It’s Not Who You Know

Entrepreneurs who launch new ventures away from industry hubs find that knowledge is portable. Page 1
Players who found themselves in last place were far more likely than any of the others to attempt to gamble their way out.” Read more on page 14.
It’s Not Who You Know

Entrepreneurs who launch new ventures away from industry hubs find that knowledge is portable.

It is a classic tale of entrepreneurship: a computer whiz spends a few years working at a large corporation in Silicon Valley, then leaves to launch a start-up. But what happens if she locates her firm in Kansas City, 1,500-odd miles away? She will forfeit the perks of working in a high-tech zone: access to clients, inside knowledge, and a community rich in expertise. Should she have stayed in Santa Clara?

Working in an industry hub confers special benefits, known as agglomeration effects. These benefits typically involve sharing both physical assets and people. Just as shipping companies share materials and infrastructure in a port, banks in a financial center like New York or London “share” a rich supply of employees who have inside knowledge and industry expertise and can jump easily between firms. Although this phenomenon is well established, little is known about whether a former employee retains these benefits after leaving the industry hub. New research by Professor Evan Rawley, who worked with Rui de Figueiredo Jr. of the University of California at Berkeley and Phillip Meyer-Doyle of INSEAD, examines how these benefits can be appropriated by an entrepreneur who leaves a firm to start a new venture, no matter where that venture is located—a phenomena they call inherited agglomeration effects.

The importance of an entrepreneur’s prior employment is often overlooked, Rawley says. “When people talk about start-ups, especially high-tech start-ups, they often think of two guys in a garage, coming up with new ideas,” he says. “When in fact that’s very unusual. Most entrepreneurial ventures are started by people who have deep knowledge of the industry.”

The researchers focused on hedge funds started by entrepreneurs who had trained in large banks in financial centers. Surprisingly, they found that agglomeration effects are portable. “You would think that staying in the financial center would help, because you would remain close to the industry, to other people,” says Rawley. “But we found that in the context of hedge funds inherited agglomeration effects are derived not from social capital but from knowledge, which for portfolio managers includes trading strategies and operational knowledge.” In fact, where fund managers spend their early careers (in a financial hub, or not) is at least as important as where they choose to locate their new venture, the study showed.

That might seem counterintuitive in an industry that values connections. But the benefits of staying in the hub are offset by the effects of greater competition, Rawley explains. “If you’re coming from a New York bank and starting up a new hedge fund, even if you are well connected in New York, you’re competing with people who are also well connected,” he says. “There are a lot of hedge funds chasing dollars in New York but very few in Missouri.”

In their research, Rawley and his coauthors studied data on hedge fund performance and interviewed portfolio managers from more than 30 funds. Many of these managers said that their prior experience at banks was what enabled their success. But when pressed, most couldn’t give specifics. “It was interesting that so many of them were unable to put a finger on it,” Rawley says. 

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Evan Rawley is associate professor of management at Columbia Business School.

READ THE RESEARCH

All they could say is that they’d had the chance to learn about the financial services industry.” By studying the managers’ bios and obtaining information about their prior employment, the researchers were able to create a clearer picture of how these managers had benefitted from working in a hub.

For entrepreneurs looking to go farther afield when they strike out on their own, these findings are encouraging, though Rawley cautions that the results generalize best to service industries. “The modern economy is about human capital—knowledge—and, in hedge funds, knowledge is the crux of the business, but in other industries workers may be tied to physical infrastructure that will limit the magnitude of any inherited agglomeration effects,” Rawley notes. However, the portability of expertise is not limited to the hedge fund industry; in any sector where human capital is critical, departing employees can take their most valuable asset with them. “Ideas aren’t tied to a physical space,” Rawley says. “Knowledge is easy to move around.”

In 2002, Cynthia Cooper, then a vice president at WorldCom, presented evidence of massive fraud to the audit committee of her firm’s board of directors. Executives, she found, had improperly inflated the company’s profits by billions of dollars. For having the “exceptional guts” to speak up, Time magazine named Cooper, along with Enron whistleblower Sherron Watkins, among its Persons of the Year.

Yet whistleblowers are not always celebrated. Reporting another’s lies can also arouse a negative response, including demotions and harassment. Even a whistleblower like Cooper, lauded by some, may face blowback from others. “Some people who used to smile and chat with Cooper and her team by the coffeemaker,” wrote Time in 2002, “don’t do that anymore.”

Nobody Likes a Rat

When are colleagues likely to report each other for lying, and what happens when they do?

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So under what circumstances is someone likely to risk the wrath and expose a colleague’s deception? For businesses to protect their bottom lines, it’s an important question. “It’s expensive for firms to monitor all of their employees for corruption,” Professor Ernesto Reuben says. As an alternative, a company can create a work environment in which employees are more likely to report a dishonest colleague. Then, the threat of getting caught may prove enough of a deterrent to prevent fraud.

Reuben, along with Columbia Business School doctoral candidate Matt Stephenson, set up an experiment designed to better understand the circumstances that lead people to lie or report others for lying. In particular, the researchers were interested in understanding how individuals behave when they know their actions will be public and that their peers may hold their activities against them.

For the experiment, each participant was given a number representing her true income.
and asked to declare it publicly. She then received a payout based on her reported income. A player seeking a higher payout could simply lie by overstating the number she had been given. The only real check was her peers. Each participant had also been assigned to a small group, within which all members knew each other’s incomes. If one of them reported her for lying, she would be heavily sanctioned.

After three rounds, one member was randomly removed from the group. In some cases, as they had been told would happen, these participants were randomly reassigned to other groups. In others, the experimenters asked the remaining players to select whom to let in. To make the choice, they were given information about the candidates, including whether those participants had blown the whistle on anyone in their previous groups.

For the researchers, some of the results were not surprising. When there was random reassignment, 32 percent of the lies were reported, making it a risky gamble to overstate one’s earnings. Yet in groups in which participants knew they might have to rely on their fellow players to get back in the game, the amount of reporting dropped to 17 percent. As those games wore on, deceptive teams formed in which lying was prevalent and no one was reported for it.

What surprised Reuben was the extent of the price the rare whistleblowers paid in the selection stage, where even honest participants who hadn’t overstated their incomes tended to block whistleblowers from joining their group. There are a few possible reasons for this, the researchers say. It could be that even people who told the truth about their own salaries understood that they might be tempted to lie under the right circumstances and, in that case, they would rather not have a whistleblower around. It’s also possible that they resented those who reported on their peers as being too self-righteous.

Either way, it may help explain why actual whistleblowers have faced difficulties, even when management is supportive of their actions. “There are certain social interactions that firms can’t control, like whether or not someone feels comfortable or is accepted by his colleagues.”

Reuben’s research underscores that businesses must consider the barriers whistleblowers may face and be prepared to help manage them. Specifically, says Reuben, companies may want to mimic his experiment to discourage employees from lying in the first place. “Firms can try to replicate the random reassignment by moving people around from one group or department to another,” Reuben says. “Some government agencies already do this to prevent corruption. While it may have a small impact on productivity, this technique is useful in preventing the high costs of fostering an environment where deception is permissible behavior.”
From Intuition to Creation

Bill Duggan explains how innovations are made, from idea to implementation.

What is creative strategy?
It’s a classic case of “theory to practice.” My previous book, Strategic Intuition, laid out the theory. It explained the science of how creative ideas happen in the human mind and documented how successful innovators actually came up with their innovations. This new book, Creative Strategy, is the practice: it shows how to apply that theory as an innovation method yourself.

Here’s how it works: you start with a problem or situation where you aim for an innovation, break that down into elements of the problem, and then search for precedents that solve each element. You then see a subset of these precedents come together in your mind as a new combination that solves the problem. That idea is your innovation.

You start the book with a history tracing the last few decades of discoveries in neuroscience. What does neuroscience have to do with creative strategy?
I was surprised to discover that 99 percent of innovation methods that people use today are based on a model of the brain that neuroscientists abandoned more than a decade ago. In essence, these innovation methods tell you to do some kind of research or analysis, and then you brainstorm to come up with your innovation idea. The theory of brainstorming is that you turn off your analytical left brain, turn on your intuitive right brain, and creative ideas pop out. But neuroscience now tells us that there is no right or left side of the brain when it comes to thinking. Creative ideas actually happen in the mind, as the whole brain takes in past elements, then selects and combines them—and that’s how creative strategy works.

You’re not a big fan of traditional methods of strategic analysis and innovation, fair to say? Should we just throw them all out the window?
There’s nothing wrong with traditional methods of strategic analysis. But after you do your analysis, then what? You need a creative idea for what to do. Traditional innovation methods don’t tell you how to get that. They tell you to brainstorm next. That’s the problem. When it comes to the actual idea for your innovation, these methods leave it to the magic of the creative right side of the brain.

Similarly, expertise can get in the way of creative strategy, correct? Can you explain?
Brainstorming works fine when you don’t need an innovation. People brainstorm mostly to solve problems they already know how to solve with their current expertise, at least as a group. When you brainstorm, you really throw out ideas from your personal experience—these come to mind fastest and strongest. If you have a problem that the total personal expertise of six people can solve, then brainstorming is very efficient. But if the solution actually lies outside their personal expertise, brainstorming is a trap—you toss out ideas and get conventional wisdom, not an innovation.

So we do the matrix, we do the iterations of the process, we keep doing the what-works scans, and the rest of the steps you outline in the book. How do we know when we’ve found a solution?
Sometimes you don’t find a solution. You can’t solve every problem on earth, though of course I wish we could. At some point you “see it” or you don’t. That is, the precedents you find seep into your mind and some of them connect to give you an idea. That can happen after one day of searching, or one week, or one month, or never. Of course in most companies you have some kind of deadline, but the key is to start early enough so you give yourself at least two months to search. The time you would normally take for strategic analysis, use it for search instead.

What habits of mind—and operations—can people and firms cultivate to open the door to strategic intuition and creative combination, even when they are not facing a specific problem?

People should cultivate curiosity about how exactly things succeed and cultivate “presence of mind” where they deal calmly with problems and let their minds wander freely rather than look for quick answers because they feel stress. For firms it’s harder, because they have myriad procedures in place already that can work against creative strategy. For example, in a typical planning cycle, does the firm start with the question “Where would we like to innovate if we could?” If not, it’s already too late, because everyone has already started down a road of goals, initiatives, timelines, and deadlines. Everyone gets busy; now the only “creative” time they can spare is two-hour or two-day brainstorming. Instead, a company should do creative strategy well before the start of its planning cycle, so by the time it has to plan, it actually has an innovation to implement. But that requires a firm to turn its whole cycle of procedures upside down. That’s a tall order for any company.

You teach a lab course at the School where students learn creative strategy and apply it to real innovation projects for major firms. How does that work?

I’ve been teaching a course on the theory—strategic intuition—and now this lab course teaches the practice—creative strategy—with real projects with real companies. It turns out that an academic semester matches well with how long it takes to do a proper job of creative strategy. My co-teacher in the lab is Ken Favaro, a senior partner at Booz & Co., who has an innovation team there that does this method for their clients, too. We seek firms that have problems they don’t see a way to solve and that don’t have enough free time to work on it themselves.

For example, a big entertainment company had a complex product that worked great in one limited sector, and they wanted to expand to other media and venues but worried about losing the quality that made them so distinctive in the first place. A team of four students goes through the creative strategy method with each client company—they break down the problem together, then the student team spends weeks searching for precedents on different pieces of the problem. The team then brings those precedents back to the client so they can see the combinations themselves, but the students also propose a combination and a plan to implement it. It’s “theory to practice” again.

In the case of that big entertainment company, when the students broke down the problem, their search solved some of the pieces and not others and led them in a different direction that solved a different but equally important problem. The company was surprised—shocked, actually—that the students changed the problem but was delighted in the end. They realized it’s better to solve an important problem they didn’t think of than not solve an important problem they did think of! That kind of “surprise” is the essence of innovation—otherwise known as creative strategy.

The idea should change as you proceed, perhaps slightly, perhaps dramatically.

What’s the most important thing to keep in mind—or do—once you’ve got that creative combination and you’re ready to make things happen?

Keep an open mind as you work hard on your idea: the idea should change as you proceed, perhaps slightly, perhaps dramatically. You’ve found enough elements to get started, and you’ll need many more as you proceed. You might even have to do the full creative strategy method again if you run into a big problem and need a new idea for that piece of the puzzle.
**Smartphone Ads That Work**

Even tiny ads—with almost no information—can be effective for certain products.

A consumer is on his smartphone, skimming the headlines and checking movie times at his local theater. A car ad appears at the top of his screen. Is such a small ad, coming when his attention is divided, effective?

Advertisers are betting it is. Global spending on mobile advertising reached $8.4 billion in 2012 and is expected to soar to $36 billion by 2016. This growth is fueled by the rapid spread of Internet-connected mobile devices, as well as the increasing tendency for consumers to access websites on their phones. And despite alternatives such as text messages and location-based ads, an increasing proportion of mobile advertising comes in the form of display ads on smartphone web browsers, which—because of the size of smartphone screens—have a very limited capacity to convey information. In fact, many display ads include only a very short promotional message or slogan or even just a logo.

Yet surprisingly, studies have shown that these ads can have a positive effect on consumers’ brand attitudes and intentions. Given the limitations, it might seem that these ads are most likely to be effective for products that command relatively little attention before a purchase is made—inexpensive, everyday items like pain relievers or cleaning products. However, new research by Miklos Sarvary, working with Yakov Bart of INSEAD and Andrew T. Stephen, PhD ’09, now of the University of Pittsburgh, shows that the ads work best for utilitarian, “high-involvement” products—big-ticket items that receive a relatively high level of attention before a consumer decides to make a purchase, such as cars and electronics. And the ads work not by providing any new information but by reminding consumers of the information they already know about a particular product.

“A weak signal will be effective at reminding people of a purchasing decision only if the product requires high involvement,” Sarvary explains. “We know from psychology, however, that the higher people’s motivation (for example, if the product is of high involvement) the more people tend to use rational decision making, relying on trade-offs. Moreover, rational decision making is more effective for utilitarian products. So if products are both important and utilitarian, the weak signals on mobile display advertising will have a stronger effect.”

In the case of car shopping, for example, a mobile display ad can be surprisingly effective at influencing a consumer’s opinion about a particular car model. “If you’ve been thinking about buying a car, you already have plenty of information in your mind about it,” Sarvary explains. “The ad’s strength is not adding new data, but reminding you of what you already know and making you think about the product again.”

It can take weeks or months before a consumer decides to make a high-involvement purchase like a car or an airline ticket. “During that time, you’re debating with yourself about which model of car you should buy or which airline you should choose,” Sarvary says. “And display ads that show up at random moments reinforce what you know about a particular brand.”

Companies can use these findings to predict whether their products are likely to benefit from mobile display ad campaigns. “If marketers are planning a multi-channel campaign, for example, it might help to launch the mobile display ads after the product has been advertised in other media,” Sarvary says. “That way, some awareness and information about the product has been generated, which can be easily triggered when cued with a mobile ad.”

The researchers studied data from more than 50 mobile display campaigns that reached about 40,000 US consumers from 2007 through 2010, involving a wide range of industries such as automobiles, packaged goods, health, and finance. It is the first study of its kind based on extensive field data.

“Digital advertising in mobile channels is experiencing explosive growth,” Sarvary says. “Since advertisers are shifting larger proportions of their budgets into this channel, it’s becoming even more important to have a detailed understanding of when these ads are effective.”

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**READ THE RESEARCH**

THE IDEA
Choose shopper marketing tools with care—some can backfire.

When Shopper Marketing Backfires

THE RESEARCH
Retailers increasingly use a variety of shopper marketing tools—from sale signs and special promotions to more subtle environmental cues such as sounds and scents—in an effort to increase sales. The tools are often costly, and it’s not clear that they always work as intended.

Professor Leonard Lee, working with Ziv Carmon of INSEAD, Ravi Dhar of Yale, and Ayelet Fishbach of the University of Chicago, took a closer look at the efficacy of shopper marketing tools. The researchers conducted lab and field experiments designed to measure shopper behavior and learn about the psychological impact of shopper marketing tools. They found that pushing these tools can actually induce an effect they call the ironic prudent spending effect, in which shoppers perceive the promotions as reminders to not spend too much rather than as prompts to spend more.

Researchers find that pushing marketing tools can actually cause shoppers to perceive promotions as warnings or reminders not to overspend rather than invitations to purchase more.

In lab experiments, the researchers found that participants who were exposed to the mere idea of shopping at the start of the experiment rated hedonic products as less tempting, and the goal of prudent spending as more important, than participants who had not been primed to think about shopping in advance.

THE APPLICATION
You can use this research to fine-tune which marketing tools you direct toward retail consumers, better allocate your marketing budget, and determine whether to link specific types of products to such promotions. The research suggests that customers exposed to shopper marketing tools shift their perception so that hedonic products become less tempting to purchase; utilitarian products may not suffer the same effect.

In experiments carried out at convenience stores and small markets, shoppers presented with a shopping basket or flyer bought fewer hedonic products, such as snacks or sweet drinks, and instead concentrated their shopping on utilitarian items, such as cleaning products and batteries. These shoppers also spent less money than they otherwise would have had they not been given a basket or flyer. Further, researchers found that shoppers who perceived themselves as impulsive were most sensitive to the shopper tools and viewed the tools as

READ THE RESEARCH

MORE IDEAS
Listen to Leonard Lee discuss his research in this Columbia Ideas at Work podcast: gsb.columbia.edu/ideasatwork/lee_podcast.
The New Ad Wars

A framework for studying advertisers’ bidding behavior in online ad exchanges can help publishers better manage this emerging channel.

Advertisers are living in a new golden age. Online tracking of consumers’ web-browsing history makes targeting potential customers easier than ever. Online publishers are reaping the benefits of tracking too, offering advertisers access to more finely tuned segments of consumers.

Large online publishers once managed online ad sales much as they managed print ad sales, offering advertisers guaranteed contracts that ensure, for example, that an ad would be viewed by a given number of viewers with specified characteristics over a predefined period of time. Today, online ad exchanges offer advertisers an alternative to such contracts, with a notable difference. These exchanges give advertisers the ability to decide in real time (and at near-lightning speed) if they want to buy each individual impression based on specific user information, such as distant and recent browsing history—and even the exact ads or merchandise a reader was looking at just prior to visiting the site.

As a consequence, when a reader clicks on a webpage, an invisible but ferocious high-speed battle for her attention takes place before the page finishes loading—in less than 1/3 of a blink of an eye. Publishers put the reader’s profile and impression up for auction, vying with advertisers who enter a bidding war with each other. Millions of these auctions happen each second, every time a reader clicks to a new page.

As a result, online advertising is increasingly competitive, and the growth of the transactions performed through ad exchanges has created the need for publishers to better understand the analytics associated with this new channel. Professors Omar Besbes and Gabriel Weintraub, together with doctoral student Santiago Balseiro, have proposed a new framework that helps publishers design these auctions and manage this new channel. Exploiting the unique features of the ad exchange market—it’s millions of daily transactions with many advertisers at any point in time—they use game theory and yield management to explore the structure of the market to optimize the auctions.

“We could design the auctions based on the assumption that advertisers will continue to use their current bidding strategies in the future. But this ignores the fundamental fact that any change in the rules of the auctions, volume in the exchange, and the information publishers provide about the users is likely to influence the bid decisions of advertisers, who use more and more sophisticated analytics to run their campaigns,” Besbes says. “The framework we propose allows one to characterize explicitly advertisers’ reactions, essentially mapping how market and auction parameters and advertiser characteristics translate into bids.”

One innovation of Besbes and Weintraub’s research is the development of a tractable theory to analyze the complexity of the ad exchange market that is both behaviorally appealing and approximates well the rational behavior of advertisers. The framework and the equilibrium concept underlying it, the Fluid Mean Field Equilibrium, is streamlined enough to allow researchers and practitioners alike to readily quantify the tradeoffs that publishers face when considering changes in the auctions. And both publishers and advertisers can benefit from the framework.

One key question publishers face is how to set the reserve price—the minimum price a publisher is willing to accept for a given impression, and a decision that is key to maximizing revenue. “We propose that publishers provide as much information as they can as long as they simultaneously adjust the reserve price,” Weintraub says. “Although the narrowed scope of possible advertisers decreases competition for each impression, the value of each impression increases because remaining advertisers are more likely to reach a prime target. By adjusting the reserve price accordingly, publishers can still extract value even as they attract fewer competitors.”

The framework also offers advertisers a simple and intuitive formula for bidding, or underbidding, on what they think the actual value of the slot will be, a common strategy used to spend down campaign ad budgets at a constant rate over the length of ad campaigns. This strategy can be especially useful for advertisers with smaller budgets: they may lose many auctions by bidding low, but protect themselves from spending too much too soon, and are making a bet that they will win enough good deals over time.

The researchers’ future research in this area will consider yet-unexplored aspects associated with ad exchanges, such as how the actions of intermediaries impact the actions of advertisers and how those in turn change the way publishers should design auctions.

Though their framework was developed with display advertising in mind, it has the potential to be adapted to other industries. “Sponsored search, while distinct,” says Besbes, “has enough in common with ad exchanges that some of the core ideas may help us better understand bids one observes in sponsored search auctions.”

READ THE RESEARCH
THE IDEA
Drive up revenue with a three-part pricing plan that capitalizes on consumers’ affinity for free goods.

When Talk is Free

THE RESEARCH
In 1996, AOL stopped charging customers every time they connected to the Internet and introduced a flat access fee. As a result, demand soared beyond the company’s expectations—existing customers stayed online longer and a million new subscribers joined in the first month of the new plan alone. AOL wasn’t completely prepared for the surge. Its servers struggled with the traffic, and customers grew frustrated.

Why did usage rise so much? Recent research has shown that consumers value free services differently than services they pay for. They don’t simply subtract the costs from the benefits—they perceive the benefits of free services as higher than when the services cost something. As a result, users place a greater value on free services than expected, and they use them more.

Since AOL first introduced its flat-fee structure, other service providers have taken similar steps (without hiccups in service). Some now offer three-part pricing plans, which feature a regular access fee, an allowance of “free” usage, and a fee for when the customer goes beyond the “free” allotment. Telecom providers have done this with cell-phone minutes.

Have these firms seen a rise in demand similar to AOL, and have they been successful at maximizing revenue? Professor Eva Ascarza, along with Anja Lambrecht and Naufel Vilcassim of London Business School, took a detailed look at what happened when a South Asian mobile phone service introduced a three-part pricing plan, in addition to its two-part plans (those that feature a regular access fee and a charge for every minute consumed).

THE APPLICATION
Marketing Managers
You can use this research to incorporate the appropriate amount of “free” tiers of goods or services as part of a multi-part pricing plan. The researchers found that, although the cell phone firm was ostensibly charging a lower rate on the new plan, the consumers that switched often spent more time on the phone than they had on two-part pricing plans, even going beyond their “free” allowance. As a result, the firm actually saw increased revenue of close to 20 percent from those customers. Since “free” goods are so highly valued by customers, consider advertising them intensely, too.

Operations Managers
You can use this research to adjust your service capacity when your company introduces a three-part pricing plan. In the study, over 80 percent of the consumers that moved to the three-part plan used more minutes than expected based on their history.

READ THE RESEARCH

Since “free” goods are so highly valued by customers, consider advertising them intensely.
As Facebook users check for friends’ latest updates, they’re also exposed to the advertisements that the social networking site pulls into their feeds. How effective is this? How can social networking sites encourage users to click on ads for new products—and increase revenue along the way?

Ad content targeted at individual users through their social media feeds depends heavily on their engagement, which can be measured in part by the amount of content they create. New research from Professor Scott Shriver, along with Harikesh Nair of Stanford University and Reto Hofstetter of the University of St. Gallen in Switzerland, investigates whether that relationship is coincidental or causal. The researchers examined the history of social tie formation and content creation on Soulrider.com, an online community of Swiss windsurfers, leveraging the fact that its users often post about wind speeds at their preferred surfing locations.

After merging the Soulrider data with wind speed information from the Swiss Meteorological Office, the researchers were able to establish that surfing-friendly wind speeds led to more user-generated content about surfing sessions. The researchers used this independent source of variation to isolate the effect that content production has on forming ties (“friendship” links) on the social network. Using data on the social network structure, the team was also able to establish the reverse effect, that greater connectivity in the network prompts more content generation. Identifying these causal links is a step forward from past research, which merely found a correlation between posting content and increased connections.

In broader terms, Shriver and his co-researchers found that more connected users visit and browse the site more often, which helps stimulate online revenue growth. In other words, together connections and content led to a self-reinforcing, virtuous cycle that could help sustain the growth of the site.

“One of the main issues sites like Facebook deal with is how to monetize the content created on their sites,” Shriver says. “This research reinforces the idea that online social networks can drive advertising revenue by encouraging dense social ties.”

This suggests that in order to maintain network and revenue growth online social networks should offer users incentives to connect with friends. Offering engagement tools that lead to content generation, such as facilitating tie-formation activities like “friending” and enabling comments and photo tagging, will help increase user interaction on networking sites. This type of organic content is preferable to paying users to generate artificial content, which runs the risk of reading as inauthentic, potentially alienating users. Smaller social networking sites, like Soulrider, could take a cue from the engagement efforts of sites like Facebook and Twitter, each of which asks users to add connections (“friend” or “follow,” respectively) as soon as they sign up and provides a constant stream of suggestions and prompts for users to connect with other users or businesses.

Shriver’s study data also shows that 80 percent of Soulrider’s content was generated by 10 percent of users, offering an additional way for sites to encourage stronger relationships and ad revenue. “Targeting engagement efforts specifically toward the preferences and habits of the most productive users—this 10-percent group—may be a more viable way of generating additional page views, increasing click-through rates, and thereby boosting ad revenues.”

This is just one way for networking sites to capitalize on this research, deepen connections among users, and increase advertising profits. “It’s not sufficient to just get people to join the site. Increasing the strength of the relationships is key to increasing page views—and, in turn, ad revenue.”

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**It’s not sufficient to just get people to join the site. Increasing the strength of the relationships is key to increasing page views—and, in turn, ad revenue.”**
Facebook Friend or Enemy?

Online social networks enhance users’ self-esteem—and lower self-control.

Today, individuals have grown accustomed to sharing intimate details about their lives online—weddings, graduations, and new jobs are all fair game for publicizing through social networks like Facebook.

“But there hasn’t been a lot of research on how using a social network affects consumer behavior, particularly its effects on how people feel about themselves and the decisions they make offline,” Professor Keith Wilcox says.

Wilcox and Andrew T. Stephen, PhD ’09, now of the University of Pittsburgh, conducted a series of experiments to explore how social network use affects consumer behavior. In one experiment, they told users to browse either Facebook or CNN.com for five minutes, then gave them a snack choice of either a cookie or a granola bar. They found that the more Facebook users focused on people they reported to be very close friends—rather than acquaintances or strangers (people they didn’t even know offline)—the more likely they were to choose the cookie more often than those who just browsed CNN. In another instance, users participated in an auction for a new...
Separations, Sorting, and Wilcox says. “The downside is that it results on social networks and browsing for as little as five minutes can enhance users’ self-esteem and make them feel better about themselves,” Wilcox says. “The downside is that it results in an overinflated ego and manifests itself in negative behaviors.”

To further test the connection between social network use, higher self-esteem, and lower self-control, the researchers also conducted an online survey with more than 500 people nationwide. The survey results were consistent with their findings on self-control in the lab experiments—users who focused more on close friends than acquaintances in their networks had higher BMIs, were more likely to engage in binge eating, and had higher credit card debt and lower credit scores. The more time people spent browsing Facebook, the less discipline they displayed in their offline decisions.

However, Wilcox cautions that the potential negatives shouldn’t outweigh the positive benefits of engaging in online social networks. “Social network use can help people feel better about themselves, enhance their social capital, and help them build relationships,” Wilcox says. “The more people are aware of these negative tendencies, the more likely they are to counteract them.”

This research may also be applicable to advertisers, who have struggled with low click-through rates on Facebook ads versus higher click-through rates for ads on other sites like Google. “If people feel higher self-esteem and less disciplined while browsing a social network, advertisers might need to appeal to these users in a different way than they would on Google, for instance,” Wilcox explains. This creates a starting point for future research, he says, on the basis that consumers use social networks to fulfill a variety of social needs. Those needs include self-expression and self-presentation—some of the same needs that underlie decisions to purchase luxury brands and affect how consumers respond to messages promoting image versus quality.

On a broader note, Wilcox stresses the importance of recognizing how behavior rules differ online versus offline; in the real world, people tend to be more modest with close friends than with distant friends. But online, those social norms do not necessarily apply, he says. “If everyone on Facebook is sharing their accomplishments, it just seems natural to do the same thing—particularly with the people you’re closest to. But users should be aware that the high self-esteem they feel from sharing online can have a dark side.”

And that effect may not be limited to Facebook—Wilcox says it could hold true for any social network where people are focused on presenting a positive self-image. Although LinkedIn is primarily used to develop one’s career, the heart of the network is about presenting a positive image to others, he says. “And while some Twitter users focus on sharing news and other non-personal information, many also use it as a form of self-promotion.”

Letting Go of the Best

Why are firms’ most productive employees the most likely to get pink slips when a recession hits?

Who does unemployment hit the hardest during recessions? Some signs have pointed toward high-wage workers. Yet these workers also tend to be firms’ most productive employees, and why firms aren’t more reluctant to let them go has remained somewhat puzzling. New research from Professor Andreas Mueller digs deeper to not only provide strong evidence that high-wage workers are disproportionately impacted in recessions but also to explain why firms seem so overeager to shed their most productive workers.

Mueller looked at the Current Population Survey, the main labor force survey in the United States, which the Bureau of Labor Statistics uses to estimate the unemployment rate. The survey tracks unemployment and wage information, following households for more than a year, and has a high response rate. By using a complicated matching process, Mueller was able to conduct an analysis of every recession since 1962.

He finds that even controlling for education, work experience, gender, and other easily observable characteristics of the unemployed, those with high wages—beyond any other similarities they may share—tend to get disproportionately laid off in recessions. In particular, those with high residual wages—high wages relative to others with similar education and experience—are the most heavily impacted.

Mueller also analyzed the data to see whether the changes could be driven by factors not easily observed. For example, might high-wage workers, once laid off, have a much harder time finding a job in a recession than low-wage workers? “It turns out it’s just as difficult for a low-wage worker to find a job in the recession as it is for a high-wage worker,” Mueller notes. “So that doesn’t
An obvious candidate for what’s behind disproportionate layoffs of high-wage workers is firm and plant death: if a plant shuts down, it sheds all workers, not just low-skilled workers. But Mueller found that plant and firm deaths don’t happen that much more during recessions than during better times and only explain a small part of the layoff pattern.

Among the handful of theories about what causes this pattern, Mueller found the strongest evidence points to credit constraints that emerge in recessions. During recessions, firms would prefer to keep their high-wage, high-productivity workers, who will be key to the firm’s performance once the recession ends. But many firms must rely more heavily on credit during recessions. Since borrowing costs rise in recessions while available credit contracts, these firms find themselves crunchcd by current costs and appear more inclined to get rid of high-wage workers despite their productivity.

Yet another theory about high-wage layoffs suggests that the bulk of high-wage workers getting laid off during recessions are those who were simply lucky at some point in their careers and were able to secure a higher wage than their productivity called for. In hard times, the theory goes, these supposedly overvalued, lower-quality workers are the first to go. In a related study Mueller and his coauthors, Peter Fredriksson of Stockholm University and Björn Öckert of the Institute for Evaluation of Labour Market and Education Policy, used employer-employee data to track workers’ employment as they move from firm to firm and examine the composition of Swedish unemployment during recessions. The researchers matched that data with cognitive and non-cognitive ability test scores from Sweden’s compulsory military service, which allowed the researchers to see not just whether individuals are “book smart” but also to get a sense of their social and other skills.

Although Sweden’s labor market is in many ways very distinct from the US labor market, the initial results show the same patterns of unemployment among high-wage earners in recessions. And those with higher IQ scores, greater proven abilities, and higher non-cognitive scores do increasingly get laid off in recessions. The pool of unemployed reflects a higher share of among the highest quality workers—which controverts the idea that firms primarily shed their least talented high-wage workers when credit thins.

“One often hears anecdotes about firms’ unwillingness to hire laid-off workers—firms assume the pool of unemployed is of low quality,” Mueller says. “But if I were in HR, I would want to hire in recessions. I’d have a much better chance of recruiting high-ability staff.”
In 1899, baseball’s Cleveland Spiders were historically bad. They played 154 games and lost 134—easily among the worst seasons ever. Not surprisingly, attendance that season was equally poor. So few Ohioans showed up to watch the Spiders lose, historian Bill James later wrote, the team eventually canceled its remaining home games and spent the rest of the season on the road.

Cleveland fans are not alone in their aversion to last place. People often celebrate first place: there’s a parade for the Super Bowl champions; the top salesman at the office gets a bonus. Yet whether it’s an innate human trait or a response to seeing others treated poorly, people are also conditioned to avoid being labeled—or associated with—the worst.

Professor Ilyana Kuziemko, along with Ryan Buell and Michael Norton of Harvard and Taly Reich of Stanford, explored this question through a series of laboratory experiments.

In one experiment, the researchers were interested in subjects’ willingness to take risks. Generally speaking, economists say, the poorer the person, the more averse he probably is to gambling an absolute amount of money. Consider a person with a mere $10 to his name. He might be wary of risking $5 on a coin flip since, if the toss were to go the wrong way, he’d have lost half his net worth in the blink of an eye. A person with more in the bank, on the other hand, would likely be bolder.

In the lab, though, the researchers saw something different. There, participants were ranked in terms of randomly assigned wealth and, over a series of rounds, given the chance to move up. Each round, participants had the choice between taking a small but guaranteed sum or gambling to earn (or lose) even more. Those who fell to the bottom, the researchers found, were far more likely than...
Low-income workers, those making just above the minimum, are in fact often the least likely among all wage earners to express support for a minimum wage hike.

Any of the other players attempt to gamble their way out. “We attribute that to their being so desperate to get out of last place,” Kuziemko says.

In another set of games, the players were again assigned money and ranked. Then each had the choice of giving additional funds to the player one spot up or down (they couldn’t keep it for themselves). Most participants were charitable to those less fortunate, the researchers found, with one exception.

“Almost half of the people who were in second-to-last place,” said Kuziemko, “actually gave the money to the person who was already richer, because giving to the person below would mean that that person would leapfrog over them and they, the second-to-last place player, would be in last.”

Last-place aversion can also be seen in relation to the federal minimum wage. In his State of the Union address in February, President Obama called on Congress to raise that hourly rate from $7.25 to $9. While the proposal is likely to be popular among those making the current minimum, a surprising number of workers earning slightly more may oppose it, according to Kuziemko. She and her colleagues surveyed workers on the subject as part of the same study.

From the results, and from looking at data from a similar Pew Research Center report, the researchers saw that low-income workers, those making just above the minimum, are in fact often the least likely among all wage earners to express support for a minimum wage hike. For these people, such a raise could lead to their joining the lowest income bracket. And like the lab participants, many of the workers show signs of being last-place averse.

While minimum wage increases are generally popular, these results suggest that support among low-income households might be less predictable than expected. Kuziemko emphasizes that the results are unrelated to the merits of the policy. “Our results might explain why it is or isn’t popular,” she says, “but they don’t suggest anything about whether or not it’s a good policy.”

Minding the Gap

As financial markets deregulate, income inequality grows.

In September 2011, the Occupy Wall Street movement took its grievances about income inequality between the “99 percent” and the rich, particularly bankers and investment companies, to the sidewalks of New York City and beyond. Its movement, Occupy said, represented the frustration of middle-class employees, unemployed college graduates, and unskilled workers across the country and around the world.

“The Occupy movement was concerned that 1 percent of people were getting really rich while the wages of the bottom 99 percent of earners stagnated,” says Professor Mauricio Larrain. “Previous research has found that an economy full of inequality doesn’t allow a democracy to work well and leads to social unrest.”

Even within the ranks of the 99 percent, Larrain says, there is growing wage inequality. According to the Bureau of Labor Statistics, employees with bachelor’s degrees earned $1,053 per week on average in 2011, compared to $638 for those with high school diplomas. Between 1980 and 2005, the wage gap between workers with some college education and those with only a high school education increased by 25 percent. Increasing wage inequality in the United States, most notably between skilled and unskilled workers, is believed to be a key factor in the financial crisis of 2007–08. As the gap between college-educated top earners and everyone else widened, politicians responded by relaxing financial regulations that in turn eased consumers’ access to credit.

But why has wage inequality between skilled workers—those with college educations who perform non-routine tasks—and unskilled workers, who usually have only a high school education and perform routine tasks, increased in the last few decades, both in the United States and abroad?

For an answer, Larrain followed the Occupy lead and looked at Wall Street and the finance markets. He noticed that the wage gap among the finance industry’s executives increased by 400 percent between 1995 and 2005.

For researchers in the nation’s capital, this kind of rapid change is unsettling. To the policymakers they serve, they are expected to provide economic explanations that are as tidy as the numbers are arbitrary. And yet, the story of Wall Street’s executives is anything but tidy; it is the result of decisions made by consumers and policymakers, all of whom have a stake in the financial system.

“Explain it to me like I’m 5,” says Larrain. “This kind of leveling down was unprecedented in the last couple of decades. And it has to do with financial deregulation.”

Larrain says, there is growing wage inequality.

Financial deregulation contributed to the growth of the finance industry and widened the gap between skilled and unskilled workers. As the finance industry grew, so did the pay of its executives. “Finance liberalization helped the pocketbooks of Wall Street executives, but it also widened income inequality,” he says.

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Wage Inequality and Financial Liberalization Index

increase in income inequality paralleled a period of financial liberalization fueled by deregulation policies in American states and European countries. In the United States, banks were restricted from branch expansion both within and across state lines prior to the late 1970s. At that time, states began lifting these restrictions, a decade-and-a-half-long process that culminated in the 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act, which allowed bank holding companies to acquire banks in any state. European countries followed a similar trend starting in the 1970s.

For the United States, Larrain calculated wage inequality using the Current Population Survey (CPS), which provides national household wage and education data. He compared wages and education levels before and after the dates when each US state eliminated geographical restrictions on banking. Similar information from the EU-KLEMS dataset (which collects information on labor and wages by education level) provided a comparison of wage inequality and financial liberalization for European countries.

Larrain found that when an economy deregulated its financial markets—whether a US state or a European country—wage inequality increased the most in industries where employees conduct very routine tasks, such as manufacturing. Although other sectors—such as retail—also employ unskilled workers, those fields in which machines, computers, and equipment can perform routine tasks and replace unskilled workers experienced a greater increase in wage inequality.

“When an economy liberalizes its financial markets, much more credit is going to flow to companies from banks in the form of loans. With these funds, companies can buy capital—those machines and computers [that can replace unskilled labor]—that need to be operated by skilled workers,” Larrain explains. “That leads to an increase in the demand for workers with college educations, while reducing the need for unskilled workers.”

Although financial liberalization is not the only factor in increasing wage inequality, Larrain found that liberalization accounts for about 20 percent of the overall increase in income disparity in the United States and the United Kingdom over the last three decades.

One implication for policymakers, Larrain says, is for the government to temper wage inequality by promoting policies that increase the number of college-educated workers. “With more skilled employees on the market—increased human capital—the supply can better meet the demand, the two groups’ salaries level out, and everyone wins. This might mean reforming government student loans or providing specialized training that will help more people attain the skills they need.”

Larrain says that while there are many dimensions to understanding the connection between financial markets and the macroeconomy, focusing on wage inequality is an important start. “There is a clear link between Wall Street and Main Street that we don’t understand well enough.”

Increasing wage inequality in the United States, most notably between skilled and unskilled workers, is believed to be a key factor in the financial crisis of 2007–08.
Luring the Informed Investor

Does investor sophistication correlate with firms’ disclosure activities?

All investors are not created equal. Each, whether individual or institutional, varies in the attention and resources—whether in time, ability, finances, computing power—he can devote to maximizing his investments. Typically, the most sophisticated investors are active gatherers and users of information about firms, while the less sophisticated don’t cull as much high-quality information or are unable to make the best use of the information they do collect.

Because of these differences, says Professor Alon Kalay, what firms disclose and how they disclose it matters. In a recent paper, Kalay articulates a new way to detect whether investors in publicly traded firms are sophisticated or unsophisticated; he then correlates the relationship between what and how firms disclose to the types of investors who tend to invest in those firms. He calls this a disclosure clientele effect, the idea that if investors do vary in ability, sophisticated investors—those who build an information advantage—prefer to invest in firms that provide certain types of disclosures. Alternatively, less-sophisticated investors prefer to invest in firms that provide disclosures in a way that makes information easier to use.

A common proxy used to measure the sophistication of an investor base is to measure the percent of a firm’s shares held by institutional investors or specific types of institutional investors. The assumption is that these institutional investors are sophisticated. Kalay sought a more elegant method that would capture not just the percentage of shares held but how investors actually behave, arguably a more fine-tuned signal about investors’ abilities. To do so, he turned to the options market.

When investors buy call options on stocks, they can in some cases earn extra profit by exercising options early in an optimal manner. Kalay used open (unexercised) options as a proxy for unsophisticated investors: leaving options unexercised that, if exercised early, could have led to higher profits likely signals an investor’s limited ability to gather and analyze relevant information. He established a measure of how sophisticated a firm’s investors are and found significant variation across firms.

Kalay’s next step was to look at his observed variations in the options markets in conjunction with different disclosure channels that public companies use to provide information to investors. Kalay looked at three types of disclosure:

- **Press Dissemination**: Some firms are more likely to be covered by the press than others, and press coverage is often viewed as a low-cost shortcut for culling important information about firms. Kalay found that unsophisticated investors concentrate their investments in firms with more press dissemination. “If the press publishes information in a more accessible manner than other sources of information, firms with increased press dissemination make it easier to gather and analyze information. Thus the more comfortable these unsophisticated investors may feel,” Kalay says.

- **Investor Relations (IR)**: Kalay finds that firms rated highest for IR by the industry publication IR Magazine are more likely to attract a greater proportion of unsophisticated investors. “As with the press, good IR departments issue information in a well-organized way and disseminate it in a way that is easy for investors to access.”

- **Earnings Guidance**: Some firms issue earnings guidance on a regular basis, forecasting earnings for future periods. While this can help market watchers understand firms over time, there’s debate about how desirable this prevalent channel of disclosure is. Many firms worry that issuing forecasts will attract speculators, for one thing. Kalay finds that it is largely sophisticated investors who follow these firms. (The effect was larger before the implementation, in 2000, of Regulation Fair Disclosure, or RegFD, an SEC rule mandating that publicly traded firms provide disclosure to all investors simultaneously. But even post-RegFD, Kalay finds that the relationship between guidance and sophisticated investors remains strong.) “You may expect a future single number to be easy and quick to understand and for less sophisticated investors to prefer to invest in these firms,” Kalay says. “However, when you think about who plugs these forecasts into their spreadsheets, it makes sense that sophisticated investors utilize guidance more effectively.”

The 10,000-foot view is that more disclosure isn’t always better. “Just as all investors are not created equal, all disclosure activities are not created equal,” Kalay says. “Managers should understand that better disclosure may be a matter of substituting one form of disclosure for another, and we can’t just say that more disclosure will lead to a better regulatory environment, transparency, or a level playing field for all investors. What information firms release and how they release it matters.”

Alon Kalay is assistant professor of accounting at Columbia Business School.

READ THE RESEARCH
In the popular imagination, China’s economy is often viewed as a lopsided three-horse chariot: exports and investment are steroid-fed giants, while consumption is a dwarf, perhaps intentionally stunted by government policy. But there are a few things wrong with this image.

While China does need to adjust to the fact that exports can’t outpace imports forever, there is nothing wrong with high export growth in and of itself, and China will continue to benefit from high export volume, even as a share of GDP, as long as imports keep pace.

Its investment-to-GDP ratio may need to be moderated somewhat. But the primary problem is not the level of investment, it’s the composition. China can—must—improve its financial system by capping the allocation system to allow more domestic and foreign capital to be allocated away from the less efficient majority state-owned entities toward more efficient privately owned entities.

Consumption does need a boost, but it’s hardly a dwarf among giants: per capita real consumption in China, adjusted for inflation, has increased by 80 percent cumulative over the last seven years, in spite of a global recession.

Will China Slow Down? Not So Fast.

BY SHANG-JIN WEI

After three decades of barely checked expansion, the world is waiting for China’s economy to run out of steam. Shang-Jin Wei argues that China’s unique features will likely help it offset some of the slowing forces and maintain speed for the next decade.
There are well-known factors that could tend to slow China's growth rate. Reforming the household registration (the "Hukou" system) would be another way to improve income distribution.

Third, the country needs to find a way to reduce competitive saving triggered by a high sex ratio imbalance. This is a hard problem, but the first challenge is for the policymakers to recognize the significance of the competitive saving motive.

The competitive saving motive is a less immediately tractable aspect of consumption. China must alter the consumption habits of its citizens. But this is considerably more difficult to address because it is directly linked to why Chinese people save so much.

Some experts attribute China’s high savings rate, which depresses consumption, to artificially depressed interest rates. But a rise in the interest rates would have two competing effects on savings. Higher rates may give people a little more income to consume but they also make saving more attractive relative to consumption. Some years ago, the Chinese Central Bank tried to alter the incentive to save by introducing (and then removing) a tax on interest income. This of course altered the after-tax interest rate, but the aggregate household savings rates before and after the tax remained unchanged—there was no net effect.

The status competition triggered by a high sex ratio imbalance also has important implications for the country’s growth rate. There are well-known factors that could tend to slow down the growth rate for China over the next few years—rising labor costs, a declining share of the labor force in the total population, environmental challenges, and the need to switch from cost-based competition to innovation-based competition. And we know that most countries that experience decades of high growth will start to slow after 30 years.

But China has some unusual features that will partially offset the conventional factors: before 2002, the ratio of men to women in China was close to 1 to 1, which is where it should be. Today it is 1.15 to 1. A difference of .15 sounds small, but it has major implications for growth. It translates into the fact that, mathematically speaking, one out of every nine men cannot get married.

Most young people want to get married, and most Chinese parents with a son want him to get married. How do you respond to the one in nine chance—a very real possibility—that your son may not be able to get married? Parents see wealth as a useful comparative weapon in the marriage market and, suddenly, accumulating wealth, which was already important, has become even more important. And the desire to accumulate more wealth leads to more savings, working harder, being more productive, and an increased willingness on the part of more people to take entrepreneurial risks, all of which collectively translates into extra growth.

Interestingly, the enhanced desire to accumulate wealth by young men and families with sons can spill over to other families, including families with daughters. This is a subtle argument. On the one hand, families with a daughter may free ride and work less. On the other hand, if families with a son start to save more to prepare to buy and live in a bigger house or apartment, other families may feel compelled to do the same in order not to lose their own social status. Moreover, parents with a daughter may wish for her to be matched with the best possible man. If men or families with a son also prefer women from a relatively wealthy family to one from a poor family, other things being equal, this could translate into a race for more wealth by families with daughters. In any case, the net effect of a sex ratio imbalance on economic growth can be estimated with household and regional data.

In recent research with Dr. Xiaobo Zhang of the International Food Policy Research Institute, I estimate that this has given China about 2 percentage points of extra growth over the last decade. We know this will get stronger over the next 10 years. Why? Because demographic data tells us the sex ratio of today’s 15- and 20-year olds, who will be looking to get married sometime over the next decade and a half.

The sex ratio imbalance at birth has already started to moderate since around 2009. However, the sex ratio imbalance for the age cohort looking for a marriage partner will continue to be bad and, in fact, deteriorate over the next decade and a half, eventually becoming 1.2 to 1.
Caution on Cocos

Research suggests that mandatory contingent convertible bonds with a market trigger may not address the problem they were designed to solve.

One of the mandates of the 2010 Dodd-Frank Act included examining banks’ capital structures: could bank losses somehow be absorbed by the banks’ creditors rather than taxpayers? In particular, Dodd-Frank charged regulators with assessing whether banks should be required to issue contingent capital—a type of debt capital raised through the sale of contingent convertible bonds, or Cocos, that can be converted to equity. If so, how should such securities be designed to ensure that banks have sufficient loss-absorbing capital?

Banks sell Cocos when their balance sheets are stable and, as with regular bonds, pay interest to the bondholder (creditor). But when a bank faces an unanticipated and destabilizing crisis, Coco debt automatically converts into equity capital. As a result, the bank no longer owes the investor interest on the bond, and the investor holds shares, rather than bonds, in the bank. Thus, Coco investors, transformed from creditors to shareholders, cannot threaten a costly and disruptive bankruptcy suit to secure their investment (as happened with Lehman Brothers).

Under one of the two main proposals for designing Cocos, regulators would designate a trigger for conversion based on accounting measures. For example, mandatory conversion can be triggered if the core tier 1 capital (a measure regulators use to determine a bank’s core financial strength) falls to or below 5 percent of the total risk-weighted assets.

Unfortunately, accounting measures such as tier 1 are backward-looking and can be easily manipulated. The other main proposal for designing Cocos skirts this problem by using a market trigger. Cocos would convert as soon as the bank’s stock price hits a predetermined low, on the rationale that stock prices are less easy to manipulate because they are forward looking and incorporate the knowledge of millions of investors.

“The idea sounded good at the outset,” says Professor Suresh Sundaresan, who, with coresearcher Zhenyu Wang, then head, financial intermediation, at the Federal Reserve Bank of New York and now at Indiana University, participated in a research project initiated by the New York Fed to analyze contingent capital as a way to design the capital structure of banks.

Sundaresan and Wang quickly discovered a significant problem. Using the well-accepted binomial pricing model, they show that the proposed market trigger design would introduce broad scope for manipulation and high volatility in prices of equity and Coco bonds both before and at the time of conversion.

“Unlike convertible bonds, mandatory conversions of debt to equity don’t allow Coco investors to choose the best time to convert in their own best interest,” Sundaresan says. They are obligated to accept conversion at a predetermined condition, such as when the stock price hits a low trigger level designated by regulators.

“If the conversion dilutes the value of shares, existing equity holders bear the burden while Coco investors gain a big advantage. But, if the conversion is done so that Coco investors lose value relative to equity holders, Coco investors will be worse off.”

One of the main results of the research is to show that the only way to avoid such problems is to ensure that there is no such transfer of value when the mandatory conversion occurs. The researchers discovered that this requirement runs counter to a key provision of Dodd-Frank. “The regulators required conversions to be punitive toward equity holders—they wanted the conversion ratio to be so high so that when Coco investors’ bonds converted, lots of equity had to be issued, which would dilute share values,” Sundaresan explains. “But if equity holders know they would face dilution at mandatory conversion, they may be incentivized not to take the kind of risks that would prompt the stock price to drop in the first place.” This in turn can increase the likelihood of systemic instability, with taxpayers once more at risk of footing the bill for bailouts.

Informed, in part, by the work of Sundaresan and Wang, regulators around the world are increasingly viewing contingent capital with market triggers with caution. None have yet adopted it as part of their capital prudential requirements for banks. In 2012, the Financial Stability Oversight Council submitted its study to Congress and recommended that banks continue to explore the design of contingent capital, but that “market-based triggers can exacerbate the problem of death spiral.”

Sundaresan and Wang, meanwhile, are thinking about alternate designs for securities that will address the problems of manipulability and touching off market instability. “Designing effective and efficient bank capital structure—including contingent capital—remains a work in progress,” Sundaresan says.
Select Ideas
A roundup of ideas you might have missed in recent electronic issues.

The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Product Market Competition
Wei Jiang with Alon Brav of Duke University and NBER and Hyunseob Kim of Cornell University

Idea: This project studies the long-term effect of hedge fund activism on the productivity of target firms, finding that target firms improve production within three years of hedge fund intervention, concentrated in industries with low product market concentration.

Applications: The overall evidence suggests a real long-term effect of hedge fund intervention on target firms' fundamentals, facilitating improved efficiency in production and capital reallocation.

Read more about this research, featured in the May 2013 electronic issue, at gsb.columbia.edu/ideasatwork/hedge.

The Expected Rate of Credit Losses on Banks’ Loan Portfolios
Trevor Harris, Urooj Khan, and Doron Nissim

Idea: The researchers used publicly available financial disclosure data to develop a timely, unbiased measure of expected credit losses that can be used to better assess the risks and profitability of banks’ lending activities. Its predictive power offers a significant improvement over current metrics.

Applications: Accounting standard setters and regulators can use this research as they consider making changes to reporting requirements. Investors and banks can use the research to better assess profitability and risk.

Read more about this research, featured in the April 2013 electronic issue, at gsb.columbia.edu/ideasatwork/rcl.

Severe Weather and Automobile Assembly Production
Marcelo Olivares with Gérard Cachon and Santiago Gallino of Wharton

Idea: The project examines how severe weather events impact the productivity of auto plants in the United States. The researchers find that productivity declines by about 1.5 percent per plant on average due to extreme weather events, with individual plant productivity declines ranging from .05 to 3 percent.

Applications: As climate change threatens to bring more extreme weather, the findings should prompt manufacturers to consider implementing practices aimed at mitigating the productivity-dampening impact of bad weather.

Read more about this research, featured in the April 2013 electronic issue, at gsb.columbia.edu/ideasatwork/climate.

It’s Good to Be King: Neurobiological Benefits of Higher Social Standing
Modupe Akinola with Wendy Berry Mendes of the University of California San Francisco

Idea: This study looks at the psychological, physiological, and behavioral effects of having high status. Subjects in higher status positions exhibited more adaptive hormonal and cardiovascular reactions. High-status subjects also performed better and faster and were more generous, both in allocating resources to their partners and in having positive perceptions of them.

Applications: Managers can use this research to adjust how they supervise both higher- and lower-status individuals when there are opportunities to move up the ranks, since the research suggests that when people know that they can move from being a supporter to a leader, they’re more likely to give an optimal performance.

Read more about this research, featured in the May 2013 electronic issue, at gsb.columbia.edu/ideasatwork/king.

Power Gets the Job: Priming Power Improves Interview Outcomes
Adam Galinsky with Joris Lammers of Tilburg University, David Dubois of INSEAD, and Derek Rucker of Northwestern University

Idea: This research looks at whether power priming, a technique for reducing stress before important events, can also prompt others to perceive people as more powerful and confident.

Applications: Job applicants who power-primed before writing job application letters or participating in mock interviews were significantly more likely to be ranked highly and were judged as being more confident and persuasive than those who did not power prime. Individuals can use power primes judiciously in high-stakes situations where appearing confident is crucial.

Read more about this research, featured in the May 2013 electronic issue, at gsb.columbia.edu/ideasatwork/powerprime.
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