

Executive Policy Seminar Series
Capital Markets Research Center

Back to Basics
in the Financial Markets

Abby Joseph Cohen

Chair, Investment Policy Committee and
Managing Director, Goldman, Sachs and Company

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Introduction

David A. Walker

Director, Capital Markets Research Center

It is my distinct pleasure to introduce tonight's Executive Policy Seminar speaker, who surely needs no introduction to this audience. I am pinch hitting for Tom Healey, who is a Managing Director with Goldman Sachs and a member of the Board of Advisors for the Capital Markets Research Center. Tom expected to introduce our speaker, but was called out of town at the last minute.

Abby Joseph Cohen chairs the Investment Policy Committee for Goldman, Sachs & Co., where she became a Managing Director in 1996. She began her professional career as an economist with the Board of Governors of the Federal Reserve, and then joined T. Rowe Price, before becoming a Managing Director at Drexel Burnham Lambert. She joined Goldman Sachs in 1990.

Ms. Cohen's extracurricular activities focus on education. She is a Trustee Fellow of Cornell University and serves on the Board of Overseers of the Weill Medical College of Cornell. Previously Abby served as Chair of the Institute of Chartered Financial Analysts (ICFA) and of the Association of Investment Management and Research (AIMR), which awarded her their Distinguished Service Award.

She is also a member of the Boards of the Council for Excellence in Government and the Council on Foreign Relations. Abby is highly ranked in U.S. portfolio strategy by Institutional Investor Magazine and Greenwich Associates. She was inducted into the Wall Street Hall of Fame in 1997 and has been honored by many groups, including the Financial Women's Association and the New York Stock Exchange. Her education includes undergraduate and graduate degrees in Economics from Cornell and the George Washington University, respectively. She has received honorary doctorates in Engineering and Humane Letters.

Back to Basics in the Financial Markets

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Getting Back to Basics

I have a constructive view about recent developments in US financial markets, including the sustainability of the rise in stock prices from their multi-year lows. For much of the last three years, investors in financial markets and many decision-makers in the economy were not focusing on the fundamentals of the economy or their industries. Instead, they were understandably distracted by other events such as the crises of confidence in accounting and corporate governance, and the broader worries associated with terrorism and the recent military engagement in Iraq. As a consequence, many investors made their decisions without focusing on the basics.

My first, and perhaps most important, message is that we are back to the point at which the usual issues and factors should be considered. The focus of analysis should be economic developments, the pricing of financial assets, and the operating performance of corporations. The troubling distractions have faded, but are not entirely gone.

Capital Allocation

I do not intend to minimize the problems we have faced. In early 2000, the United States equity market reached notably over-valued levels, but perhaps of greater consequence was that the economic growth itself had reached overly energetic levels. In retrospect, it is easy to conclude that there was too much investment in plant and equipment and too many dollars being used by companies in an inefficient way. Capital was also squandered in other countries, often in the same industries.

In a perfect world, capital flows to projects with the highest returns. This requires accurate information about the prospective returns. At the outset, perfect information is not available, and educated guesses are required. In retrospect, we now know that some capital invested in the 1990s was allocated to projects with poor or negligible returns. In the equity capital markets, some companies without appropriate business plans, such as immature technology companies, were nevertheless funded. There were no positive consequences for either economic growth or job creation. Similarly, the fixed income markets provided some capital unwisely, for example, funding the global overexpansion of telecommunication services.

Importantly, this was not a phenomenon limited to the United States. Indeed, the misallocation of capital was typically a consequence of misjudgments by industry and sector, rather than by country. Much is now said about the excess enthusiasm for young technology companies in the United States and the manner in which they were able to receive funding at much earlier stages of their development than might have been possible in previous market cycles. Computer technology (“T”) was a smaller sector in Europe, but those nations had notable focus on media (“M”) and telecommunications equipment and services (another “T”). The resulting TMT acronym was used worldwide. At the end of the late 1990’s and early in this decade, telecom companies dominated several European bourses and accounted for the lion’s share of corporate bond issuance in several countries, including the United States.

In some cases, investors were basing their decisions on financial data, later determined to have been inaccurate. These decisions were also colored by expectations for revenue and demand growth that proved to be unrealistic.

Market Valuation

A proper assessment of market valuation requires accurate data on the performance of the underlying corporations. We now know, based on the massive corporate accounting adjustments announced in 2001-2003, that the data previously provided for

earlier years were wrong. Keep in mind that write-offs announced in a particular quarter or year do not usually reflect on that period, but on earlier periods in which revenues, earnings or other factors may have been misstated. Again, in retrospect, it can be seen that the corporate financial statements used by investors to assess equity valuations in 1998-2000 were misleading. If investors had access to more accurate information for those years *at the time*, we would have likely concluded that equities were overvalued at an earlier stage.

Where is the market right now? Using a discounted cash flow approach to the market, we think that the fair value of the S&P 500 is about 1150, or about 15 percent above today's level. This price target was introduced as our 12-month forward forecast in early 2003, and seemed very aggressive at the time. The S&P 500 was then trading below 800 and is currently near 1000. Our view of prospective fair value is not based upon market sentiment, which was quite gloomy earlier this year. Instead, we focus on the fundamentals of economic and corporate performance. We think these factors are again moving in a positive direction.

Although we believe that stocks are undervalued, they are not as inexpensive as they were in February of this year or in October 2002 when the S&P 500 fell to about 780. We primarily rely on a discounted cash flow, or dividend discount, model to gauge the fair value of the S&P 500. Many people prefer simpler approaches such as price-earnings (P/E) ratios that we believe are not as statistically robust because these ratios do not factor in the level of interest rates, inflation, or position in the economic cycle.

Consider that the current conventional wisdom is that the average P/E, now in the low 20s, is high. When compared to other periods of mild inflation and low interest rates, the current mean P/E is within normal ranges. Also consider that P/E ratios tend to be at their highs when the economy is beginning to recover, and earnings are depressed. It is often the low E, rather than the high P, that leads to high P/E ratios. There is also a mathematical issue based on the differences between mean (the arithmetic average) and median (the midpoint which is unaffected by extreme values at either end of the distribution). The median

S&P 500 P/E ratio is about 14.5 based on 2003 earnings, and about 13 based on projected 2004 earnings. That does not seem to be overpriced.

Accounting and the Economy

Developments in the economy and corporate behavior are essential when considering prospective asset returns. With regard to the economy, we have gone through a very difficult three-year period. There have been three years of deceleration and dramatic adjustments, punctuated by eight months of outright recession. During this period, capital spending and inventory investment have been squeezed to low levels. In particular, business fixed investment has declined from the excessive levels of the late 1990s during which time capital had been allocated to projects that had very poor returns.

In addition to these dramatic adjustments in the economy, there have been unprecedented accounting adjustments announced by companies in the S&P 500. Many dubious records were established in 2002. For example, the dollar amount of write-offs reached 140% of reported earnings; stated differently, corporate write-offs were substantially larger than reported earnings. Oddly enough, this embodies two pieces of good news. First, the accounting statements released by companies should now be more accurate reflections of reality. Second, we can more clearly see the sources of the prior excesses.

About two-thirds of the companies in the S&P 500 engaged in some accounting adjustments last year. But only a small handful of companies were responsible for 90 percent of the dollars, most if it linked to “impaired goodwill,” or the overstatement of the value of corporate transactions such as mergers and acquisitions. AOL/Time-Warner alone was responsible for about half of the write-offs taken by all 500 firms in the S&P 500 index. Last year was the year of the big clean up. Although there have been some additional write-offs in 2003, these are much smaller in magnitude.

As a consequence of the cleanup during the last three years, we expect to see an economy without the excesses, a corporate sector with reliable earnings data, and financial asset prices based on more accurate and transparent information.

Current Concerns Throughout the World

International Economy

COUNTRY COMPARISONS

At the top of my list of macro concerns for the past three years has been the weakness of the other major economies. In the United States, many have been concerned about GDP growth that was too slow for several quarters and an unemployment rate that is still too high. Even so, GDP growth in the US this year will be about 3 percent, with a faster pace in the second half. The world's second largest single economy, Japan, is likely to have GDP growth around one percent. Germany, as a proxy for Euroland, which has aggregate GDP larger than that of the US, is projected to have economic growth below two percent. And the unemployment rates in Germany, France and other major economies in Europe are 10-12%.

It is a major concern that aggregate demand in other developed economies is growing slowly and that there has been a belated economic policy response to those conditions. A cynical person might say that the European Central Bank has been waiting for the US to provide a significant amount of stimulus so that they would not have to do so. The trade statistics, which show much faster growth in imports than exports, would support that view.

By focusing on the value of the Euro, rather than on the underlying dynamics of the European economy, the European Central Bank has followed a beggar thy neighbor approach. The US is both the world's largest importer and the world's largest exporter. Our most important trade partners outside of North America are Western Europe and Japan, and when they do not expand at their potential growth rates, there is a notable impediment to our own growth.

VALUE OF THE DOLLAR

The dollar has declined relative to most senior currencies. Although many in the financial markets are nervous about the decline, this may prove to be an overrated or mistaken concern. There is an old joke that in the United States the only people who really worry about a weakening dollar are those planning vacations

abroad. Indeed, our economy is likely to benefit from the decline in the dollar relative to the Euro and the Japanese yen. US companies become more competitive selling their goods and services in Europe and Japan, and our domestic products become more attractively priced than imported goods at home. Many US companies have complained for several years that the strong dollar hurt their competitiveness.

A second benefit, which is a bit of a technicality, relates to the currency translation of foreign-based profits. Assume that a US company has earned 100 Euros in its European-based operations and repatriates this profit. In the meantime, also assume that the Euro has risen by 10% relative to the dollar. The 100 Euros are now worth 10% more than they were, and the company can report profits 10% higher than otherwise would have been the case. Although the stronger profits make for happy reading, our statistical analysis suggests that investors ultimately see through this and will not pay much, if anything, for currency-translated profit boosts. However, they will pay for the increase in profits that results from improved competitiveness and increased market share that derives from a weaker currency.

The third benefit may be a consequence of the dollar's decline on policymakers in other nations. The European Central Bank (ECB), for example, has stated in the last few months that the weaker dollar has become an impediment to growth in Europe and, therefore, has encouraged them to lower interest rates. Previously, a strong dollar encouraged strong exports from Europe to the United States, offsetting weak domestic demand in Europe. Now, the ECB is following a policy of economic stimulus through lower interest rates, and there are intensified discussions on the need for fiscal policy stimulus and economic restructuring in several nations. We think the increased European focus on strengthening the European economy, rather than growth through exports, is a positive development. Our trade deficit has widened in large part due to the differential in economic growth rates; we are importing goods from our trading partners and they are not yet robust enough to return the favor. The differential in economic growth rates at this time may actually favor the dollar, preventing further notable declines in the currency.

INTERNATIONAL TRADE

Foreign exchange traders often point with alarm to the United States' current account deficit. However, proper interpretation of a nation's current account balance hinges on several factors, including whether that nation's currency is a reserve currency. The dollar is widely held as the dominant reserve currency, suggesting that demand for dollars and the nation's ability to maintain a current account deficit over time may be considerable.

The current account deficit has grown along with the trade deficit, but has also increased because the US is the world's single largest magnet for foreign direct investment. When non-US companies conclude that the US is a good location for foreign direct investment (FDI), they invest here and establish operating facilities, boosting the current account deficit.

Data aficionados are also aware of some weaknesses in trade deficit data. Our government does a relatively good job of measuring imports because of the desire to collect duties and tariffs and to monitor incoming goods for a variety of reasons. However, we do a relatively poor job of measuring exports, and the mismatch can be quite significant. According to some government estimates, the undercounting of exports may be as much as 30% in manufactured items.

US Economy

The discussion of concerns would not be complete without a review of problems facing our domestic economy. Let's begin with the consumer and employment. We are all well aware that employment growth is currently disappointing. Labor markets are typically among the last to recover. When an economy emerges from recession, it does not expand (as opposed to recover) until the labor markets are tighter and household incomes are growing solidly. Until that point is reached, there may be concerns about economic growth stalling.

Employment

The early 1990s offer an interesting precedent to the currently sluggish response of labor markets. At that time, there was a multi-

year period of lackluster GDP growth following the end of the 1990-1991 recession. There was an intense controversy among investors in 1992-1993: Were we out of recession or were we still in recession? That debate foreshadowed much of the current discussion and was a consequence of the corporate restructuring of the time.

Prior to the 1990s, the end of recessions typically meant that laid-off workers were invited back to their jobs, or similar positions. The industries that had lost demand regained it. This was not the case in the early 1990's because the economy was being restructured, with a shift away from low-level manufacturing and towards high-level manufacturing and services. Many people who lost their jobs during the early 1990s never returned to their original employers or positions. Instead, when the economy rebounded, they needed to be retrained and find entirely new employment.

Let us be clear about the overall unemployment picture at present. Since 2000, most of the people who have lost their jobs have been lower middle income and lower income workers. Although there have been painful job losses in my industry and others known for attractive compensation, the reality is that roughly two-thirds of the people who have lost their jobs during the last three years earned below the average wage. Once job creation improves, many of these people may still have difficulty finding new positions without suitable retraining. The outsourcing of jobs to other nations may further slow the domestic recovery.

Consumer Spending

Consumer spending, broadly defined, has been the economic stalwart during the last three years but may have already begun to slow. The Federal Reserve, by keeping interest rates very low for so long, stimulated housing demand, auto demand, and demand for other goods that are credit sensitive. We are forecasting a deceleration in consumer spending, the largest single sector in the US economy, highlighted by a rotation within the sector. The household balance sheet, especially at lower income levels, may require additional adjustment as it often does following a difficult economic period. A pleasant surprise is that household finances have not gotten worse over the last year or two, despite sluggish

economic growth. This is due in part to the fact that interest rates are low, but we don't assume that will continue indefinitely. At some point, interest rates will rise, and our analysis shows that balance sheets will be in good conditions for most US households. For many families, the recent rise in their debt levels represents mortgage refinancing at lower interest rates; much of the equity extracted from their homes is being saved, not spent.

Corporate Restructuring

The early 1990s offer only a partial precedent to the current round of corporate restructuring. At that time, the industries being most actively restructured and downsized were in manufacturing. There were also large accounting writedowns in 1991-1993, which were the largest ever seen to that point. Within the S&P 500, corporate write-downs ranged between 35 and 40% of reported earnings. Much of this related to tangible assets that were carried on the books for too long and at excessive valuations. This was an aftermath of the extended period of general price inflation in which book values were overstated.

Company managements faced a new, low inflation reality. For example, when it was recognized that a plant in Akron with a stated book value of \$500,000,000 would never be reopened on a profitable basis, the value was written down. Most of the billions of dollars of that were written off were concentrated in industries that had lost market share, pricing flexibility, and growth prospects. Importantly, writeoffs had never been used on a widespread basis, and those taken during this period reflected several years of cleanup and the prior overstatement of the value of tangible assets.

Ten years later, the writedowns taken in 2001, 2002 and early 2003 have been very large, but have been in different industries – mainly technology, media, and telecommunications. This time, writeoffs have been focused on intangibles, such as goodwill, that were carried at unreasonably high values. Like the early 1990s, the preconditions were similar: some companies overexpanded, require restructuring, and create the need for finding new jobs for displaced workers.

An important difference between the period of writedowns for tangible assets in the early 1990s and the current writedown of

intangibles, including impaired goodwill, relates to the time involved in the adjustment. (By the way, you may be wondering: What is impaired good will? Suppose a company is acquired for an amount above and beyond that priced into the financial markets, or beyond the stated value of its balance sheet. The difference is goodwill and reflects the extra value the acquirer expects to achieve. Following the acquisition, the company may discover that the returns initially expected from that investment have not developed; the goodwill was not worth the original purchase price and is therefore “impaired.”)

In the past, there was no preset timeframe by which a company needed to determine whether or not investments were earning suitable returns. In the early 1990’s, the tangible assets that were written down may have been overstated for a decade or longer. In early 2002, the Financial Accounting Standards Board (the FASB) introduced a new accounting standard under which companies were required to identify, and remove, impaired goodwill from their balance sheets. That is the primary reason why the writeoff announcements last year were so large and so concentrated in time. There will undoubtedly be goodwill impairments in the future related to future mistakes, but the catch-up is over.

Corporate Pensions

Contrary to much common perception, the American corporate pension system is in reasonably good financial condition, although the specific plans of a small number of companies may be in duress. The US corporate system is among the most conservative in the world. We introduced ERISA, which requires the prefunding of long-term pension liabilities decades ago, and FAS 87, the accounting standard for pensions has been in place for years. By comparison, several European nations do not require funding for these long-term pension liabilities, nor are there any international accounting standards. (A few countries, such as the UK and the Netherlands have quite rigorous standards, however.)

Also easing concerns about the status of corporate pension systems, and their impact on corporate earnings and balance sheets, is the decreasing role of defined benefit programs. There are only one-third as many defined benefit programs as ten years ago. Almost all of the growth in pension assets has come under defined

contribution programs. Once the company has contributed to the program each year, there is no additional corporate liability. Despite some unfortunate examples to the contrary, most defined contribution programs were well managed in the late 1990's, displaying good balance in asset allocation and avoiding over-emphasis on the stock of the individual's employer.

Deflation

Some observers are now expressing grave concerns over possible deflation; I believe these fears to be unwarranted. The normal state of affairs in our economy is not excessive inflation. The 1960's, 1970's, and early 1980's were an historical anomaly. You would have to go back 100 years to the Civil War to find a comparable period of inflation. Deflation, especially in prices of goods, is not unusual.

Deflation has been defined in several different ways, contributing to some confusion. The deflation that is fearsome is the sort that occurred in the US in the 1930's, or more recently in Japan. The economy shrank, household incomes declined, and the banking system failed. In the US, about one-third of workers were unemployed during the Great Depression. Today, we are concerned that the unemployment rate has reached 6% of the workforce.

There have been disappointments in Japan during the last decade, but until recently, policymakers there have pointedly failed to admit them. This has begun to change, with some near-term gains in growth and employment. The extent of bank failures is also more widely discussed.

We do not expect deflation in the US that would be similar to either Japan in recent years or the US situation of the 1930s. The US has an extraordinarily robust banking system that has weathered the last three difficult years without a single major bank failure. Returns on equity in the banking system were somewhat reduced, but remained positive and are now rising again. This reflects well on the effective supervision by federal and state regulators, and better internal controls and greater attention to loan portfolios.

There is always deflation in some agricultural commodities and minerals, and this tends to be helpful to the overall economy, even if some producers are harmed. (Consider the phenomenal increases in

the productivity of our farms and mines in recent decades.) Deflation in selected prices is a problem depending on whether you are the producer or the consumer. Deflation becomes a systemic economy-wide problem when it afflicts aggregate GDP growth, national income and the banking system. This is extremely unlikely in our forecast horizon.

Public Finance

Another concern is the current status of public finance, particularly at the state and local levels. Forty-six of 50 states have already reached dramatically into their reserves to balance their budgets in the current budget cycles. Most state and local governments do not have the flexibility of the federal government, which can run large deficits for an extended period. Many state and local governments must balance their budgets within a one- or two-year cycle, which explains the use of their reserves.

Approximately 30 of 50 states have either increased taxes or are seriously talking about increasing taxes, and roughly 30 of 50 states have either cut back spending on services or are seriously considering it. There are considerable disparities in the regional effects. For some, the pain is being enhanced because they previously enjoyed strong growth along with the successes of some industries that are now no longer generating new job growth or tax revenues.

Summary

Investors and economic decision-makers can now return their focus to the basics, after a three-year hiatus. The emphasis can turn away from the special and often unpleasant, factors (including terrorism and financial misbehavior) that captured much attention. Again, the emphasis should be on economic developments, the appropriate pricing of financial assets, and the operating performance of corporations. In retrospect, it can be seen that some equity and fixed income capital was misallocated to companies without appropriate business plans, and there was little benefit in the form of sustainable economic growth or job creation. In addition,

there were examples of poor corporate governance and misleading corporate accounting.

Using a discounted cash flow approach to the market, we think that the forward-looking fair value of the S&P 500 is about 1150, about 15 percent above current price levels. This would be our forecast for early 2004. The median S&P 500 P/E ratio today is 14.5 using 2003 earnings. This seems reasonable, especially considering the low level of inflation and interest rates, and the likelihood that profits will continue to grow in 2004.

The accounting writeoffs announced in 2002 by companies in the S&P 500 established unpleasant records in terms of the aggregate dollar amount and as a percentage of reported earnings. We expect economic growth to become steadier and for the corporate sector to report reliable earnings data, allowing a restoration of investor confidence.

Current concerns include the sluggish growth of other major economies. Unemployment rates are quite high by US standards, and local policymakers have been reluctant to introduce more notable stimulus.

Within the US, we are uncomfortable that employment growth is lagging the overall recovery, although this may be the typical pattern. Another concern is the state of public finance, particularly at the state and local levels. Forty-six of 50 states have reached dramatically into their reserves to balance their budgets. The value of the dollar has declined relative to other senior currencies, spurring worries that we believe are mistaken.

The weaker dollar relative to the Euro and the yen allows our companies to become more competitive, and may encourage foreign policymakers to stimulate their own economies. The European Central Bank, for example, has stated in the last couple of months that the weaker dollar is an impediment to growth in Europe, which has encouraged them to lower interest rates.

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