“Corporate Capital Budgeting”

Ivo Welch

Friday, October 24, 2014
At the Marian Miner Cook Athenaeum
In the Security Pacific Dining Room
Lunch: 12:00 p.m. Lunch Program: 12:20 p.m.
Make reservations at http://www.claremontmckenna.edu/mmca/cur_reserve.php

Professor Welch is the J. Fred Weston Chair at UCLA Anderson School of Management where he is also the Director of The Fink Center. He was previously on the faculties of Yale’s School of Management and the economics department at Brown University. He received his PhD from the University of Chicago. Welch is currently the Managing Editor of Critical Finance Review; Publisher and Associate Editor of FAmE; and is a Research Associate with NBER Corporate Finance and Asset Pricing group.

Welch has placed among the top-100 most influential economists in some academic rankings. A number of his academic papers have won awards and/or are highly cited. Known for his work on informational cascades, he has also published in a variety of other areas, such as initial public offerings, capital structure, dividends, market-timing, performance evaluation, earnings management, overconfidence, socially responsible investing, bankruptcy, etc. He has written an introductory corporate finance textbook and earned a number of teaching awards.

His co-authored paper on “Corporate Capital Budgeting” tests whether the expected rate-of-return estimates for long-term capital budgeting from the Fama French Model (FFM) and the CAPM could outperform those from a simpler risk-neutral term-structure-based model. It first estimates reasonable shrinkage (input parameters) based on historical data. The paper shows (1) factor exposures drift(ed) significantly over longer horizons (2) since 1970, the arithmetic (geometric) equity premium relative to long-term Treasuries has been only 1.7% (0.8%) per year. This decline was primarily due to higher long-term Treasury yields, not lower average stock returns. Together, this evidence suggests that a user of the FFM and CAPM should drastically shrink the model-input parameters to the point where project cost-of-capital is often no longer meaningfully heterogeneous, i.e., different from that of a risk-neutral pricing model. In addition the data suggests that (3) textbook application of both the FFM and CAPM failed to predict subsequent rates of returns given estimated inputs, often even with the wrong sign. This evidence is fundamentally opposite to the recommendations in all major finance textbooks and curriculums in use today.

Professor Welch will present at the Marian Miner Cook Athenaeum as part of the Financial Economics Institute Speaker Series and as the Keynote Speaker for the Southern California Finance Conference.