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SIMON BALANCES RESEARCH & TEACHING.
The world-renowned Simon faculty is known as much for its excellence in academic research as it is for its instruction and innovation. Simon professors keep the spirit of debate alive and well. Scholarly insights and breakthrough research make an impact in the classroom and raise the bar of excellence in today’s business climate.

GREETINGS FROM SIMON BUSINESS SCHOOL

It is my distinct pleasure to introduce you to four business research pieces that I am sure you will find both interesting and applicable. From window dressing financial statements and monitoring the world’s banks to the latest studies in retail advertising and the dynamics behind innovation and competition, Simon faculty members continue to shape the worlds of business and business education.

As many of you know, Simon’s iconic dean Bill Meckling believed in a direct and immediate link between the production of scholarly works and the teaching of business. While the nature of business research has become increasingly complex, it is our goal at Simon to ensure that we continue to offer our students an optimal mix of cutting-edge theoretical research and practical business training.

Time and time again, we hear from recruiters and industry leaders that what they need is talent who can offer original, well-thought solutions without requiring excessive on-the-job training. One look at the research included in this piece will allow you to recognize how some of the most exciting and innovative knowledge from the field can be quickly utilized in a classroom setting.

As dean of the Simon Business School, it is my aim to simultaneously invest in our research mission and in teaching excellence. That essential balance is the best way to inspire students to build new insights to business problems and it is exactly what we strive to do every day at Simon.

Sincerely,

Andrew Ainslie
Dean
Simon Business School
University of Rochester
How does increased competition affect product innovation?

A new study looks at how competing firms invest in innovation to increase overall market share.
How does increased competition affect product innovation? A paper by senior associate dean Ronald Goettler, “Competition and Product Innovation in Dynamic Oligopoly,” tackles this important question, relevant to corporate strategy.

“We analyze the relationship between competition and innovation using a model with important features missing from most previous studies,” says Goettler, who is the James N. Doyle Sr. Professor of Entrepreneurship.

In particular, most studies analyze the effect on innovation of hypothetically adding or removing firms. But measuring competition using the number of firms is inappropriate, Goettler says, because it’s influenced by the same factors that drive incentives to innovate. He focuses on three such factors: entry costs, the ability of firms to copy each other’s advances, and the degree of product substitutability in an industry.

Consider the last of these. The more similar products are, the more substitutable they are, and thus the competition is greater even if few firms are competing. For example, just two companies, Intel and AMD, control 95 percent of the PC microprocessor market. Despite the low number of competitors, competition is fierce. Both companies invest heavily to produce faster and more power-efficient CPUs to satisfy consumers.

In contrast, if only two firms were to compete in the fashion industry, each would have little incentive to innovate, because most fashion products are poor substitutes for one another. Instead, competition in this industry results from the large number of firms that enter in response to the low product substitutability.

For years, economists have debated the effect of competition on innovation. Firms need market power to generate the increased profits that make investments in innovation worthwhile. Some researchers, starting with Joseph Schumpeter in the 1940s, have argued that increased competition reduces market power and therefore reduces innovation. Others have argued that firms with market power already have high profits and therefore low incentives to innovate, and that reducing market power via more competition spurs innovation.

Goettler and coauthor Brett Gordon, of Northwestern University, find that accounting for the effect of competition on the number of firms is important and gives rise to an inverted-U relationship between competition and industry innovation, measured as the rate at which the industry’s frontier product improves. “When product substitutability is low, increasing substitutability leads to more innovation,” he says, “as firms innovate to protect their own market share and to steal market share from the large pool of competitors.”

“But as substitutability gets very high, the lead firm captures most of the profits and laggard firms exit,” Goettler says. “The lead firm invests heavily to protect its lead when laggards are close, but because laggards have few profits to invest in R&D, eventually the leader pulls away and reduces its investments once it’s securely ahead.” The result, he says, is that further increases in substitutability lower innovation, yielding the downward portion of the inverted U.
A study investigates how a large sample of bank-holding companies leverage numbers. Are holding companies window-dressing to appear less risky?
In 2010, the Wall Street Journal published a series of articles that focused on discretionary actions that 18 big banks take to mask risk. At the end of each quarter, when they were required to report debt levels, the banks were window-dressing their leverage to appear less risky in their borrowing throughout the quarter as a whole, the Journal reported.

Simon School professor Joanna Shuang Wu, professor of accounting, and former Simon faculty member Edward L. Owens, assistant professor of accounting, set out to investigate for themselves whether a large sample of bank-holding companies were indeed window-dressing leverage numbers to mask fluctuations during the quarter. They also wanted to see if the market knew—and if it cared.

In their paper, “Window Dressing of Financial Leverage,” the authors studied the use of short-term loans, the tool banks are most likely to use. They find evidence that a large percentage of the companies do pay off short-term loans at the end of the quarter. These loans were repurchase agreements, or repos.

Banks are required to report quarter-end numbers and quarterly averages in Y-9C regulatory filings with the Federal Reserve, but only quarter-end numbers appear in financial statements filed with the Securities and Exchange Commission (SEC). Owens and Wu showed that during the quarter debt levels fluctuate, but they often find their lowest point at the quarter’s end. This means higher debt levels during the quarter are shielded from view, and the quarter’s overall risk appears lower than implied by quarter-end numbers in SEC filings.

They also found that the stock market is paying attention: It responds when banks’ quarterly average leverage figures are published in the Y-9C. “It is an economically significant effect,” Owens says. “You see a stock market reaction when the Y-9C is published. It would have been surprising if we found no stock market reaction.”

In September 2010, the SEC unanimously voted to propose rules requiring both financial and non-financial public companies to provide enhanced disclosure of short-term borrowings.

The reason is rooted in the recent financial crisis, which has brought the risk-taking behavior of financial institutions into sharper focus, the authors write. Short-term borrowing is of particular concern to the SEC for at least two reasons. For one, firms that rely heavily on it are more susceptible to fluctuations in market conditions. Second, because the levels of short-term borrowing can vary greatly during a reporting period, end-of-quarter balances are less likely to accurately represent activities during the period.

The SEC wants greater transparency. Reports that are released to the investing public should have more complete information that makes transactions more obvious, regulators say. And they want more than just banks to cooperate, calling for the regulations to apply to all companies.

“Banks already have to file disclosures,” Owens says. “The stock market responds. The implication is that the market values the in-quarter, short-term borrowing information. And the SEC recognizes that it would be useful if all firms filed disclosures.”
The progress of the world depends almost entirely upon education.

— George Eastman

American innovator, entrepreneur, and philanthropist, his support was instrumental in transforming the University of Rochester into one of the world’s finest research universities. (July 12, 1854 – March 14, 1932)
WHAT SPURS BANKS TO MONITOR THEIR BORROWERS?

New research suggests it is bank equity, not bank debt.
In the highly leveraged world of banking, what spurs banks to monitor their borrowers: Bank debt or equity?

Theories abound suggesting bank capital structure plays a key role in encouraging banks to monitor their borrowers. But bank activities are hard to observe, and testing what form of capital structure spurs monitoring is hard to establish. “How hard does a bank manager work? And does he or she work harder when the bank has more equity or more debt in its balance sheet?” says Simon professor Sudarshan Jayaraman. “We can’t really see the manager perform his day-to-day duties. We can’t observe it as researchers.” In a working paper, “Who Monitors the Monitor? Bank Capital Structure and Borrower Monitoring,” Jayaraman and coauthor Anjan Thakor test prevailing theories in a new way. The coauthors examined changes to creditor rights in more than a dozen countries to understand what motivates banks to monitor their borrowers. Some countries have strong laws protecting creditors, while others do not. In countries where such laws are on the books, banks have less incentive to monitor. That’s because there’s a legal process in place to recoup at least some of their losses should the bank not monitor and the borrower default on a loan.

The authors also found strong evidence that a climate of improved creditor rights spurs banks to shift their capital structures away from equity and toward deposits. “What we find is that equity is providing banks with the incentives to monitor their borrowers,” Jayaraman says. “So why are banks so risky with so much debt? We don’t know; all we know is that’s not for monitoring. Debt doesn’t seem to provide monitoring incentives; it’s equity.”

In addition, the authors ran tests that showed such shifts in capital structure are not explained by supply-side effects—for example, that bank creditors are more willing to lend to banks when creditor rights become stronger. Their conclusion: Bank equity is a stronger source of discipline on banks than bank debt.
New research from assistant professor Garrett Johnson and his coauthors shows the cause and effect of online advertising and retail sales.
A large-scale study by Simon professor Garrett Johnson and two coauthors provides for the first time strong evidence that online retailer ads increase internet and brick-and-mortar sales. Especially effective is repeated ad exposure among the 80 percent of users who see up to 50 ads per person over two weeks, they found.

Johnson conducted the study as an intern at Yahoo! Research while earning his PhD at Northwestern University. He and coauthors Randall Lewis and David Reiley ran a controlled experiment examining two consecutive weeklong ad campaigns on Yahoo! that targeted three million customers of a nationwide retailer. Yahoo! Research and the retailer partnered to explore how online display advertising affects both online and in-store purchases. The coauthors share their results in a paper, “Location, Location, Location: Repetition and Proximity Increase Advertising Effectiveness,” now under journal review.

Advertisers have long questioned how much advertising a firm should purchase before diminishing returns set in. Equally puzzling is whether ads should target a company’s most loyal customers or woo those on the margins.

Effective advertising frequency is higher than many might expect, Johnson says. The returns to advertising hold strong even up to 50 ad exposures in two weeks. The coauthors also found ads had the biggest effect on the retailer’s most active customers and those who live near a store. In those groups, online and in-store purchases went up the most.

In the study, a full treatment group saw the retailer’s ads, and a control group was exposed to unrelated control ads. The study showed that retailer ads increase sales 3.6 percent in the full group relative to the control group—a statistically significant rise, Johnson notes.

The experiment is among the largest and most statistically powerful in the ad effectiveness literature. And because the research combined consumer level ad exposure with valuable retail purchase data, it established important and unprecedented causal effects.

“Typically, it’s hard to get a sense of who sees the ads,” Johnson says, “and even harder to connect these people to their sales.”

As a result of the research, in 2011 Yahoo! launched Proximity Match, which helps marketers find consumers who live near their brick-and-mortar locations. The product has since brought in significant revenues for the company.
Simon faculty members continue to make their marks as founders and editors of some of the world’s most highly acclaimed business publications. Many have also published books that are now used at top business schools.

Journal of Accounting and Economics

The Journal of Accounting and Economics encourages the application of economic theory to the explanation of accounting phenomena. It provides a forum for the publication of the highest quality manuscripts, which employ economic analyses of accounting problems.

Journal of Applied Corporate Finance

Simon Business School is the new academic sponsor of the Journal of Applied Corporate Finance (JACF). The journal brings together leading thinkers and practitioners to offer content that appeals to students and professionals alike. Our faculty and alumni serve on the journal’s advisory board.

Journal of Financial Economics

The Journal of Financial Economics provides a high-quality professional outlet for scholarly studies of actual cases, events, or practice. Together, they provide a rich source of data that illustrate or challenge accepted theory and lead to new insights about the world. Applications and case studies are often included in the publication. The published pieces often raise new questions, or pose old questions in an innovative ways to theories, or document interesting phenomena.

Journal of Monetary Economics

The strong interest in monetary analysis has been matched in recent years by a growing attention to the working and structure of financial institutions. The role of various institutional arrangements, the consequences of specific changes in banking structure, and the welfare aspects of structural policies have attracted interest. The Journal of Monetary Economics provides a specialized forum for the publication of this research.
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