Praxis is the process by which a theory, lesson or skill is enacted, practiced, embodied or realized. A term in use since Aristotle ... praxis is one of the three basic activities of human beings (the others being theoria or theory and poiesis or skillful manufacture). Praxis in Aristotle includes voluntary or goal-directed action ... sometimes the action is itself part of the end, an action done for its own sake.

*Oxford Dictionary of Philosophy*
It is with great pride that I welcome you to the first issue of *Olin Praxis*.

This publication began with a desire to share the rigorous and relevant research produced by our renowned faculty with a wider audience of practitioners who are on the front lines of business. It evolved into a student-driven project, written and designed by three of our very talented MBA students.

Melody Chang, Susan Daker and Ali Reza Malik, all members of the MBA class of 2012, volunteered to create *Olin Praxis* from scratch. Melody is a graduate of Yale University, where she worked on the *Yale Daily News*; she is concentrating in marketing. Susan, a graduate of Northwestern University’s Medill School of Journalism, interned this summer at Morningstar and plans to pursue a career in business journalism. Ali discovered his interest in graphic design while he was a student at New York University’s Stern School and is concentrating in marketing at Olin. Together they studied their professors’ papers, distilled the essence of the research and produced succinct summaries that, I hope, will whet your appetite for more research from our renowned faculty.

Olin Executive in Residence and former CEO of Monsanto Richard Mahoney challenges Olin faculty to pursue research that can transform business with the annual Olin Award. Each year, a panel of distinguished corporate executives judges the competition and encourages us to disseminate the winning papers beyond academic journals. The 2011 Olin Award recipients are featured on pages 2-3.

Please feel free to share *Olin Praxis* with your colleagues and let us know how this research inspires you. The faculty, students and I look forward to hearing from you.

Mahendra R. Gupta, Dean
Geraldine J. & Robert L. Virgil Professor
of Accounting & Management
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THE OPTIMAL DURATION OF EXECUTIVE COMPENSATION: THEORY AND EVIDENCE

RADHAKRISHNAN GOPALAN, TODD MILBOURN AND ANJAN THAKOR
Three Olin Business School professors have developed a new formula corporations can use to calibrate executive compensation packages.

The measure, pay duration, characterizes the short-term and long-term compensation options for corporate leaders. It has long been believed that short-term pay motivates chief executives to allocate firm capital in a way that quickly boosts companies' share price but may not lead to sustainable growth. When the pay duration framework is applied to past compensation data, the result is a number of suggestions that can help companies better align executive pay with the best interests of the corporation and shareholders.

The paper “The Optimal Duration of Executive Compensation: Theory and Evidence” was born out of the need for an empirical measure to quantify compensation packages, the authors wrote. Without a model, the idea that short-term executive pay can negatively affect the long-term prospects of a company is merely an intuition.

Co-written by Radhakrishnan Gopalan, assistant professor of finance; Todd Milbourn, Hubert C. and Dorothy R. Moog Professor of Finance; and Anjan Thakor, John E. Simon Professor of Finance, the paper received the 2011 Olin Award for research that is relevant and applicable to business. Public and regulatory scrutiny of high executive payouts in the wake of the financial recession has focused attention on the compensation process. The model could prove useful to those who sit on corporate board compensation committees, Olin Award judges said.

The professors compute pay duration as a weighted average of the vesting periods of pay components including salary, bonus, option grants and restricted stock. The weight for each part is equal to the fraction of that component in the executive’s total compensation. Once the professors developed the pay duration model, they tested it by analyzing compensation data including all stock and option grants to all named executives of firms in the S&P 1500 index from 2006 to 2008.

Their findings:

• Pay duration should be longer for leaders of firms with more liquid stocks and with less variability in analyst earnings forecasts.

• Optimal pay duration is longer for executives at firms with smaller boards and smaller nonexecutive director shareholdings and for executives with lower shareholdings.

• Pay duration should also be longer at firms with a higher entrenchment index, which is a measure of several corporate governance provisions that lessen the ability of shareholders to influence decision making within a company.

• Executives with short-duration compensation contracts appear to act myopically compared with those with long-duration compensation. For example, an executive with shorter-duration compensation is more likely to cut research and development budgets, which lowers potential future growth but makes the company’s balance sheet look better in the short term.
Location in Negotiation: Is There A Home Field Advantage?

Markus Baer
A nyone who watches sports recognizes home-field advantage, the boost that teams get when playing on familiar turf, cheered on by their own fans. Markus Baer, assistant professor of organizational behavior at Olin, wondered, Do business professionals get the same effect in the comfort of their own offices? And if they do, would there be a way to counteract that advantage? To have, in effect, a very enthusiastic cheerleading team at an away game? Baer and Graham Brown of the University of British Columbia set out to explore these questions in their study, “Location in Negotiation: Is There a Home Field Advantage?,” published in the journal *Organizational Behavior and Human Decision Processes*.

Baer and Brown designed three sets of experiments to test whether home-field advantage occurred in business settings. In the first experiment, students were asked to personalize an office with activities like hanging posters, putting their names on the door and checking their email. They were told that they would be negotiating over the price of a pound of coffee, taking the role of either buyer or seller. These “resident” students then negotiated with two other types of students, “neutral” students and “visitor” students. The neutral students were led into the negotiation believing that the resident had simply arrived at the office earlier, while the visitors were told that the resident occupied this office as a daily work space.

Out of the three groups, residents negotiated the “best” prices, followed by neutral students, with visitors losing the most ground. This result demonstrated not only that residents had a distinct home-field advantage, but also that visitors actually experienced a disadvantage upon encountering the residents at “home.”

If residents have an advantage, what’s a businessperson to do when forced to march into an opponent’s stronghold? Baer and Brown suspected that confidence might mitigate some of that away-field disadvantage experienced by the visitors. The second experiment tested this hypothesis by having students fill out a self-confidence evaluation before they entered the negotiation. Negotiation results were then plotted against the students’ levels of confidence. The analysis revealed that students’ success rates could be partially attributed to confidence.

In the third experiment, the researchers took it a step further by manipulating confidence levels. Visitor students were asked to take a fake assessment and then told that the results indicated high negotiation ability. With this boost in confidence, visitors performed just as well as residents did in the negotiations.

These results indicate that location can be a very important aspect in approaching a negotiation. In light of these findings, the researchers write that “luring the other party into one’s lair or, at the very least, not entering theirs,” will increase the chances of having one’s way in a business deal. The researchers also point out a very personal application of their research, writing that when asking for a raise or a bonus, one should leave the office entirely. “Inviting the boss to a coffee,” they write, “and negotiating in a more neutral setting is likely to be more fruitful.”
CONTINGENCY STRATEGIES IN MANAGING SUPPLY SYSTEMS WITH UNCERTAIN LEAD-TIMES

PANOS KOUVELIS
In the wake of the devastating earthquake and tsunami in Japan in March 2011, some U.S. car buyers were contemplating a much less dire situation: How would they get their hands on a Prius?

The popular Toyota hybrid was manufactured almost entirely in an area just outside of the areas worst hit by the disaster, while high gas prices and a recovering economy continued to drive rising U.S. demand for the already best-selling car.

Some of the issues Toyota faced are addressed in “Contingency Strategies in Managing Supply Systems With Uncertain Lead-Times,” by Panos Kouvelis, Emerson Distinguished Professor of Operations & Manufacturing Management and director of Olin’s Boeing Center for Technology, Information and Manufacturing, and Jian Li of the College of Business and Management at Northeastern Illinois University. The paper is published in the journal *Production and Operations Management*.

The authors point out that with greater globalization and outsourcing, supply chains have increasingly long and variable lead times that are especially vulnerable to disruption due to natural disasters, political turmoil or labor disputes. These disruptions often result in delayed deliveries or unmet demand. Kouvelis and Li assert that when used exclusively, the conventional approach to lead-time uncertainty, statistically planned Safety Lead-Time (SL), may fail to address these issues fully, causing unnecessarily high economic costs in the form of lost sales and expediting fees.

Kouvelis and Li present two additional contingency strategies that are useful for avoiding these high costs and restoring supply after disruptions have caused a late delivery. The authors identify these strategies as Disruption Safety Stock (DSS) and Dynamic Emergency Response (DER). The paper demonstrates that both strategies are useful when combined with the current conventional approach, and offer different benefits in response to specific circumstances.

DSS is planned before an emergency and consists of holding inventory equal in size to a “normal” order. This inventory would then be deployed with expedited execution in the event of a late delivery. Kouvelis and Li’s analysis shows that in a situation of high-lead time variability, this strategy is cost-effective and easily implemented in combination with the conventional SL and in fact decreases the length and cost of SL implementation.

In the second strategy, DER, the firm would establish a relationship with nearby suppliers willing to serve as emergency resources. In the event of a late delivery, the firm would obtain resources from these suppliers at the opportunity cost of their capacity resources. Kouvelis and Li demonstrate that DER in combination with SL is also highly effective and similarly decreases reliance on SL, but its performance is subject to fluctuations in prices of the emergency market.

Kouvelis and Li caution that these approaches have trade-offs. DSS guarantees availability and price of emergency stock but incurs high inventory-holding costs. DER, however, relies on last-minute emergency supply, which may not always be available and, if available, may impose high costs. But for firms with long supply chains, these strategies represent powerful tools in securing and maintaining steady supply in an increasingly uncertain world.
Do Bank-Affiliated Analysts Benefit From Lending Relationships?

Xiumin Martin
Within a banking conglomerate, a “Chinese wall,” or “informational firewall,” exists to inhibit the flow of inside information from the private side to the public side of the institution. It’s no secret that occasionally the legally mandated, invisible barrier leaks and undisclosed information finds its way to the public marketplace to the benefit of a select few. In some of the latest scholarship on the hot-button topic, Xiumin Martin, an assistant accounting professor at Olin Business School, and a co-author show how equity analysts benefit from relationships on the private side of their banks.

The research indicates that stock pickers employed at banks, which also loan huge sums of money to publicly traded companies, are able to publish more accurate earnings forecasts. (An equity analyst’s worth is associated with how accurately he or she can predict the future earnings of a publicly traded company.)

“Our findings suggest that despite the purported existence of Chinese Walls, financial analysts still have access to superior information from lending relationships and exploit this access to improve their forecast accuracy,” the authors said in the paper, which was published in the *Journal of Accounting Research*. Titled “Do Bank-Affiliated Analysts Benefit From Lending Relationships?,” the paper was co-written by Ting Chen, a professor at Baruch College, The City University of New York. The two professors analyzed a sample of bank loans and analyst forecasts from 1994 to 2007.

They found that the informational advantage is present only for banks that serve as the lead arrangers of the loans. Lenders merely participating in syndicate loans do not have the same advantage.

Furthermore, when the lending information suggests that companies are in financial trouble, analysts are even better than their competitors at predicting earnings per share, or EPS. The paper does not offer any suggestions on how the knowledge is exchanged.

The concept of the informational firewall dates all the way back to the stock market crash of 1929. Federal regulation requires that banks divide the public side of the bank, which typically handles equity research and trading, from the private side of a financial conglomerate, which deals with undisclosed information. In the present day, this means that stock analysts are barred from attending meetings with executives of the companies they cover if an investment banker or deal maker is also present. In addition, analysts cannot solicit business on behalf of their banks’ mergers and acquisitions teams.

In 2003, some of largest U.S. investment firms agreed to a pay a more than billion-dollar settlement over the conflicts of interest between their securities research and investment banking business. Some of the money has been funneled to firms that publish independent stock research.

However, analysts from large banks still have a great deal of influence over the market, and the issue over the Chinese wall is much-discussed in the finance world. “Although information sharing is beneficial to financial conglomerates, it is not without controversy, particularly when much of the superior information comes from ongoing correspondence between borrowers and banks,” the study found.
Estimating the Willingness to Pay to Avoid Violent Crime: A Dynamic Approach

Kelly Bishop and Alvin Murphy
Common wisdom might say that a sense of safety is priceless. Yet property values are highly dependent on this feeling of security, in addition to other unobservable neighborhood attributes, such as school quality. In their paper, “Estimating the Willingness to Pay to Avoid Violent Crime: A Dynamic Approach,” Olin assistant professors of economics Kelly Bishop and Alvin Murphy update and refine an economic model traditionally used to estimate demand for products with changing attributes. The updated model more precisely describes buyers’ behavior by reflecting a buyer’s consideration of the future.

In this study, Bishop and Murphy refine the standard model, known as the Hedonic Model, by using housing purchase decisions as a subject. In the standard Hedonic Model, buyers were assumed to estimate a house’s value based solely on information apparent at the point of purchase. In addition, the model did not reflect associated costs, such as the costs associated with finding and moving to a new location.

In their dynamic model, the authors incorporate a buyer’s consideration of future benefits when purchasing a product for which attributes change. A home buyer, for example, would evaluate the level of crime going on in a neighborhood and decide whether to continue living there based on whether he thinks crime rates are rising or falling. Based on this consideration of the future, a homeowner can also decide to move and incur moving costs or to stay put.

To compare the two approaches, Bishop and Murphy use housing data to estimate household willingness to pay to avoid violent crime. They apply their dynamic estimator and the traditional Myopic Model to a set of data on housing transactions and crime rates in the Bay Area of California. The results show that the standard model estimates that an average household is willing to pay approximately $10 a year to avoid one additional crime per 100,000 residents, while Bishop and Murphy’s dynamic model estimates approximately $13 for the same benefits. This indicates that the standard model presented a 21 percent downward bias in willingness to pay.

Bishop and Murphy point out the usefulness of the more realistic dynamic model for analyzing costs and benefits with public goods such as a local police force. For a community of 100,000, the Myopic Model would underestimate the residents’ collective willingness to pay to avoid a single violent crime by about $278,870 per year. Such a sum would be enough to expand the local police force, even including nonsalary benefits.

The Hedonic Model has long been used by everyone from Zillow, a popular real estate valuation website, to local and federal government agencies to estimate the prices and demand for such invisible but highly important “products.” By updating the Hedonic Model to describe a forward-looking buyer, Bishop and Murphy give industries as varied as public finance and real estate a more nuanced tool for understanding complex buyer behaviors and, by extension, a way to make such markets more efficient.
The Professors

Markus Baer  
*Assistant Professor of Organizational Behavior*  
PhD, University of Illinois at Urbana-Champaign  
BA, MA, University of Giessen, Germany

Kelly Bishop  
*Assistant Professor of Economics*  
PhD, Duke University  
MA, University College Dublin  
BA, Barnard College, Columbia University

Radhakrishnan Gopalan  
*Assistant Professor of Finance*  
PhD, University of Michigan  
MBA, Indian Institute of Management, Lucknow  
BE, Annamalai University, Tamil Nadu, India

Panos Kouvelis  
*Senior Associate Dean and Director of Executive Programs; Director of The Boeing Center for Technology, Information & Manufacturing; and Emerson Distinguished Professor of Operations & Manufacturing Management*  
PhD, Stanford University  
MSISE, MBA, University of Southern California  
Diploma, National Technical University of Athens

Xiumin Martin  
*Assistant Professor of Accounting*  
PhD, University of Missouri-Columbia  
MS, Hong Kong Baptist University  
BE, Nanjing University, China

Todd Milbourn  
*Hubert C. & Dorothy R. Moog Professor of Finance*  
PhD, Indiana University Bloomington  
BA, Augustana College

Alvin Murphy  
*Assistant Professor of Economics*  
PhD, Duke University  
MA, University College Dublin  
BA, Trinity College Dublin

Anjan Thakor  
*John E. Simon Professor of Finance and Director of Doctoral Programs*  
PhD, Northwestern University
The Papers

“The Optimal Duration of Executive Compensation: Theory and Evidence”*
Radhakrishnan Gopalan, Todd Milbourn, Fenghua Song, Anjan Thakor
Video: http://www.olin.wustl.edu/News/Pages/NewsItem.aspx?SID=415

“Location in Negotiation: Is There a Home Field Advantage?”
Graham Brown, Markus Baer
Organizational Behavior and Human Decision Processes

“Contingency Strategies in Managing Supply Systems With Uncertain
Lead-Times”
Panos Kouvelis, Jian Yi
Forthcoming in Production and Operations Management

“Do Bank-Affiliated Analysts Benefit From Lending Relationships?”
Ting Chen, Xiumin Martin

“Estimating the Willingness to Pay to Avoid Violent Crime: A Dynamic Approach”
Kelly Bishop, Alvin Murphy

*Note: This is a working paper.

Editors’ Note

Olin Praxis was designed to recognize Olin’s commitment to applied scholarship by highlighting practice-minded research that goes beyond the halls of Simon Hall. In an ever more connected business universe, Olin Praxis is meant to be a bridge between Olin faculty, who push the frontiers of business knowledge, and Olin alumni, who put theory into practice every day. Three members of the MBA class of 2012, Melody Chang, Susan Daker and Ali Reza Malik, designed and produced this inaugural edition. Their hope for Olin Praxis is that it will animate the Olin community and inspire discussion at the intersection of forward-thinking research and innovative business practice.

Melody Chang
Susan Daker
Ali Reza Malik

For more information, please contact:
Melody Walker
Director of Communications
melody_walker@wustl.edu