Editorial

There's No Such Thing As Free Lunch

'There's no such thing as a free lunch.' Many of the obituaries and encomiums published in the days since the death of Milton Friedman in November have wrongly made the claim that he coined the phrase. There is no doubt that he, together with science fiction writer Robert Heinlein (1966) popularised it, indeed, according to Lederer (1989), in 1977 Friedman told members of the Knesset Finance Committee in Jerusalem, 'There is no such thing as a free lunch. That is the sum of my economic theory. The rest is elaboration.' He had used it in a 1973 *Playboy* interview that appears in his 1975 book of that name. The aphorism, however, had appeared in print in the *San Francisco News* as early as June 1, 1949, in an article, 'The Fable of the King and All the Wise Men—or Economics in Eight words,' by Walter Morrow, according to Safire (1994). The eight words? 'There ain't no such thing as free lunch.' The lack of an indefinite article before 'free lunch' is consistent with the folk wisdom that the saw harks back to the nineteenth century, when pubs would advertise 'free lunch' to attract patrons; but just try to eat without buying a drink: TANSTAAFL! [1]

The aphorism is a reminder, if needed, that there is seldom something for nothing, as epitomised in the joke about Milton Friedman and his acolyte walking down the street. 'Look,' says the acolyte, 'there's a $100 bill in the gutter!' 'Impossible,' says Milton, 'someone would have picked it up already'. Of course, the value of the money is clear, and accrues to the possessor. For an equivocal lunch, consider the cartoon by Sam Gross in the *New Yorker* of the two birds perched on a Bird Sanctuary sign in the woods. 'What's the catch?' says one. Obviously a Friedmanite.

I leave to others, most notably Sam Brittan and Niall Ferguson, to remember Milton Friedman the man and the monetarist, and Peter Swan to muse on the political and reform impacts of Friedman's trenchant arguments for small government, impacts which continue to affect us all, especially but hardly exclusively in Anglophone countries. I want to touch on two areas of Friedman's work that have paralleled my own.

In a noted passage in his 1962 book, *Capitalism and Freedom*, Friedman argued (p. 133), 'Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible. This is a fundamentally subversive doctrine.' He extended this argument in a long piece in the *New York Times* Sunday Magazine in 1970, and confirmed that his views had not changed thirty years later (GSB 2000), when he noted that, although the 1970 article is much used in Business Ethics courses, it actually addresses issues of social responsibility of business, not ethics. The article is, as Friedman also noted

1. The acronym was apparently sufficiently well known in 1971 to be used in the title of a book about the economics of the environment by Dolan (1971), who (p. 14) attributes the aphorism, and acronym, to Heinlein (1966). Safire (1994) discusses the possibility that the article by Morrow had first appeared in 1938.

in 2000, an extreme view, from the right, 'Only people, not businesses, have ethics'.

His general view, unchanged across forty years, was that, 'A corporation has an obligation to its owners and stockholders to make as much profit as it can while not violating its owners' ethical concerns [or] practicing deception or fraud.' As for the firm's employees, including its managers, 'If I'm employed in business that I think is unethical, I have a clear choice. I can get out of that business and find something else to do. It doesn't seem to me it's ethical to do unethical things [just] because the business can let me do [them]' (GSB 2000). That is, of Hirschman's trio of exit, voice, and loyalty (Hirschman 1970), the employee has a choice; but if voice is ineffective, and loyalty is unacceptable to the employee, then the choice must be exit.[2]

I have been using Friedman's quotes on the social responsibility of business for almost thirty years in various subjects/courses at the AGSM, as a means of stimulating thought and discussion, which they always provoke. In a course—Business Ethics—which some students apparently feel is superfluous to their studies of option pricing, market segmentation, and oligopoly theory, Friedman's views pack a punch because of the eloquence of his writing: indeed, it has proved difficult to find an alternative view arguing for stakeholder theory and broad corporate responsibility that is as well expressed. One does not have to agree with Friedman's view of the firm's responsibility to admire his rhetorical accomplishments.

Friedman's views on business ethics and corporate social responsibility are consistent with his strong belief in the intelligence and responsibility of the individual. Not for him the equivocations of the psychologist or the behaviourist. The individual, he believes, can be relied on to behave in an informed, rational and self-interested way. And via the voluntary exchange of the market, Adam Smith's invisible hand will improve the lot of all, the public interest.

His self-avowed libertarian, small-government beliefs inform his commitment to a voluntary army (no state-decreed conscription) and to ending the prohibition on the manufacture, sale, purchase, possession or use of illicit drugs. He was not 'a zero government person:' he saw a real role for government, to prevent people from harming others and to uphold the law. Following Mill (1909), he said that government never has any right to interfere with an individual for that person's own good. This belief informed his advocacy of the legalization of drugs: his adamantine conviction that it was morally wrong for government to attempt to change the individual's drug-taking behaviour 'for his own good'. Only secondarily did the costs and benefits of ending the prohibition matter to him: he argued that eliminating the many costs associated with the ineffective prohibition would vastly outweigh any costs associated with ending the drug war. (He did not advocate open slather, just the level of regulation afforded to the legal drugs of alcohol and tobacco.)

Independently, coming from a utilitarian, not a libertarian, approach, while a graduate student at Stanford, I reached similar conclusions to Friedman's about drug legalization. In a series of papers (Marks 1974, 1991, 2002), I have argued against the prohibition, have estimated the cost of the existing policies in the U.S.

2. The employee's choice is ever thus, as those of us at the Australian Graduate School of Management from April to November 2006 can attest.

and Australia, and the benefits of reform. There have been some advances, usually on account of the public-health risks of shared needles, with needle-exchange schemes and the legal injecting room here in Sydney. But the political resistance against these small steps, even in the face of the AIDS/HIV pandemic, is great, and persistent.

In the early 'nineties, I corresponded with Milton Friedman, who was kind enough to send me a glowing testimonial praising several of my publications. I never met him.

The Nine Papers

In this large number, we have a selection of papers for your reading pleasure in several disciplines, including Finance/Economics/HR (one), Finance/Economics (one), Finance/Accounting (two), straight Finance (four), and Strategy (one). The first paper in this issue is timely, given recent corporate mischief and governments' responses to it.

To what extent do executives' incentives contribute to the flurry of recent corporate scandals? Popular wisdom has it that executives' stock options contributed to the troubles. At any rate many corporations are abandoning stock options and reverting to restricted stock. But Choe and Yin argue that it's a bum rap, or at least not really deserved. Comparing option-based contracts with stock-based contracts in a general environment with no restrictions on preferences or technologies, they find that the former weakly dominated the latter, and that if the manager is risk-neutral, this dominions is strict.

In order to price an option, most techniques specify a particular stochastic process to represent the price dynamics of the asset, and then derive an explicit pricing model.

If the asset is a commodity, with seasonality's, the price dynamics are difficult to characterise explicitly. Moreover, estimation risk is difficult to deal with, and history may not provide all predictive information.

In the second paper, Foster and Whiteman apply their numerical Bayesian option-pricing technique that develops an underlying predictive density in real time in order to price derivative securities of commodities, here soybeans. They then use the non-parametric maximum entropy principle to principle to transform the predictive density to its risk-neutral form. Their results are strongest with a prior that reflects and reward past option-pricing success.

During an expansion, as we have experienced in Australia for several years now, there is no great interest in identifying firms at risk of failure, but, business cycles being just that, future investors and policy-makers will again be faced with such identification. Forty years ago Ed Altman developed his well-known Z-Score, based on publicly available accounting numbers, but, as Gharghori, Chan, and Faff argue in the third paper, such measures are backwards-looking (as most accounting data are), and, moreover, are predicated on the assumption that the firm will survive, the going-concern principle. Nobel laureate Robert Merton noted 'that a firm's equity value can be modelled as a European call option on the firm's assets, where the strike price of the option is the firm's level of liabilities.' Gharghori and his associates argue that the Merton model can thus be used to infer a firm's

probability of default (the probability that its assets are valued less than its liabilities at the option's maturity date).

As they argue, the Merton model, unlike the accounting-ratios models, does not require any prior beliefs on whether a firm subsequently defaults. Moreover, the Merton model is based on economic theory, unlike the accounting-ratios models. But there is, Gharghori, Chan and Faff report, disagreement over how to use the Merton model to obtain default probabilities since the market value of assets has a leptokurtic, not Gaussian, distribution.

Some have argued that it is the additional risk of default before maturity not captured by the Merton model that results in the observed leptokurtic distribution of the market values of defaulted firms. These researchers have argued that, since the path followed by the market value of the firm's assets before maturity is an important determinant of the firm's default probability, a 'barrier option' (Brockman & Turtle 2003) (specifically, a down-and-out call option on the firm's net assets) is a better model than a standard option. If the firm's net assets are zero at maturity or if the asset level falls below a specified level ('the barrier') before maturity, then the value of equity is zero. I note here that, from my work (Marks 2006) with barriers or hurdles and stochastic processes, I believe that there may well be a flaw in the barrier-option approach: just because a firm's asset value falls below a specified (positive) level does not, from my work, necessarily imply that the value of net assets will fall to zero. But I must argue this more vigorously elsewhere.

At any rate, Gharghori, Chan and Faff calculate default probabilities using Mertonian standard options, using barrier options, and finally using accounting ratios. They find that the Merton model is marginally better that the Barrier model, and that both options models are clearly better at measuring default risk than accounting-ratios models.

In the fourth paper, Birt, Bilson, Smith and Whaley attempt to unify the various theories attempting to explain models of firm voluntary disclosures of internal information. Both ownership and the level of competition appear to influence whether and to what extent firms disclose: the greater the degree of ownership by large shareholders, the greater the level of voluntary disclosure and the more competitive the firm's environment, the greater the level of voluntary disclosure. When they construct a new independent variable, the product of ownership and competition, they find a greater significance in the explanation of the level of the firm's voluntary disclosure.

We have remarked in earlier editorials that the aging of post-war generations and, in Australia at least, the introduction of compulsory pension (superannuation) schemes have meant a great growth in the size of equity funds, in general, and managed funds in particular. With this growth has come increasing scrutiny of the performance of the fund managers. The fifth paper, by Gallagher, Nadarajah, and Pinnuck, is the latest in this tradition, using a unique Australian monthly database to examine the implications for performance of top management turnover in actively managed equity mutual funds.

They examine monthly portfolio holdings, as well as net returns, to derive portfolio risk, and to deduce managers' stock characteristics preferences (such as momentum, book-to-market, and size) as well as portfolio turnover and concentration. What they find with their event studies is that managers of poorly

performing funds who are subsequently displaced prefer larger, growth-oriented stocks and momentum strategies (choosing previous winners), as well as showing a preference for increased portfolio concentration and higher tracking-error volatility (taking larger bets relative to the market index).

They find that after the manager of a poorly performing fund is replaced, its returns improve, but attribute this to reversion to the mean, not to better skills in stock selection. Moreover, they find that in-coming managers reduce their reliance on momentum strategies, and increase the diversification of their portfolios by reducing its concentration, without preferring any particular company size.

Australian companies do not have a good record, on average, with overseas expansions. Could the many failures be due to what Zalan and Lewis (in the sixth paper) call 'administrative heritage,' which includes the firm's physical heritage (its configuration of physical assets) and its cultural heritage (the management mentality, the corporate culture, and its leadership style)? The authors set out to explore the gap between the firm's strategic evolution and its administrative heritage, examining eleven large Australian-owned firms in the four industries of mining, paper and packaging, wine-making, and banking. They find that these firms had a distinct administrative heritage: domestic portfolio mentality, reliance on strategic assets for competitive advantage, and limited foreign direct investment traditions. They conclude that this explains in part the firms' lack of success abroad, supporting the contention of others that administrative heritage matters.

Despite the regulatory revolution of the past twenty-three years in Australian and New Zealand, many firms are still regulated, more or less—just ask the dominant Australian telco. The regulator, in determining output prices or revenues, relies on estimates of the cost of equity capital. An overestimate will result in higher prices, an underestimate will discourage reinvestment by the regulated firms. So, correct estimation by the regulator is very important, but company taxation, the use of imputation credits, capital-gains taxes, and the firm's dividend withholding policy affects the estimation. In the seventh paper, Lally sets out to compare the estimations from four models, used in Australia, in New Zealand, and elsewhere. His results are not easily summarised in words; they depend on a number of variables and assumptions.

The average punter might well have started to become aware of the credit ratings agencies, and their country ratings, as well as their company ratings; certainly, corporate CFOs are very aware of these ratings, because firms' costs of capital depend critically on these ratings. How are they determined? What actors influence the rating agencies' decisions? The agencies themselves say that they examine publicly available information and private information from the firm. Just how do they do this? In the eighth paper, Gray, Mirkovic, and Ragunathan examine the relationship between Australian credit ratings and a set of financial ratios and industry variables, to find that interest coverage and leverage ratios have the strongest effect, while profitability and industry concentration are also important. They identify too a secular trend towards lower rating—we might call it 'ratings deflation'—the hurdles are rising, in Australia as well as the U.S. Finally, they find that their ordered probit model does not discriminate well between higher rated firms—A- and AA-rated—which suggests that the agencies rely more on private information to discriminate between high-rated firms.

The term momentum in physics is related to Newton's First Law: 'Any body in a state of rest or of uniform motion in a straight line will continue in that state of rest or motion until acted upon by an outside force.' That is, still bodies exhibit inertia (they do not start moving by themselves) and moving bodies exhibit momentum. But when applied to prices (especially stock market prices), momentum is the rate of change of price changes, or what the physicist would call acceleration (positive or negative). That is, momentum reflects whether a price is increasing at an increasing rate or decreasing at a decreasing rate. (If the second momentum is unchanged, then eventually the price will bottom before increasing at an increasing rate. If the price acceleration (or momentum) persists, then the notion of market efficiency is challenged, because the logical conclusion is that a portfolio of past winners will outperform a portfolio of past losers. And yet momentum is apparently persistent and found in developed countries' exchanges, at least.

In the ninth paper, Durand, Limkriangkrai and Smith seek evidence of momentum in Australian stock prices, but conclude that there is no evidence of the momentum effects in monthly returns over the period 1980 to 2001. So they conclude that the explanation for the presence of momentum in daily data is still open.

This issue closes with two book reviews: one of a recent Harvard Business School Press volume, reviewed by Rob McLean, the last Dean and Director of the now-merged Australian Graduate School of Management, and one on a recent analysis of business ethics and how (if at all) to attempt to teach it, reviewed by Damian Grace, the philosopher.

Housekeeping

Every year the associate editors choose the best paper published in the *Journal* during the previous year, and the best runner-up. Volume 30, 2005, contained sixteen papers in two issues. By their votes, the E. Yetton Award for 2005 goes to Philip Gray for his 'Bayesian Estimation of Short Rate Models,' and the runner-up is Phyllis Tharenou for her 'Does Mentor Support Increase Women's Career Advancement More than Men's? The Differential Effects of Career and Psychosocial Support.' Congratulations to both authors. (The ratio of winners in the June issue to winners in the December issue is 3:8; the corresponding ratio for runners-up is 4:8, surprisingly.)

The end of the joint venture between the Universities of New South Wales and the Sydney, and the merger of the Australian Graduate School of Management with the Faculty of Economics and Commerce at UNSW to create the new Faculty of Business, have led to some changes here at the *Journal*. After nine years as Deputy Editor, Garry Twite has stepped down and David Gallagher, a name that has appeared many times in the *Journal*'s pages, takes over as Deputy Editor. Garry remains, with David, an Area Editor in Finance, as he moves to A.N.U. where we wish him good luck and a long continuing relationship with the *Journal*.

Robert E. Marks
General Editor

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and the drug war in particular that appeared on U.S. public television), see http://www.druglibrary.org/schaffer/Misc/friedm1.htm, accessed 21/11/06.

Australian Journal of Management

Special Issue—Delegated Portfolio Management

The General Editor and Deputy Editor of the *Australian Journal of Management* (*AJM*) are pleased to announce a special issue in the area of *Delegated Portfolio Management*, to be published at the beginning of calendar year 2008.

The special issue will be jointly edited by Professor Phil Dolan (Macquarie University Applied Finance Centre) and Professor Tom Smith (Australian National University).

Delegated Portfolio Management has received significant attention in recent years, and represents an increasingly important area of academic research. Motivation for a special issue extends well beyond the sheer size of the superannuation industry in Australia. Indeed the investment industry has grown significantly over the past decade, and is an increasing complex, sophisticated and dynamic segment of the financial services sector.

The *AJM* invites submissions of both original and scholarly research (either theoretical or empirical in nature) for review. Submissions to the *AJM* should be made on the understanding that such papers are not currently under review at any other journal. Manuscripts are encouraged to provide attention to important industry, public policy and/or management considerations operating in the delegated portfolio management field.

Submissions for the *AJM*'s special issue on Delegated Portfolio Management will be received in all areas including (but not exclusively limited to):

- Performance evaluation of investment managers;
- Index construction and management;
- Pension fund management, manager selection, investment advice and consulting;
- Asset/liability management and modeling of portfolio structures;
- Asset allocation;
- Portfolio design;
- Taxation relating to investment arrangements;
- Career concerns of fund managers, incentive contracts and fee structures;
- Principal/agency conflicts in fund management;
- Regulatory and managerial governance considerations;
- Risk management and derivative securities in the portfolio management process;
- Behavioural finance; and,
- Institutional trading strategies.

The deadline for submissions is June 30, 2007.

Submissions should be made electronically to Linda Camilleri (journal@agsm.edu.au). The *AJM*'s special issue's editorial board will then invite a number of submitting authors to present their papers at the special issue conference

of the *AJM*, to be held at the Australian Graduate School of Management's Sydney Campus (O'Connell Street, Sydney) in either August or September 2007. It is important to note that an invitation to present a paper at the conference does not imply that the paper has been accepted for publication in the special issue of the *AJM*. All papers will be peer reviewed, and selected papers from the conference are eligible for publication in either the special issue or a subsequent *AJM* issue.

We plan to publish the special issue on Delegated Portfolio Management in March 2008.