Volume 5, Number 1 *2005*

Allied Academies
International Conference

Memphis, Tennessee
April 13-16, 2005

Academy of Commercial Banking and Finance

PROCEEDINGS

Volume 5, Number 1 *2005*

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AN EXAMINATION OF THE RELATIONSHIP BETWEEN DIFFERING INTEREST RATES, P/E RATIOS AND STOCK PRICES

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ABSTRACT

Research shows that a strong inverse relationship exits between interest rates, p/e ratios and stock prices. Generally the interest rate examined in previous research has been the long-term U. S. Government bond yield or more recently the ten-year Treasury note yield. Most now accept the ten-year note as the bell weather rate in the markets.

This paper examines the relationship between differing interest rates, p/e ratios, and stock prices over the period from 1975 to 2000 to determine if there is a significant difference in the effect, on p/e ratios and stock prices, of a change in each of the different U. S Treasury yields. The expectation is that changes in interest rates will not have a significant impact on p/e ratios and stock prices until the changes occur in the long-term rates. In other words the initial change that occurs in the short-term rates will have little impact on the p/e ratios and stock prices and that these will only show significant change when the long-term rates begin to move.

This study will examine the relationship between the p/e ratios and stock prices to both short-term and long-term interest rates over time for the period of 1975-2000 period. Also, changes in the short-term and long-term rates will be compared to changes in the p/e ratios and stock prices for shorter time periods, over the 1975-2000 period, to determine how the impact of rate changes may differ under different market conditions.

LIMITATIONS OF ANALYSTS' EARNINGS FORECASTS

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INTRODUCTION

Analysts' earnings forecasts do differ significantly from actual earnings (Dreman and Berry 1995) and the market's earnings expectations do not consistently follow analysts' forecasts (Hopwood and McKeown 1990). Nonetheless, analysts' earnings forecasts are routinely employed as a predictor of future earnings and as a proxy for the market's earnings expectations. Unlike prior literature reviews on analysts' earnings forecasts, this study draws together the results of some research on limitations of analysts' forecasts.

LIMITED SUPERIORITY OF ANALYST FORECAST ACCURACY

Analysts' superior predictive ability to time-series models is explained by timeliness of forecasts and broad information set. Paradoxically, these advantages limit individual analysts' forecast accuracy. Prior studies' empirical results form the following model:

$$ACCURACY = f(\overset{-}{HORIZON}, \overset{+}{RECENCY}, \overset{+}{FREQUENCY}, \overset{+}{SIZE}, \overset{+}{COVERAGE}, \overset{+}{BROKERAGE})$$

Analysts' forecast accuracy (ACCURACY) declines with the length of forecast horizon (HORIZON), but increases with forecast recency (RECENCY) and frequency (FREQUENCY) because the latest earnings-relevant information can be incorporated in forecasts. Firm size and analyst coverage (the number of analysts following a firm) have a positive effect on availability of information and thus analysts' forecasts are more accurate for firms with larger size (SIZE) and higher analyst coverage (COVERAGE). Brokerage firms' size (BROKERAGE) also have a positive impact on analysts' forecast accuracy because large brokerage firms provide superior resources, better research networks, and closer relationships with management of companies.

Less experience and task complexity are likely to limit analysts' forecast accuracy. However, prior studies (Clement 1999; Jacob et al. 1999; Mikhail et al. 1997) report mixed empirical results. Another potential limitation of analysts' forecast accuracy is caused by analysts' herding behavior. Shroff et al. (2003) find that followers in time provide more accurate forecasts than leaders, but followers are more likely to herd on the consensus or the predecessor's forecasts. On the other hand, Bernhardt et al. (2002) and Zitzewitz (2001) document that analysts do not herd as is often assumed, but rather they exaggerate their differences with the consensus forecasts. Analysts' herding behavior that has impact on forecast accuracy is an issue for future research on the limitation of analysts' forecast accuracy.

DISCONNECTION BETWEEN ANALYSTS' AND THE MARKET'S EXPECTATIONS OF EARNINGS

Since analysts provide more accurate forecasts than do time-series models, analysts' forecasts are expected to be a more precise surrogate for the market's expectations of earnings. However, prior studies' empirical results indicate that the market's earnings expectations do not consistently follow analysts' forecasts. This anomalous relation of analysts' forecasts with stock

returns suggests analysts' inefficiency in incorporating available information and/or investors' failure in impounding some portion of the value-relevant information in analysts' forecasts.

A number of studies provide evidence of inefficiency of analysts' forecasts. First, analysts do not fully incorporate past information available at the time of their forecasts. Second, analysts have tendency to interpret information in a manner of bias. More specifically, evidence in Easterwood and Nutt (1999) shows that analysts underreact to negative information, but overreact to positive information. Third, analysts are likely to mispredict earnings when a firm reports a loss. Finally, the complexity of information contributes to the failure of analysts to properly interpret the information when forecasting earnings.

There is mounting evidence of investor's failure in incorporating value-relevant information. Elgers et al. (2001), Mendenhall (1991), Shane and Brous (2001) and Stickel (1991) provide evidence of investors' underreliance on analysts' forecasts. Walther (1997) find that investors place more weight on analyst forecasts and less weight on time-series predictions as investors' sophistication increases.

Overall, prior studies indicate disconnection between analysts' and the market's earnings expectations, contrary to widespread use of analysts' forecasts as a proxy for the market's expectations of earnings. An alternative explanation for the contradictory finding is the analysts' inefficiency in processing value-relevant information. However, prior studies have not yet full modeled how analysts process information. This unresolved question that is essential to understand properties of analysts' forecasts makes this research area lively and rewarding for both theoreticians and empiricists interested in the operation of the analyst industry, the formation of investors' expectations and the interaction between accounting numbers and stock returns (Amir and Sougiannis 1999).

BIAS IN ANALYSTS' EARNINGS FORECASTS

Absolute forecast errors may be larger for firms which are hard to predict, but analysts should err equally in both direction (under- and overestimates of future earnings) if they reveal their expectations in an unbiased manner. However, numerous studies have confirmed analysts' optimistic bias. Prior studies provide three plausible explanations why analysts' forecasts are systematically optimistic. First, analysts have the incentive to maintain good relations with management because management is the most important source of non-public information. However, the management relations hypothesis fails to consider the fact that managers may be displeased with optimistic forecasts because they have incentives to avoid negative earnings surprises (Burgstahler and Eames 2000). Second, brokerage or investment-banking firms may compensate analysts for their research service to stimulate brokerage commissions or securities-issue commissions. Thus, sell-side analysts have incentives to boost trade for their brokerage firms and to favorably evaluate investment-banking client companies. Third, several studies attempt to explain analysts' optimism by the cognitive bias, statistical and memory errors that are common to all human beings. For instance, Easterwood and Nutt (1999) document that analysts overreact to positive information, but underreact to negative information. Elton et al. (1984) also show that analysts have a marked tendency to overestimate the growth rates of securities they believed will perform well and to underestimate the growth rate of companies they believed will perform poorly. Moreover, analysts are likely to add firms they view favorably and drop firms they view unfavorably in their forecast announcements (i.e., selection bias) so that unfavorable forecasts are withheld (Affeck-Graves et al. 1990; McNichols and O'Brien 1997).

Existing empirical studies report the effect of earnings sign, firm size, analyst coverage, and forecast horizon on analysts' forecast bias. Analysts are more optimistic in forecasting earnings for firms whose actual earnings are losses. The difference in forecast bias between profit and loss firms is attributed to managers' incentives. When managers report profits, they try to meet or slightly beat

analysts' forecasts. On the other hand, managers are unconcerned about meeting analysts' forecasts when they report losses. Instead, they may undertake actions to enhance future earnings, possibly taking a big bath that increases expenses and losses in the current period and reduces expenses and losses in subsequent periods. Consequently, loss firms' forecasts are shown as being large overestimated while profit firms' forecasts are likely to be small underestimated. Small firms have relatively more optimistic bias because they are much more likely to report losses and/or their managers are less likely to manage profits. Analyst coverage and forecast horizon have negative impact on the magnitude of analysts' optimistic bias. The optimism of analysts' forecasts appears to be waning in recent years. Brown (1998) and Richardson et al. (2001) provide evidence of a switch from upward-biased to downward-biased annual forecasts as the earnings announcement date approaches. Gu and Wu (2000) suggest that such forecast pessimism is a natural result of positive earnings skewness because analysts strive to minimize mean absolute forecast error.

V. CONCLUSION

Analysts' earnings forecasts have been used extensively as a predictor of future earnings and a proxy for the market's expectations of earnings. The superior accuracy of analysts' forecasts to predictions derived from time-series models of earnings justifies this common practice in empirical studies in accounting and finance. However, analysts' forecast accuracy is limited by forecast timing (i.e., forecast horizon, recency, and frequency) and available information set (i.e., firm size, analyst coverage, and brokerage size). Also, analysts' forecasts do not consistently generate measures of earnings surprise that are more highly associated with contemporaneous stock returns, suggesting that analysts' forecasts are not necessarily better representations of the market's earnings expectations than are time-series predictions. The disconnection between analysts' and the market's expectations of earnings is reconciled by analysts' inefficiency in incorporating available information and investors' failure in impounding some portion of the value-relevant information in analysts' forecasts. Another limitation of analysts' earnings forecasts is analysts' optimism in forecasting future earnings although the optimistic bias is waning in recent years. The findings in this study indicate the need for further research in several areas: the relation of analysts' herding behavior on forecast accuracy, how analysts process information to produce forecasts, and a structural shift toward forecast pessimism in recent years.

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FURTHER EVIDENCE ON LIQUIDITY MOTIVE FOR STOCK SPLITS

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ABSTRACT

We examine signaling-based versus liquidity-based explanations of stock splits using market data for both industrial firms and depository institutions. Consistent with information signaling hypothesis, we hypothesize that market reactions to split announcements by industrial firms are significantly greater than the market reactions to split announcements by depository institutions. Contrary to our hypothesis, we find that the market reactions to stock split announcements exhibit no significant difference between the two groups. However, our results show that the average monthly trading volume following these splits is significantly higher compared to the pre-split level for both groups. We interpret these findings as supportive of the liquidity explanation of stock split announcement effects. Our results have significant implications for investors, corporate management, fund managers, and financial economists.

Keywords: Stock Splits, Signaling, Liquidity, and Market Reaction
JEL Classification: G15 and G29

THE EVOLUTION OF DERIVATIVE USE BY COMMUNITY BANKS FROM 1995-2003

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ABSTRACT

We analyze the use of interest rate derivatives by community banks from 1995 to 2003. We can be reasonably sure that community banks' use of derivatives securities is purely as end-users of the products. It is commonly known that derivative use is related to the size of the firm. Several studies have isolated community banks and studied their use of derivatives in the early 1990s, but we hypothesize that those studies are in fact mostly driven by the largest quartile of banks. We also hypothesize that derivatives as a whole are much more widely used in the late 1990's and early 2000's than they were a decade ago. This study will be a survey of what bank derivative usage looked like over the past nine years.

JEL Codes: G21, G28
Keywords: community banks, derivatives, hedging

INTRODUCTION

It goes without saying that the banking industry has changed over the last decade. There have been several seminal events to cause the changes, notably the easing of Depression era regulations and as a result the ever-increasing penetration of the large "mega-banks" into smaller and smaller markets. Additionally, and likely a result of the increased competition caused by the aforementioned events, banks have been forced to dramatically increase their product offerings. It is now common for the smallest of banks to offer such products as home equity lines of credit, certificates of deposit with the interest rate tied to the performance of an equity index, and even interest-only home mortgages.

The increased competition from the mega-banks has also forced the small bank to manage itself in ways that they did not need to in the past. For example, it is not uncommon to see smaller banks using more sophisticated derivative securities as a vital tool in Asset/Liability management. Clearly, the use of these complex financial tools introduces additional accounting and regulatory risks to the small bank. It is our goal in this paper to determine how this subset of banks has evolved since 1995 in their use of derivative securities. A second question that we will attempt to answer is whether or not derivative use affects the performance of the banks in our sample, and whether the results are driven by the largest banks.

The firms we examine are U.S. commercial banks with total assets between $100 million and $1 billion, which we will refer to as community banks. We choose these firms because they are small enough so that derivatives should be a relatively new tool for them as compared to the larger national banks. Yet, they are large enough that they should have enough interest rate risk on their balance sheet to warrant hedging with derivatives. Also, as pointed out by Carter and Sinkey (1998) this subset of banks should be using derivatives for hedging purposes rather than for dealer activity. The paper proceeds as follows. Section 2 reviews the existing literature. Section 3 describes the data used in our study and our methodology. Section 4 presents the results and Section 5 concludes.

II. RELATED LITERATURE

There are several studies that have examined the effect of derivative use on the firm. Smith and Stulz (1985) were the first to discuss how hedging with derivatives can be used to offset interest-rate risk and decrease the probability of insolvency. Carter and Sinkey (2000) use year-end data from 1996 and find approximately 5% of community banks use derivatives. They examine the user versus nonuser banks and find usage related to riskier capital structure, larger maturity mismatches between assets and liabilities, greater net-loan charge offs, and lower net interest margins. An additional set of researchers are studying swap positions of U.S. commercial banks. Gorton and Rosen (1995) find that interest rate risk from swap positions has had very little effect on the systematic risk of the banking industry as a whole. Boukrami (2003) finds larger banks with better asset quality and higher capitalization use swaps more intensely.

One study which focuses exclusively on community banks is Deyoung, Hunter, and Udell's (2004) examinion of the past, present, and future of community banks. They show that although regulatory and technological changes have created increased competition for community banks, it has also left well-managed community banks with a potential exploitable strategic position in the industry. Carter and Sinkey's (1998) evaluation of derivative use by community banks from 1990-1993 shows that cost-related incentives motivate interest-rate derivative use. Specifically, they show that community banks use derivatives to control interest-rate risk, with swaps being used in conjunction with credit-risk minimization mechanisms. We will build on the existing literature in two ways. First, we look at an extended time period, and one in which increased competition has forced community banks to use more complex management techniques. Second, we will examine whether the change in derivative use and their effect on performance is driven by the largest quartile of banks.

Although previous research has looked at the use of derivatives by commercial and community banks, this paper will be the first to look specifically at derivative use over such a long time period by so many banks. We are examining the change in derivative use by 4,397 banks over a 9 year period, 1995-2003. This paper is the first to look at how derivative use has evolved among community banks over an extended time frame.

III. DATA, VARIABLE SPECIFICATION, AND METHODOLOGY

We gather our community bank derivative data from the Annual Reports of Condition and Income (Call Report) required by the Federal Deposit Insurance Corporation. We use the definition of community banks as defined by Carter and Sinkey (1998). We examine US commercial banks with Total Assets between $100 million and $1 billion. There are 4,397 banks and/or bank holding companies in this category between 1995 and 2003. Our sample cannot start earlier than 1995 because there is a lack of derivative data available prior to 1995. The call reports include the notional amount of derivative contracts and the type of derivatives (e.g. option, swap, futures contract) used for hedging purposes.

The Call Report breaks down the total notional amount of derivative contracts into the following categories: futures contracts, forward contracts, option contracts and swaps. Option contracts are further broken down into written or purchased options and exchange trades or over the counter (OTC). To evaluate the evolution of derivative use of community banks we divide our sample into banks who use derivatives and those who do not use derivatives. For each sample we compute and compare summary statistics. We also compute summary statistics on the number of users each year and the type of derivative use. The variables that we will use in our analysis are defined as follows:

TA = Log of Total Assets
EC = Equity Capital divided by Total Assets
AL = Liquid Assets divided by Total Assets
PS = Dollar amount of Preferred Stock divided by Total Assets
DIV = Dividends divided by Total Assets
NIM = Net Interest Income divided by Total Assets
NLCO = Net Loan Charge-Offs divided by Total Assets
GAP = 12 month Rate Sensitive Assets – 12 month Rate Sensitive Liabilities
SWAP = Notional Amount of Interest-Rate Swaps divided by Total Assets
F&F = Notional Amount of Interest-Rate Futures and Forwards divided by Total Assets
OPTION = Notional Amount of Interest-Rate Options divided by Total Assets
SDUMMY (FDUMMY, ODUMMY, DDUMMY) = Dummy variables in which users are assigned a value of 1 and non-users a value of 0 for Swaps, Futures & Forwards, Options, and Derivatives respectively.
LIBOR = The 3-month London Interbank Offer Rate
S&P500 = The return on the S&P 500 stock index
ROA = Net Income divided by Total Assets
ROE = Net Income Divided by Total Equity

To answer our second question we break our sample into quartiles and examine the differences between how derivative use has evolved among the largest quartile compared to the smallest three. We use regression analysis to determine whether firm performance is better for users versus non-users of derivatives in each sub-sample. The regression equation we use for this analysis is as follows:

$$\textit{Performance Measure (ROA or ROE)} = a_0 + a_1 ln(TA) + a_2 EC + a_3 AL + a_4 PS + a_5 DIV + a_6 NIM + a_7 GAP + a_8 NLCO + a_9 F\&F + a_{10} OPTION + a_{11} SWAP + a_{13} S\&P500 + a_{14} LIBOR$$

We use the log of total assets to capture the effect of firm size on derivative use. Equity capital is included to control for a firms ability to use derivatives as allowed by regulatory agencies. Asset liquidity is included to control for the bank's on-balance sheet assets and to test whether asset liquidity could represent an alternative to hedging as previous researchers have proposed (Nance, Smith & Smithson, 1993). Preferred stock is included to control for the possibility that it may be viewed as an alternative to hedging. The amount that a firm pays in dividends can indicate whether the firm has sufficient funds to enable them to be approved by creditors to use derivatives for hedging purposes. Previous researchers have shown a positive relationship between derivative use and dividend payouts indicating that if the firm has the cash to pay dividends then it has the ability to use derivatives. Net interest margin is expected to be positively related with banks attempting to protect their spread between interest income and interest expense through the use of derivatives. Net loan charge-offs is used as a proxy for credit risk and tests whether joint management of credit risk and interest rate risk occurs. Finally, we use twelve month GAP because it is the best measure available to proxy for interest-rate risk exposure. Twelve month GAP (GAP) is measured as the dollar gap between interest sensitive assets and liabilities in the twelve-month maturity range. F&F, Option, and Swap denote the ratio of each type of derivative's notional amount divided by total assets. These variables are used to test whether the level of derivative use enhances firm performance. The annual return on the S&P500 and LIBOR is included to control for changing market conditions.

IV. EMPIRICAL RESULTS

Table 1 will present the summary statistics for the community banks in our sample, and reveals several differences between users and non-users of derivatives. To determine whether or not these differences are statistically significant we compare these variables for the users of derivatives versus nonusers using a simple t-test. We will be able to conclude from this simple analysis how the derivative users verses non-users differ in regards to banks size and other descriptive statistics.

Additional summary statistics will be shown in Table 2, which includes the number of banks and notional amounts of futures, forwards, options and swaps in each year. Our analysis thus far ignores the possibility that our results could be driven by a small subset of our sample. Therefore, we break the sample into quartiles based on the banks' total assets. We will use charts to show the number of users of derivatives by quartile and the percentage of users each quartile represents. These charts will emphasize the fact that size matters in determining derivative use by banks. The last chart we want to examine will show derivative use by type each year based on the notional values of swaps, options, futures and forwards.

Last, we will use Tobit regression analysis to examine how the use of derivatives affects performance of the community banks in our sample. Since very few of the community banks in our sample are publicly traded we cannot use stock return as a measure of performance, so we will evaluate firm performance by comparing return on assets (ROA) and return on equity (ROE) for each firm in our sample.

V. CONCLUSION

This paper examines the use of derivatives by U.S. commercial banks with total assets between $100 million and $1 billion. We limit our study to these "community banks" because we can be reasonably certain that derivative use will be limited to hedging purposes instead of dealer activity. The purpose of this paper is to provide researchers with an understanding of how derivative use has changed over the time period of 1995 to 2003.

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WHY CUSTOMERS CHOOSE COMMUNITY BANKS: AN EMPIRICAL STUDY

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ABSTRACT

This paper examines the reasons customers choose community banks and the perceptions of community bank chief executive officers as to why customers might choose a community bank. Additionally, the paper examines what services and facilities the customer prefers. It represents two studies. First, a survey was sent to chief executive officers from 60 banks, with 41 banks responding. Subsequently, 150 surveys were sent to each of the 41 responding banks for random distribution to each tenth customer who came to the lobby or motor bank. Both customers and chief executive officers were surveyed in the three major population areas of Texas (Houston, Dallas-Ft. Worth, and Austin-San Antonio). 'The research included both urban and rural banks within the three major population areas. The second study was a confirmation study surveying 50 banks outside the state of Texas with 32 banks responding. Subsequently, their customers were surveyed in the same fashion as the first study.

INVESTMENT STRATEGIES, PERFORMANCE, AND TRADING INFORMATION IMPACT

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ABSTRACT

This paper examines a set of investment strategies based on past market information to evaluate performance and trading impact on the Canadian Market. In doing so, we assess whether trading information adds value to the effectiveness of these strategies. Utilizing variant models of four different methodologies, we find strong evidence that supported the Momentum Investment Strategy, which buys past winner stocks and sells past loser stocks. Our evidence did not support Contrarian Investment Strategy, which posits that investors overreact to good and bad news. Our winner's portfolios outperform our loser's portfolios. The Negative Volume Effect Strategy did not work. This is, contrary to Foerster, Prihar and Schmitz (1995) study. We found that winners stocks did not reverse in cases of heavy volume; nor did loser stocks reverse in high volume context. However, we did find that trading information has an impact on stock returns and thus adds value to investment strategies at least for the 1990 to 2000 investment period. Investors who combine past price and trading volume information in constructing their investment strategies would achieve higher returns than investors who base their portfolio construction decisions solely on stock prices.

THE IMPACT OF MONETARY POLICY ON THE UNITED STATES ECONOMY: EVIDENCE FROM 9-11

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ABSTRACT

The effects that the September 11, 2001 terrorist attacks posed on the United States were great. One of the concerns of the Federal Reserves instantaneously following the attacks was the likelihood that the events that had, and would be taking place could be crippling to the United States economy. Immediate actions taken by the Fed were vital in minimizing the disruption to the United States as a whole but what could the Fed do to regain the confidence of the American people? How could they prevent a major economic downturn in the aftermath of the attacks?

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