# Øystein Olsen: Promoting high-quality research in financial economics

Closing remarks by Mr Øystein Olsen, Governor of Norges Bank (Central Bank of Norway), at the Norwegian Finance Initiative (NFI) conference 2012, Oslo, 20 June 2012.

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In 2011 Norges Bank established the Norwegian Finance Initiative – NFI. Through the NFI we aim to promote excellence. Excellence in research, in curiosity and in criticism.

One objective of NFI is to contribute to a qualified debate in Norway on the fund, its strategy and its management. Top-quality research at academic institutions in Norway is a necessary condition for this. The fundamental idea of the NFI is to provide incentive programs that will lead to long-run structural improvements in research and teaching in financial economics.

Over the past year, we have introduced seven programs, directed at both students and faculty of financial economics at academic institutions in Norway. One important program involves co-sponsoring positions and hiring of outstanding academics. In this way the Norwegian Finance Initiative can help academic institutions in Norway build the infrastructure needed to sustain a lively research culture.

Another NFI program is the publication bonus. The publication bonus has been established by the Norwegian Finance Initiative to provide incentives for existing faculty to go the extra mile to produce high-quality, high-impact research. The program also signals to young scholars the value their institutions place on this level of achievement. As scholars in Norway begin to respond to these incentives, they in turn will help to set expectations for their peers and students, leading to a virtuous cycle.

Today, I am very proud to announce the first of two such bonuses for articles that have been accepted for publication in the best journals after this NFI program was established. The first is for Øyvind Norli, professor at the Norwegian Business School – BI. In 2007, Norli authored a much cited paper: "Sports Sentiment and Stock Returns", published in the *Journal of Finance*. Here, Norli documents the effect of mood swings: Stock markets tend to take a serious hit the day after losing what is perceived as an important football match.

Interesting as that is, this is not why we have decided to pay him this bonus now. Recently, the Journal of Financial Economics accepted another of his papers: "Geographic Dispersion and Stock Returns". Norli and his co-author Diego García show that companies which are truly local outperform more geographically dispersed companies by eight percentage points a year – a remarkable effect.

The other winner I am equally happy to announce is Richard Priestley, also professor at BI. Priestley has published several papers on exchange rate regimes, many on the relationship between the establishment of the euro and equity pricing across the region.

The scope of his bonus-winning paper is even more global. It is titled "The World Business Cycle and Expected Returns", which has been accepted for publication in the premier European finance journal: the Review of Finance. In this paper, Priestley and co-author Ilan Cooper use a novel and interesting measure of the business variable, namely the ratio of capital to output. This ratio is a good predictor of return on financial indices, both equity and bond returns and credit spreads, across time and across markets.

The paper by Cooper and Priestley demonstrate neatly a central element of modern financial economics: expected returns on financial securities vary over time, and tend to move with the business cycle. This fact is highly relevant for a long-term investor such as the fund, and is one of this conference's central topics.

Since its inception in 1998, the mandate of the fund has prescribed a strategic fixed equity share; at 40 percent in the initial years, increased to 60 percent some years ago.

A fixed share may sound trivial. It is not. The average portfolio of all investors cannot be rebalanced. As the risk premium varies over time, equity values swing. Equities are more volatile than bonds, and the equity share of the combined market portfolio of bonds and equities fluctuates substantially.

Rebalancing as we do implies taking on more risk just when risk is already perceived to be high. When the value of equities fall more than that of bonds, rebalancing means that we would sell bonds and buy equities. To develop a robust rebalancing strategy, we must understand why there are other, also highly competitive investors, who take the other side of these trades. We also need to understand our own edge, the comparative advantage – or disadvantage – of the size, time horizon, and governance structure of the fund. These issues are all intimately linked to questions on the research frontier of financial economics.

So far, the rebalancing strategy has served the fund well. From 1998 to 2011, around 0.5 percentage point – a considerable portion – of the total annual return can be attributed to rebalancing. We believe rebalancing will also be important going forward, but we need to further deepen our understanding of time-varying expected returns and risks.

The other main topic of today's conference – well-functioning markets – is also of particular interest to us. Without well-functioning markets, the massive reallocation of wealth from oil in the ground to a claim on a small share of future global output would not have been feasible. Well-functioning financial markets are also, through the allocation of real resources, important for sustained growth at a global level.

The financial crisis displayed great challenges related to how the markets function. We saw mispricing of risk, and the difficulties of managing financial imbalances. Other problems were related to liquidity. Trading of fixed income instruments take place at the desks of the large investment banks. The problems of these banks in September 2008 implied a literally closing of the main fixed income markets. The financial crisis and subsequent great recession have dramatically increased interest among academics in research of asset pricing with frictions. Questions of regulation, segmented markets, liquidity and principal/agent problems represent central issues for a fund manager, and at the same time topics on the forefront of academic debate. We need to understand how these issues affect our investment possibilities, given the fund's strategy and characteristics.

I have pointed to some of the links between the management of the fund and the two main areas discussed in this conference – time-varying risk premiums and well functioning markets. The questions on the forefront of academic debate – and their potential answers – are not just of theoretical interest, but of immediate practical relevance to us.

The fund will be a significant contributor to Norwegian government budgets for decades, maybe centuries to come. The strategy of the fund will need continuous development. We hope our annual research conferences will provide valuable inputs to this process.

I would like to thank the organizers for making this conference possible, and not least, the speakers for their very valuable contributions. Also, thanks to all the participants – I hope to see you again for the conference next year!