The Third International Moscow Finance Conference

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hosted by the International College of Economics and Finance (ICEF) and the International Laboratory of Financial Economics (LFE), Higher School of Economics

LFE INTERNATIONAL LABORATORY OF FINANCIAL ECONOMICS

CONTENTS

CONFERENCE PROGRAM

FRIDAY, NOVEMBER 8
(ROOM 3211, BUILDING 3, UL. SHABOLOVKA, 26)

10.00 **OPENING SPEECHES**

10.10 **SESSION 1 "AGGREGATE DYNAMICS AND FINANCIAL MARKETS"**

Aggregate Investment and Stock Returns

Presenter: Dmitry Livdan, Haas School of Business, University of California Berkeley (co-authors: Fernando Duarte and Leonid Kogan)

In this paper we study the relation between returns on the aggregate stock market and aggregate real investment. While it is well known that the aggregate investment rate is negatively correlated with subsequent excess stock market returns, we find that it is positively correlated with future stock market volatility. Thus, conditionally on past aggregate investment, the mean-variance tradeoff in aggregate stock returns is negative. We interpret these patterns within a general equilibrium production economy. In our model, investment is determined endogenously in response to two types of shocks: shocks to productivity and preference shocks affecting discount rates. Preference shocks affect expected stock returns, aggregate investment rate, and stock return volatility in equilibrium, helping the model to reproduce the empirical relations between these variables. Thus, our results emphasize that the time-varying price of aggregate risk plays an important role in shaping the aggregate investment dynamics.

Discussant: Dimitrios Tsomocos, Saïd Business School, University of Oxford

Volatility Risk Premia and Exchange Rate Predictability

Presenter: Lucio Sarno, Cass Business School, City University London and CEPR (co-authors: Pasquale della Corte and Tarun Ramadorai)

We investigate the predictive information content in foreign exchange volatility risk premia for exchange rate returns. The volatility risk premium is the difference between realized volatility and a model-free measure of expected volatility that is derived from currency options, and reflects the cost of insurance against volatility fluctuations in the underlying currency. We find that a portfolio that sells currencies with high insurance costs and buys currencies with low insurance costs generates sizeable out-of-sample returns and Sharpe ratios. These returns are almost entirely obtained via predictability of spot exchange rates rather than interest rate differentials, and these predictable spot returns are far stronger than those from carry trade and momentum strategies. Canonical risk factors cannot price the returns from this strategy, which can be understood, however, in terms of a simple mechanism with time-varying limits to arbitrage.

Discussant: Vladimir Sokolov, ICEF, Higher School of Economics

12.00 **KEYNOTE SPEECH 1**

The Macroeconomic Determinants of Financial Predictability

Presenter: Rajnish Mehra, Luxembourg School of Finance, W.P. Carey School of Business, Arizona State University, and NBER

In this paper we take a first pass at formalising the underlying questions and articulating a pertinent theory for predictability. The fundamental construct we will employ is the well-know family of dynamic stochastic general equilibrium macroeconomic models that form the foundation of business cycle theory, growth theory, monetary theory and nearly every other inter-temporal equilibrium construct whose attributes can be conveniently related to the data. We show that under fairly general assumptions the neo classical growth model implies that the stochastic process characterising equity returns is stationary and mean reverting. This forms the theoretical underpinnings of predictability.

13.20 **LUNCH BREAK**

14.30 **SESSION 2 "CORPORATE FINANCE"**

Does Nationalization Work? Evidence from Russian State Takeovers

Presenter: Carsten Sprenger, ICEF, Higher School of Economics, Moscow

Nationalization and its consequences have attracted new interest in the recent financial crisis. We study the effects of nationalization on company performance using a sample of Russian firms. The Russian government has increased its role as an owner in several sectors of the economy in the 2000's. We have assembled a comprehensive data set of nationalization transactions in Russia for the period from 2004 to 2008. Operating performance is measured relative to a close match of a non-nationalized firm that is found using propensity score matching. Overall, the empirical results show no significant effect of the fact of nationalization on performance. There is however, an increase in leverage over the first two years after nationalization. We also shed light on the changes in corporate governance going along with nationalization that can have intermediating effects on performance.

Discussant: Thomas Noe, Saïd Business School, University of Oxford

Empirics of Executive Compensation: What Determines CEO Pay?

Presenter: Stanimir Morfov, ICEF, Higher School of Economics, Moscow (co-author: Manuel Santos)

This paper is concerned with an adverse selection model of executive compensation. The structure of the optimal contract depends on the uncertainty about the productivity and reservation wage of the manager's type, and measures of performance of the firm. We analyze the sensitivity of the optimal contract to firm's characteristics such as volatility, size, technology and new economy, and CEO age.

Discussant: Bart Taub, Adam Smith Business School, University of Glasgow

16.00 **COFFEE BREAK**

16.30 **SESSION 3 "OPTION PRICING AND MARKET MICROSTRUCTURE"**

Affine Option Pricing Model in Discrete Time

Presenter: Stanislav Khrapov, New Economic School

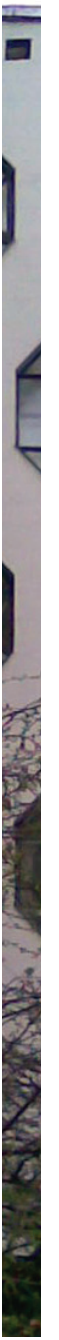
We propose an extension with leverage effect of the discrete time stochastic volatility model of Darolles et al. (2006). This extension is shown to be the natural discrete time analog of the Heston (1993) option pricing model. It shares with Heston (1993) the advantage of structure preserving change of measure: with an exponentially affine stochastic discount factor, the historical and the risk neutral models belong to the same family of joint probability distributions for return and volatility processes. This allows computing option prices in semi-closed form through Fourier transform. The discrete time approach has several advantages. First, it allows relaxing the constraints on higher order moments implied by the specification of a diffusion process. Second, it makes more transparent the role of various parameters: leverage versus volatility feedback effect, connection with daily realized volatility measure on high-frequency intraday returns, closed-form formulas for affine dynamics of the first two moments of return and volatility that are robust to temporal aggregation, impact of leverage on the volatility smile, etc. This sheds some new light on the identification issue of the various risk premium parameters. An empirical illustration is provided.

Discussant: Marcelo Fernandes, Sao Paulo School of Economics, Fundação Getulio Vargas and Queen Mary University London

Dealer Networks: Market Quality in Over-The-Counter Markets

Presenter: Norman Schürhoff, University of Lausanne, Swiss Finance Institute, and CEPR (co-author: Dan Li)

We use the MSRB Transaction Reporting System audit trail to study dealer intermediation and liquidity provision in decentralized over-the-counter markets. The dealership network in municipal bonds exhibits a hierarchical core-periphery structure with about 20-30 highly interconnected dealers at its core and several hundred peripheral dealer firms. Market quality varies significantly across dealers depending on their interconnectedness and centrality within the trading network. Central dealers charge larger trading costs to investors and face lower loss probabilities than peripheral dealers. Yet, investor orders flow through central dealers. Central dealers place bonds more readily with investors than other dealers, consistent with smaller search frictions. Central dealers also provide more liquidity immediacy than peripheral dealers, leading central dealers to hold larger and more volatile inventories, keep bonds longer, and intermediate fewer pre-arranged trades. Investors trade with central dealers when liquidity is otherwise low. Central dealers can thus be considered liquidity providers of last resort.



Discussant: Christian Julliard, London School of Economics

18.00 **COFFEE BREAK**

18.30 **KEYNOTE SPEECH 2**

Systemic Risk, Sovereign Yields and Bank Exposures in the Euro Crisis

Presenter: Marco Pagano, Università di Napoli Federico II, CSEF, EIEF and CEPR (co-authors: Niccolò Battistini and Saverio Simonelli)

Since 2008, euro-area sovereign yields have diverged sharply, and so have the corresponding CDS premia. At the same time, banks' sovereign debt portfolios featured an increasing home bias. We investigate the relationship between these two facts, and its rationale. First, we inquire to what extent the dynamics of sovereign yield differentials relative to the swap rate and CDS premia reflect changes in perceived sovereign solvency risk or rather different responses to systemic risk due to the possible collapse of the euro. We do so by decomposing yield differentials and CDS spreads in a country-specific and a common risk component via a dynamic factor model. We then investigate how the home bias of banks' sovereign portfolios responds to yield differentials and to their two components, by estimating a vector error-correction model on 2008-12 monthly data. We find that in most countries of the euro area, and especially in its periphery, banks' sovereign exposures respond positively to increases in yields. When bank exposures are related to the country-risk and common-risk components of yields, it turns out that (i) in the periphery, banks increase their domestic exposure in response to increases in country risk, while in core countries they do not; (ii) in most euro area banks respond to an increase in the common risk factor by raising their domestic exposures. Finding (i) hints at distorted incentives in periphery banks' response to changes in their own sovereign's risk. Finding (ii) indicates that, when systemic risk increases, all banks tend to increase the home bias of their portfolios, making the euro-area sovereign market more segmented.

20.00 **RECEPTION**

SATURDAY, NOVEMBER 9

(ROOM 3211, BUILDING 3, UL. SHABOLOVKA, 26)

10.00 **SESSION 4**
"ECONOMETRICS, STATISTICS AND FINANCE"

Who's afraid of selection bias? Robust inference in the presence of selection bias

Presenter: Thomas Noe, Saïd Business School, University of Oxford

This paper considers competitive selection dominance: what conditions on the unconditional distribution of of a random prospect will ensure that the prospect stochastically dominates a rival random prospect conditioned on competitive selection, i.e., conditioned on the prospect's realized value exceeding its rivals? Because standard distributional orders, such as stochastic dominance and the monotone likelihood ratio property (MLRP), do not provide either necessary or sufficient restrictions on the unconditional distributions to ensure selection dominance, new distribution orders are required. We provide the requisite orders, which we term supermultiplicativity on average and geometric dominance. These orderings generate conditions, satisfied by many, but not all, scale shifts of standard textbook distributions, under which the selection-conditioned distribution is stochastically dominant if and only if the unconditional distribution is stochastically dominant. When these conditions are satisfied, robust qualitative inferences concerning the unconditional population distribution can be drawn from the selection-conditioned subsample distribution and vice versa.

Discussant: Fabian Slonimczyk, ICEF, Higher School of Economics

Conditional alphas and realized betas

Presenter: Marcelo Fernandes, Sao Paulo School of Economics, Fundação Getulio Vargas and Queen Mary University London (co-authors Walter Distaso and Valentina Corradi)

This paper proposes a two-step procedure to back out the conditional alpha of a given stock from high-frequency returns. We first estimate the realized factor loadings of the stock, and then retrieve the conditional alpha by estimating the conditional expectation of the stock return in excess over the realized risk premia. The estimation method is fully nonparametric in stark contrast with the literature on conditional alphas and betas. Apart from the methodological contribution, we employ NYSE data to determine the main drivers of conditional alphas as well as to track mispricing over time. In addition, we assess economic relevance of our conditional alpha estimates by means of a market-neutral trading strategy that longs stocks with positive alphas and shorts stocks with negative alphas. The preliminary results are very promising.

Discussant: Sergey Gelman, ICEF, Higher School of Economics

11.30 **COFFEE BREAK**

12.00 **SESSION 5**
"MUTUAL AND HEDGE FUNDS"

Hedge Fund (Non)Transparency: Skill or Risk-taking?

Presenter: Olga Kuzmina, New Economic School (with Sergiy Gorovyy)

Why do hedge funds that hide their strategies from investors ("non-transparent" funds) over-perform funds that are less secretive about what they are doing? In this project we attempt to disentangle two competing hypotheses. The first one is that non-transparent funds simply do not want others to replicate their strategies in order to protect their competitive advantage in e.g. stock-picking or market-timing ability. If this explanation is true, these funds should be earning a positive 'alpha' as compared to transparent funds, i.e. over-perform in both good and bad market conditions. The other explanation is that by being non-transparent funds can hide excessive risk-taking from their investors. In this case, non-transparent funds should over-perform during good market conditions by earning the risk-premium, but under-perform during bad market conditions when the risks realize. By comparing performance of secretive and transparent funds before and during the global crisis (i.e. in good and bad periods), we disentangle these two competing explanations and find out that the evidence is consistent with hiding excessive risk-taking from investors, rather than protecting proprietary strategies, with secretive funds earning a risk premium of about 5% annually as compared to transparent funds.

Discussant: Branko Urošević, University of Belgrade and National Bank of Serbia

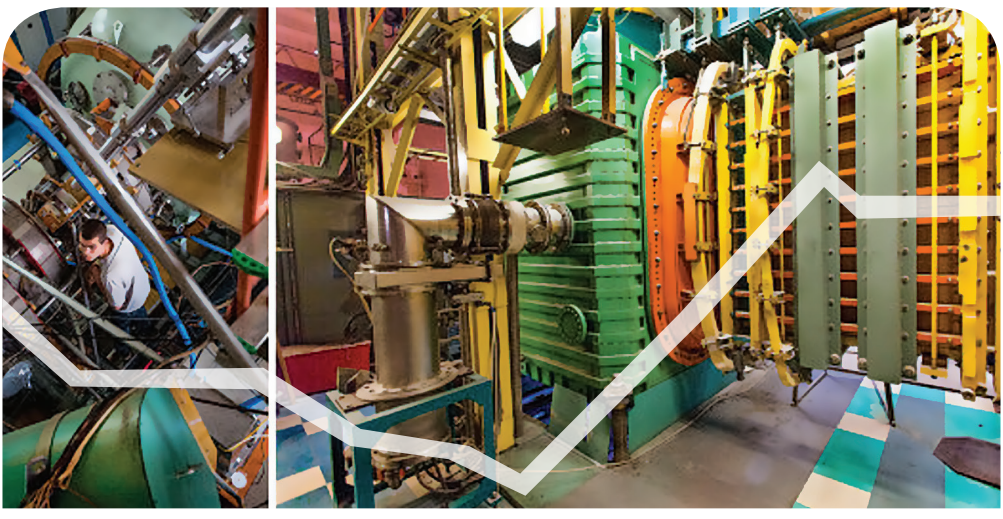
Competition among Portfolio Managers and Asset Specialization

Presenter: Dmitry Makarov, New Economic School

This paper investigates the competition among portfolio managers as they attempt to outperform each other. We provide a tractable dynamic continuous-time model of competition between two risk-averse managers concerned about relative performance. To capture the managers' asset specialization, we consider two imperfectly correlated risky stocks whereby each manager trades in one of the stocks, and so faces incomplete markets. We show that a unique pure-strategy Nash equilibrium always obtains, and provide the ensuing equilibrium portfolio policies explicitly. We find that competition makes a relatively risk tolerant manager decrease, and a risk intolerant increase, her portfolio risk. Moreover, a higher own risk aversion induces a manager to take more risk when the opponent is advantaged, in that she specializes in the stock with the relatively higher Sharpe ratio. We then explore the link between our two key ingredients, competition and asset specialization, and show that competition can be conducive to asset specialization. In particular, we find that both managers, when relatively risk tolerant, can voluntarily opt for asset specialization and the corresponding loss of diversification to avoid competing on the same turf by trading in the same set of stocks. When they are risk intolerant, however, the no-specialization scenario is more likely. When we consider a client investor of a manager, we show that her preferences for or against asset specialization could well be the opposite to that of her manager. We also examine the potential costs to a client investor, arising as managerial turnover or changing stock characteristics misaligns the client manager's policy. We find that the client loses more when it is her manager who is replaced than the other manager. In contrast, the client's losses are the same for a given change in her manager's stock characteristics as for that in the competitor manager's stock.

Discussant: Mihail Zervos, London School of Economics

13.30 **LUNCH**



PARTICIPANTS' PROFILES

Marcelo Fernandes

Sao Paulo School of Economics, Fundação Getulio Vargas and Queen Mary University London

Marcelo Fernandes is a Professor of Economics and Finance at Queen Mary, University of London and a Professor of Finance at the Sao Paulo School of Economics, Getulio Vargas Foundation. He holds a PhD in Management Science from the Solvay Business School, Universite Libre de Bruxelles. His research interests span the areas of Financial Econometrics, Empirical Finance, Nonparametric Methods. Marcelo has published in the Journal of Econometrics, Econometric Reviews, Journal of Financial Econometrics, Journal of Economic Dynamics and Control, among others.

Sergey Gelman

ICEF and LFE, Higher School of Economics

Sergey Gelman is an Assistant Professor at the International College of Economics and Finance of the Higher School of Economics and senior research fellow at the International Laboratory in Financial Economics. He holds a PhD in Economics from the University of Münster.
His main research interests are stock price dynamics around takeovers, identification of structural breaks and regime switching in financial time series, pricing of derivatives in forefront of anticipated significant events, asset pricing and consumption preferences.
Sergey has published in the Journal of Empirical Finance and the European Review of Economic History.

Christian Julliard

London School of Economics

Christian Julliard is an Associate Professor of Finance and a senior research associate of the Financial Market Group (FMG) at the London School of Economics. He is also a research affiliate of the International Macroeconomics and Financial Economics programmes of the Centre for Economic Policy Research (CEPR), and an associated editor of Economica.
He was awarded a PhD by the Department of Economics at Princeton University where he was also affiliated with the Bendheim Center for Finance and the Woodrow Wilson School of Public and International Affairs. His research interests span Macroeconomics, Finance, and the frontier of Applied Econometrics. His research has been published in top economics and finance journals such as the Journal of Political Economy and the Review of Financial Studies.

Stanislav Khrapov

New Economic School

Stanislav Khrapov is an Assistant Professor of Finance at the New Economic School in Moscow. He holds a PhD in Economics from University of North Carolina at Chapel Hill. He specializes in the area of financial economics and econometrics. His primary lines of research are long-term asset pricing, discrete time option pricing, and volatility modeling.

PARTICIPANTS' PROFILES

Olga Kuzmina

New Economic School

Olga Kuzmina is a Promsvyazbank Assistant Professor of Finance at the New Economic School, Moscow. She holds a PhD in Business (Finance and Economics) from the Columbia Business School. Her main research interests are Empirical Corporate Finance, Organizations and Strategy, Applied Microeconometrics. Olga has published in the American Economic Review.

Dmitry Livdan

Haas School of Business,
University of California Berkeley

Dmitry Livdan is an Associate Professor of Finance at the Haas School of Business, University of California, Berkeley. He holds a PhD in Finance from the Wharton School, University of Pennsylvania, and a PhD in Physics from the City University of New York. His main research interests are Asset Pricing, Informational Economics, and Corporate Finance. His research has been published in the Journal of Finance, the Journal of Financial Economics, the Review of Financial Studies, and the Journal of Financial Markets.

Dmitry Makarov

New Economic School

Dmitry Makarov is an Assistant Professor of Finance at the New Economic School, Moscow. He holds a PhD in Finance from the London Business School. His research interests include Asset Pricing, Portfolio Choice, and Money Management. Dmitry has published in the Journal of Finance, Journal of Financial Economics, and Finance Research Letters.

Rajnish Mehra

Luxembourg School of Finance,
W. P. Carey School of Business
Arizona State University and NBER

Rajnish Mehra holds the Deutsche Bank Luxembourg Chair at the Luxembourg NBSchool of Finance of the University of Luxembourg, the E.N. Basha Arizona Heritage Chair in Finance and Economics at Arizona State University, and is a Research Associate of the NBER. He holds a PhD in Finance from the Graduate School of Industrial Administration, Carnegie-Mellon University. His research interests focus on capital markets, asset pricing and growth theory. He has published in Econometrica, Review of Economic Studies, Journal of Monetary Economics, Journal of Economic Dynamics and Control, The Financial Analysts Journal, Annals of Finance and other journals. His work has been featured in The Financial Times, The Economist and in Business Week. He has been awarded a Graham and Dodd scroll for excellence in financial writing by the Association for Investment Management and Research.

PARTICIPANTS' PROFILES

Stanimir Morfov

ICEF, Higher School of Economics

Stanimir Morfov is an Assistant Professor at the International College of Economics and Finance of the Higher School of Economics in Moscow and senior research fellow at the International Laboratory in Financial Economics. He holds a PhD in Economics from the Universidad Carlos III de Madrid. His main scientific areas of research are Dynamic Contracts Theory, Corporate Governance, Pricing at Stock Markets, Executive Pay, Computation, Asset Pricing.

Thomas Noe

Said Business School, Oxford University

Thomas Noe is the Ernest Butten Professor of Management Studies at Saïd Business School. He holds a PhD from the University of Texas at Austin. Thomas' main areas of research fall within corporate finance and corporate governance focusing on developing and experimentally validating rational choice models of financing, investment, governance, and management compensation. He is one of the 20 most prolific researchers in leading finance journals since the turn of the century, with his research appearing in journals such as the American Economic Review, Journal of Finance, Journal of Financial Economics, Review of Economic Studies, and Review of Financial Studies. Currently, he is a co-editor of the Journal of Economics and Management Strategy.

Marco Pagano

University of Naples Federico II, CSEF, EIEF and CEPR

Marko Pagano is a Director of the Centre for Studies in Economics and Finance (CSEF) and a professor of Economics at the University of Naples Federico II.
He was awarded the BACOB European Prize for Economic and Financial Research, jointly with Ailsa Röell. He holds a PhD from the M.I.T. Most of his research is in the area of financial economics, especially in the fields of corporate finance, banking and stock market microstructure. He has also done research in macroeconomics, especially on its interactions with financial markets. His publications have appeared in several journals, such as American Economic Review, Review of Economic Studies, Quarterly Journal of Economics, Journal of Finance, Review of Financial Studies, RAND Journal of Economics, Journal of the European Economic Association, European Economic Review, and Economic Journal.

Lucio Sarno

Cass Business School, City University London, CEPR

Lucio Sarno is a Deputy Dean, Head of Finance Faculty and a Professor of Finance at the Cass Business School, City University London. He holds a PhD in Economics from the University of Liverpool. His main research interests are International Finance, Macrofinance, Empirical Asset Pricing, Monetary Economics, Financial Econometrics. Lucio is the author of over 70 articles in refereed economics and finance journals, including the Journal of Economic Literature, Journal of Finance, Journal of Financial Economics, Review of Financial Studies, Journal of Financial and Quantitative Analysis, Journal of Business, Review of Economics and Statistics, International Economic Review and Journal of International Economics.

PARTICIPANTS' PROFILES

Norman Schuerhoff

University of Lausanne,
Swiss Finance Institute, and CEPR

Norman Schuerhoff is a Swiss Finance Institute Chair Professor of Finance and Director of Doctoral Program in Finance at the Ecole des HEC, University of Lausanne and a research fellow at the Swiss Finance Institute.
He obtained his PhD in financial economics from Carnegie Mellon University. His main research interests lie in corporate governance, capital structure dynamics, and bond market microstructure. Norman has published in the Journal of Monetary Economics, Journal of Finance, Journal of Financial Economics, and Review of Financial Studies.

Fabian Slonimczyk

ICEF, Higher School of Economics

Fabian Slonimczyk is an Assistant Professor at the International College of Economics and Finance of the Higher School of Economics, Moscow. He holds a PhD in Economics from the University of Massachusetts Amherst. The main research interests of Fabian are Labor Economics, Economic Development, Applied econometrics, Macroeconomics. His research has been published in the Journal of Economic Inequality and the Journal of Economic Behavior and Organization.

Vladimir Sokolov

ICEF, Higher School of Economics

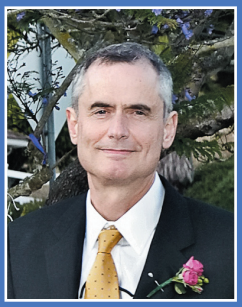
Vladimir Sokolov is an Assistant Professor at the International College of Economics and Finance of the Higher School of Economics, Moscow and senior research fellow at the International Laboratory in Financial Economics. He holds a PhD in Economics from the University of Notre Dame. The main research interests of Vladimir are International Economics, Financial Economics, Monetary Economics, foreign exchange markets, exchange crises and exchange rate management, bond markets, derivative financial instruments, Macroeconomics of the banking sector. His research has been published in the Pacific Economic Review, Economic Policy, and the Journal of the New Economic Association.

Carsten Sprenger

ICEF and LFE, Higher School of Economics

Carsten Sprenger is an Assistant Professor at the International College of Economics and Finance of the Higher School of Economics and head of the International Laboratory in Financial Economics. He holds a PhD in Economics from the Universitat Pompeu Fabra. His research interests span the areas of Corporate Finance, Corporate Governance, Credit Risk, and Real Estate Markets. Carsten has published in the Journal of Comparative Economics and the Journal of the New Economic Association.

PARTICIPANTS' PROFILES



Bart Taub

Adam Smith Business School, University of Glasgow

Bart Taub is a Professor in Finance (Economics) at the Adam Smith Business School of the University of Glasgow. He holds a PhD from the University of Chicago. Bart Taub studies dynamic models in which information and commitment play a role. He currently is applying these ideas to models of stock markets, international lending and corporate mergers. Main research interests of Bart Taub are Dynamic Models of Market Microstructure, Industrial Organization, Monetary Theory, Economic Development, Contract Theory. Bart Taub has published in the Journal of Economic Theory, the Journal of Financial Markets, Economic Theory, Economic Inquiry, the Journal of Finance, the Journal of Macroeconomics, the Review of Economic Design, Finance and Stochastics, and the Annals of Finance.

Dimitrios Tsomocos

Said Business School, Oxford University

Dimitrios Tsomocos is a Reader in Finance at the Saïd Business School University of Oxford and fellow in Management at St. Edmund Hall. He is also a senior research associate at the Financial Markets Group at the London School of Economics.
He holds a Ph.D. from Yale University. Dimitrios Tsomocos' current research focuses on banking and regulation, incomplete asset markets, systemic risk, financial instability and issues of new financial architecture.
Dimitrios Tsomocos has published in the Journal of Financial Stability, Economic Theory, International Game Theory Review, Journal of Mathematical Economics, Journal of World Economics Review, Greek Economic Review, Journal of Economic. International Journal of Central Banking, Annals of Finance, among others.

Branko Urošević

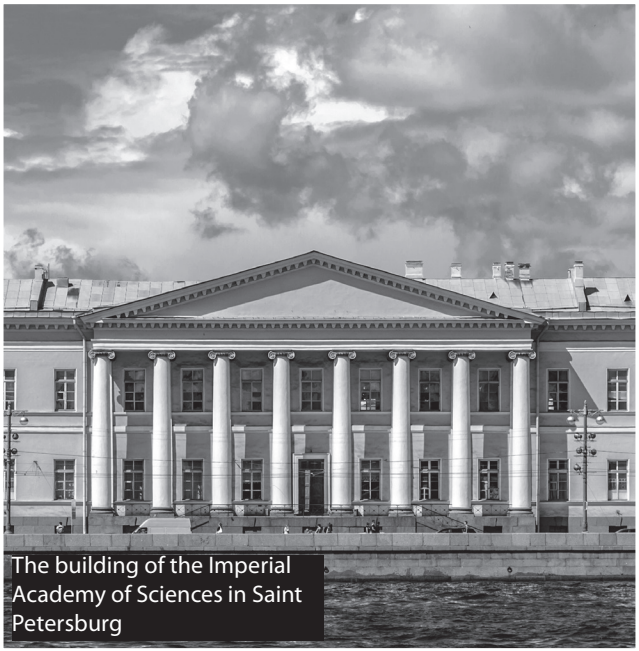
University of Belgrade,
National Bank of Serbia

Branko Uroševic is a Professor of Financial Economics and Operations Research at the Faculty of Economics of the University of Belgrade and directs the International Master in Quantitative Finance (IMQF) program at the Faculty of Economics, University of Belgrade. He is also an Advisor to the Governor of the National Bank of Serbia (for research). He holds a PhD in Physics from Brown University, USA, and a PhD in Finance from the Haas School of Business, University of California at Berkeley, USA. His research covers a wide range of topics including risk management, financial stability, education economics, real estate finance, and connection between corporate finance and asset pricing. Branko´s research has been published in leading international journals such as the Journal of Political Economy, Proceedings of the American Academy of Sciences (PNAS), Journal of Financial Markets, and Management Science, among others.

Mihail Zervos

London School of Economics

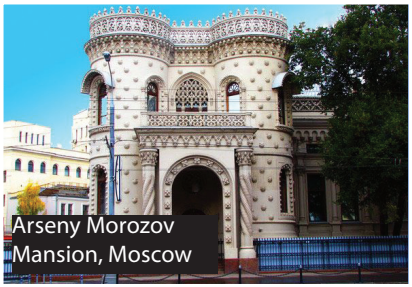
Mihail Zervos is a Professor of Mathematics at the London School of Economics. He received his PhD degree in stochastic control and optimization from the Imperial College London. His current research interests include stochastic analysis, stochastic control and optimisation, optimal stopping problems, valuation of investment decisions and investments in real assets, real options, options of American type, derivative pricing in incomplete markets, and weather derivatives. Mihail Zervos is an associate editor of IMA Journal of Mathematical Control and Information and International Journal of Theoretical and Applied Finance. His research has been published in The Annals of Applied Probability, Applied Mathematics and Optimization, Finance and Stochastics, Quantitative Finance, Journal of Applied Mathematics and Stochastic Analysis.



The building of the Imperial Academy of Sciences in Saint Petersburg

Lev Pontryagin

Alexander Rodchenko

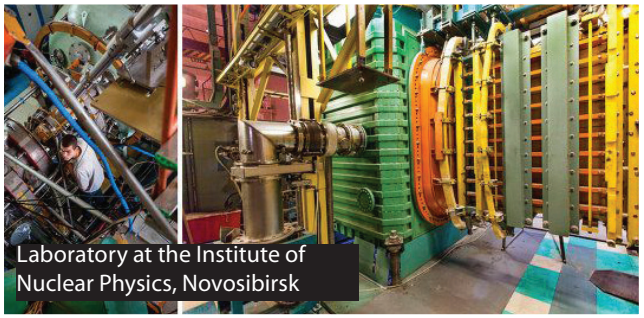


Arseny Morozov Mansion, Moscow

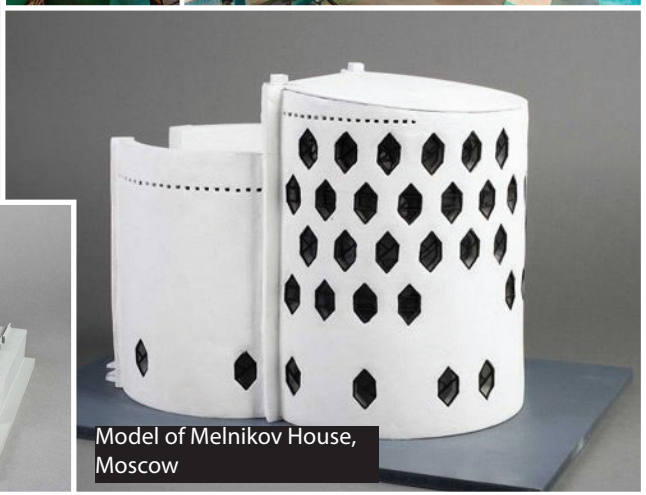
Shabolovka Radio Tower, Moscow

Moscow International Business Center


Soviet Constructivism


Laboratory at the Institute of Nuclear Physics, Novosibirsk

Model of Lenin mausoleum, Moscow


Model of Melnikov House, Moscow

THE INTERNATIONAL LABORATORY OF FINANCIAL ECONOMICS

The International Laboratory of Financial Economics (LFE) has been established in 2010 at the International College of Economics and Finance (ICEF) of the Higher School of Economics (HSE) in collaboration with the London School of Economics (LSE). Its main goal is to support research at best international standards. Many research projects have a particular focus on emerging financial markets. The core research team consists of Moscow based researchers who hold a PhD degree from recognized European and US universities with an affiliation to ICEF or HSE, as well as international fellows. The Laboratory is headed by Christian Julliard (LSE) and Carsten Sprenger (ICEF). A particular feature of the Laboratory is its close cooperation with LSE.

The LSE Academic Director of the Laboratory Christian Julliard and invited experts are crucial in the design of the research program of the Laboratory, the choice of research projects to be supported, in giving advice on the projects conducted in the framework of the LFE. The laboratory helps to create an intellectual environment for fruitful research in financial economics and provides research support to the resident researchers and international fellows. LFE serves to broaden the interaction and contacts of its resident researchers with the international scientific community. To this end,

LFE organizes the annual International Moscow Finance Conference on research in finance and invites researchers to the joint LFE-ICEF research seminar. Laboratory researchers regularly present their work at international conferences and publish in recognized peer-reviewed international journals in finance and economics. Many papers are previously disseminated in the ICEF Working paper series. Research assistants form an integral part of the team of the laboratory. As a rule, these are students enrolled at the two-year Master's Program in Financial Economics of ICEF or advanced students in ICEF's Bachelor Program. This helps students who are interested in research to get experience in economic research and to raise their academic profile. In addition, results of the research find their way into the courses and student seminars at ICEF. The laboratory benefits from the library and data resources available at the Higher School of Economics and should facilitate the purchase of new datasets. Currently, the work of the laboratory is funded by the Center of Fundamental Research of HSE and ICEF.

The laboratory has three priority areas of research:

- Finance, banking and the macroeconomics
- Efficiency of financial markets, and
- Corporate finance and governance.

The International College of Economics and Finance (ICEF) is a unique college, that was established in 1997 thanks to the combined efforts of the London School of Economics and Political Science (LSE), one of the world's leading centers of education and scientific research in economics, and the National Research University Higher School of Economics (HSE). Today ICEF in academic cooperation with the LSE offers a unique in Russia and Eastern Europe double degree Bachelor's program and international Master's program in Financial Economics.

The National Research University Higher School of Economics (HSE) is one of the most prestigious universities in Russia and the leader in economics and social sciences. In October 2009 the HSE received the status of a National Research University.

The London School of Economics and Political Science (LSE) is a world class centre for its concentration of teaching and research across the full range of the social, political and economic sciences. Founded in 1895, LSE has an outstanding world reputation for academic excellence

CONTACTS

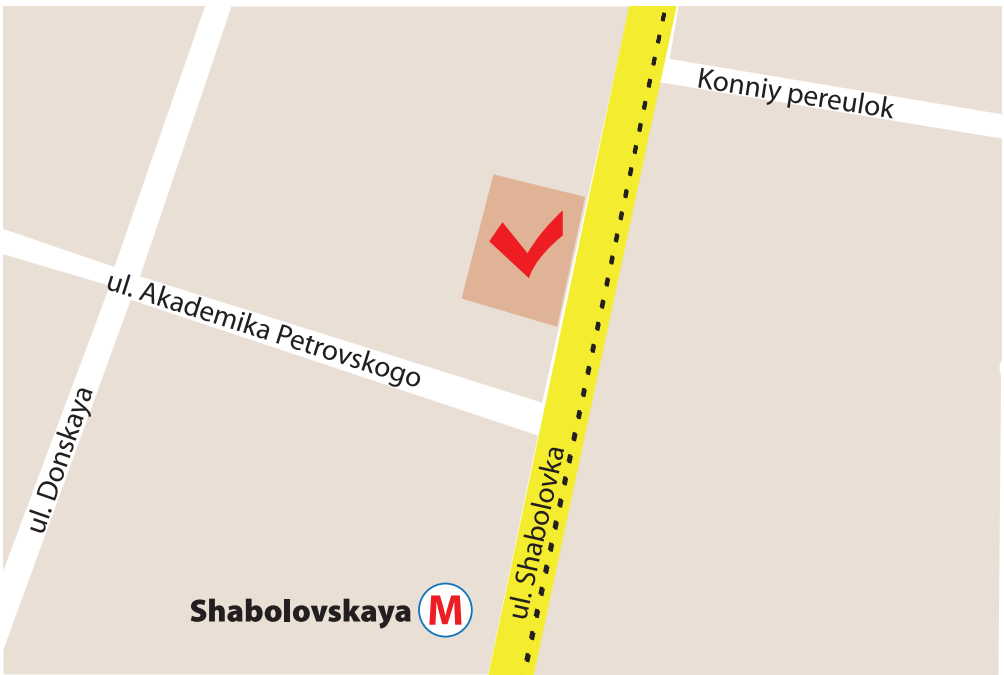
PHONE:
+7 (495) 580-89-19
FAX:
+7 (495) 772-95-90 * 026124

E-MAIL:
ICEF@HSE.RU

ICEF.HSE.RU
LFE.HSE.RU

HOW TO FIND US

ADDRESS:
26, UL. SHABOLOVKA,
MOSCOW, RUSSIA
NATIONAL RESEARCH
UNIVERSITY "HIGHER
SCHOOL OF ECONOMICS"



HSE SHABOLOVKA CAMPUS

The International College of Economics and Finance of the National Research University Higher School of Economics

26, ul. Shabolovka,
Moscow, Russia
icef.hse.ru
lfe.hse.ru

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