Essays in financial economics

Golec, P.M.

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Introduction

This thesis contains three Essays in Financial Economics. In the first essay, I document that in the subsequent years after firms go public, they gradually cut the rate at which they invest. Interestingly, over half of the decline in investment is unrelated to their size or profitability. This fact is at odds with standard economic theory, where the decline in investment after going public simply reflects firms’ gradual growth path towards their efficient scale.

I build a dynamic investment model which features different sources of the decline in investment conditional on size and profitability. Firms grow towards their efficient scale, learn about their efficient scale, become more rigid, experience mean-reversion in productivity and decline in volatility of productivity. I then estimate the parameters of the model using data on U.S. public firms. The joint dynamics of investment, profitability and market valuation allow me to differentiate between the sources and infer their contribution towards the decline in conditional investment. I find that the unique combination of growing towards the efficient scale and increasing rigidity, as well as learning and decreasing volatility of productivity all explain roughly a third of the decline in investment unrelated to size or profitability. I also revisit interpretations of different phenomena, such as why firms’ market-to-book ratio declines, why their profitability declines and why firms react less to fundamentals in the subsequent years after they go public.

The second essay is inspired by how the recent financial crisis in 2008 came as a surprise. There, the riskiness of asset-backed securities and the underlying mortgages only came to light when U.S. house prices declined nationwide and foreclosures rapidly increased. A common view is that these securities are optimally designed to be opaque so as to limit the amount of information trading parties can produce about the underlying assets. This facilitates trade because there is little fear of being exploited in case the other party knows more.

I show theoretically that issuers of asset-backed securities may be tempted to obscure too much information. In my model opaqueness also has a dark side: if trading parties do not acquire information, then the prices of the securities are also less informative. This can lead to booms fueled by ignorance due to a lack of knowledge whether assets are toxic. The reason opacity is excessive is a free-riding problem, which arises when issuers’ assets are exposed to similar risks, for example how sensitive they are to house prices. On the one hand, all of them would benefit from outsiders producing information. But individually they worry too much about obscuring information to make their own securities easily tradable, because that makes their funding cheap. The model suggests regulations that incentivize information production, which would limit overinvestment.
In the third essay (together with Enrico Perotti), we survey the emerging literature on safe assets. At the core is the recognition of investors’ fundamental demand for safety, distinct from the demand for assets that are easily tradable. We report that considerable evidence has emerged on a strong and stable demand for safe assets. Periods of low supply of government debt, the safest asset, tend to incentivize the financial sector to produce (quasi-) safe assets in the form of short-term debt to meet the demand. On the asset side, this appears to be associated with an expansion in credit and an increase in net long-term investment. We review recent theoretical advances highlighting how pressure to satisfy this demand for safety, a source of cheap funding, leads to contractual forms that ultimately create and propagate risk. This had major implications in the financial crisis of 2008, where uninsured bank debt turned out not to be safe at all. Risk-intolerant investors fled into government debt, leaving the financial system short of funding. We conclude the survey with insights for financial stability and regulatory policy emerging from the literature. Of particular importance is the role of government debt as a financial stability tool.