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Bank Dividend Policy as a Signal of Bank Quality (pp. 1-8)

Robert Boldin, Keith Leggett

This article examines whether the dividend policy of bank holding companies is used as a signal of their quality. The study found evidence to support the dividend signaling argument—that is that there is a positive relationship between bank dividends per share and bank quality rating. Additionally, an inverse relationship between the dividend payout ratio and bank quality was found. Therefore, both aspects of a bank holding company's dividend policy yields information about the quality of a financial institution.

Tax Savings Opportunities in Estate Freeze Transactions: An Application of the Black Scholes Model (pp. 9-22)

James R. Hamill, Joel S. Sternberg

Transfer tax valuation rules for interests in family business include a minimum value to reflect the option value of "junior" equity interests transferred to family members. We examine the option features of the junior interest and use the Black-Scholes model to identify situations in which an estate planner could structure a plan of ownership succession that results in undervaluation of the transferred interest. The Black-Scholes model may also be used to identify situation in which a lifetime ownership transfer should be avoided because of the minimum value rule.

Quantifying Time Value Errors (pp. 23-30)

George A. Mangiero, Susan M. Mangiero

Time valuation of cash flows is an essential part of personal financial planning and management. Many financial arrangements are priced according to a cash-flow valuation model. Expected cash flows associated with a stock or bond are discounted at an appropriate risk-adjusted rate in order to determine the fair value of the financial asset. Home mortgage loans are priced according to the discounted value of the future principal and interest cash flows. Yet, despite the importance of the discounted cash flow methodology in pricing assets, computational errors are often made when discount factors are not calculated precisely. This article attempts to quantify the magnitude of the error when the mathematical function for present value is ignored and interpolation is used instead to determine the discount factor.

A Simplified Approach to Measuring Bond Duration (pp. 31-40)

Jean L. Heck, Terry L. Zivney, Naval K. Modani

Because interest rates vary over time, the realized return on a fixed-income investment will depend on the price at which the instrument is ultimately liquidated and the rate at which interim cash flows are reinvested. This variation in realized return, known as interest-rate risk, should be addressed by both individual and institutional investors. Tools for measuring the impact and adjusting for the effects of interest rate changes on fixed-income instrument performance have long been available with duration and its companion adjustment factor, convexity. In this article, a simplified alternative to the traditional complex duration calculation is developed and demonstrated. Thus anyone who can calculate a bond price can quickly estimate the interest rate risk associated with a bond as well as calculate the expected bond price change for a given change in market-yield-to-maturity.

Analysis of U.S. Savings Bonds (pp. 41-56)

Tom L. Potts, William Reichenstein

U.S. savings bonds are complex contracts. Financial planners have traditionally paid little attention to savings bonds, in part because they often offer below-market interest rates. However, they sometimes offer above-market interest rates, especially when one learns how to view and value their option features. All savings bonds contain put options that protect the investor against a rise in interest rates. Thus, they can be viewed as short-term, intermediate-term, or long-term bonds. The EE bonds also offer several tax options. We show how savings bonds can be used to beat the kiddie tax, to finance postsecondary education, and in retirement planning.

A Practitioner's Perspective: Comments on "Analysis of U.S. Savings Bonds" (pp. 57-60)

Barbara S. Poole

In this issue, Potts and Reichenstein describe features of U.S. savings bonds and discuss their evaluation. The article can serve as a reference for busy practitioners who may not follow changes in the savings bond market closely, especially those who tend to rely on product related education for updates on financial instruments. Savings bonds remain an important investment for individuals; on March 31, 1994, individuals held \$174.9 million in U.S. savings bonds, a 7% increase from one year prior (Williams, 1994). Further, as Table 1, "Demographic Characteristics of Individual Savings Bond Holders," indicates, the holding of savings bonds is not exclusive to any particular age group or income level (Federal Reserve Bulletin, 1994).

Fund Closings as a Signal to Investors: Investment Performance of Open-End Mutual Fund That Close to New Shareholders (pp. 71-80)

Timothy R. Smaby, John L. Fizel

This article examines the growing phenomenon of mutual fund closings by analyzing the investment performance of open-end funds that close to new investors. We find that: (1) the average excess return (estimated by Jensen's alpha) was positive in the 24 months prior to closing, (2) the average excess return was not significantly different from zero in the 24 months after closing, and (3) the funds in the sample on average exhibited a significant decline in investment performance after closing. These findings suggest that the fund managers' strategic decision to close the fund in order to slow down the growth in net assets does not prevent investment performance from declining. For the individual investor, an impending fund closing is a signal not to invest in the fund. It is also a signal that current shareholders consider alternative investments.

Commission-Motivated Trading Patterns Of Brokers Across the Production Month (pp. 81-95)

Earl D. Benson, David S. Rystrom, Greg T. Smersh

The intramonth pattern of broker commission earnings is examined for a sample of one hundred brokers from a national brokerage firm. It is hypothesized that the structure of broker commissions leads to distortions in trading. The evidence shows that in the last five days of the production month, more than one-fourth of the brokers earned a significantly higher proportion of their monthly commissions than would be expected if trading were uniform across the month. This suggests that the structure of the commission system may lead some brokers to encourage individual investors to unnecessarily trade securities near the end of the production month to boost their commission income.

Optimal Holding Period for Assets That Must Be Liquidated: A Certainty Equivalent Wealth Approach (pp. 97-108)

John R. Knight, Lewis Mandell

Consumers often invest with a specific goal in mind and often know with some precision when the investment proceeds will be needed to achieve that goal. Because different investors have different attitudes toward risk and because different asset types exhibit different risk characteristics, there is often confusion as to the appropriate investment asset for a particular investor with a known investment horizon. It is also frequently unclear as to whether investments should be switched to a less risky asset as time to liquidation becomes short. This paper addresses the issues of initial asset choice and the advisability of switching among assets when the investment goal date is known, employing the methodology of certainty equivalent wealth. In addition to suggesting optimal

investment strategies for individuals based upon holding period and degree of risk aversion, it shows that switching investment assets produces suboptimal results.

The Market Pricing of Disability Income Insurance for Individuals (pp. 109-122)

Larry A. Cox, Sandra G. Gustavson

Individuals' needs for disability income insurance dominate those for life insurance, yet relatively few buyers and sellers enter into disability contracts compared to life contracts. This phenomenon appears contradictory to the existence of a workably competitive market. This study examines the relation of disability income insurance prices to underlying contractual and insurer characteristics. Our results are supportive of a competitive market scenario. We observe a strong relation between prices and elimination periods, which is consistent with the presence of adverse selection. Our results have implications for how individuals should choose some policy and insurer characteristics, but they also suggest that buyer may need to be better informed about other pricing factors.

Credit Cards and the Option to Default (pp. 123-136)

A. Charlene Sullivan, Debra Drecnik Worden

The value of the option to default on unsecured credit contracts is estimated and found to be significantly impacted by state and federal laws governing creditors' collection practices and bankruptcy. The data suggest that the expected value of the option to default influences debtors' choices in default and is correlated with their use of their credit cards before default. Cardholders who use their lines of credit very intensely before default are significantly more likely to make choices in default which allow them to realize a greater benefit from default. Furthermore, these results offer a possible explanation for consumers' seeming insensitivity to interest rates charged on revolving lines of credit.

Household Insolvency: A Review of Household Debt Repayment, Delinquency, and Bankruptcy (pp. 137-156)

Sharon A. DeVaney, Ruth H. Lytton

This review paper explores the issues related to the meaning and measurement of insolvency within the domain of household finances. Conceptual and empirical evidence to explain the onset of insolvency is reviewed. Predictive models and financial ratios are presented as techniques for identifying insolvent households. Implications for monitoring of solvency by households and responses to insolvency are presented.