From the Editor

Entering its fourth year of publication, *Financial Services Review* has tenaciously held to its editorial policy of publishing only high-quality research in the field of individual financial management. The dual criteria of academic rigor and focus on the individual have had the disadvantage, from an editor's perspective, of limiting the number of manuscripts submitted for publication. However, the scope and caliber of articles that have been published in the first seven issues of this journal have set the foundation for an academically respectable subspecialization of finance.

The five articles in the current issue continue to apply the tools of modern financial analysis to decisions faced by individuals and their advisors. Some decisions are complex, such as the use of junior equity interests to save taxes when passing on a family business to the next generation. Others appear to be mundane, such as the purchase of U.S. savings bonds, the true value of which can only be evaluated through option pricing analysis.

Many individuals own stock in banks. This is due to the fact that banks make up a sizeable proportion of publically traded corporations in the United States as well as to the local or regional appeal stemming from prohibitions on nationwide banking. To a great extent, the financial condition of banks depends upon the fair market value of their assets and liabilities, figures which need be reported only as a footnote to the annual financial statement. Lacking this information on an ongoing basis, investors must seek other clues about the banks' financial condition. In their article titled "Bank Dividend Policy as a Signal of Bank Quality," Boldin and Leggett examine the extent to which the dividend policy of bank holding companies is a signal of their quality. The argument is that banking organizations in poor financial condition are unlikely to distribute large cash dividends. The study found a positive relationship between bank dividends per share and bank quality rating but also found an **inverse** relationship between the dividend payout ratio and bank quality. Banks that paid out a large proportion of earnings in the form of dividends were left with little in the way of retained earnings to build up a capital position.

Hamill and Steinberg examine a complex but important issue in their article titled "Tax Savings Opportunities in Estate Freeze Transactions: An Application of the Black Scholes Model." Since much of the growth in employment in the United States comes from smaller, often family-owned businesses, there is policy interest in smoothing the ownership succession of these businesses from one generation to the next. However, with federal estate taxes taking as much as half the value of assets passed to descendents, it is difficult to keep a business in the family.

One method of doing so involves the use of two classes of stock. The older family members will recapitalize the company, retaining voting preferred equity for themselves and passing on the common equity to the next-generation managers. This transaction has the effect of freezing the value of the corporation at the time of recapitalization for estate tax

purposes and passing on an option to the younger generation to acquire the preferred shares at this frozen price after the death of their elders. If the corporation has grown in value, this call option may become quite valuable.

In a series of tax law changes in 1987 and 1990, Congress tried to deal with the value of these options for estate tax purposes, first assigning a minimum value of 20% of the interests held by the senior generation family members and then lowering that to just 10%. The article shows how the Black-Scholes option pricing model can be used to value the junior interest created by the freeze and to determine whether a freeze, with the statutory minimum value set by Congress, is justified. This article may be of great value for valuation experts brought in advise the family on whether they should recapitalize.

The third article, "Quantifying Present Valuation Errors" by Mangiero and Mangiero, will be of interest to anyone who has learned or taught finance using the ubiquitous present value tables. While we have intuitively realized that linear interpolation was inaccurate, this article shows mathematically why it is inaccurate and estimates the degree of error. Although the use of computers and finance calculators have rendered these tables obsolete, the authors point out that many existing mortgage contracts and other installment contracts that are several years old may be inaccurate as well, resulting perhaps in overcharges which may be recoverable.

The fourth article, "A Simplified Approach to Measuring Bond Duration" by Heck, Zivney, and Modani, gives readers a quick way to approximate duration and convexity. This will make it less daunting for those who wish to have a quick estimate of interest rate risk when evaluating alternative investments.

In their article titled "Analysis of U.S. Savings Bonds," Potts and Reichenstein find that these bonds are complex contracts which have some valuable features that are often overlooked. For example, as opposed to other bonds of comparable duration and coupon, the value of savings bonds (which can be redeemed at any time) cannot go below the purchase price plus some stated (positive) rate of interest. This put option, which is generally overlooked by financial planners, can make a savings bond a better buy at times than other bonds that lack this feature.

As begun in the previous issue, managing editor Barbara Poole gives readers her perspective on how an article from this issue can be used in practice. Finally, Phyllis Schiller Myers presents abstracts of articles relating to individual financial management from a variety of academic journals.

Lewis Mandell
Editor