Running the numbers: Inside the classroom and research of a finance PhD

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Patrick Lageraaen:

Welcome to another episode of the UB School of Management's Manage-A-Bull Podcast. My name is Patrick Lageraaen. I'm a second year MBA student, teaching assistant for a few classes at the School of Management, and I'm your host for this episode. This is the second episode in a series where we talk to MBA professors about themselves and about their courses. Today in the studio I have Professor Veljko Fotak who teaches the first year MBA class, Financial Analysis for Managers. Veljko, thanks so much for being here.

Veljko Fotak:

Thank you very much for having me. It's a pleasure to get here to talk to you about my class.

Patrick Lageraaen:

And then also in the studio we have another one of our hosts, Eric Raine. He's a PharmD/MBA student with a background in financial asset management.

Eric Raine:

Yeah, happy to be here. I think this is a great conversation to have and coming into my MBA part of my degree path, having a professional background in finance and investment advisory, I was really excited about taking a course in finance. And to be honest, even having a background in finance it kind of, I think, helped in a certain way, but I think there was a lot that I took away from it that was new to me that I really enjoyed about the course. So I'm happy to be here and kind of talk about it and share some of our experiences as students, but also kind of hear more from Veljko.

Patrick Lageraaen:

Great.

Eric Raine:

Thanks for being here.

Patrick Lageraaen:

Let's come back to Veljko. Could you tell us where you're originally from and then a little bit more about yourself?

Veljko Fotak:

Of course. I hope you don't mind if I just interject for a moment though, because I think you raised a really interesting point, right? I'm really glad to hear that you found the class engaging and interesting or, well, maybe I'm putting words in your mouth.

Eric Raine:

No. Yeah, absolutely.

Veljko Fotak:

Because that heterogeneity student backgrounds is the biggest challenge for us teaching this course. And at the risk of oversharing, I think that we get some students who have a very strong background in finance that have some professional experience and maybe an educational background from business schools. We get students at times with very different backgrounds, and for us as instructors, the challenge becomes making sure you don't overwhelm the students with the perhaps less relevant background while still keeping those like you who are-

Eric Raine:

Engaged.

Veljko Fotak:

... coming with a slightly stronger ... Exactly, engaged and interested. My philosophy, you guys know it, you guys have seen it in action, but for the prospective students, perhaps listening, my philosophy has always been try to rely a lot on optional material. Keeping a core set of material in the class, which is mandatory. Everybody has to tackle and try to offer the opportunity to dig deeper to those of you who want to do so. Of course, last year was the first time actually for me teaching the course in this format, so we are still calibrating and expanding a little bit that optional material. The students taking the class this year, I'm slightly reducing the core material, slightly expanding the optional set. Of course, I'm also calibrating.

Eric Raine:

Yeah, and I honestly think it was an elegant balance between the two, because that's a very challenging thing to do. I could imagine as a professor trying to make sure you're catering to your audience, but at the same time not losing people along the way. Patrick, not necessarily having a finance specific background, we kind of bring both perspectives to the table here. Like me coming from finance and Patrick having a different professional background before school, and yet both of us sit here and respond positively to the way that the course was run, even in its first iteration.

Veljko Fotak:

I appreciate it. And nobody slashed my tires last year, so-

Eric Raine:

It worked out.

Veljko Fotak:

I guess it worked out.

Patrick Lageraaen:

Yeah. Let's get back to you.

Veljko Fotak:

I'm sorry. Yeah, you did have a question already about my background, right?

Patrick Lageraaen:

Yes.

Veljko Fotak:

So a big elephant in the room, I was born in Croatia, but I grew up in Italy. That's probably where the atypical accent comes from. I've been told the vowels are Slavic and the ups and down are Italian. I tried to get rid of it without too much success. I did all my primary education in Italy, mostly in the northeastern corner of Italy. We lived in the Venice and Venetian area for the most part. Through high school I spent my summers in England. My very first job was at the McDonald's in the British Museum. I managed to get fired from that. I think I told that story before in class, it took some effort. But yeah, I tried learning this language of yours there with limited success, I suppose. After that, moved to the United States, got my undergraduate education at the Rochester Institute of Technology next door. Really liked it there, stayed for my MBA and also for a Master of Science in Applied Statistics at the school.

It was an interesting experience when I was still a graduate student, I got hired by their technology licensing office. My job was to provide valuation assessments for the new technologies that faculty and students would produce within the school. And I think when I teach valuation, when we start talking about discounted cash flows in our MBA course, I always hark back at that experience. That was my first doing this in the real world and working for a university in those kind of technology licensing/commercialization roles is interesting because schools are underfunded and you often get jobs which are way above your pay grade. I was an 18-year-old kid making 12 bucks an hour negotiating with these venture capitalists, flying in the private jets and pretending we're negotiating as equal and we clearly aren't, right?

Eric Raine:

Right.

Patrick Lageraaen:

Right.

Veljko Fotak:

But it's a sink or swim kind of experience, and I think I grew a lot. That ended for me in 2001. After September 11, the difficulties with immigration system led me to leave the country. I got a job at a hedge fund in Switzerland, did a little bit of currency trading there, mostly on the risk management side. These funds were raising capital in Europe, mostly in Euros, Swiss Franc. They were investing in dollars. They had a currency mismatch between assets and liabilities, and we were trying to eliminate the risk exposure for them. And so that led to most of what I teach nowadays in my other course, International Financial Management. After that got my PhD and that landed me to be an academic and focus on research and eventually here at Buffalo.

Patrick Lageraaen:

Didn't you do something with NetJets?

Veljko Fotak:

Yeah, I had a job at NetJets very briefly, but that's exactly when the 2001 issue came to bite me. So after I finished my Master of Science in Applied Statistics, I was hired by this small company in Ohio, NetJets, which was doing timeshares for airplanes.

Eric Raine:

This was in 2001?

Veljko Fotak:

Well, yeah, it was ... I think my job offer came late 2000, and then as an international student, you have a certain period during which you can work, right, optional practical training. I was using that-

Eric Raine:

OPT.

Veljko Fotak:

Yeah, OPT. And by September 2001, my OPT was expiring and I needed to apply for a visa. And that's unfortunately when the immigration system followed the-

Patrick Lageraaen:

What timing.

Veljko Fotak:

... tragic terrorist attacks froze and those of us who were here on visas were forced to leave. But yeah, the company was an extremely vibrant place. The idea there was companies could sign up for a timeshare jet, you were paying an annual membership, and we are talking about six figures for an annual membership. And once you had an annual membership, the company would guarantee that within 24 hours, if you wanted a private jet available, they would provide it to you with a crew anywhere in the world, with anywhere in the world having a couple of big asteriks.

Eric Raine:

Within reason, yeah.

Patrick Lageraaen:

Yeah.

Veljko Fotak:

Not North Korea, not Iran.

Eric Raine:

Right.

Patrick Lageraaen:

Right, sure.

Veljko Fotak:

But the job that I was supposed to be doing there, or that I did start doing there for a very brief period of time had to do with the logistics of making sure that crews and planes were always within that 24 hour window of our clients. So our clients, if they really wanted the guarantee of service, they were supposed to wear tracking devices. We had a fantastic operating room. We could see in real time where our clients are around the world to make sure-

Eric Raine:

That's incredible, yeah.

Veljko Fotak:

Of course, for privacy reasons some were choosing not to, right?

Patrick Lageraaen:

Yeah.

Eric Raine:

Which makes it hard to deliver on that service model, right? Yeah.

Veljko Fotak:

Of course, right. But then you kind of have an excuse for failing to deliver. And of course, within the United States, it was not an issue. It's when your clients end up in slightly more exotic places. But as a statistician, that was a dream job. And my official title for whatever reason was the idea guy alleged, which I think was the coolest job title ever. They literally told me to pick job title for this position because it was a new position. But, yeah, unfortunately with September 11, I was forced to leave the job. At first, they told me, "Don't worry, we'll wait for you." After three months it was, "Don't worry, but it would be great if things could be sped up." After six months it was, "We can't wait for you anymore." But the funny thing is, right after I left, the company was actually bought by Warren Buffet. And I don't know if you read The Economist, almost every issue of The Economist has an NetJets ad with Warren Buffet and Bill Gates sitting right in one of their planes.

Patrick Lageraaen:

I think a lot of people have seen that ad.

Veljko Fotak:

Yeah, yeah. It has really made rounds. But the funny thing is that after Warren Buffet bought the company, it was a young startup, most employees had options and it was bought at a great premium. And I remember visiting a couple of years afterwards, and the parking lot was just absolutely jam packed with Lamborghinis, every secretary in the place was driving a Lamborghini. And so I missed my boat in that case, but it's led me to Switzerland and to a new career in finance, more focused on finance I would say. I saw myself more as a statistician before then than as a finance professional. I think the change was beneficial in the long run. So there's always a silver lining in the ways life turns, but of course-

Patrick Lageraaen:

I just want to mention one more thing about NetJets, and correct me if I'm wrong. Didn't it come about at a time of increasing corporate governance concerns and then companies were shifting private jets off of their balance sheets into a subscription model?

Veljko Fotak:

Oh, you're absolutely right. I do tell that story occasionally in class. It's a cynical model, it's a very cynical play. Somewhere in the late nineties, we started having some research, academic research in finance really highlighting how certain expenses by management correlated with agency costs. The idea that agency costs are costs derived from the fact that managers are not always working in the best interest of shareholders. The idea that managers might under exert effort or simply overexpand because it's not their money that they're spending. So in the late nineties, this research led to renewed interest in corporate perks and-

Patrick Lageraaen:

Private jets.

Veljko Fotak:

Like private jets. There was, in particular, one piece of research that was finding that companies that had one or more private jets for the use of their managers were actually underperforming the rest of the market. So all of a sudden everybody's trying to figure out-

Eric Raine:

Find the relationship between the two.

Patrick Lageraaen:

Yeah, exactly.

Veljko Fotak:

To the point that Bloomberg started having data on jet ownership and nowadays Bloomberg even as a jet tracker. It kind of expanded from the initial. Let's be honest, what the research was highlighting was over consumption. It's not the jet that makes you poor, right? It is that-

Eric Raine:

The practice of what goes on around the mindset that leads to its usage, right?

Patrick Lageraaen:

Sure.

Veljko Fotak:

Exactly. It's indicative of a mindset of perk consumption by managers. So the interesting thing is that companies scrambled to sell their jets to get them off the books, and somebody at NetJets had a brilliant idea maybe we can take advantage of that. And to be entirely honest, I remember our internal documents at the time were actually revealing that it was more expensive to rent a jet through this time ownership model than to actually own one. But COs-

Patrick Lageraaen:

It looks better to governance concerned shareholders.

Veljko Fotak:

Oh, absolutely. It was totally an image management. These COs were going in front of the shareholders, "We hear you. We heard your concerns. Don't worry, we sold our jets." Nevermind that-

Eric Raine:

But we're still flying private

Veljko Fotak:

And spending 10 times as much.

Eric Raine:

Right. Yeah, exactly.

Patrick Lageraaen:

Yeah.

Veljko Fotak:

NetJets, as an example of corporate greed, was unfortunately emblematic in many ways, but it was a fun environment to work at for a very short period of time, unfortunately.

Eric Raine:

Especially at such an inflection point, too. Yeah.

Veljko Fotak:

Oh, yes. Oh, yes. And the job came with fantastic perks, actually. Once a year for a weekend, you actually got to use a jet for private-

Eric Raine:

Oh, wow.

Patrick Lageraaen:

Very cool.

Veljko Fotak:

... purposes. It made for some really impressive first dates. But yeah, once a year.

Patrick Lageraaen:

Yeah. All right, so let's get back to you. So you have a PhD?

Veljko Fotak:

Yes.

Patrick Lageraaen:

Are you just teaching here at the University or do you have other?

Veljko Fotak:

No, actually my main role at the University's research oriented, or at least our contracts loosely specify the balance between teaching and research. But roughly speaking, I think that the expectation for people in my role is 80% research, 20% teaching. So in some sense, I think it's unfortunate that I don't think our students understand necessarily our job because your guys are seeing one side, right?

Eric Raine:

Right, we see you in the teaching mode. Right.

Veljko Fotak:

Exactly.

Eric Raine:

Whereas to your point, if it's 80/20, there's a lot that you're doing behind the scenes in the research capacity that we don't necessarily see unless you bring it to the classroom, which is also a benefit to students.

Veljko Fotak:

And you raise a good point. We try to bring it to the classroom. There is pollination there, but at the end of the day, yes, sometimes the feeling is that you're seeing the tip of the iceberg. But yeah, research is my supposedly main activity. I concentrate my teaching in the fall semester, so I'm usually teaching from September through mid-December. The rest of the year is dedicated purely to research, I should say. My research in that sense, I really double in geopolitics. Nowadays, it's corporate finance, it's empirical corporate finance. Ultimately, my question is always how do geopolitical events affect firms? There's always that ultimately we want to know about firms. But my interest, yes again, it's in geopolitics.

Patrick Lageraaen:

Right. And then for the research, it's not just go research, you have to publish a certain amount of papers, right?

Veljko Fotak:

Oh, yeah. Our system of promotions and rewards depends heavily on your research production level.

Eric Raine:

So publications?

Veljko Fotak:

Yes, you're absolutely right. There are three metrics, if you will, by which you judge the productivity of a research faculty member, the number and quality of publications, the citations that these publications get-

Eric Raine:

The effect after the fact.

Veljko Fotak:

Indeed. You might publish a piece of research in a journal with a high level of reputation, but then if after 10 years, two people have cited your work, it probably hasn't had a huge amount of impact. So citations is the number of times other research refers to your work. So there's this expectation that over time people will build upon your research. That's the ultimate signal of quality. And then the third one specifically for us in finance, more so than in other disciplines, we also consider confidence, acceptance as a signal of quality of research in the sense some of our confidence is a very low acceptance rate, talking two, three, four percent. And so when you see somebody whose research work is being presented at some of these top conferences, that's also being read as a signal of quality,.

Eric Raine:

There's a level of interest in it, that it's being used by other people actively, yeah?

Veljko Fotak:

Correct.

Patrick Lageraaen:

Sure. Conferences?

Veljko Fotak:

I'm sorry, conferences.

Eric Raine:

Like presentations at a conference.

Patrick Lageraaen:

Oh, okay.

Eric Raine:

Right.

Patrick Lageraaen:

Understood.

Eric Raine:

Which there's obviously different types of research conferences depending on the area of focus you're in. And then same with the different publications, is some of those conferences are going to actually be looked at as they're nationally looked at or internationally. And then in that case, if you're churning up more at these types of conferences, then that means that obviously that's a rate that you can be measured by.

Veljko Fotak:

Oh, yeah, absolutely. And that's where we academics get to interface with the real world, because at the end of the day, you want your research to lead to outcomes. You want regulators to act in your research, you want professionals to adopt techniques that you're championing. And the way you do it is, yes, by presenting your work, by bringing it out in the public. And now my work has often a regulatory side to it, if you will, because so much of what I study crosses borders, and we know that that often leads to interference by politicians and regulators, but I enjoy it. I enjoy that type of work a lot.

My most recent research really deals with the intersection of geopolitics and politics and finance. We are now traveling presenting one paper that looks at trade tariff exemptions granted by the Trump administration in 2019 and 2020 ... I'm sorry, 2018 and 2019. The Trump administration started a trade war with China, and during that trade war imposed tariffs on American companies importing goods from China. Now, if you're an importer, you can actually ask for an exemption from these tariffs and exemptions are usually granted if there are reasons connected to national security. So the idea is if you're doing things that are important for our national security, we don't want to penalize you.

Patrick Lageraaen:

So like Lockheed Martin and Groman importing parts?

Veljko Fotak:

That's what you would expect, right? When we started looking for this data, that's exactly what we were expecting to find, military companies or maybe high tech or things like that.

Eric Raine:

Was it showing up in things as normal as automobiles or something that's like a high volume?

Veljko Fotak:

We had Meco Tennessee, which is actually a manufacturer of grills for barbecues, right?

Patrick Lageraaen:

That's one [inaudible 00:21:10]

Veljko Fotak:

Right. We were wondering-

Eric Raine:

Like, "What is this," yeah.

Veljko Fotak:

Yeah, you could think of grills or barbecues, I guess you could throw them and hurt somebody or drop them off from planes. But yeah, it's really hard to see the national security element there. And then we started digging into what these company is, and we found whoa, they're really spending a lot of money on campaign contributions, they're really spending a lot of money on lobbying. And then you see this pattern across companies and then you start wondering, are these allocations that look weird that you can't really explain with the stated criteria of the program, is there something more going on here? And as I said, we started noticing some of these firms that were getting exemptions had really abnormally high levels of political expenditures. So that led us-

Eric Raine:

But they were also ones that were getting treated lightly on the tariff side, potentially.

Veljko Fotak:

Oh, yes. Yes. We had a list of companies that actually received exemptions from these tariffs and you're seeing the national security element, or at least it's not obvious. Not only that, but we had some companies that looked like they were doing very similar things. We had a canoe manufacturer from West Virginia getting an exemption from tariff exemption and another canoe manufacturer from California, direct competitor-

Eric Raine:

Not getting the same treatment?

Veljko Fotak:

... not getting an exemption and it's-

Eric Raine:

Follow the money though, right? It will lead you to an answer of some kind.

Veljko Fotak:

At the end of the day, you put your cynical hat on and you start wondering, perhaps these campaign contributions that we are seeing are distorting things. And of course, the administration in power was a Republican administration, so we started looking to campaign contributions specifically going towards that side of the aisle, have anything to do with the likelihood-

Eric Raine:

Which I would think during that time too, one of the things that would be unique about the alignment of the potential for that to happen might not necessarily be due to one party versus another, it's just they also had all three chambers. They had control of the executive branch and they had both Congress and Senate and the ability to affect those potential leniencies or exemptions and such. Also, while being the party in power, getting potential campaign contributions, you can see where that alignment starts to become potentially an issue, right?.

Veljko Fotak:

Oh, no. You raise a really interesting point because prior to this regime that we study, the regime of tariff exemption was administered by Congress and under the Trump administration, Congress actually surrendered the authority over trade exemptions. Previously firms were literally applying, and their applications were going into bills they were consolidating, and then these bills would be voted in Congress and there was a process of bipartisan bargaining that was-

Eric Raine:

Some level of agreement, yeah.

Veljko Fotak:

Some level of agreement, and also some level of transparency in the overall process. What we saw with the Section 301 or China Tariffs as they're more widely known, is that for the first time, we created an office of the US Trade Representative that was overseen purely by the White House and-

Eric Raine:

So Congress has less of an oversight in the process, and therefore ... yeah.

Veljko Fotak:

Oh, absolutely. Congress basically washed their hands of it and it became an executive position or a position appointed by the executive without any transparency really. And all of a sudden leading to some outcomes that we were struggling to explain, or at least that the press was struggling to explain at that time. So long story short, collected data on campaign contributions and we finally found out that the amount of money that firms were spending in cultivating links to the Republican Party seemed to explain a lot of the patterns we were seeing. Firms that were contributing more to Republican and politicians were actually getting exemptions. Firms that were contributing to Democrat politicians were actually getting punished.

Patrick Lageraaen:

Interesting.

Veljko Fotak:

They were actually even less likely to get exemptions than firms that were not contributing to anybody, which was actually one of the normative things in our paper. The fact that political connections lead to positive outcomes for firms, it has been documented before.

Eric Raine:

Yeah, that's not the first time, right?

Veljko Fotak:

Yeah. Yes, we documented within a specific program that was not previously started.

Eric Raine:

But not in this unique way. Right? Yeah.

Veljko Fotak:

Correct. But what is really unique in our research is I believe we are the first ones to really document this retaliation against-

Eric Raine:

Where it's weaponized potentially, right?

Patrick Lageraaen:

Yeah.

Veljko Fotak:

Yeah. And at the cost of getting too philosophical, there is a big puzzle in the finance/politics literature about why firms spend actually so little in campaign contributions. Every time we try to quantify the returns to political expenditures, they're huge. Papers disagree, there is a paper by [inaudible 00:26:49]

Eric Raine:

For every dollar you put in. Yeah, sure.

Veljko Fotak:

How many benefits. And benefits come in various forms, you get federal contracts, perhaps your investigated less, perhaps you get exemptions from-

Eric Raine:

Or leniency.

Veljko Fotak:

Yeah, or-

Eric Raine:

Maybe you're ...

Veljko Fotak:

You get exemptions-

Eric Raine:

Or leniency [inaudible 00:27:02]. Or your opponent will get the hammer brought down more on them than you type of thing.

Veljko Fotak:

Or regulatory changes favoring one firm versus another. But the point is that once you start actually trying to quantify this effect, researchers disagree on the exact magnitude, but all estimates are astronomical. [inaudible 00:27:27] Purdue has one paper that shows that for every dollar that firms spend on campaign contributions, they get $10,000 of benefits back from the federal government. And if you're putting your economist hat on, marginal revenue here does not equal marginal cost. Campaign contributions like anything else is probably diminishing returns phenomena. So you would expect that firms would spend more and more and more until-

Eric Raine:

Until they hit the point where it evens out or it's less. Yeah.

Veljko Fotak:

Correct. Correct. So when you're having such a difference between cost and returns, it doesn't make sense from a national perspective. And I think that the piece of the puzzle that is missing from this narrative is the fact that if you back the wrong team, you can actually be punished for it. And I think that that risk element is actually undocumented in the literature donating to Democrats. If the Democrats don't get elected now, you might get retaliated against. I think that suppresses the overall level of political spending by firms. And kind of explains-

Eric Raine:

Has that been something that's been followed since that time and seeing like, "Okay, as Congress lets off some of that responsibility to it being concentrated more towards a smaller group of individuals," that over time does it swing the other way? And basically it's like if you're a firm and you're underneath an administration that is on one side of the aisle, if you're instead of keeping it one-sided, if you just donate into different directions just depending on where the power falls, does that just up your outcomes as far as the return on that dollar?

Or has it just not been sort of a long enough timeline to see where the fluctuation in political power is and where the money goes? Because obviously that would be more of a snapshot and time and also being in unique circumstances given the fact that there was a change in who's overseeing it. But I guess that's the nature of research, right? It's a moving target?

Veljko Fotak:

No, no, no you're asking some super interesting questions, but you're packing a lot in this question. So let me break down for a moment. First, the full disclaimer. We studied the Trump Administration because that is the data we have. In some sense, this paper is revealing that the behavior was not above board. So we are documenting something that at the end of the day, is legalized corruption. And I think it's natural to ask the question, is a feature of one particular regime or one particular administration, or does this generalized future administrations, does this generalize to the-

Eric Raine:

It's the opportunity there to just take advantage, sure.

Veljko Fotak:

So I love the way you've put it. Because first of all, it's the opportunity. Because what we say in defense of our work is, yes, our results are specific to one administration at a time. We do not know whether other administration put the same conditions, would abuse the system in the same manner. But what we do know is the system can be abused, that the system does fault that the institutions are not robust to this type of political distortions.

Now, for full disclosure, we are trying to obtain the same type of data from the Biden Administration and to replicate this kind of analysis and to reveal whether these kinds of distortions flip signs now that the Biden Administration is in control of the exemption process, or democratic firms-

Eric Raine:

Like what happens next. Yeah.

Veljko Fotak:

... being favored. And we try to stay as agnostic in politics as possible and to stay as objective. But I think a lot of us had the perception that the Trump Administration was in some ways a little bit more prone, let's say, to misbehavior of these sorts than the average US administration. And in that sense, the disappointing finding so far is that while the Trump administration released data that shows distortions in this process, the Biden administration has not even released data.

Eric Raine:

So it makes you wonder what's in there, like what's in the data.

Veljko Fotak:

It was curious because actually during the campaign process as President Biden, then candidate Biden, was extremely vocal about both, vocal and critical, I should say, both about the tariffs themselves and about exemption process. As a matter of fact, one of his campaign contributions was to abolish tariffs or at least to substantially decrease the amount of tariffs and to create a more transparent exemption process. None of that has happened.

So we are actually now filing, actively have been filing and are still filing Freedom of Information ACT requests, hoping that that will force the administration to release the data. We've multiple times received positive answers alleging that at some future date we would get the data. And then the date comes, the data doesn't arrive.

Eric Raine:

You don't have it.

Veljko Fotak:

Yeah. We've been playing this game now for about a year. The latest kick of the can is to the 31st of month. We are 10 days away. I suspect on-

Eric Raine:

You won't hold your breath.

Veljko Fotak:

I'm not holding my breath on the first. We already have the next Freedom of Information Act request ready for filing on November 1st. But yeah, it was an exciting project.

Eric Raine:

It sounds very interesting and obviously there's a lot of impact that that can have in many different ways to your everyday consumer like us sitting here wondering how does this affect us at the end of the day.

Veljko Fotak:

Absolutely. These trade tariffs, at the end of the day, it's very clear how they affect us. Despite all the promises that we had from both administrations saying this is not going to hurt our wallets, it did hurt our wallets, right? Now, again, economists disagree on the exact amount, but I think that most estimates show that the average American family has ended up spending between $500 and $1,000 more on a yearly basis out of pocket-

Eric Raine:

Based on that.

Veljko Fotak:

Because of the tariffs.

Eric Raine:

It's very interesting.

Veljko Fotak:

Yes. At the end of the day, the mechanism is pretty clear. The idea behind tariffs has raised the cost of products to discourage people from buying products coming from abroad and increase consumption at home. If you're not increasing prices, you're not doing your job. So for any administration to be telling us, "This is not going to increase prices to consumers is disingenuous." If it's not increasing prices, then it's not working.

Eric Raine:

It has to increase prices.

Veljko Fotak:

Right. Absolutely. Absolutely.

Patrick Lageraaen:

Do I remember some of your research having to do with consumer websites that are subscription-based?

Veljko Fotak:

Oh, I'm sorry. The way you worded it has-

Patrick Lageraaen:

I tried to be ambiguous.

Veljko Fotak:

No, yeah, yeah, yeah. Of course. A lot of my research has to do with firms that have a hard time accessing capital. And the reality is that I always go back to the role of government in financial markets and how governments affect and distort financial markets. And one of the things that I've been always fascinated by is how politicians are trying to use the banking and financial system to shape our morality.

We live in a democratic country, and even if our democracy is sometimes flawed, but the idea is that certain moral decisions, what is acceptable, what is permissible, should be decided by a majority through a voting process. But you look at specific areas, largely we know that the US population has decided to allow some degree of pornography in the country. Adults in the country are legally allowed to access pornography.

And yet we see year after year after year, politicians trying to find ways to prevent producers of pornography from accessing capital. So in other words, the feeling that you get is that politicians don't have the vote to the democratic process to restrict the practice that perhaps a minority of them find unspeakable. And because of that, they try to get a run around the legislative process through the regulatory aspect in banking and finance.

So one of the sectors that's greatly affected by that, and I suspect that's what you meant with subscription-based, is of course pornography. And it's the OnlyFans producers. Now, some of those have graduated from domestic and amateurish level of production to the point where they're looking to acquire better cameras, better microphones, perhaps hire a crew to work with them.

Eric Raine:

It's like a production.

Veljko Fotak:

Oh, yeah, absolutely. Every business starts small and then expands. And they're finding an extremely hard path to access capital. We are seeing a very similar narrative in the cannabis industry.

Patrick Lageraaen:

We can't get loans.

Veljko Fotak:

Absolutely. In the cannabis industry, in particularly, is stuck between states that are decriminalizing and legalizing. And a federal government that oversees the banking system that does not recognize the legality of marijuana, any instance. So banks are afraid of losing licenses if they operate with businesses they're doing something that the federal government considers illegal. Many of these cannabis shops are having hard time accessing banking systems, and often they have to rely on... Well, nowadays, most cannabis shops are really incorporated, there's two entities. There's one entity selling actual marijuana flower product. Things are regulated. There's another entity. They're selling T-shirts, hats, [inaudible 00:38:32].

That's the one that gets the loan. And then there's a little bit of gray area counting in the books of the two businesses to do some transfer pricing. But I find it fascinating how do these constricted businesses operate. But the big picture, what fascinates me about this is really that idea that politicians are trying to impose morality in a roundabout way, and is it successful or not?

Eric Raine:

It's basically like we're not going to necessarily tell you what you have to do and what's right or wrong, but if you're creating a business and seeking capital, and we don't necessarily agree with what you're doing, we might just put you in a position where you can't access that capital, and therefore we're not telling you what to do, but we're not letting you do it in a way. And yeah, it is very interesting, the nuance that goes on in any of those categories.

Veljko Fotak:

It is, but it's also the hypocrisy in some of the statements. For example, the FDIC is the entity that regulates Federal Deposit Insurance Corporation. They regulate banks that are insured, which is virtually every commercial bank in the United States. And-

Eric Raine:

To a certain extent, right?

Veljko Fotak:

Yeah. Yes. Insurance covers deposits up to X amount, that X amount gets updated over time. But if you're a bank that's part of the FDIC system, they actually have quite some oversight and quite some say in which businesses you can lend to and which businesses you cannot lend to.

Eric Raine:

And they're like, "If you want the insurance from us, then you're going to have to play by our rules," sort of thing. Right.

Veljko Fotak:

Correct. Correct. They cannot prevent you necessarily. There are certain businesses they can prevent you from lending to, but this is the extreme criminal, right? For the most part, they can't really prevent you from lending to cannabis gambling, pornography businesses. But what they can do is they can classify these loans as high risk, which means that you as a bank have to put additional capital aside to prevent losses, which effectively makes this-

Eric Raine:

It's another stressor that causes-

Patrick Lageraaen:

It makes it more expensive for the bank to actually loan to these people.

Veljko Fotak:

Correct. It often makes it unprofitable for the bank to loan to these people to the point that they just don't do it. But it's interesting because the FDAC classifies these loans as high risk. And of course, when you actually look at the cash flow of these businesses-

Eric Raine:

They're relatively low risk, right?

Veljko Fotak:

Extremely low.

Eric Raine:

It's just so interesting.

Veljko Fotak:

There's nothing-

Patrick Lageraaen:

Low downside risk.

Veljko Fotak:

Right. In finance, at the end of the day, we think of risk as a systemic. What we want to know is how do your cash flows correlate with the rest of the economy, right? And we consider businesses with cash flows don't correlate well with the rest of the economic cycle, are the safest businesses in some sense, because they allow you to diversify. When you look at gambling, pornography, prostitution, these are recession-proof for the most part. Gambling, a little bit less, but certainly drugs and prostitution, people actually seem to indulge more when the economy stuff and... And so these businesses have extremely stable cash flows. So the FDAC at some point was actually forced to clarify that the risk that they talk about this regulatory risk. But now-

Eric Raine:

And not actual financial risk.

Patrick Lageraaen:

Interesting. Sure.

Veljko Fotak:

But now you have a government entity telling you, "You cannot lend to these businesses because they're risky, because we are making them risky." It's extremely circular reasoning and it's extremely self-serving. Now, we are talking about three lines of business that are often attacked by the Republican side, if you will, or perhaps by the more conservative side of the government. We're just talking about my research on the Trump Administration. I don't want to make it sound like we are constantly attacking one side of the aisle here. For example, there are pretty big example of distortions of this kind under the Obama Administration.

The Obama Administration was actually trying to put pressures on banks to offer discounts to businesses that were green in order to push for the adoption of environmentally-friendly technologies. And again, regardless of how you feel about the goal, the idea that politicians are using these roundabout ways when they do not have the votes-

Eric Raine:

Just leveraging for this. Yeah.

Veljko Fotak:

That makes me extremely uneasy. And let's be honest guys, if we are thinking of a group of people that we want to have in charge of our morality and social norms, it's probably not bankers. It's probably not as in finance, we don't exactly have a reputation for social-

Eric Raine:

Not bankers, but also not politicians.

Patrick Lageraaen:

Right.

Eric Raine:

Right.

Veljko Fotak:

Well, let's be honest, bankers might have a bad reputation, but lawyers and politicians outrank us in that sense.

Eric Raine:

And I think it's funny that you say us because it's like this is the world that you live in and work in and you've dedicated a vast majority of your life to. But I think it is very interesting research. And I'm glad that we're able to dive into it a bit. We enjoyed learning about it in class, and I think students listening to this or prospective students, whoever tunes in will find it very interesting, just the different components of research that is being done behind the scenes that might not make its way into, let's say, the structure of the core parts of the class. Especially because with this MBA class, it's a seven-week block of your first semester. So relatively speaking, it's a very short timeframe to be able to cover material.

Veljko Fotak:

Absolutely. Squeezing discourse into seven weeks is the biggest challenge for us instructors. It's definitely too short for me. I'm not sure all students would agree. I'm sure it's too long for some, right? But yeah, there's a lot of stuff that you wish you could... Cutting material is the hardest thing when you're really preparing to teach a course like this. There's so much you would want to talk to. But we do our best and try to keep the most interesting material.

Patrick Lageraaen:

Thanks for going into your research. That's really, really interesting. But let's get back to the course-

Veljko Fotak:

Of course.

Patrick Lageraaen:

... that you're teaching. So your course is called Financial Analysis for Managers. Can you just elaborate on what's covered in this course?

Veljko Fotak:

It's a broad corporate finance course. So the vantage point is that of a manager or a corporation. And I want to make sure that that word doesn't scare us. What we mean with a corporation here is any business. So what we're talking about, this class should apply to the hotdog stand on the corner of the street up to the big publicly traded firm with hopefully some nuance or hopefully a lot of nuance. The course is primarily focused on valuation.

We use discounted cash flow analysis as the primary tool, if you will. The underlying idea is that the value on asset equals the present value of the cash flows that can generate in its lifespan discounted back at some appropriate rate. So the class starts with building the technological toolset to apply discounted cash flow analysis first to projects, that's what we call capital budgeting, and then eventually to actual firms. And it culminates in a couple of case studies in valuing firms in different contexts, mergers and acquisitions or listing of shares.

So since it's the only mandatory corporate class within our MBA program, we do try to spend, let's say, the breadth of the corporate finance universe. We start with project selections, project selection, if you want capital budgeting. We spend a lot of time talking about the appropriate return from a project to measure appropriate return. We have to talk about risk, of course. So we spend a lot of time in how do you measure risk and how does risk translate into returns and required rates of return.

From there, yes, we move a little bit more towards how do we apply these to firms to spend the second half of the class talking about that a little bit more. But it is a course that prioritizes breadth over depth. That's the necessity that's imposed by our curriculum. We have limited amount of time, but really we are trying to show you the forest here. I wish we had a little bit more time to look at the leaves, but hopefully, that comes from the electives.

Patrick Lageraaen:

Yeah. So my next question was about why is this a required course and not just an elective, but I think you pretty much summarized it for all the reasons that you just mentioned. That's why it's valuable to managers, because even if you're not working in the finance department, you're still going to be dealing with it and you're still going to be making go-no-go decisions on projects throughout your career.

Veljko Fotak:

Absolutely. You have been well-trained. No, jokes aside. Yeah, you absolutely have it right. We say finance is pervasive to the organization. If you're a marketing manager and you're trying to select which campaign you want to initiate, we say you should be applying capital budgeting techniques, right?

Patrick Lageraaen:

Absolutely.

Veljko Fotak:

If you are an operations person and you have the new warehouse, you have to figure out how do you finance the new warehouse. So financial decisions end up playing a role in some sense across the organization and interface with all sorts of different functions. Then, of course, everybody's going to think their own course is the most important one. But mine really is.

Patrick Lageraaen:

One of the cases I wanted to highlight was the Netscape IPO case study. I loved it, Eric loved it. Could you tell us a little bit more about that case specifically?

Veljko Fotak:

I love the fact, it's always great to hear that you guys liked that the certain part of the course. The case studies are the fun part for me as well, right? All these cases are like little onions, there's always one additional layer of analysis. And in that sense, the Netscape case is to me particularly valuable and that's why I've chosen to present it in class.

So first, the context. We are in 1995, and the Netscape is a firm behind the largest browser. At the point, they had about 95% market share, and they are approaching a moment in which they want to list publicly. An initial public offering or IPO is the process by which a firm is listing shares on the market in the first time. And the problem for Netscape at this point is to coming up with a price at which to sell shares.

Of course, the price per share derives from firm value. It's the firm divided by the number of shares, which means you have to come up with some sort of firm valuation model to decide what is the appropriate IPO price for the firm. And this is where I think that the case becomes interesting because it has these different layers where on one side, from a technical standpoint, it leads students to take those discounted cash flow techniques that they have learned and apply them in this particular context.

So benefit number one gets you to practice a little bit the quantitative techniques. Number two, you're learning a little bit about the IPO process itself. We are going to see the valuation in IPO depends to some extent where some of the decisions and characteristics of the process. And here you have to learn a little bit about how do firms go public, how do firms list shares, why are they doing it, why are they not raising capital in different manners. And then there is the third element you're learning a little bit about a specific industry, about a specific sector, about a specific point of time. There is a little institutional detail that I believe can be fun.

And then there is this whole element of this was an iconic IPO. Netscape going public was, in many ways, the beginning of the inflation of the bubble of the .com bubble that exploded six years later. In this case, this IPO became almost emblematic as the beginning of the enthusiasm for these new technologies. But I think it's also interesting because again, it also highlights how hard it is to value a firm that's growing so rapidly.

Patrick Lageraaen:

Absolutely.

Veljko Fotak:

Because again, you have to forecast those future cash flows. Small deviation in growth rate creates huge deviations in future cash flows. So the assumptions that you make underlying the methodologies that you're applying become extremely important. Which is why I think that this ultimately also teaches students that for as much as there is objective techniques and a collection of objective techniques that you can apply, there is still a level of judgment that you have to apply-

Eric Raine:

And the sensitive nature of the valuation, especially depending on how far out you're looking. Right.

Veljko Fotak:

Absolutely. Absolutely. And that's why we ultimately say valuation is just as much art as it is science. And that's why ultimately, reasonable people can reach different conclusions. But that's exactly, I think, for students, it leads to a little bit of an aha moment in why is it that these tech firms are so high to value? Why are they're so volatile in the valuations and why is there so much disagreement out there?

Patrick Lageraaen:

And I think that was the most interesting part for me because the decision to go with a high IPO price or a low IPO price was less about the firm's true value than about the externalities of choosing the high price or choosing the low price. And what are these waterfall effects of picking the high price or picking the low price? Really interesting to look into.

Veljko Fotak:

No, absolutely. I'm really glad you mentioned it. I'm really glad that came through the case because at the end of the day, I think there is an oversimplification of the IPO story. Firms are going public to raise capital, but raising capital is only one of the reasons why you lease

Patrick Lageraaen:

Liquidity. Instantly revaluing your existing shares.

Veljko Fotak:

Absolutely. Giving away that liquidity is giving a way out to your...

Veljko Fotak:

...That liquidity is giving a way out to your managers.

Eric Raine:

And additional capital in the future.

Veljko Fotak:

Absolutely. But it's also the oversight and the improvement in governance that the market pushes on you, the discipline that the market imposes on you. But the one thing that students often don't think about is that managers also rely on markets for signals. The wisdom of the crowd is often superior to the wisdom of an even very smart and very informed CEO. And we actually have increasingly evidence that CEOs do adapt their decisions based on market reactions, revealing actually information about the firm.

Patrick Lageraaen:

Because the market is investors and it's literally their job to go around and research their competitors.

Veljko Fotak:

Oh, absolutely, absolutely. And there is something almost magical that happens when you aggregate a lot of people with different opinions. Because none of them might have the right value of the firm in mind, but you aggregate all of their opinion, and the average usually converges at some true valuations. Because I might overestimate, you might underestimate but if our mistakes are just random mistakes, they will average out and reveal-

Eric Raine:

It's almost like process gain, which takes us back to some of the OB principles that we learn about. And it is fascinating how that process kind of brings those conclusions out naturally.

And I think that that brings us into the next question that we were going to touch on, which is what might students struggle with coming into this course and things that maybe you've noticed students, it takes a little bit longer to pick up on or... Because obviously a lot of this stuff in listening to you describe the different steps in the course, there's a lot of challenging components of the course and I think students that have a finance background, sure, it might help. Students that don't, they're coming into it open-minded. But I just wondered if maybe there's anything that sticks out to you that might be something for students to just be aware of or maybe even have in mind as they enter into taking the course.

Veljko Fotak:

There is, from some students, a certain level of fear approaching this course, which I hope is not justified. In a sense I think students know this is going to be a quantitative course. So sometimes the initial approach is with the apprehension and I hope the feedback... They usually get is that eventually they find out it wasn't as scary as they thought.

Now, you ask me specifically what do students have a problem wrapping their heads around. And I think it's the whole way we think about risk in finance. First, to the common person, the lay person, a risk is the possibility of that something bad will happen. Whereas in finance, risk is two-sided, right. Risk is-

Patrick Lageraaen:

Variability of outcome.

Veljko Fotak:

Exactly. Uncertainty, right. So risk is something could go wrong or something could go really well. But it's a deviation from expectation. And that seems like a subtle point but oftentimes you have a hard time really conveying that.

Eric Raine:

Mostly because we're just risk averse by nature. I know when we had our podcast with Professor Neubert, he talked about these biases that humans have on a neurochemical level almost. Where you want to avoid something that could potentially hurt you or harm you. And so this definitely leaks into, when you start to talk about risk in the classroom from a financial perspective, I think a lot of times if you were to have people just define what do you believe risk is in finance, it's oh, "Well, how much is there a likelihood that we're going to lose money on this project?" But it's also like, "How much of a likelihood is there that we're going to make money on this project?" And I think that to your point, it's straying from your target point and really measuring an accurate degree of where are our expectations and how close will we be once the outcome is there.

And I think that goes back to what you said earlier about the idea that this course is future looking and the future is such an unknown. And I think that's where some of the maybe struggle, I say struggle, but just the challenges, which is fun because that's the part that you can really learn from in the course. And I don't mean to ask the question in a way to make it seem like it's positioning it to be a fearful step [inaudible 00:58:40]. It could definitely happen. I could see that. But I think that's what's exciting about it.

Veljko Fotak:

Perhaps I'm too self-conscious about [inaudible 00:58:47] the fear. No. But the other element of risk, if you will, that's problematic for students is the fact that we are generally really concerned with diversification. So that leads us to really overemphasize systemic risk because that's the risk component that cannot be simply diversified away. And I think that students sometimes have a hard time wrapping their head around that. It's not about how volatile a particular asset is but it's about how correlated a particular asset is with the rest of the market. Because if you have an asset whose price doesn't move in line with the rest of the market, that asset is actually making your portfolio safer because It's allowing you to diversify. And whereas where you have an asset whose value tends to move in line with markets, adding into the portfolio amplifies your portfolio volatility and tends to make your portfolio riskier.

So you have these two concepts. On one side, the fact that risk is two-sided, that risk means both good and bad deviations. On the other side, the idea that we are not really concerned with overall how uncertain your distribution of cash flows is, as much as we are concerned with how correlated your cash flows are with the rest of the economy. I think these are the two main, maybe two of the core principles in the entire field of finance that people have struggled to really replicate it.

Eric Raine:

So I'd be curious to get your thoughts on this. Because Patrick and I were talking about net present value and this idea of bringing it back to, okay, if you're taking this course and you might not be going into finance specifically but you can take principles away from the course that will help you in your marketing project or whatever, some of the other examples we give, is this idea of does this project have a positive NPV or not? And if so, the decision to take on a project or not. And one of the things that I found really interesting is this idea that even if a project had an NPV that was at zero, where it was essentially going to say, okay, the net present value today is $0, do we still take on this project? And the answer from that was, well, obviously it depends, but the answer is also probably yes because it depends on your cash flows. And you can still be churning a lot of money and making a lot of money, even if you're not necessarily working on a project that has a positive NPV. And that was something that I took away from the course. And I remember you talking about it to a certain extent. I don't know how far we went into it with that specific lecture.

But that's another one of those things where you learn something and you think to yourself, you know what? My preconceived notions of what I thought this meant is, well, you'd really only want to take on a project that had a positive NPV. That's what I was thinking for myself in my mind. But then learning more of what goes really into the behind the scenes workings of figuring that out is pretty fascinating.

Veljko Fotak:

You raise some interesting points here and I think that perhaps, yeah, you just asked me earlier, what are some of the concepts that students must struggle with? And one my answer was the concept of risk. But the other thing is that this difference between nominal and real returns. The idea of real returns in finance is the returns adjusted both for time value of money but also for risk. So I guess what I'm trying to say here is that a project with an NPV of zero is usually creating positive nominal returns. But an NPV of zero means you're effectively creating zero returns in real terms,.what does that mean? That yes, your project is generating money but there are other alternative projects that can generate the same returns at the same level of risk, which ideally makes you different between this project and your alternatives. But I think that's always an insight into the fact that in the real world, we are never acting in a vacuum. We are never selecting a project in isolation. The decision is never do I accept project A, yes or no? There's always a, if I don't accept project A, I'm doing something else. And you always have to take into account what is the value of this something else? What is the return on this something else.

Eric Raine:

Or the risk of something else.

Veljko Fotak:

The risks of something else. So in other words, right now... Historically we kind of tend to lose sight of that because with low interest rates, our alternatives are often very low returns. So the difference between nominal and real geta lost in the conversation. Now that interest rates are rising all of a sudden these distinctions between nominal and real become very, very important. If somebody comes to you and is offering you a project with a 5% return when interest rates are near zero, well that might sound very appealing. Right now when you can get a saving account that gives you a risk-free return at 5%, a project that's offering a risky 5% is not looking as attractive. So again, looking at these nominal returns in isolation is wrong. You have to consider alternatives.

But to your point, we can always take this type of analysis too far. I teach international finance and for years I had a currency trader from one of the financial firms in town actually come and talk to my class. And every time he would come in, he was showing these charts to my students showing positive returns to his portfolio. And he was investing fairly conservatively and his portfolio was really generating positive returns year after year after year. But I remember looking at these numbers and they always struck me as being not large, let me put it that way. So I remember one year asking him a question, "Have you ever compared..." He was showing a chart to my students with 10 years of past returns and he's showing them over the last 10 years. I get green every year. And at some point I asked him, "Have you ever compared your return with the Treasury market?" So he mumbled something, evaded the question. But then I downloaded Treasury bill returns and eight out of the past 10 years, Treasury bill returns were greater than the returns on his portfolio. Now, the project rate, these were positive nominal return, negative reality. These were negative NPV projects effectively once adjusted at the proper discount rate.

And so I'm sitting smug in the back of my class thinking, "Oh, I got him." And I even mentioned that and his response, he was speaking on past. He was saying, "Look, my clients, they just want me to make money for them. They don't spend their days necessarily benchmarking my returns to that of others."

Eric Raine:

They don't want to know the money that could've potentially been made otherwise.

Veljko Fotak:

But that's the point. To his point, I think I understand a little bit more of financial markets, yet he's driving to my class in a Ferrari to talk to my students. And so I can sit here and go, "Oh, gotcha. Your properly risk adjusted returns are negative." But yeah, to your point, this project is generating positive nominal returns and sometimes that's what you need in life. At the end of the day, the world's stochastic, we face all these choices with all sorts of different outcomes and all sorts of different distributions, but at the end of the day, we choose one project, we observe one outcome. Then that's what makes sometimes wrapping our head around this concepts of risk returns so hard.

Eric Raine:

Yeah. Thanks for commenting on that present value.

Patrick Lageraaen:

Yeah, absolutely. It's very interesting.

Eric Raine:

And I think the important part is that it's better for comparing two different options rather than just a singular option. So I'm going to give an example and you can tell me what you think about it. So take a company like Apple. They have tons of cash reserves. If you give them a project with an NPV of zero, but it's at least something for their cash to do, they'd probably take it. Whereas another company that doesn't have so much cash, they're going to be more selective about which projects they undertake. So they would accept a project if it has a positive NPV, whereas they probably wouldn't accept one with a zero NPV.

Veljko Fotak:

You're not wrong in the real world. But let's be honest, this difference in the amount of cash that Apple has versus other firms perhaps, ultimately that should factor into discount rate.

Eric Raine:

Because they're not borrowing the money.

Veljko Fotak:

Because they're not borrowing the money. Their cost of capital is clearly lower. Now, you're not borrowing the money. You do have an opportunity cost of capital. You could be investing your money and you could be generating a certain level of return. So you shouldn't think of that money as being free, but borrowing is frictions that, you here, are avoiding. So in some ways, cash on hand should affect your cost of capital. And by lowering your cost of capital, it should affect your NVP computation. Now, firms are not always as rigorous in adjusting their cost of capital to the present conditions. So you end up instead adjusting the decision rule. You end up coming with statements like that saying, "Well, maybe I will accept a zero NVP or maybe even a slightly negative NVP project because I have to find a use on my cost of capital." And in practice, you're right.

Eric Raine:

That's the reality. You would've backed into that NPV equation by changing their cost of capital, in which case it still might result in a positive NPV.

Veljko Fotak:

Correct. Correct. The accurate thing to do would be for that difference in capital structure to be reflected into a different discount rate and in the different discount rate. But the reality is we know that firms are often pretty sloppy. Oftentimes that hurdle rate simply comes from benchmarking. We are taking the hurdle rate that everybody else in my industry uses instead of adjusting it for the fact that, "Oh, I have less debt" or "I have more cash". And then again, then I'm rebalancing my decision rule instead of rebalancing the discount rate and the computation. That's not necessarily what we teach, but of course it is what often happens in real world.

The reality is your discount rate should also affect your particular project. And your particular project might be financed with a mix of debt, equity or cash, which is actually different from your firm overall. But now adjusting discounts rates for different proj... That really happens. The firm will use a universal hurdle rate. And then you again fall into consideration. "Oh, but this project is actually not financed with that. So even though my NVP is slightly negative, well the hurdle rates should actually be slightly lower." So you fall into this kind of...

Eric Raine:

Right.

Veljko Fotak:

So you're absolutely right in the real world, that kind of adjustment would happen.

Eric Raine:

Yeah, makes sense. Thank you.

Veljko Fotak:

Cheers.

Eric Raine:

All right, so let's get back into the course. So what do students have to look forward to in this course?

Veljko Fotak:

Blood, sweat, and tears. I hope that the students are acquiring a tool set and a skillset that allows them to spot opportunities and spot the threats. At the end of the day, this is a social science. We live in a messy world. We have other courses that tend to be constructed with here's what happens and effects happens. You do Y. But unfortunately, once we start falling into the domain of social sciences and especially social science that's as quickly evolving as the world of finance, that approach is not possible. So what students really have to look forward to here is the development of a tool set, a skillset, that allows them to spot the opportunities, smell the risks, and then be able to hopefully use this tool set to come up with the appropriate solutions, to take advantage or to gain protection. That, at least is my philosophy in teaching this course. Now whether this is really successful, I hope so.

Eric Raine:

I think it is.

Patrick Lageraaen:

Yeah. I agree. And in seven weeks, that's the challenge too.

Veljko Fotak:

Sure.

Patrick Lageraaen:

Look at us here, sitting here talking about NPV and internal rate of return after a seven-week course.

Eric Raine:

Yeah. And it's things that we think about, and whether it's direct or indirect to the things that we're working on, on other projects or in our own jobs or whatever it might be, it's still bringing those thoughts to the forefront on how to evaluate risk.

Veljko Fotak:

Well, we have a gap in our education system where we do not... A lot of these concepts, we are applying them here at the firm level, but at the end of the day, they also apply at the personal finance level.

Eric Raine:

For sure.

Patrick Lageraaen:

They definitely do.

Veljko Fotak:

This concept of NPV and IRR should help you pick between different mortgages and value your card and evaluate the decision to lease versus purchase versus get a loan. So yeah, I do think that this framework later on applies in all sorts of different contexts. But then again, I'm a man with a hammer. I'm trained as a financial economist and a man with a hammer sees nails everywhere. So I'm trained as a financial economist, I see financial problems everywhere. So I have my own biases.

Eric Raine:

Well, thank you. So are there any student success stories that you can share?

Veljko Fotak:

There are many students that make you proud and leave you with a smile on your face. There are so many through the years.

Some that I remember most fondly [inaudible 01:14:50], mention him by name. He was a student of mine at the University of Buffalo for a while, and he's now actually a professor of finance tenure in Sydney. He went to Australia. He's somebody who's... Sometimes you encounter these individuals that you just know they're smarter than you from day one. I was more trained and hopefully I was able to teach him some things but he's always had a level of insight that has taught me a lot.

I had another student I'm extremely proud of. I'll stick to initials for him, but I'm sure you guys can find pretty easily, KS. He graduated from our program, must have been six or seven years ago, spent three years in the NFL after being a star student here at Buffalo. Yeah, yeah, definitely glamorous and successful career. Even though short-lived, he suffered a career ending injury, I think it was in his fourth year. But has actually reinvented himself as a financial advisor. He now manages money for, he has about 60 clients. All of them are athletes, most in the NFL. He's now spacing a little bit towards basketball and expanding in that sense. But really I've always admired how he was able to marry his two passions and his two skillset. He seems to understand the specific needs of sports professionals who clearly have a financial situation that's different from the majority of us. You have this-

Eric Raine:

And very different from the first part of their life.

Veljko Fotak:

Yes. They're often coming from backgrounds that they've not taught them how to manage money since early childhood-

Eric Raine:

And then all of a sudden they're high net worth individuals that are looking for advice, right?

Veljko Fotak:

Yes.s High net worth individuals with very busy lives and other priorities-

Patrick Lageraaen:

In a culture of spending,

Veljko Fotak:

In a culture of spending. And oftentimes with, let's be honest, nowadays we live in a society that it's very, very efficient separating people from their own money. You have a financial industry that oftentimes seems to operate more for the benefits of the finance industry itself than for its clients. And then of course, when you have a large influx of money, you find out you have a lot of friends all of a sudden.

Eric Raine:

Exactly.

Veljko Fotak:

And so yeah, he seems to understand the specific needs of a group of people who tend to have extremely short careers. The tenure in the NFL is some of the shortest in all sports, but large salaries in few years. And investing that money wisely to provide for retirement becomes really important.

Eric Raine:

And making less for the rest of their lives, just for that short time.

Veljko Fotak:

Absolutely.

Eric Raine:

Really interesting.

Veljko Fotak:

And so in some sense, I think there is, at the end of the day, you want to see your students succeed but you also want your students improve the world, make it a better place. And when I talk to him, I definitely get the feeling that there is a real problem that these athletes are often taken advantage of and that he's, as far as I can tell, he's a very conscientious person-

Eric Raine:

And an honest steward of their money as well.

Veljko Fotak:

Absolutely. He seems to take his fiduciary duties extremely seriously. And then he seems to... He's seen friends and colleagues being taken advantage of and he doesn't want to make sure that that doesn't happen to the new athletes. So again, I don't want this to be a marketing message but yeah, an inspirational story. That's what,

Eric Raine:

Yeah, absolutely. Thanks for sharing.

Veljko Fotak:

Cheers.

Eric Raine:

So the last one I want to touch on is about the MBA degree itself, and then just graduate degrees in general. So is an MBA degree necessary for finance? Because I know a lot of undergrads, they're looking to get internships at banks or maybe even front offices in New York City. Should they be looking into graduate degrees?

Veljko Fotak:

An MBA degree is not necessary to enter the world of finance. And let's be honest, a lot of entry level positions in the world of finance tend to be on the sales side in finance. And that's not always true. But a lot of entry level goes through wealth management and that's fairly commission based oftentimes. So entry level position in the world of finance don't necessarily have very high barriers. Now I'm over generalizing. Rather there's huge differences between wealth management, corporate finance and consulting, and so on and so forth. For example, if you want to get into any sort of consulting, then a graduate degree is a [inaudible 01:20:01], even at the entry level.

But generally speaking, if you want to take a broader perspective, most financial jobs are approachable even without a formal education, certainly without a graduate degree. But the problem is jobs come with ceilings. Or rather, if you don't have a graduate degree, there will always be a ceiling above your head. So the difference that we see, and even statistics that seem to be published, you look at the starting salaries of students that approached the first job in finance with an undergraduate versus starting salaries of students with an MBA that approached the first job in finance, there is a difference but it's fairly marginal. And once you account for the fact that MBA students tend to have a little bit more experience, you're really left wondering, is there a difference if that starting salary?

Eric Raine:

But that's just looking at it from the front end, right?

Veljko Fotak:

Absolutely. Three to five years later, an enormous gap starts opening up.

Eric Raine:

Yeah.

Veljko Fotak:

Yeah, right.

Veljko Fotak:

An enormous gap starts opening up. So at that point, I think anybody who's considering a career, I keep talking about the world of finance, of course that's the world I know. You have to budget for getting a graduate degree at some point. Then the question becomes, is sooner better than later? And generally speaking, the answer is yes. If you're thinking of a degree as raising your income, well, raising it sooner has more present value impact than raising it later. But not only that, there are a lot of personal considerations. Studying is easier when you're young. Minds are fresher, brighter. Study habits fade over time. It's a lot harder to go back to school once you have a family. Once you have kids.

Eric Raine:

Social life changes, right?

Veljko Fotak:

Social life changes. So perhaps all of these reasons to get a graduate degree sooner rather than later, but at the end of the day, it's going to be a personal decision that anybody is going to have to face. You're thinking MBA versus job. You have a job offer from Goldman Sachs or you're thinking MBA, go work for Goldman Sachs [inaudible 01:22:27]. It's time for your MBA, right? So you have to anchor it to specific circumstances, but the short answer, not necessarily for entry, absolutely necessary for growth.

Eric Raine:

Understood.

Veljko Fotak:

Then there is the other big question that our students seem to have, or at least for those who are interested in finance specifically is, do I want an MBA? Do I want a Master of Science in Finance? And then that's what, it's not always easy to answer. An MBA is a degree that has more breadth. They both give you access to a higher managerial level, a higher level of executive positions. The MBA in a broader sense, there are certainly some positions for which an MBA is a lot more valuable than an MSF, right? The question is the opposite, true. Let's say that you're sticking already that what you want to do is finance and it's finance or nothing else. And at that point, does a master of science in finance favor you over an MBA because it's narrower and more targeted? And I would say that on the margin, perhaps that is true, but it's a very small delta. I would say that-

Eric Raine:

... But then it would limit you in the longer term career progression, as far as the ability to sort of move across different areas of a company, right?

Veljko Fotak:

I mean, it's not for me to judge, but if I were to express an opinion, I think that the breadth of an MBA program is extremely valuable.

I think that what you gain in terms of breadth of access to positions certainly makes up for the fact that perhaps compared to some more discipline specific master of science, you're losing a little bit of depth. But let's be honest, technical depth is in some sense, I want to use the word overrated, but the reality is everything changes too fast. Technical depth doesn't last long. That's the ongoing education, the breadth and skillset that you get in terms of ability of seeing the big picture, that's a skill set that never fades. And that's really where the breadth of an MBA becomes valuable.

Eric Raine:

Sure. Yeah. I think it's interesting because as you were describing the idea of looking at whether or not graduate school is in the present moment a good idea and whether or not that will be beneficial to what your target outcome is in the future, sort of begs the question is getting an MBA a positive MPV project? And I'm kidding.

It's the idea of could you get a job now, or what will that job be and how soon will it be till you hit that ceiling that you talk about potentially? And then what the breadth that is offered by the NBA, what opportunities does that potentially bring to you? And so I think it's really interesting.

Veljko Fotak:

I mean, I think that framing it as an MPV decision is absolutely correct, and I think it's a good way to also wrap your head around this idea that it makes opportunity costs extremely clear.

Patrick Lageraaen:

Because getting the MBA now earlier in your career, the opportunity cost is lower. Your salary is lower.

Veljko Fotak:

Absolutely. That's a good way of thinking about it. There are a lot of studies out there. Most of them seem to focus on the difference in wages between students coming in and coming out of programs. And most of the studies seem to ultimately come down to the conclusion that, yeah, programs are valuable, but it's difficult to assess because you never know the counterfactual. You never know.

Eric Raine:

You don't know what didn't happen. And the other thing too is if you were to take what someone's making today and what they're making four years from now, without the degree, that could be potentially a lot higher as well, except you just don't know, right?

Veljko Fotak:

Correct. There would've been some salary growth in the private sector, we've been working. But the other thing that... We are business people. I have a PhD in finance, so I love money, right.

And I don't disagree that it's an objective measure of value. Nevertheless, sometimes I wonder, should we be measuring all the value of education in terms of returns on salary or there is a soft component, education and knowledge makes us better citizens, better parents, better relatives, better human beings, and enrichens our lives in ways that are not always monetary right.

Now, of course, that kind of argument is easier to sell when you're talking about ancient Greek philosophers when we are, we are talking about discount rates. I mean, does the discount rate make me a more moral person, understanding discount rates? I'm not sure. But knowledge does enrich in you. And then even if you really want to stick to just the rewards, sometimes you're comparing pay, but the comparison in pay misses the fact that you're not only getting a job that pays more, but you're getting a job that you enjoy doing or that your functions are hopefully changing. Because at the end of the day, our pay has a component that simply rewards our skillset, but our pay is also a component that rewards our tolerance for unpleasant tasks. And generally speaking, as you move up the ladder, your compensation is to move more towards compensating you from skill rather than pain and discomfort avoidance. So sometimes I can think of many jobs paying exactly the same salaries, but I prefer job A to B right. And I think we lose that a little bit in economic-

Eric Raine:

... I agree. And I think that that sort gets to the point of whether or not someone... I think something I was recently looking into sort of outside of the scope of necessarily finance or the podcast specifically, is whether or not to prioritize happiness in the workplace from a leadership perspective and should it be something that's focused on as far as a goal or outcome? And some of what it was looking into is this idea that really, it's not necessarily that people are just purely trying to find happiness in the work that they're doing, but they're trying to find purpose and they're trying to find an ability to have growth orientation around what they're doing. And as a byproduct of that growth mindset and the ability to be able to actually have purpose in what you're doing, it sort of causes you to have a sense of happiness around what you're doing.

So, I think some of what you're getting at, or at least the way I'm translating it and taking it personally here, is just the idea that if you do choose to take the degree path and that process in and of itself, aside from the idea of yeah, your earning potential could go up, you could make more money, it might provide you a higher ceiling or take the ceiling away as far as your career progression, but the process of going through a program like this may help you find, one, the ability to actually grow and also find more of a purpose around what you're doing. And therefore, to your point, this idea of job A and B might pay the same, but I'd much rather be doing A than B. And if you're not a hundred percent sure of what A and B might look like or how to differentiate, maybe going through a program like this helps you. And it's hard to quantify that. It's a difficult thing to actually wrap the head around, but I think that that's what some of the value is in it as well.

Patrick Lageraaen:

But the degree can also provide more opportunities to pursue those things.

Veljko Fotak:

For me, it's been perhaps a couple of extra years than for you guys. I got my MBA 30 years ago, 25 years ago almost, and some of the people I met in the program are still my friends. Some of those relationships have paid off in a professional sense. The people I met through my MBA program became part of my professional network, but some of those people have become my friends. And how do you put that benefit into an equation? I think it's extremely hard.

And I think that in many ways, one of the values of an MBA degree lies in your ability to think differently, to change mindset. And that's also you know, as we said before, it doesn't just translate into hopefully better decision making at the corporate level. Hopefully it translates into better decision making at a personal level, whether you're weighting the pros and cons of a financial problem or whether you're weighting the pros and cons of selecting college, which, okay, that might be financial to, but you can apply some of these techniques to life choices. But I was still stuck in my head to something that you said earlier. You were talking about should we be concerned with happiness in the workplace? Should we be concerned with some of those intangibles? And my theoretical answer, my theoretical answer is absolutely yes.

Eric Raine:

I would agree with that initially as well. It sounds like that'd be like saying, do we not want to prioritize happiness? Is that the counter argument? So yeah, it is interesting, right?

Veljko Fotak:

It's interesting, but it's also problematic because, and I qualified my answer by saying my theoretical answer. The problem is how do you put that down in practice? In my spare time, I love playing chess. And one of my heroes was Capablanca, one of the big masters from the eighties. And he always used to say that having a plan, even a bad plan, is better than not having a plan. And I am not sure if this translates directly into what I'm thinking of, but having measuring financial returns, measuring money, it's objective. We are still struggling with objective measures of happiness. And that's why if you're really talking to an economist, they will try to tell you that money in an efficient market is the measure of happiness in some sense, because I'm paying more for something that I like or something that makes me happy. So the point is, we all want to maximize our utility. The question is how do we define that utility?

Do we define it simply in monetary terms? Do we define it by adding intangibles into the equation? And again, the problem is that as soon as you start talking about these intangibles, you run into two problems. One is how do you measure them? And we have a lot of research out there saying that one clearly defined goal, even if suboptimal leads to better outcomes than many loosely defined and poorly measured goals.

Because the problem is, let's be honest, in the loose definitions, hides the ability to hide all sorts of shenanigans. A manager that if you're operating within a shareholder value maximization and your manager is not performing stock returns, you call them on it, hopefully they lose their job or at least their pay gets cut. But good luck accusing a CEO of not delivering happiness, right? That CEO is going to find the metric by which they're delivering more happiness than any other CEO the job ever met. Because in that fuzziness lies our ability to distort things. So sometimes I would rather take an incomplete but objective measure over a theoretically, correct. Of course, we should have all these intangibles in there, but we don't know how to measure.

Eric Raine:

I think that that's some of what the argument is as far as reasons for why potentially happiness shouldn't be prioritized in the workplace, is because of the fact that it can be so subjective and it can be different for everyone. So if you set a target and you say, okay, we've measured, this is what happiness is, if you fall short of that, then the idea is basically like, well, now we're promoting a workplace that's an unhappy workplace.

Veljko Fotak:

Absolutely.

Eric Raine:

So I think that it's interesting because both sides of the argument can be made pretty well. And I think that kind of goes back to what you're saying is, all right, if you prioritize it, well, how do you measure it? And so I think some of that, and you could get into saying, okay, well some of the ways of measuring it is if the idea, instead of prioritizing happiness, you're trying to provide a platform for growth and for building purpose into what people are doing in their work. And as a byproduct, they feel happier in their own personal way of gauging it. That could lead to turnover rates going down and average tenure going up. And so could you start to actually quantify it in a certain way over the long period of time? But I think it's really hard to get a snapshot of what does that mean? What is happiness in the workplace?

Veljko Fotak:

But yeah, I mean ultimately we've risen ourselves back to Milton Friedman with this conversation because that's exactly what he was saying. Firms should only worry about creating wealth. And his argument often gets distorted because his main argument for wealth creation being the sole objective of the firm was that everything else is impossible to establish in any objective manner. He was fearful of a tyranny of a minority or even a tyranny of a majority. Saying anything that's not codified in laws is subjective. And even if a majority of people, even if a majority of my shareholders as a preference for a particular choice, I'm imposing something that's subjective on a minority that doesn't agree, and that's a form of tyranny in his view. It goes back to our economic homo economic assumptions are usually based on, we are all trying to maximize our utility function. That utility malfunction is the same for everybody.

The assumption is we all prefer $2 to $1. And that's pretty straightforward. As soon as you start deviating from maximizing wealth, that utility function stops being uniform. And then as a manager, are you maximizing the utility of the majority? I mean, I guess that becomes right, but that effectively means there's a group of shareholders you're working against and that gets you into horrible places. So the only way to define that fiduciary duty with any objectiveness is to stick to just maximize wealth and let people choose how to spend that wealth-

Eric Raine:

... How to spend it right-

Veljko Fotak:

... And hopefully that maximize their own happiness.

Eric Raine:

To go back to your example with using Friedman as an example, it'd be the same thing in a way where a firm says, okay, this is what happiness is and we've quantified it and this is the target. And now we're telling you as the people who are working here at the company what happiness is, rather than it being, okay, look, we're providing a platform that you could be happy with here, but you're also free to go and participate by working for another firm if you find happiness in some other things there.

And it's the same thing with shareholders, right? It's like, rather than telling you how we're going to use your money, you are free to invest your money here where you can see the things that are measurable or you can go and invest it somewhere else, rather than us putting that onto you and telling you and dictating to you what that is. And I think it could be a lot of ways there probably are similarities between that and whether or not happiness in the workplace should be prioritized or can it be at all. And I agree with the fact that it in many ways can't.

Veljko Fotak:

But I just want to be clear on this point. I think that it's not that we shouldn't measure happiness, it's just that we don't know how to do it. And at the current moment, I don't think we should be introducing theoretically correct, empirically fuzzy concepts into our utility function. But that doesn't mean that we shouldn't be striving to correct this. I think that measuring happiness is challenging. I don't think it's impossible. And if we have to start recognizing the utility functions are not uniform, then maybe we have to start recognizing the utility functions are not uniform, right? And not just hide behind that. We don't know how to do this, so let's just stick to shareholder value maximization. I agree, we don't know how to do it. Let's stick to shareholder value maximization. But hey, in the meantime, let's try to figure out how to do it.

There's a professor at the University of Chicago, his name is Luigi Zingales, the director of the Stigler Center, which is basically a think tank for the study of the political economy. He's probably been the biggest proponent of the idea that we need to rewrite utility functions to incorporate non-pecuniary, non wealth related elements. The problem is that, now you get into the subjective. Interestingly, I think with the computational capabilities that we have nowadays, we can start diving into that a little bit, right? It requires starting to build profiles of individual investors, I mean individual investors, individual workers, what does make you happy? And then create metrics that look at-

Patrick Lageraaen:

... Find trends.

Veljko Fotak:

Find trends, but also find correlations, right? I mean, in a sense, measure, happiness obviously has many different dimensions, right?

Score how you prioritize dimensions, score how firm X delivers those dimensions to workers-

Patrick Lageraaen:

... And start connecting the dots.

Veljko Fotak:

And start connecting the dots. Start looking at how, well, because my preference, I might be a conservative person, I want a conservative workplace. I value the fact that I have to wear a tie that everybody has to look proper around me, that's a benefit. Or I might actually find that very oppressive. And so now all of a sudden we measure the preferences of the person, we measure the delivery firm, we look at how the delivery of the firm matches the preference of the person.

It's complicated. We don't know how to operationalize something like that. But conceptually we can see it in action. And the world in which we live in where computing power is expanding maybe starts allowing us to make some tailored approaches like that. I'm working on something of these sorts in a political sense, and that's perhaps why my examples always go back to that. But we are actually doing a lot of work, trying to measure the political alignment of firms, but then we try to measure how much is that political alignment worth to investors? And then you have the problem that the political alignment takes a positive or a negative sign to different investors. Perhaps you're a very conservative person. This firm is very conservative. That stock is worth a little bit more to you than just the cash flows that it generates because of the impact the firm has on society.

And because it furthers your political view and your cases. Conversely, to a person who's a Democrat, that stock is maybe worth a little bit less than the cash flows it generates because they view the political activities as externalities. But nobody has developed that framework yet, because in the past we just didn't have the data, we just didn't have the computing power. But if you start making profiles of investors measuring these characteristics, you can measure these correlations, start to get into value. This is where I get excited. I think that this is where some of our research is going towards, but we just need to drop this pretense that utility functions are objective, universal and that everybody has the same.

Eric Raine:

Yeah, makes sense. And I think what's really cool about that is it kind of ties everything back together with the idea that yes, there's a lot to learn in the classroom, but there's also a lot that can be learned outside the classroom. And when it comes to research, there's never ending opportunities to be able to plug into something you're interested in.

Veljko Fotak:

Oh, absolutely. Stay curious, keep your eyes open. There's a lot of interesting finance and economics problems everywhere around us.

Patrick Lageraaen:

All right. Veljko, thanks so much for being here.

Veljko Fotak:

Oh, thanks so much for having me.

Eric Raine:

We appreciate you taking the time.

Patrick Lageraaen:

You're very busy.

Veljko Fotak:

It's a busy semester. The fall always is, but this is actually a fun part of the job. And certainly if it helps students develop some idea what this course is about and decide how it fits into their program of study, that certainly is a big, I mean, I suppose for most MBA students, they don't have a choice. It's a core class, but, at least they know what they have to look forward to.

Patrick Lageraaen:

Absolutely.

Eric Raine:

And hopefully we're able to distract you a little bit from some of the grading that you have to kind of take care of.

Veljko Fotak:

Indeed guys.

Eric Raine:

We did our part. Hopefully.

Veljko Fotak:

Indeed, guys. I appreciated that. That's the part of my job I like the least, the grading, but unfortunately it is part of the job and that's what I have been doing today and that's what I'll be doing for the rest of the day after we're done.

Eric Raine:

Okay. Well yeah, thanks again.

Patrick Lageraaen:

Thanks very much.

Veljko Fotak:

Cheers.

Patrick Lageraaen:

Again, my name is Patrick Lageraaen and I was your host for this episode. Thanks for listening.