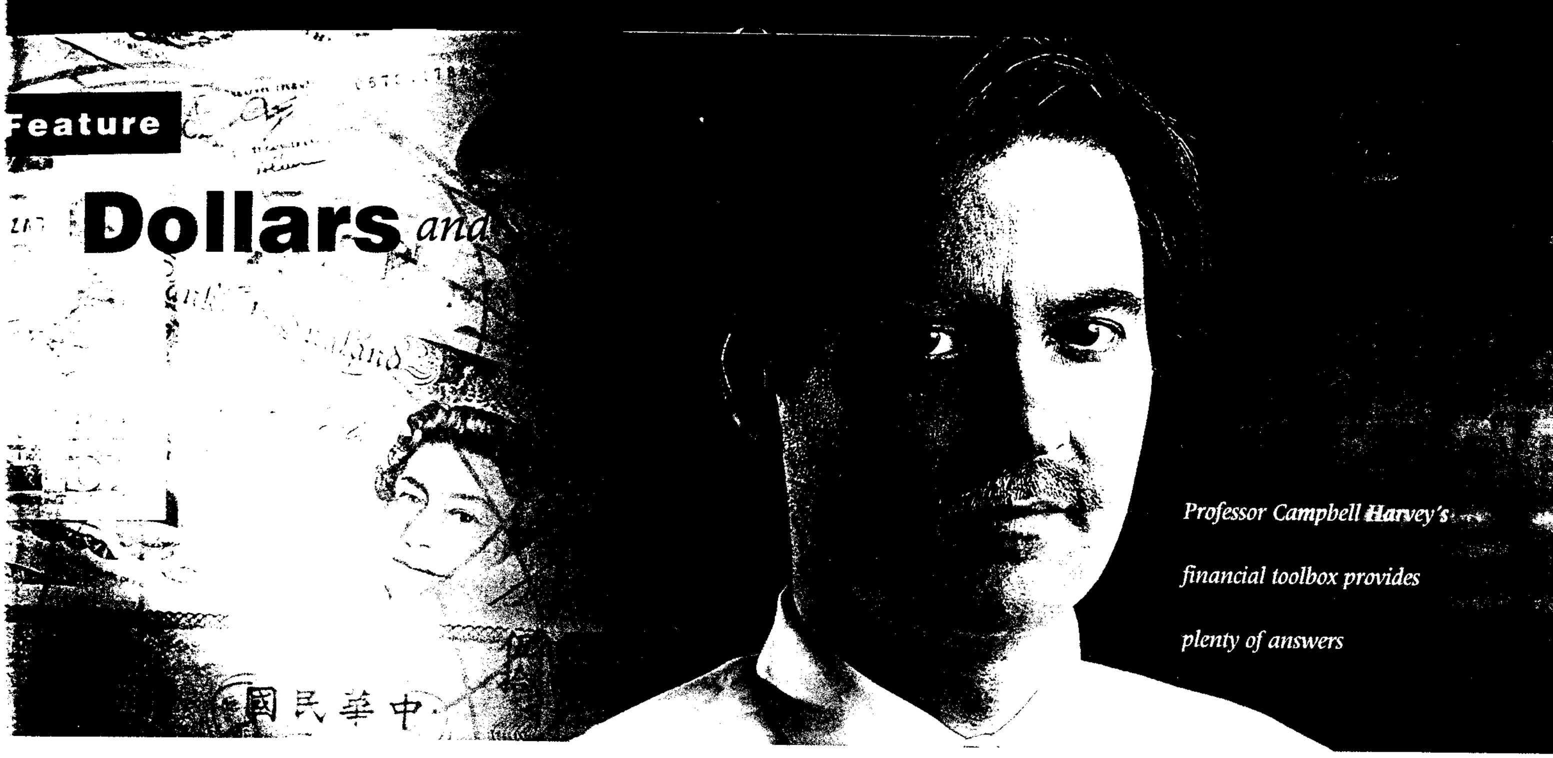

Feature

Dollars and

Professor Campbell Harvey's financial toolbox provides plenty of answers

By Matthew J. Hergott '98

When *Business Week* needed to cite investment advice in a recent article on global portfolio diversification, one of the experts the magazine sought out was **Campbell R. Harvey**, Fuqua's J. Paul Sticht Professor of International Business. One need only look the depth and breadth of Harvey's published research to understand why his observations are among the most sought after in the world of finance.

Last year, Harvey received the 1997 Graham and Dodd Scroll for excellence in financial writing from the Association of Investment Management and Research. This is the third straight year and the fourth time overall that this prestigious award was conferred upon Harvey. Only Martin Leibowitz and the late Fischer Black have won more Graham and Dodd awards. The only other Fuqua faculty member to be honored with this distinction is Robert E. Whaley, the T. Austin Finch Foundation Professor who won in 1986 and 1987.

This latest award recognizes Harvey for his continuing work in advancing financial thought in a number of important areas, most notably global investment strategy. The study of international investments is the unifying theme in Harvey's research. His work on global markets is even more crucial to investors given the Asian financial crisis that began late last year. "The recent meltdown in East Asia has brought emerging markets investments to an even higher profile," says the popular and distinguished finance professor. Yet Harvey remains bullish on the continuing prospects for these areas, noting, "Over the long term, emerging markets continue to outperform developed markets."

Risk and Reward in International Markets

When Harvey joined the Fuqua faculty in 1986, most researchers assumed that risk and rewards in the financial markets were stable through time, and that any deviations from this theory reflected imperfections in the capital markets themselves. In contrast, Harvey studied how volatility and expected returns can change dynamically. He published work showing how to forecast risk and rewards through time. "Investors cannot afford to ignore the fact that risk changes—often rapidly—in emerging markets," says Harvey.

Harvey has not been content to apply his research only to those emerging markets in vogue of late. He has performed investment analyses of many countries that are not commonly represented in investors' portfolios. "I think I am the only faculty member at a Top-10 business school who has a research paper focusing on Africa," he says. Such a focus on countries off the beaten path can lead to greater portfolio returns. "There are a number of countries in Africa that provide investment opportunities," points out Harvey. His future research efforts may also involve the Middle East, and he has just finished reading Philip Moore's book, *Islamic Finance: A Partnership for Growth*.

International Cost of Capital

While a large part of Harvey's work is devoted to refining global portfolio selection methods, he also has done research with direct and immediate relevance to the daily operations of the world's multinational firms. For instance, current methods to estimate the international cost of capital, a topic that Harvey calls "one of the great unsolved issues in corporate finance," often appear arbitrary and unsystematic. Harvey explains, "There is a real problem with standard methods. For example, using textbook methods you would discount a project's cash flows in India with a rate less than the U.S. T-bill yield. Try taking that to your CFO." Moreover, the lack of consistent academic thought on this issue often leads the various divisions of global firms to use different discount rates for the same country. Harvey is quick to comment on this, saying emphatically, "You can imagine some of the poor decisions that can result from this confusion."

In response to the obvious shortcomings and unsettled issues involved in calculating the cost of international capital, Harvey developed a systematic technique to estimate equity price for almost every nation in the world. "My method uses country credit ratings. It is simple: the higher the country risk, the higher the discount rate. My Internet site (www.duke.edu/~charvey) provides discount rates for 136 countries," says Harvey. His process has been quickly adopted by several prominent multinational corporations—including The Procter & Gamble Company—and many more are studying its application to their decision-making process.

Academic Debate

While contributing so much cutting-edge research to many of the unresolved issues in finance, it seems inevitable that Harvey would be involved in some rigorous academic debate. Currently, he is participating in a high-profile discussion related to the evaluation of investment funds.

Harvey and Fuqua colleague John R. Graham developed the Graham-Harvey measures, which give risk-adjusted returns of funds so that the performance of the investments can be compared to an appropriate benchmark after accounting for risk. The Graham-Harvey measures were described in a 1995 *Forbes* article entitled "The Graham-Harvey Test." The author of this piece applied the Graham-Harvey measures to fund evaluation and witnessed impressive results with the portfolio of funds selected.

The current debate arose when Nobel laureate Franco Modigliani and his granddaughter, Leah Modigliani of Morgan Stanley, Dean Witter & Co., developed a similar method for deriving risk-adjusted returns for mutual funds. The Modigliani measure is termed "M-squared" and is a simple extension of the commonly used Sharpe ratio. This means that M-squared ranks funds in exactly the same order as the Sharpe ratio. It also means that M-squared suffers from the same limiting premises as the Sharpe ratio. For instance, M-squared assumes that there is no co-movement between equity returns and T-bills. Yet, as Harvey points out, "No one believes that the correlation between interest rates and stock returns is zero. Almost always, when interest rates go up, equity returns drop." Additionally, M-squared presupposes that there is no variance in T-bill returns. Harvey comments on this as well, saying, "No one believes interest rates are constant."

Harvey sees enormous potential for application of the Graham-Harvey measures to individual investors as they consider their mutual fund selections. He comments, "Our measures have received a lot of play since they were first featured in *Forbes*. John and I look forward to further work detailing all the ways the Graham-Harvey measures can provide valuable information to investors as they choose among competing investment portfolios."

Real-World Applications

In addition to his impressive research efforts, Harvey is greatly appreciated among Fuqua students for his ability to communicate his knowledge of finance in the classroom. William B. Bane '98, now a Wall Street trader, says, "After taking his course, I feel that I am much more able to digest and analyze many of the most interesting and important issues in investment finance. It's mind-boggling to see what's possible in Cam's world."

Students attribute part of Harvey's teaching success to his skill at integrating Internet technology into the classroom. He often runs his class lectures right out of Netscape, and his homepage—one of the first on the Internet—has received numerous accolades, including a Top 5% ranking among all business/economics sites by Lycos, a popular Internet search engine. Harvey points out that much of the attention his home page has received is the result of his 3,500-word financial glossary, to which Yahoo (the world's most popular Internet site), the *Washington Post* and a number of other financial sites have established links. He says, "My glossary has generated a lot of interest. I am currently preparing for increased bandwidth and the increased use of intranets within firms with a new version that includes much more audio and video."

While such endeavors continue to be of valuable assistance to financial firms and investors all over the world, what is most appreciated at Fuqua is the time he takes to keep his students informed about consequential new developments in finance. Notes Jeremy Krasner '98, "Cam is one of the most accessible professors here at Fuqua. In general, no matter what he is doing, Cam is willing to stop and take some time to help out a student." No doubt many future Fuqua students will discover the same and will also find Harvey's effective teaching style and global financial expertise to be of tremendous advantage as they prepare for their careers.

Raising the Bar

Professor Harvey has won a total of four Graham and Dodd Scrolls for excellence in financial writing as awarded by the Association of Investment Management and Research, including three consecutive awards from 1995 to 1997. Only two others in the history of finance have received this honor more times than Harvey.

A list of his research papers that won this prestigious award, all of which were published in the *Financial Analysts Journal*, includes:

- *"Demographics and International Investments," 1997;*
- *"Political Risk, Economic Risk and Financial Risk," 1996;*
- *"Inflation and World Equity Returns," 1995;*
- *"Sources of Predictability in Portfolio Returns," 1991.*