Problem Set # 1

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Research Interest

Currently, I am really interested in two types of research in economics or financial economics. One is the agency issue in an environment where information asymmetry is present. The other one is about a firm's decision to go public.

Previous literature regarding agency problems mainly focus on the vertical conflict between principal and agent. For example, the pioneering work of Jensen and Meckling (1976) documents that principal delegates the operation to an agent who would not always act in the best interest of principal. This may decrease the value of a firm. The agency costs can also result from the information asymmetry between principal and agent. That is, principal can only observe the output or revenue produced by the agent. But it can not observe the effort of agent. This gives rise to the moral hazard issue. A very standard principal-agency model is presented as follows.

$$
\begin{aligned}
&\max_{e,P(.)} E(r(g(e,\epsilon)) - P(g(e,\epsilon))) \\
&\text{subject to:} \\
&e \in \arg\max_{e'} \{ABCDTA\} \\
&E(V(P(g(e,\epsilon)))) - H(e) \geq U
\end{aligned}
$$

In contrary to extensive papers examining the impacts of this vertical agency issues on firm's operation, there is little research about another type of agency costs, the monitoring delegation between agents.

Institutional investors increasingly play crucial roles in the financial market. Typically, they are large in size, hold significant percent of shares in a firm, and behave actively if it is necessary to favor their own interests. However, not all the institutional investors are active. Literature always categorizes investors into active and passive according to their investment strategies. For those large passive investors, they always sign a contract with fund advisors to delegate monitoring. More specifically, passive investors delegate the voting rights to their relationship fund advisors. Two reasons contribute to the existence of this specific delegation. Firstly, efficient monitoring requires private information about the portfolio firm [1]. Those large fund advisors have economies of scale in terms of information production. This advantage makes it much cheaper for the passive investors to delegate monitoring to fund advisors than to acquire information by themselves Diamond (1984). Secondly, monitoring also requires expertise. Fund advisors have specific knowledge about the portfolio firms of the passive investors, which makes them easier to conduct monitoring. Notably, fund advisors have voting rights without holding any shares in the firm. It is possible that fund advisors would take advantage of these voting rights to benefit themselves with or without the hurt of passive investors who are the real holders of the firm. In this

[1] Portfolio refers to those firms hold by investors.

regard, it will be very interesting to examine how this horizontal agency conflicts will affect corporate governance and the performance of portfolio firms.

The second topic that I am really interested in is about the number of public firms in U.S.. Public firms listed on stock markets in U.S. have kept decreasing for nearly two decades Doidge et al. (2017) . Doidge et al. (2017) report that since the listing peak of 1996, the propensity to be listed is lower for all size categories and industries. They ascribe this unpredicted trend to the decrease of firms going to be public and the increase of firms delisting. However, it is not very clear why this phenomenon persists after 1996. Is it because the regulatory shifts, business cycle, technology development, or objective/preference change of private firm managers? Or is it related with the improvement of the pre-IPO financing market which makes private firms easier to get funding from investors either debt or equity? Is it related with the evolvement of the investment banking industry that reduces the importance of investment banking business. If the investment banks allocate more resources to the asset management department and less resources to the investment banking department. A direct consequence would be that they will underwrite lower number of IPOs and will only choose those mature and large firms. Answering these questions would be important for us to understand this interesting phenomenon and also the movement of the financial market.

References

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