 11 spots. Canada comes third with 6 spots, followed by the U.K., Japan, Spain, and France…."

RECENT DEVELOPMENTS

The world’s 25 largest banks in 2015 (Forbes)

1. ICBC, China
2. China Construction Bank, China
3. Agricultural Bank of China, China
4. Bank of China, China
5. JPMorgan Chase, US (7)
6. Wells Fargo, US (4)
7. HSBC Holdings, UK (2)
8. Citigroup, US (1)
9. Bank of America, US (3)
10. Banco Santander, Spain (12)
11. Mitsubishi UFJ Financial, Japan
12. Bank of Communications, China
13. Itaú Unibanco Holding, Brazil
14. Commonwealth Bank, Australia
15. Royal Bank of Canada, Canada
16. China Merchants Bank, China
17. Westpac Banking Group, Australia
18. Banco Bradesco, Brazil
19. TD Bank Group, Canada
20. UBS, Switzerland (6)
21. Industrial Bank, China
22. ANZ, Australia
23. Sumitomo Mitsui Financial, Japan
24. China Minsheng Banking, China
25. National Australia Bank, Australia

RECENT DEVELOPMENTS

Number of top 25 banks per country

Bank location	2003	2015
Australia	0	4
Brazil	0	2
Canada	0	2
China	0	8
Europe, Ex UK	9	2
Japan	2	2
UK	5	1
US	9	4

RECENT DEVELOPMENTS

"…As the financial services industry continues its path to recovery, the importance of trust – or lack thereof – remains front and center. Despite slight improvements in trust levels compared to five years ago, the demand for structural and regulatory reform in the industry remains high across the globe, and the need to rebuild trust through performance is increasingly apparent.
Today's consumer wants to be sincerely engaged in a way that conveys a deeper understanding of their personal goals and values, and what is important to them about their financial institutions. Yet, as negative headlines continue, it is increasingly difficult for consumers to trust when the discussion continues to surround new fees, narrow product offerings and fine print – all of which signal a return to the "old ways" of business.
So, what's ahead? As the financial services landscape changes, so comes opportunity. The Edelman Trust Barometer, now in its 14th year, makes it clear that engagement and integrity are the path forward to building trust with consumers, employees, regulators, partners and clients. Now is the time for industry leaders to seize the opportunity by rebuilding trust in a way that is sustainable for business and puts customers and society at the center of focus…"

TOWARDS CHANGE IN ACADEMIC FINANCE

So there is a challenge for academic research and education. The financial way of thinking is powerful for estimating market values. But we need to know more about the **underlying assumptions**. The current interest for behavioral aspects is serving that purpose, but there is more. We also need to look behind the numbers: where does value come from, where does risk come from, etc. We should learn to cope better with **context**, which becomes more important every day. Our theories should be complemented with the analysis and valuation of **other impacts than purely monetary effects alone**.
Education should reflect the latest results of research and it should be complemented with explicit attention for **corporate responsibility** and **ethical aspects** of financial decisions

LET’S CHANGE FINANCE: SOME SUGGESTIONS

Three types of decisions (attention for games needed)

Dynamic games and systems frameworks

Decision making to be embedded in management processes

Multidimensional preferences (multiple stakeholders)

Behavior (individual, group, social) needs more attention

Look behind the numbers

Be careful with centralization