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Abstracts of Articles on Individual Financial Management

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CONSUMPTION-SAVINGS BEHAVIOR

Non-marketable Assets and Households' Portfolio Choices: A Case Study of Italy, Claudio Giraldi and Rony Hamaui (Banca Commerciale Italiana, Economic Research and Planning Department, Milan, Italy) and Nicola Rossi (University of Modena, Italy)

This paper analyzes the determinants of aggregate households' portfolio choices conditional on those components of wealth which can be regarded as highly or totally illiquid because of the existence of substantial transaction costs and/or institutional constraints on agents behavior. The empirical analysis broadly confirms the importance of the above-mentioned institutional aspects in the allocation of financial wealth and provides the means for addressing some interesting questions regarding the behavior of portfolio holders in financial markets. In particular, it is shown that the presence of non-tradable assets changes the risk premia on marketable assets. Hence, in cases such as the Italian one, where the State is both the issuer of government securities and the collector of social security funds, the positive correlation (due to a common default risk) between returns on government securities and on non-marketable assets could lead to a higher cost of public debt financing. *Journal of Banking and Finance*, December 1993, 17(6): 1171–1190. (Reprinted with permission of the North-Holland Publishing Company.)

Mental Accounting and Outcome Contiguity in Consumer-Borrowing Decisions, by D. Eric Hirst (University of Texas at Austin), Edward J. Joyce (University of Minnesota) and Michael S. Schadewald (University of Wisconsin at Milwaukee).

Research indicates that decisions are affected by how outcomes are framed. Mental accounting is a type of framing in which individuals are hypothesized to form psychological accounts for the costs and benefits of outcomes. Prior research has focused on mental accounting's consequences rather than its determinants. Thus, little is known about the processes that underlie mental accounting. This study investigates the role that temporal contiguity (the co-occurrence of multiple outcomes) plays in mental accounting for consumer-borrowing decisions. Thaler's (1985) extension of Kahneman and Tversky's (1979) Prospect Theory was used to predict that consumers will prefer to finance purchases

of goods with loans whose terms correspond with the life of the good. The results of four experiments involving 131 MBA students provide support for this prediction. The present study adds to our knowledge of mental accounting by examining the effect of temporal contiguity in the domain of multi-period costs and benefits. It also adds to the consumer behavior literature by examining an important factor affecting debt utilization. *Organizational Behavior and Human Decision Processes*, April 1994, 58: 136–152. (Reprinted with permission of *Organizational Behavior and Human Decision Processes*.)

ESTATE PLANNING AND DISTRIBUTION

Government Intervention as a Bequest Substitute, by Michel Strawczynski (Hebrew University of Jerusalem).

A subsequent generations model is used in order to characterize consumption allocation under the future generation's income uncertainty. Altruistic concerns towards future generations give rise to 'precautionary bequests' which act as a hedge on risk. It is shown that given a first-order correlation between mean future income and the present generation's income, government can provide a Pareto improvement through a tax-transfer policy with universal participation. This policy acts as a substitute for precautionary bequests. Distributional aspects of governmental tax-transfer policy are also discussed. *Journal of Public Economics*, March 1994, 53(3): 477–495. (Reprinted with permission of *Journal of Public Economics*.)

FINANCIAL SERVICES DELIVERY AND PRODUCTS

Brokerage Commission Schedules, by Michael J. Brennan (University of California, Los Angeles, and the London Business School) and Tarun Chordia (University of California, Los Angeles).

It is generally optimal for risk-sharing reasons to base a charge for information on the signal realization. When this is not possible, a charge based on the amount of trading, a brokerage commission, may be a good alternative. The optimal brokerage commission schedule is derived for a risk-neutral information seller faced with risk-averse purchasers who may differ in their risk aversion. Revenues from the brokerage commission are compared with those from a fixed charge for information and the optimal mutual fund management fee. *The Journal of Finance*, September 1993, 48(4): 1379–1402. (Reprinted with permission of *The Journal of Finance*.)

IMPLICATIONS FOR FINANCIAL PLANNING

Is Investing for the Long Term Theory or Just Mumbo-Jumbo?, by P.L. Bernstein.

In academic models and in Wall Street, investment "for the long run" presumes the existence of a long-run trend. The notions of "undervaluation" and "overvaluation" implies a "regression to the mean." The long run in the popular view is a process that smooths the bumps and captures the main trend. In reality, the long run is a complex, ambiguous, and

elusive concept in which volatility as well as liquidity matter. Volatility is unimportant only if liquidity is unimportant. If liquidity is important, in the long run, one cannot presume that a volatile investment will regress to the mean. *Journal of Post Keynesian Economics*, Spring 1993, 15(3): 387–393. (Reprinted with permission of Economic Literature.)

INSURANCE DECISION AND INDIVIDUAL RISK MANAGEMENT

The Inefficiency of Private Constant Annuities, by Tadashi Yagi (Nagoya University) and Yasuyuki Nishigaki (Yokkaichi University).

This article investigates why individuals save to finance consumption during retirement, and we focus this investigation on the inefficiency of constant annuities. To thoroughly examine this problem, we first derive the demand function for the annuities in the case where the capital market is imperfect and the annuities are constrained to be constant throughout the retirement period. With these constraints, we then show that the individual holds assets not only in the form of actuarial notes but also in the form of monetary wealth. *The Journal of Risk and Insurance*, September 1993, 60(3): 385–412. (Reprinted with permission of *The Journal of Risk and Insurance*.)

Consumer Information and Decisions to Switch Insurers, Harris Schlesinger (University of Alabama) and J.-Matthias Graf von der Schulenburg (University of Hanover).

This article examines the interaction of various factors in an individual's decision to switch insurers. In particular, expectations about insurer quality attributes as well as search costs and switching costs are modeled as affecting the consumer's switching decision. Data from a 1983 survey of 2,004 German individuals are used to determine consumers' impressions about the quality and price of their auto insurance policies. The empirical analysis shows how consumer informedness plays a key role in the switching decision. Factors affecting consumer informedness and the sources of consumer information also are examined. *The Journal of Risk and Insurance*, December 1993, 60(4): 591–615. (Reprinted with the permission of *The Journal of Risk and Insurance*.)

INVESTMENT PERFORMANCE

Investment Performance Over Bull and Bear Markets: Fabozzi and Francis Revisited, by John M. Clinebell (University of Northern Colorado), Jan R. Squires (Southwest Missouri State University) and Jerry L. Stevens (University of Richmond).

Fabozzi and Francis present strong evidence in a widely referenced paper that alpha and beta measures do not change over bull and bear markets. Test procedures used by Fabozzi and Francis are replicated in this paper for new samples and for more current periods. Unlike the findings of Fabozzi and Francis, stocks exhibiting statistically different beta measures over bull and bear markets are significantly greater than predicted by chance. This result was especially strong for the 1972 through 1977 market period. *Quarterly Journal of Business and Economics*, Autumn 1993, 32(4): 14–25. (Reprinted by permission of *Quarterly Journal of Business and Economics*.)

Aftermarket Support and Underpricing of Initial Public Offerings, by Paul H. Schultz (Ohio State University) and Mir A. Zaman (University of Northern Iowa).

We study the aftermarket for 72 initial public offerings (IPOs) using comprehensive trade and quote-change data from every market maker for the first three days of trading. Underwriters quote higher bid prices than other market makers for issues that commence trading at or below the offer price. Underwriters repurchase large quantities of stock in the aftermarket without risk by overselling the issue by the amount of the overallotment option. If the IPO is hot, the overallotment option is exercised. If not, the short position is covered with aftermarket selling. We discuss several reasons for underwriter support. *Journal of Financial Economics*, 1994 35: 199–219. (Reprinted with permission of the North-Holland Publishing Company.)

Relative Mean-Variance Efficiency of a Given Portfolio: An Application to Mutual Fund Performance, by Shafiqur Rahman (Portland State University).

This research article uses two performance measures based on mean-variance efficiency to evaluate the performance of managed portfolios. They do not require the specification of the market portfolio and the risk-free rate. As a result, the measurement error attendant in the proxy is resolved. Our empirical results show that for the test period, approximately half of the sampled funds performed better than a naive buy-and-hold strategy based on these measures. When compared to other measures, results indicate that only these measures are independent of their risk proxy and as such are unbiased measures, results indicate that only these measures are independent of their risk proxy and as such are unbiased measures of investment performance. *The Quarterly Review of Economics and Finance*, Spring 1994, 34(1): 13–24. (Reprinted with permission of *The Quarterly Review of Economics and Finance*.)

INVESTMENT SELECTION AND INDIVIDUAL PORTFOLIO MANAGEMENT

Portfolio Performance of the SDR and Reserve Currencies: Tests Using the ARCH Methodology, M. G. Papaioannou and T. Temel

In evaluating their foreign exchange exposure, international investors often compare actual portfolios with those calculated under the assumption that the variability of returns on various currency assets is time invariant. This paper uses autoregressive conditional heteroskedastic models to test that assumption. For major reserve currencies, including the SDR, the authors find evidence that the variances of returns do vary over time and that autoregressive conditional heteroskedastic models that specify changing variances are superior to models that assume constant variance. By incorrectly assuming a constant variability of returns, the error introduced is smaller with the SDR than with any other national currency. *International Monetary Fund Staff Papers*, September 1993, 40(3): 663–679. (Reprinted with permission of the *Journal of Economic Literature*.)

Art as an Investment: The Market for Modern Prints, James E. Pesando (University of Toronto)

Repeat sales of modern prints at auction are used to estimate a semiannual index of prices for the period 1977–1992. As in other studies of art as an investment, prints do not compare favorably to traditional financial assets. There is substantial noise in auction prices, but little or no support for the proposition that some artists command higher prices in certain countries or that masterpieces outperform the market. One puzzle is the continuing tendency for prices realized at certain auction houses to exceed those realized at others: notable, at Sotheby's relative to Christie's in New York. *The American Economic Review*, December 1993, 83(5): 1075–1089. (Reprinted with permission of the American Economic Association.)

Downside Risk and Investment Choice, by K.S. Maurice Tsi (Indiana University), Jamshed Uppal (Catholic University of America) and Mark A. White (University of Virginia).

This paper develops an optimal investment strategy for individuals concerned with avoiding the possibility of realizing returns below a predetermined target level within a prescribed period of time. Assuming a Brownian motion process, a model is developed which allows computation of the exact probability of failure. The algorithm and associated comparative statics with respect to the mean and standard deviation of returns, target return, time horizon, and risk-free rate of return are likely to have many useful practical applications. *The Financial Review*, November 1993, 28(4): 585–605. (Reprinted with permission of *The Financial Review*.)

Intertemporal Asset Pricing Under Knightian Uncertainty, by Larry G. Epstein (University of Toronto) and Tan Wang (University of Waterloo).

In conformity with the Savage model of decision-making, modern asset pricing theory assumes that agents' beliefs about the likelihoods of future states of the world may be represented by a probability measure. As a result, no meaningful distinction is allowed between risk, where probabilities are available to guide choice, and uncertainty, where information is too imprecise to be summarized adequately by probabilities. In contrast, Knight and Keynes emphasized the distinction between risk and uncertainty and argued that uncertainty is more common in economic decision-making. Moreover, the Savage model is contradicted by evidence, such as the Ellsberg Paradox, that people prefer to act on known rather than unknown or vague probabilities. This paper provides a formal model of asset price determination in which Knightian uncertainty plays a role. Specifically, we extend the Lucas (1978) general equilibrium pure exchange economy by suitably generalizing the representation of beliefs along the lines suggested by Gilboa and Schmeidler. Two principal results are the proof of existence of equilibrium and the characterization of equilibrium prices by an "Euler inequality." A noteworthy feature of the model is that uncertainty may lead to equilibria that are indeterminate, that is, there may exist a continuum of equilibria for given fundamentals. That leaves the determination of a particular equilibrium price process to "animal spirits" and sizable volatility may result. Finally, it is argued that empirical investigation of our model is potentially fruitful. *Econometrica*, March 1994, 62(3): 283–322. (Reprinted with permission of *Econometrica*.)

REAL ESTATE INVESTMENT

Probabilistic Valuation Models and Income Tax Asymmetries with an Application to the Analysis of Passive Loss Restrictions, by David C. Ling (University of Florida).

This paper develops a modified version of the standard real estate discounted cash flow valuation model that allows the analyst to specify probability distributions, rather than point estimates, on general inflation and rental income for each year of the expected holding period. Explicit modeling of rental income uncertainty is especially critical in the presence of restrictions that cause the tax treatment of income-producing property to be asymmetric. This is demonstrated by an analysis of the restrictions on passive activity losses (PAL) that were introduced with the passage of the Tax Reform Act of 1986. The probability model results indicate that rational investors can pay significantly more for an income property as a result of the elimination of PAL restrictions than would be indicated by the results produced by a standard discounted cash flow "point estimate" model. This is due to the reduction in the skewness of the after-tax returns generated by the property when PAL restrictions are eliminated, and the decline in the required equity discount rate that results from the decreased variance of the after-tax returns. *The Journal of Real Estate Research*, Spring 1993, 8(2): 205–220. (Reprinted with permission of *The Journal of Real Estate Research.*)

Factors Influencing Capitalization Rates, by Brent W. Ambrose (The University of Wisconsin-Milwaukee) and Hugh O. Nourse (The University of Georgia).

This study examines the variations in quarterly mean "capitalization rates" for commercial and industrial investment properties. By explaining the variations in the capitalization rate, we hope to expand the research in explaining variations in the overall return to property. This study differs from other research on portfolio capitalization rates because we separately analyze the rates by property type. The results show that using "averaged" capitalization rates across property types eliminates important information. We use the band of investment approach to develop a theoretical model explaining the capitalization rate and test this model using both Seemingly Unrelated Regression (SUR) and cross-sectional/time-series regression (panel data). *The Journal of Real Estate Research*, Spring 1993, 8(2): 221–237. (Reprinted with permission of *The Journal of Real Estate Research.*)

Neighborhood Racial Transition and Housing Returns: A Portfolio Approach, by Michael Devaney (Southeast Missouri State University) and William B. Rayburn (University of Mississippi).

A portfolio test was used to determine whether neighborhood racial transition impacts the risk/return of housing. We conclude that the diversification advantages of residential real estate were adversely affected by racial transition and that hedge efficiency was positively related to neighborhood income and the proportion of owner occupancy. This result applied only to neighborhoods with a high rate of racial transition and was independent of neighborhood racial composition. *The Journal of Real Estate Research*, Spring 1993, 8(2): 239–252. (Reprinted with permission of *The Journal of Real Estate Research.*)

RISK ATTITUDES OF INVESTORS

Increased Risk Aversion and Risky Investment, by Jiarong Fu (University of Iowa).

This article investigates the relationship between the size of investment in a risky asset and the degree of risk aversion. The necessary and sufficient conditions are established that permit the prediction of whether agents with differing degrees of risk aversion will increase or decrease investment in the risky asset. It shows, in particular, that when the marginal return to investment decreases (increases) with an improvement in the state of nature, greater risk aversion will induce higher (lower) investment. *The Journal of Risk and Insurance*, September 1993, 60(3): 494–501. (Reprinted with permission of *The Journal of Risk and Insurance*.)