["Don't Ignore Inflation Ignorance: On the Relevance of Money Illusion for Economic Modeling"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3105976&partid=22912&did=373677&eid=1216719" \t "_blank) Free Download

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Behavioral research on money illusion shows that investors tend to ignore inflation and focus on the nominal returns of their investment opportunities. Yet, economic modeling mostly disregards these findings and follows the standard paradigm in which investors base their decisions on real returns only. A possible reason for the disregard is that the degree of money illusion has not yet been quantified in a way that allows a well-founded discussion of the relevance for modeling. We conduct a rigorous investment experiment to close this gap. We find a substantial degree of money illusion in participant behavior and show that extending a standard model by a money illusion component can be vital to capture the observed behavior adequately. Our findings have far-reaching implications and call for a more prominent role of money illusion in economic modeling.

["Who Gains and Who Loses in Derivatives Trading, and Why? Evidence from Chinese Brokerage Account Data"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3115973&partid=22912&did=373677&eid=1216719" \t "_blank)

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In contrast to a wealth of knowledge on trading in equity markets, comparatively little is known about who gains and who loses via derivatives trading. We consider these issues in the context of an episode in China where equity investors obtained access to warrants due to regulatory reform, in an environment without other established options markets. The data, which allow us to analyze how well agents comprehend unfamiliar and complex securities, reveal that individual investors trade warrants with high skewness and pay for high skewness, while institutions do not. Investors earning the most profits are active traders and hold the least amount of warrants interday. Small investors tend to hold warrants for a relatively long period, which contributes materially to their total losses. A considerable number of investors act irrationally: they treat expiring deep OTM warrants as stocks, and pay positive prices for warrants that guarantee a complete loss of investment owing to price limits in the underlying asset market. Price limit rules for the warrant market are set to preclude convergence to fundamentals.

["Risk Neutral Densities: A Review"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3120028&partid=22912&did=373749&eid=1203968)

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Trading in options with a wide range of exercise prices and a single maturity allows a researcher to extract the market's risk neutral probability density (RND) over the underlying price at expiration. The RND contains investors' beliefs about the true probabilities blended with their risk preferences, both of which are of great interest to academics and practitioners alike. With particular focus on U.S. equity options, this article reviews the historical development of this powerful concept, practical details of fitting an RND to option market prices, and the many ways in which investigators have tried to distill true expectations and risk premia from observed RNDs. I touch on areas of active current research including the "pricing kernel puzzle" and the "volatility surface," and offer thoughts on what has been learned about RNDs so far and fruitful directions for future research.

["The Expansion of Algorithmic Governance: From Code Is Law to Law Is Code"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3117630&partid=22912&did=373287&eid=887072)   
Hassan, S. & De Filippi, P. (2017). The Expansion of Algorithmic Governance: From Code is Law to Law is Code. Field Actions Science Reports: The Journal of Field Actions. Special issue 17: Artificial Intelligence and Robotics in the City. Open Edition Journals

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“Code is law” is a form of regulation whereby technology is used to enforce existing rules. With the advent of Blockchain and Machine Learning, we are witnessing a new trend, whereby technology is progressively taking the upper-hand over these rules. Yet, as opposed to traditional legal rules, which merely stipulates what people shall or shall not do, technical rules determine what people can or cannot do in the first place. This eliminates the need for any third party enforcement authority to intervene after the fact, in order to punish those who infringed the law. Moreover, as laws are incorporated into a code-based system whose rules dynamically evolve as new information is fed into the system, it might become difficult for people to not only understand, but also question the legitimacy of the rules that are affecting their lives on a daily basis.

["Bitcoin: Investment or Illusion?"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3101107&partid=22912&did=373429&eid=1068123) Fee Download   
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The case describes a hypothetical hedge fund manager who is examining whether to invest in bitcoin. The case discusses potential risks and rewards of investing in bitcoin, the role of bitcoin and digital currencies more broadly, and financial innovation in the space, such as ICOs. It can be taught as part of a second-year MBA elective course in investments, financial institutions/capital markets, or fintech.   
  
Excerpt , UVA-F-1819, Rev. Jan. 29, 2018   
  
Bitcoin: Investment or Illusion?   
  
Stay away from bitcoin. It is a mirage. —Warren Buffett   
It is a fraud. It is worse than tulip bulbs. —Jamie Dimon   
Bitcoin offers a sweeping vista of opportunity. —Marc Andreessen

["When Does The 1/N Rule Work?"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3111531&partid=22912&did=373012&eid=729478) Free Download

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The 1/N rule provides a simple way to obtain a diversified portfolio. Studies have shown it often outperforms more sophisticated approaches. We show that the 1/N rule only outperforms an optimal portfolio in two out of seven major equity markets: the USA and Japan. We develop a market-specific measure that indicates when the 1/N rule will dominate. Our measure is based on the distance between the 1/N portfolio and the maximum Sharpe ratio portfolio. We label it the 1/N favorability index. The 1/N rule also does well when the market as a whole performs well and we analyze the joint contribution of this factor and the favorability index.

["Richard Thaler and the Rise of Behavioral Economics"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3111475&partid=22912&did=372944&eid=710278) Free Download

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The emergence of behavioral economics is one of the most significant conceptual developments in the social sciences in the past 40 years. The central figure in the field in its early years was Richard Thaler. In this article, I review and discuss his scientific contributions.

[Trust and Finance: A Review of Empirical Research"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3105693&partid=22912&did=372938&eid=706951) Free Download

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We propose a construct, the Trust Triangle, that highlights three primary mechanisms that discipline and deter opportunistic behavior and therefore build trust in economic relationships: (i) a society’s legal and regulatory framework, (ii) market-based discipline and reputational capital, and (iii) culture, including individual ethics and social norms. We use the Trust Triangle to summarize recent developments in the finance literature that empirically examine how trust is formed and how trust, or its absence, affects financial markets, firm performance, and the incidence of financial fraud.

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How does greater public disclosure of arbitrage activity and informed trading affect informational efficiency? To answer this, we exploit rule amendments in U.S. securities markets, which increased the frequency of public disclosure of short positions. Higher public disclosure can potentially improve or deteriorate informational efficiency. We find that with more frequent disclosure, short-sellers' information is incorporated into prices faster, improving informational efficiency. In support of the mechanism driving this result, we document significant market reactions to short interest announcements, suggesting investor learning, and furthermore, we find increases in short-selling activity and reductions in short-sellers' holding periods with the rule amendments.

[Hyperbolic Discounting Can Be Good for Your Health"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3110094&partid=22912&did=372615&eid=521768) CEGE Discussion Paper 335 – January 2018

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It has been argued that hyperbolic discounting of future gains and losses leads to time-inconsistent behavior and thereby, in the context of health economics, not enough investment in health and too much indulgence of unhealthy consumption. Here, we challenge this view. We set up a life-cycle model of human aging and longevity in which individuals discount the future hyperbolically and make time-consistent decisions. This allows us to disentangle the role of discounting from the time consistency issue. We show that hyperbolically discounting individuals, under a reasonable normalization, invest more in their health than they would if they had a constant rate of time preference. Using a calibrated life-cycle model of human aging, we predict that the average U.S. American lives about 4 years longer with hyperbolic discounting than he would if he had applied a constant discount rate. The reason is that, under hyperbolic discounting, experiences in old age receive a relatively high weight in life time utility. In an extension we show that the introduction of health-dependent survival probability motivates an increasing discount rate for the elderly and, in the aggregate, a u-shaped pattern of the discount rate with respect to age.

[The Demand for Central Clearing: To Clear or Not to Clear, That Is the Question"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3116261&partid=22912&did=372541&eid=393936)   
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This paper analyses whether the post-crisis regulatory reforms developed by global-standard-setting bodies have created appropriate incentives for different types of market participants to centrally clear Over-The-Counter (OTC) derivative contracts. Beyond documenting the observed facts, we analyze four main drivers for the decision to clear: 1) the liquidity and riskiness of the reference entity; 2) the credit risk of the counterparty; 3) the clearing member’s portfolio net exposure with the Central Counterparty Clearing House (CCP) and 4) post trade transparency. We use confidential European trade repository data on single-name Sovereign Credit Derivative Swap (CDS) transactions, and show that for all the transactions reported in 2016 on Italian, German and French Sovereign CDS 48% were centrally cleared, 42% were not cleared despite being eligible for central clearing, while 9% of the contracts were not clearable because they did not satisfy certain CCP clearing criteria. However, there is a large difference between CCP clearing members that clear about 53% of their transactions and non-clearing members, even those that are subject to counterparty risk capital requirements, that almost never clear their trades. Moreover, we find that diverse factors explain clearing members’ decision to clear different CDS contracts: for Italian CDS, counterparty credit risk exposures matter most for the decision to clear, while for French and German CDS, margin costs are the most important factor for the decision. Clearing members use clearing to reduce their exposures to the CCP and largely clear contracts when at least one of the traders has a high counterparty credit risk.

[Exchange Traded Funds 101 for Economists"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3112037&partid=22912&did=372104&eid=91888) [NBER Working Paper No. w24250](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/PIP_Journal.cfm?pip_jrnl=209249&partid=22912&did=372104&eid=91888)

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Exchange-traded funds (ETFs) represent one of the most important financial innovations in decades. An ETF is an investment vehicle that trades intraday and seeks to replicate the performance of a specific index. In recent years ETFs have grown substantially in assets, diversity, and market significance. This growth reflects the rise in passive asset management where investors seek to track a benchmark index rather than outperform the market as a whole. As a consequence, there is increased attention by investors, regulators, and academics seeking to assess and understand the implications of this rapid growth. This article explains the key drivers of ETF growth and their implications for economists and policy makers.

[When Nudges are Forever: Inertia in the Swedish Premium Pension Plan"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3099886&partid=22912&did=372045&eid=20594)

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To inform economists and policy makers about whether the effects of nudges are persistent in one specific context, we study the choice architecture of the Swedish Premium Pension Plan. The data we study consist of all initial choices and subsequent rebalancing activities by the entire population of 7.3 million retirement savers in Sweden during the period 2000 to 2016. Based on our analysis of these data, we conclude that the effects of nudging in this case were surprisingly persistent and seem to last nearly two decades, if not forever.

[Inertia of Institutional Investors, Stock Returns, and Performance"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3103741&partid=22912&did=371619&eid=1241966)

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Email: [hugh.kim@moore.sc.edu](mailto:hugh.kim@moore.sc.edu)

This paper examines a group of stocks not frequently traded by institutional investors, termed as “inertia stocks.” Studying over 28 million institutional investor-stock-quarter level observations, we find that institutional investors do not trade any shares for one out of four companies in their portfolio for at least three months. These stocks are small and illiquid, but size and illiquidity do not fully explain their non-trading tendency. Inertia stocks are likely to underperform in the future, hence undermining the overall performance of institutional investors. Institutional investors make some profit from actively trading other stocks, but the additional profit does not cover the loss from inertia stocks. The results suggest that institutional investors can increase their overall performance by understanding the adverse effect of inertia stocks.

["Up-Cascaded Wisdom of the Crowd"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3030573&partid=22912&did=374439&eid=386287)

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Economic activities such as crowdfunding often involve sequential interactions, observational learning, and successes contingent on achieving certain thresholds of support. To analyze them, we incorporate an all-or-nothing (AoN) feature in a classical model of information cascade. Relative to standard settings, we find that an AoN target effectively delegates early supporters' downside protection to a later "gate-keeper", and leads to uni-directional cascades and prevents agents' ignoring private signals and imitating preceding agents' rejections. Consequently, information aggregation improves, and issuance becomes less under-priced, especially with a large crowd of agents, and even when agents have the options to wait. More generally, endogenous AoN targets improve the financing efficiency of costly projects and the harnessing of the wisdom of the crowd under information cascades.

["The Promises and Pitfalls of Robo-Advising"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3122577&partid=22912&did=374437&eid=381168)

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We study a robo-advising portfolio optimizer that constructs tailored strategies based on investors' holdings and preferences. Adopters are similar to non-adopters in terms of demographics, but have more assets under management, trade more, and have higher risk-adjusted performance. The robo-advising tool has opposite effects across investors with different levels of diversification before adoption. It increases portfolio diversification and decreases volatility for those that held less than 5 stocks before adoption. These investors' portfolios perform better after using the tool. At the same time, robo-advising barely affects diversification for investors that held more than 10 stocks before adoption. These investors trade more after adoption with no effect on average performance. For all investors, robo-advising reduces -- but does not fully eliminate -- pervasive behavioral biases such as the disposition effect, trend chasing, and the rank effect, and increases attention based on online account logins. Our results emphasize the promises and pitfalls of robo-advising tools, which are becoming ubiquitous all over the world.

[Asset Pricing: A Tale of Night and Day"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3117663&partid=22912&did=374125&eid=131546)

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Stock prices behave very differently with respect to their sensitivity to market risk (beta) when markets are open for trading versus when they are closed. The capital asset pricing model (CAPM) performs poorly overall as beta is weakly related to 24-hour returns. This is driven entirely by trading-day returns, i.e., open-to-close returns are negatively related to beta in the cross section. The CAPM holds overnight when the market is closed. The CAPM holds overnight for the U.S. and internationally for: beta-sorted portfolios, 10 industry and 25 book-to-market portfolios, cash-flow and discount-rate beta-sorted portfolios, and individual stocks. These results are consistent with transitory beta-related price effects at the open and the close.

["The Predictability of Equity Returns from Past Returns: A New Moving Average-Based Perspective"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3111334&partid=22912&did=374090&eid=115800)

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Email: [subra@anderson.ucla.edu](mailto:subra@anderson.ucla.edu)

The distance between the short- and long-run moving averages of prices is a potent predictor of stock returns in the cross-section. The greater the positive (negative) distance between the short-run average and the long-run one, the greater (lower) is the expected return. The corresponding strategy yields reliable profits that do not decay even after several months and that survive modern factor models and reasonable transaction costs. The distance also reliably predicts returns at the market and industry levels, as well as in international settings. We propose and provide supporting evidence for the notion that large deviations of prices from their long-run moving averages represent surprises relative to prevailing anchors to which investors react insufficiently.

[Active Share and Emerging Market Equity Funds"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3116380&partid=22912&did=371670&eid=1226257) [Journal of Investment Consulting, Vol. 18, No. 1, 2017, pp. 11-23](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/PIP_Journal.cfm?pip_jrnl=1658599&partid=22912&did=371670&eid=1226257)

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This paper represents the first attempt in the literature to specifically and solely examine the relationship between active share and emerging market equity fund performance. To do this we use a sample of U.S.-based actively managed diversified emerging market equity funds that we follow for six years from 2009–2014. With this sample of funds, we find a positive and significant relationship between the average level of a fund’s active share and fund performance. Funds that are more active have significantly better performance than other funds. We also find evidence that highly active funds that keep the level of activeness consistent over time have significantly better performance than funds that vary the level of activeness. Finally, we document that a significant number of diversified emerging market funds were closet indexing over the period 2009–2014.

[Factor Momentum"](https://hq.ssrn.com/Journals/RedirectClick.cfm?url=https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3116974&partid=22912&did=374567&eid=480674) Free Download

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Past industry returns predict the cross section of industry returns, and this predictability is at its strongest at the one-month horizon (Moskowitz and Grinblatt 1999). We show that the cross section of factor returns shares this property, and that industry momentum stems from factor momentum. Factor momentum is transmitted into the cross section of industry returns via variation in industries' factor loadings. Momentum in industry-neutral factors spans industry momentum; factor momentum is therefore not a by-product of industry momentum. Factor momentum is a pervasive property of all factors; we show that factor momentum can be captured by trading almost any set of factors. Factor momentum does not resolve the puzzle of momentum in individual stock returns; it significantly deepens this puzzle.