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Chair's Corner
Scott Besley

I'm certain you will find this to be another interesting issue of the Department of Finance newsletter. The articles are both quite interesting and timely. As always, any opinions expressed in the articles are those of the authors and do not necessarily represent the opinions or policies of the University of South Florida.

Many of you attended the corporate governance conference that was hosted by the department last fall. The conference was such a huge success that we expect to present a similar conference either at the end of the Fall 2003 semester or the beginning of the Spring 2004 semester. Planning for the next conference currently is very preliminary—we are considering a topical area that relates to either the financial IQs of individual investors or the financial markets in general. If you have suggestions as to specific topics for the conference, persons or organizations that you think should be included in the conference, or other ideas regarding the presentation of such a conference, please contact me as soon as possible.

The courses offered in the department continue to be in great demand. As in previous semesters, undergraduate courses fill to capacity very soon after registration begins and graduate courses remain popular, with many filling to capacity by the time the semester begins. Because we continue to seek ways to improve the quality of the education we offer, this year the faculty will examine the curriculum of the undergraduate program as well as the courses offered in the MBA program to ensure that the pedagogies provided in these programs are technologically current and contribute to students' capacities for success in "real-world" business. If you have suggestions or comments as to how we can better evaluate our programs and modify them appropriately to ensure we continue to offer a quality product to the business community, please let me know.

We are continuing the assessment of our programs by surveying both recent graduates who majored in finance and businesses that employ these graduates. If you receive a survey—either because you are an alumni or an employer of one of our graduates—please take the time to complete and return it. The results of the surveys are used to improve the

curriculum we offer in the undergraduate program. The results also help us document the steps we have taken to achieve the goals established by the department, college, and university, which is a requisite for continuing the accreditation of the university. Thank you in advance for providing feedback that can be used to strengthen the programs offered by the Department of Finance.

The department, like the rest of the university, continues to experience reductions in resources, which presents unique challenges to the faculty—that is, trying to maintain the same level of productivity with fewer resources. We are trying to service the same number of students while at the same time attempting to maintain the quality of the pedagogy provided in the classroom. To better utilize the resources we currently have, during the summer semester we offered Principles of Finance (FIN 3403) as a 50 percent Web-based course. The lectures were presented online rather than in a classroom setting. Students still attended a live class, which we called a lab section, but only to work problems, take quizzes and exams, and answer questions about the lectures. This alternative method of presenting the course worked well enough that we are trying it again in the fall semester. The benefits of such a course include that students can view the lectures at times that fit into their schedules and the lectures can be viewed numerous times if desired. It appears that the primary disadvantage to the online lectures is the loss of "real-time" interaction between the students and the instructor. As we continue to search for alternative methods to present courses, our goal is to ensure quality is maintained in educational product that we offer.

We welcome a new faculty member, Alex Butler, who earned his Ph.D. at Indiana University. Prior to joining the faculty at USF, Alex taught at LSU and Rice.

This newsletter is only as good as you, our alumni and business supporters, make it. Each issue presents informative articles and news. Please send us information on your recent accomplishments, job changes, newsworthy items, and other information that you would like to share with us and other supporters of the Department of Finance. Send any information, questions, or other material to Murad Antia. Murad can be reached via e-mail at mantia@coba.usf.edu or via regular mail at the return address provided at the end of this issue.

***Deducting Dividends:
Lets Get it Right***

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It looks like ending the double taxation of dividends is an idea whose time has finally come. The idea is not new. For years, economists, politicians and investors have questioned the fairness of taxing profits at the corporate level and then requiring investors to pay taxes on them again at the personal level when received as dividends. In fact, it has even been a bit of a bi-partisan issue among politicians. Along with Presidents Bush and Ronald Reagan, Jimmy Carter proposed correcting the double taxation during his administration; so this is not just a Republican issue.

But the critical question is whether the dividend deduction should occur at the corporate or personal level. If we want the most bang for the buck, it is important to make dividends a corporate, and not personal, deduction. One of the criticisms of the president's proposal to exclude dividends from personal taxation is that it favors the wealthy. That criticism is correct. But, if the dividends were deducted before taxes on corporate returns, the relative benefit to both high-bracket and low-bracket individuals would be the same.

Let's look at an example under the current tax regime. Assume a corporation earns \$1,000 before taxes, is in a 35% tax bracket and pays all after-tax income out to shareholders. If low-income shareholders are in the 15% tax bracket, whereas wealthy stockholders are in the 35% bracket:

| | Low Bracket <u>15%</u> | High Bracket <u>35%</u> |
|---------------------------------|---------------------------------------|--|
| Corporate earnings before taxes | \$1,000 | \$1,000 |
| Corporate taxes @35% | \$350 | \$350 |
| Net income | \$650 | \$650 |
| Dividends | \$650 | \$650 |
| Personal taxes | \$97.5 | \$227.5 |
| Net to investor | \$552.5 | \$422.5 |

If the president's proposal becomes law and personal taxes on dividends are zero, then we have:

| | Low Bracket <u>15%</u> | High Bracket <u>35%</u> |
|---------------------------------|---------------------------------------|--|
| Corporate earnings before taxes | \$1,000 | \$1,000 |
| Corporate taxes @35% | \$350 | \$350 |
| Net income | \$650 | \$650 |
| Dividends | \$650 | \$650 |
| Personal taxes | 0 | 0 |
| Net to investor | \$650 | \$650 |

The low bracket investor gets only an 18% increase in after-tax income while the high bracket (and likely, wealthy) investor receives a 54% increase. The president's proposal is clearly relatively more beneficial to the higher income individual.

Now let's assume Congress chooses to exclude dividends from taxes at the corporate level. In that case, we have the following:

| | Low Bracket <u>15%</u> | High Bracket <u>35%</u> |
|---|---------------------------------------|--|
| Corporate earnings before dividends and taxes | \$1,000 | \$1,000 |
| Dividends | \$1,000 | \$1,000 |
| Taxable corporate earnings | \$0 | \$0 |
| Corporate taxes @ 35% | 0 | 0 |
| Net income | \$1,000 | \$1,000 |
| Dividends | \$1,000 | \$1,000 |
| Personal taxes | \$150 | \$350 |
| Net to investor | \$850 | \$650 |

Compared to the original scenario, which exists under current tax law, the low bracket investor now gets the same 54% increase in after-tax income realized by the high bracket person. If the merits of equality of this plan could be communicated with sufficient clarity, it should actually be easier, rather than more difficult, as others have opined, for the administration to bring Congress, and the public at large, on board. If we want a dividend deductibility tax cut that treats all taxpayers the same, then the corporate deduction is the right way to go.

Political issues aside, we might address the question as to whether the economy will be better off if we treat all people the same? The answer is a pretty emphatic: Yes! The first point we might make deals with the marginal propensity to consume. It is generally recognized that low-income individuals spend a relatively larger portion of their income than higher income. Also, there are significantly

more lower bracket individuals than there are higher bracket. On balance then, we would expect a tax cut for lower income people should probably create a greater economic stimulus on the consumption side than one that favors higher income earners.

Second, many stock market investors pay no taxes at all pension funds and owners of IRA, 401(k) and 403(b) plans, to name a few. If the president's proposal prevails, these investors receive no benefit at all and have little incentive to return to the market (unless they believe those who do benefit will drive prices up and so would purchase in anticipation of others' actions). But corporate deductibility of dividends will benefit everyone – even the pension programs. As a result, if Congress wants to stimulate total stock market returns, it should pass the latter and not the former and everyone will have incentives to return to the market. A robust stock market will lower the cost of corporate capital and thus encourage new real investment and will also encourage personal consumption via a wealth effect. Both outcomes will foster economic growth.

Current tax law provides incentives for corporations to issue debt because interest is tax deductible at the corporate level whereas dividends are not. However, both interest income and dividends are taxable at the personal level. Both proposals for dividend deductibility should make tax policy somewhat more neutral with respect to debt. Insofar as there is a belief that capital structures have become too heavily debt-laden, we would expect any dividend deductibility would be good. But, there is considerable sentiment that the interests of managers and corporate boards are not closely aligned with those of their shareholders. If this is the case, then the president's proposal may not discourage the use of debt because managers might be prone to ignore the deduction at the personal level. Moreover, the president's proposal increases the cost basis of the stock by the amount of the after tax earnings per share not paid out as dividend. Consequently, some companies might deem it unnecessary to increase dividends at all.

Both, the proposal we discuss and the president's should encourage high dividend payout ratios. But, if there is a misalignment of manager and shareholder interests, making dividends an expense at the corporate could be much more effective. Essentially, a personal dividend deduction wouldn't affect the firm very much. But, a corporate deduction would raise reported net income, *ceteris paribus*, and the larger the payout, the higher the earnings. Because it more directly affects managers, we believe that the proposal under discussion would encourage greater payouts than the president's.

Any plan to make dividends deductible should bring about three other positive effects. One would be that increase in payouts should reduce the growth rate of stock prices over the long term (as investors swap taxable growth for tax-free yield). If that happens, executive stock options would have little value and the abuses associated with that form of compensation should abate. Restricted stock awards could be substituted for stock options, which would more closely align the long-term interests of stockholders and management. The second is that deductibility should increase earnings transparency. If reported earnings are significantly greater than dividends paid, then investors will

know to ask questions because managers are probably gaming earnings, or not maximizing dollars available for the suppliers of capital – especially the shareholders. In either case, the investors will start asking questions and they will be less at the mercy of external auditors to provide good information. The third is that companies will have less money available for inefficient empire building, which has become a significant agency cost borne by the stockholders.

All of this suggests that dividend deductibility is an idea whose time has come. But the choice of the deduction is critically important. Corporate dividend deductibility should be the choice over the personal deduction because it is fairer to the broad spectrum of investors in different tax brackets, should provide a greater economic stimulus, may help minimize corporate abuse of shareholders and last but not the least, if communicated properly, could be a tax cut embraced by all Americans. We will likely only get one chance at this – so let's get it right.

Analyst Herding And Global/Industrial Diversification

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Given the recent market uneasiness about the quality of security analysts' services, it is important to examine whether there is a relationship between the quality of the analyst coverage and characteristics of the firm that analysts choose to cover. The ability of security analysts to provide information dissemination and managerial monitoring services depends on a firm's degree of organizational complexity and potential for agency conflicts. These characteristics, which are more common among diversified firms, could lead to large forecast errors coupled with unusually high levels of forecasts' consensus. This phenomenon is referred to as herding among security analysts. Moreover, since such behavior is synonymous with ineffective analyst coverage, herding could account for differences in valuation in a cross-section of firms with different degrees of diversification.

In this study we use security analysts' summary earnings forecast data for a large sample of firms over the 1980-1998 period to detect whether security analysts' herding behavior is related to characteristics of the firms they follow. The degree of diversification is measured by the proportion of foreign sales and assets, and the number of business segments reported by the firm. We define herding among analysts as cases of clustering of analyst earnings forecasts coupled with large forecast errors. We maintain that, given the different nature of diversified and non-diversified firms, the extent and quality of analyst coverage of domestic firms that are industrially focused are different than those of diversified firms. Consequently, analyst

propensity toward herding behavior is expected to be different between diversified and non-diversified firms.

Diversification may exacerbate analysts' tendency toward herding due to the fact that analyst task difficulty increases with diversification. Diversified firms are generally larger, have more complex organizational structures and less transparent operations. In addition, they are more likely to exhibit agency conflicts and informational asymmetry problems, which also increase analyst task difficulty. Therefore, we argue that firms that are focused in a single line of business (single-segment firms) and operate exclusively in the domestic market should display less herding among analysts following them than firms that are industrially diversified (multi-segment firms), geographically diversified (multinationals, hereafter MNCs), or both. Consequently, if herding behavior serves as a proxy for analyst ineffectiveness (i.e., sub-par monitoring and information dissemination services) then the differential firm valuation between diversified and non-diversified firms could be partly driven by differences in analyst propensity toward herding behavior.

We utilize combinations of forecast dispersion and forecast error measures to devise two alternative measures of analyst propensity toward herding behavior (herding indices) for each firm. We then use panel data regressions (fixed effects regressions) to test the following hypotheses:

- Herding behavior is more pronounced among analysts following diversified firms than domestic and industrially focused firms.
- Herding should increase with the degree of both geographic and industrial diversification.
- Market value declines with analyst propensity toward herding behavior.
- The impact of herding on market value is stronger for diversified firms.

All four hypothesis are supported by our empirical results. Our findings indicate that geographically or industrially diversified firms display on average more herding than domestic and industrially focused firms. Our results provide strong evidence in support of the notion that herding increases with the degree of both industrial and geographic diversification. In addition, we estimate two-stage least squares regressions and find that herding results in lower market valuation, which implies that the market penalizes security analysts' propensity toward herding behavior. Consistent with our previous results, this effect is stronger in the case of diversified firms.

Dividends and Debt with Managerial Agency and Lender Holdup

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An important concept in corporate finance is that if firm insiders enjoy a degree of control that motivates their continuation of unprofitable operations, then it can be efficient to transfer the liquidation decision to the firm's lenders. In a recent paper we extend this idea to a setting where lenders behave opportunistically when they control the firm's liquidation decision. In our model, following a default and consequently being in control of the liquidation decision, lenders learn the true condition of the firm. However, in this context, the same information acquired by the lender in control of the firm gives him an informational advantage over potential lenders and enables him to behave opportunistically in negotiations with the firm's shareholders. For example, the lender may offer to continue the firm, if it is solvent, only if the shareholders are willing to accept particular price concessions. In this case, while the disposition of the firm may still be efficient, the prior recognition of the lender's moral hazard distorts the firm's investment decisions and consequently reduces firm value. We show that under these circumstances, an integrated policy of debt and dividends mitigates both manager and lender moral hazard problems and therefore increases firm value relative to having solely a debt policy. Our model has additional empirical implications. For example initiating dividends lowers debt payments but raises total cash disbursements—the sum of interest and dividends—to investors.

Debt in our model helps mitigate the managerial agency problem. The payment of the debt obligation enables lenders to update their expectations concerning the firm's future cash flows while a default is indicative of possible deterioration in the firm's condition and the need for further inspection. However, we also recognize that dividend payments can serve similar functions. The payment of the promised dividend provides information to investors about the firm's future cash flows, and an unexpected cut in dividends may alert investors of a possible deterioration in the firm's profitability and trigger an inspection. Dividends therefore can serve a similar informational role as that of debt. The empirical evidence that indicates a reduction in bond values, and subsequently of credit ratings, upon announcements of a dividend cut is supportive of lender concern and suggestive of possible lender inspection.

While both interest and dividend payments provide important information to debtholders and serve as "tripwires," the basic difference lies in the relative power that lenders have if there is a dividend reduction that results in information of firm deterioration compared to that if the firm fails to pay its debt obligation. Failure to pay interest on the debt constitutes a default on the debt agreement and generally triggers a contractual condition that makes the entire debt due immediately, and inability to then repay it results in control of the firm being transferred to its lenders. In contrast, following a dividend cut, an inspection by the lender that indicates that his claim is jeopardized is not sufficient for the lender to be given control as long as required debt payments have been made. The lender must still establish that the firm has violated a condition in the debt agreement in order for the firm to be in technical default. Therefore, the difference between the two tripwires relates to the greater difficulty that lenders have in assuming

control when the omitted payment is a dividend rather than a debt obligation.

This greater difficulty for lenders to assume control after a dividend cut lowers the expected costs to shareholders from lender holdup and results in the usefulness of a coordinated policy of debt and dividends. Such a policy addresses both the managerial agency problem and the potential holdup problem of the firm's lenders. In particular, since lenders have greater difficulty assuming control following a dividend cut, the level of total cash disbursements—interest plus dividends—can be set higher than would be the level of interest payments alone in the absence of a dividend policy. This enables more information to be made available to investors relative to having solely a debt policy, thereby reducing further the likelihood of the management being able to continue unprofitable production. And the reduction of the lender holdup problem reduces the distortion in the firm's prior investment decisions and thereby increases firm value.

Our analysis applies, in principal, to both capital market and bank lenders. While the informational benefit of debt and dividend payments is probably greater for capital market lenders, their ability to act on this information is more limited, given their collective action problem. Nevertheless, it is plausible that the bond trustee of capital market lenders can arrange for inspection when the firm cuts its dividends and can also act as the negotiator in debt renegotiation. In contrast, private lenders, such as banks, can use the information provided by debt and dividend payments to determine whether to inspect the firm more carefully—that is, a reduction in these payments serves as a tripwire for the bank lender as well. In particular, the bank lender can reduce costly continuous monitoring of a firm by undertaking instead a careful examination of the firm only when there is a cut in debt or dividend payments. Moreover, the holdup problem is likely to be more severe with the bank lender, and in this context, a dividend policy that mitigates this holdup problem can become more important.

Our analysis stresses the informational role of debt and dividend payments. While we do not suggest that this is the most important explanation for such payments, we do view as compelling the idea that there is information content in the firm's continued payment or in its suspension or reduction of committed cash flows, whether these are debt payments or dividends. Lenders can forego continuous monitoring of the firm if it has instead installed such "tripwires," and monitor the firm only when such payments are omitted.

Finance majors often seek internships to apply what they have learned in the classroom and to gain valuable work experience. If your company is looking for an intern with a good understanding of finance, please let us know. We will be happy to recommend students that have the appropriate qualifications. Contact Scott Besley via e-mail at sbesley@coba.usf.edu. Please send a description of the responsibilities of the internship, a list of preferred qualifications for the position, and the name and contact information of the person to whom information about candidates should be sent.

The Inefficient Stock Market: What Pays Off and Why; Second Edition: Robert A. Haugen

Summary and Critique

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Summary

Robert Haugen was (now retired) a highly reputed finance professor with a prolific research and publication record. So when he writes a book contradicting the efficient markets hypothesis (EMH), the academic community needs to take notice and address the issues that he raises.

Active investment management would indeed be a waste of effort and resources if markets are efficient. And because the academic literature has led to the widespread belief that markets are efficient, the logical course of action, according to students of finance, would be to invest in index funds.

Haugen contends there is a growing mountain of evidence that markets are inefficient and that the models used to test these hypotheses are inaccurate. A primary cause of inefficiency is that investors make big mistakes in pricing stocks because they are overly optimistic about future earnings. They project past success far too long into the future. The recent bubble in technology stocks would serve as an excellent example of that claim.

The Capital Asset Pricing Model (CAPM), he believes, is incorrectly specified because it is critically dependent upon the assumption that investors are mean-variance optimizers whose portfolios plot on the efficient frontier. Professional money managers, who are the dominant players in the market, are not mean-variance optimizers, but instead measure risk as tracking error relative to an index such as the S&P 500. Tracking error is an estimate of the degree to which portfolio performance can deviate from an index. Because market indices, and consequently actively managed portfolios, reside deeply inside the efficient frontier, the CAPM prediction of market beta as the determinant of expected return yields inaccurate estimates.

The Arbitrage Pricing Theory (APT) is also fraught with problems. It predicts a linear relationship between factor sensitivities and expected return, although in reality the relationship may be non-linear. Consequently, it is difficult to obtain an unbiased estimate of factor sensitivities. Most importantly, in real markets, it is virtually impossible to build risk-free portfolios from risky securities as is evidenced by the track record of "hedge funds".

Haugen builds an ad hoc expected return model, using regression analysis on historical pricing and financial statement data to determine what factors have worked in the past. He then uses this model to predict excess returns on stocks in the future. Some of the most statistically significant factors, and their direction (+/-) on expected return are:

- One, two and six month excess return (-)

- One year excess return (+)
- Trading volume trend (+)
- Earnings-to-price and cash flow to price ratios (+)
- Return on equity and return on assets (+)
- Dividend payout ratio (-)

What is most intriguing about his results (these results have been replicated by quantitative money managers) is the importance of past price performance as a predictor of future performance. One- and two-month excess price performance usually reverses in the near future (often referred to as specific return reversal) and serves as a contrarian indicator. One year excess return is a technical indicator of relative strength and ranks second in terms of statistical significance. One month excess return is the most significant factor. These findings would contradict the weak form of the EMH.

From the model, a Super Stock portfolio is developed. The attributes of this portfolio are: Large company stocks, low risk, financially sound companies, above average profitability, relatively cheap and strong relative performance over the past year. These portfolios are tested out-of-sample to preclude data mining. The portfolios earn impressive excess returns, on paper, after adjusting for theoretical transactions cost associated with monthly rebalancing of the portfolios. Impressive results are also demonstrated in tests of foreign stock markets.

The author gives an example of a client who steadfastly uses his expected-return model with a risk-factor model to create risk-neutral portfolios of stocks in the S&P 500 index. A risk-neutral portfolio is not a zero risk portfolio. It is a portfolio that makes no bets relative to the factors in the risk model used to control tracking error. The annualized excess return earned by this manager between October 1996 and December 2000 was 4.30 percent.

Critique

The book paints a fairly accurate picture of the rationale and methodology behind quantitative equity management strategies. The presumption behind any kind of active management strategy, besides the potential of earning an exceedingly good living by those who practice it, is that markets are inefficient to a degree such that value-added active management can yield excess returns after transactions costs and manager fees.

The book does not conclusively demonstrate that markets are inefficient. Yes, the paper portfolio results are impressive. But sadly, as many quantitative equity managers will attest, paper portfolio results are not worth the paper they are printed on. It is difficult to translate paper portfolio results into actual results. Value Line's highest ranked stocks yield impressive paper portfolio results, but Value Line's mutual fund that buys these stocks has been a poor performer.

Any strategy that includes price momentum will experience substantial leakage between paper and real portfolio results because between the time an order is entered and completed, the stock price could have changed by an amount far more than estimated by theoretical transactions costs. In theory, a buy rated stock may have appreciated to a point that is not a buy rated stock, before trading in the stock is completed

The actual excess returns earned by a client, while impressive, are inconclusive. According to the investment consulting firm, BARRA, at least 15 years of actual performance data are needed before one could differentiate between skill and luck. Fewer than five years of performance data does not conclusively demonstrate skill. It is suspected that a substantial portion of the excess performance resulted from the one-month specific return reversal factor. This factor can be exploited while portfolios are relatively small in size. As the assets under management increase, the relative usefulness of this factor diminishes.

Haugen's discipline, often referred to as Growth at a Reasonable Price (GARP), was not a stellar performer during the latter half of the past decade. During that time period, the highest price-to-earnings technology stocks were by far the best performers and were the primary source of market leadership during the last throes of the bull market. One would suspect that the specific return reversal factor contributed a substantial portion of the excess return

Over the past 15 years, quantitative equity managers have developed expected return models and trading strategies far more complex and sophisticated than the model that the author has developed. While these strategies have generated positive excess returns over short time frames, the longer-term returns have tended to regress toward market averages. These models are relatively inexpensive to develop and minor variations of the same theme are being increasingly used by investment professionals. It is this widespread use that would make it virtually impossible to consistently earn excess returns over the long run.

The author is correct in his portrayal of risk management by equity managers. The use of complex risk management software to control tracking error is fairly widespread in the investment business. Managers are loath to underperform their benchmarks significantly because of the potential threat of losing business.

Plotting on the efficient frontier is a non-issue and is probably considered a nebulous concept by most active managers, although there is evidence that such a strategy could be value added. The author, in a research paper¹, explains why stock market indices reside within the efficient frontier. The reasons include an absence of short positions in indices, disparity of marginal tax rates between investors and the participation of foreign investors in U.S. equity markets. He creates an "efficient index" based upon ex-post pricing data, which between 1981 and 1989 earned higher annual geometric returns and lower volatility of return than the S&P 500 and Wilshire 5000 indices.

There are time periods during which most active money managers have been able to earn positive excess returns. But these time periods are limited in duration. The industry has attracted a large number of capable and talented professionals, each trying to outdo the other in what is essentially, after expenses, a less than zero sum game. To infer that a few are in possession of the philosopher's stone, while the remainder are suffering from intellectual amnesia would not be wise.

¹ Haugen, Robert. *Introducing the Efficient Index*. Working Paper (1990)

The F.I.R.E. is Going Out

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The SIC system creates a hierarchical organization for categorizing an establishment. At the bottom, the most refined partitions are called industries. At the top, the economy is coarsely partitioned into divisions. F.I.R.E., the longstanding acronym for Finance, Insurance and Real Estate, is one of the 10 divisions of the economy for classifiable establishments within the SIC system.

Although the SIC system has been revised many times during its life, the changing structure of the nation's economy caused it to become somewhat cumbersome. The SIC system is incompatible with an economy driven by new technologies, more service-oriented establishments, fewer manufacturing businesses, and more open trade among the United States, Canada and Mexico than ever before. Hence, the United States, joined by Canada and Mexico, is replacing the SIC system with a new North American Industry Classification System (NAICS). NAICS is a "clean slate" revision of the system used to classify businesses by industry and although *The North American Industry Classification System – United States, 1997* was published in mid-1998, its effects are just now beginning to take hold.

NAICS doubles the number of top-level groupings of industrial classification. The highest level of NAICS industrial classification is called "sector" and it is similar to the previous SIC "division" classification. The NAICS system also increases the identifying code for an industry from four digits (under the SIC system) to six digits. For example, under the new system the industry formerly called Security Brokers, Dealers, and Flotation Companies (SIC 6211) is divided into two industries under the NAICS: the Securities Brokerage industry (NAICS 523120) and the Investment Banking and Securities Dealing industry (NAICS 523110). The NAICS hierarchical structure proceeds from a National Industry (6-digit) to a NAICS Industry (5-digit) to an Industry Group (4-digit) to a Subsector (3-digit) and culminates at the Sector level (2-digit).

Division H of the *Standard Industrial Classification Manual, 1987*, is Finance, Insurance, and Real Estate. In NAICS, there is not a single Sector that corresponds to the

old Division H. NAICS Sector 52 is Finance and Insurance. NAICS Sector 53 is Real Estate and Rental and Leasing. The Table below shows the sectors and subsectors for Finance and Insurance and for Real Estate and Rental and Leasing.

North American Industry Classification System

| | Identifying | |
|-------------|---------------|--|
| <u>Name</u> | <u>Digits</u> | <u>Description</u> |
| Sector | 52 | Finance and Insurance |
| Subsectors | 521 | Monetary Authorities – Central Bank |
| | 522 | Credit Intermediation & Related Activities |
| | 523 | Securities, Commodity Contracts and Other Financial Instruments and Related Activities |
| | 524 | Insurance Carriers and Related Activities |
| | 525 | Funds, Trusts, and Other Financial Vehicles |
| Sector | 53 | Real Estate and Rental and Leasing |
| Subsectors | 531 | Real Estate |
| | 532 | Rental and Leasing Services |
| | 533 | Lessors of Nonfinancial Intangible Assets (except Copywrited Works) |

With the transition to NAICS, data series continuity may pose a problem, because there is not a straightforward concordance between the SIC and NAICS systems. Some guidance for continuity can be found in Appendix A, "1997 NAICS U.S. Matched to 1987 U.S. SIC," of *The North American Industry Classification System – United States, 1997*. However, guidance in the appendix is incomplete. For example, SIC industries often are not reclassified into a NAICS industry in their entirety. Rather, an SIC industry is split into two or more NAICS industries. But the guidance in Appendix A does not provide details of the split.

The conversion from the SIC system to NAICS poses a serious continuity problem for research that employs trend (time-series) analysis, because there is not a straightforward concordance between the old and new systems. A wide array of data sets use the industrial classification system and the transition will be ongoing over the next several years.

Congratulations

The Department of Finance would like to congratulate Dr. Ninon (Kohers) Sutton and Dr. Chris Pantzalis. Both were granted tenure and promoted to the rank of Associate Professor. Tenure was granted on the basis of their prolific publication record and the quality of their teaching. Drs. Sutton and Pantzalis also received the President's Award for Faculty Excellence. The award was based on their achievements and their contributions to making USF an even stronger national research university.

Electronic Delivery of the Newsletter

We hope that you find the newsletter informative and interesting. We now have the capability to e-mail the newsletter to you. Transmission via e-mail will facilitate a quicker delivery and reduce our printing and postage expenses. If you would prefer that we e-mail the newsletter to you, please send your e-mail address to mantia@coba.usf.edu.

We also would like your feedback about the content of the newsletter. Specifically we would like to know if you find the content to be pertinent, interesting, and written with sufficient clarity. Because the newsletter is written for your benefit, we invite your suggestions regarding the kind of material that you would like to read. If you would like for us to publish an article that you or one of your colleagues has written, please send us a copy and we will give it careful consideration.

Thank you,

Murad Antia, Editor

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