

efl quarterly

04 | 2011

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High-Frequency Trading: Myths and Realities

Situation Awareness in Financial Service Institutions through Social Collaboration Platforms

Good Financial Advice – Wanted but not followed

Financial Supervision in the EU



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Impressum

Redaktion
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Dipl. rer. pol. techn. Kai Zimmermann

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Gestaltung
Novensis Communication GmbH
Bad Homburg

4. Ausgabe, 2011
Auflage 1.700 Stück

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Printed in Germany
ISSN 1866-1238

Editorial

High-Frequency Trading: Myths and Realities

Mark Spanbroek

Lately, it has become conventional wisdom that high-frequency trading is making the equity markets more volatile. While it is true that the speed of trading has advanced enormously in the last several years, it is far too simplistic to blame technology for market volatility. In fact, academic research has shown that high-frequency trading has a dampening effect on volatility.

First of all, just to be clear, high-frequency trading is a method for executing trades. It can be used for a variety of different trading strategies, but it is not a strategy in itself. It is simply the latest phase in the evolution of electronic trading technology, much as the smart phone is the latest iteration of the personal communication device.

So why do members of FIA EPTA use high-frequency trading? The reason is simple – this method of trading makes it possible for high-frequency traders to provide liquidity to the exchange-traded markets more efficiently.

Every price quote that high-frequency traders provide to an exchange creates a risk exposure. For any given quote, the value of this exposure is very low, but across an entire market the exposure can be significant, so high-frequency traders have to be very nimble in adjusting their quotes. In those markets where exchange speeds are very high and the latency of trading is very low, firms can manage their risk more effectively. And that allows high-frequency traders to quote narrower spreads for larger size and fill resting orders more frequently. This improves liquidity and reduces costs for end users.

There is a widely held view that restricting high-frequency trading will somehow reduce volatility. Nothing could be farther from the truth. As liquidity providers, high-frequency traders buffer the exchange-traded markets from external shocks. Without their participation, the screens will go dark and prices will go to extremes. Putting “sand in the gears” would reduce the ability to provide



Mark Spanbroek
Vice Chairman
FIA European Principal Traders Association

liquidity and make the markets more susceptible to volatility, not less.

This is borne out by research done by academics who have carefully analyzed data from a number of exchange-traded markets around the world. Their findings are consistent: volatility is dampened, not increased, by high-frequency trading. A sample of this research is available on the FIA EPTA website at <http://www.futuresindustry.org/epta/academic-research.asp>

It is often claimed that the increasing use of high-frequency trading is damaging investor confidence and making investors more reluctant to trade. This criticism seems misplaced. The reasons for investor uncertainty are all around us – the grave fiscal problems facing several European countries, the once-unthinkable downgrade of the U.S. credit rating, the potential for another round of huge losses in the banking system, and the growing fear that the tools of monetary policy

have reached their limit in preventing a global recession, to name just a few.

In any case, sentiment alone should not be the basis for policy decisions. Regulators must arm themselves with empirical data to help them distinguish perception from reality. And to the best of our knowledge, all the empirical data show that high-frequency trading has improved the quality of exchange-traded markets to the benefit of all investors.

This view is also supported by Blackrock, a leading asset management firm. In a paper published in June 2011, Blackrock said high-frequency trading has a beneficial effect on European equity markets. “HFT helps to create efficient markets by facilitating price formation, lowering the cost of trading and improving the linkage between markets,” Blackrock said. “All of this, in turn, aids in achieving optimal investment performance for end investors.”

Research Report

Situation Awareness in Financial Service Institutions through Social Collaboration Platforms

THE INCREASING ABSENCE OF FACE-TO-FACE COMMUNICATION IS A CHALLENGE FOR EMPLOYEES AND ENTERPRISES IN ORDER TO MAINTAIN SITUATION AWARENESS.

Christoph Seebach
Immanuel Pahlke

Roman Beck

Introduction

With its information-driven business processes, continuously changing customer demands, and above-average volatility, the financial industry critically relies on an efficient exchange of information. However, as work becomes more global, distributed and non-located, it also becomes more difficult for workers to stay aware of all relevant information in their business environment (Gutwin and Greenberg, 2002). Specifically when collaborating with others, individuals often lack what has been labeled situation awareness (SA). In short, SA is defined as an individual's knowledge about what is going on in its immediate environment. With respect to collaborative work, individuals need to know, e.g., about their colleagues emotional state or whom to ask about the solution for an issue which needs to be solved. While in traditional work settings, SA is gained in face-to-face communication, information systems (IS) are needed to create and main-

tain SA between people working apart from each other. In this regard, social collaboration platforms such as Enterprise Microblogging (EMB) are suggested to be a promising solution to solve this challenge. Originally rooted in social psychology, SA is the result of exchanging and processing environmental information in order to develop a mental picture of the situation as guidance for further action. Based on this definition, two separate types of SA can be distinguished from a collaboration point of view: Team situation awareness, which is defined as the aggregation of the individual SA across all collaborators, and shared situation awareness, i.e. the individual's SA with respect to the activities of its co-workers. Within IS research, the focus has been largely on how to support SA from a rather technical point of view. Due to this predominant technical orientation, attention has shifted away from the original concept of SA as a cognitive process. As a

result, the concept lacks the clear theoretical understanding needed to support SA with IS effectively.

Accordingly, we develop a general conceptual model to enhance our understanding of SA in distributed collaboration and to provide guidance for the design and evaluation of IS that support the creation of SA. Further, we demonstrate how the model may be utilized by evaluating an existing social collaboration platform regarding its ability to support the creation of SA. Specifically, we conduct a content analysis on a rich dataset of EMB data from a financial services provider.

Development of the Conceptual Model

Since SA is inherently based on information, IS are needed to provide individuals with specific awareness information about their environment. However, and with respect to distributed collaboration in particular, it is not clear which specific

kind of information IS should provide to support SA. Therefore, we conducted a systematic review of the literature in order to determine categories of awareness information being needed.

The first identified category, activity awareness (AC), includes all SA subtypes relating to activities needed to achieve a common goal. Structure awareness (ST), which we define as an aggregation of all subtypes of SA related to knowledge about informal and formal structures at work, is specified as the second category. The third category includes all subtypes of SA relating to social interaction between collaborating individuals and is labeled social awareness (SO). Finally, we conceptualize context awareness as an aggregation of all subtypes emerging from the 3 categories of SA over time. Since information holds little value without context this category provides individuals with a general sense of the context in which things are happening.

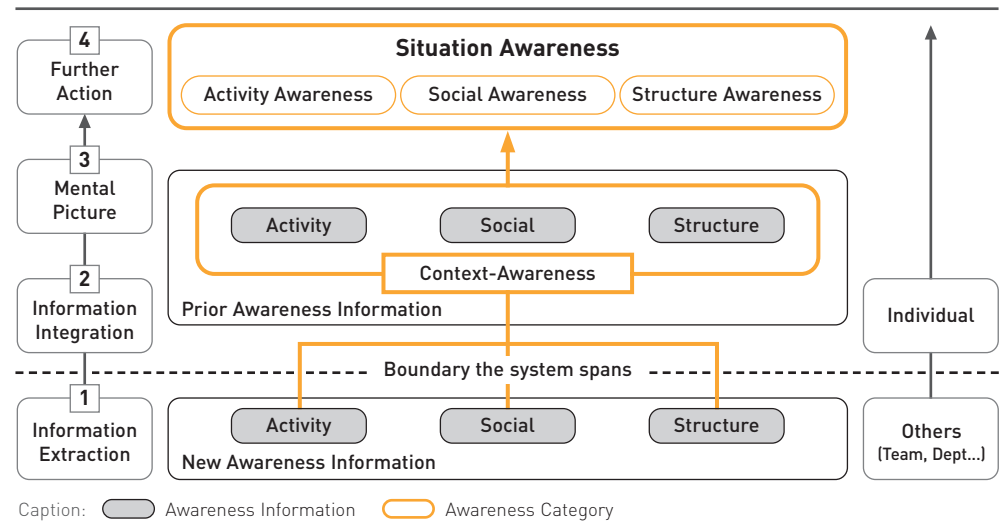


Figure 1: A conceptual model of SA in Distributed Collaboration

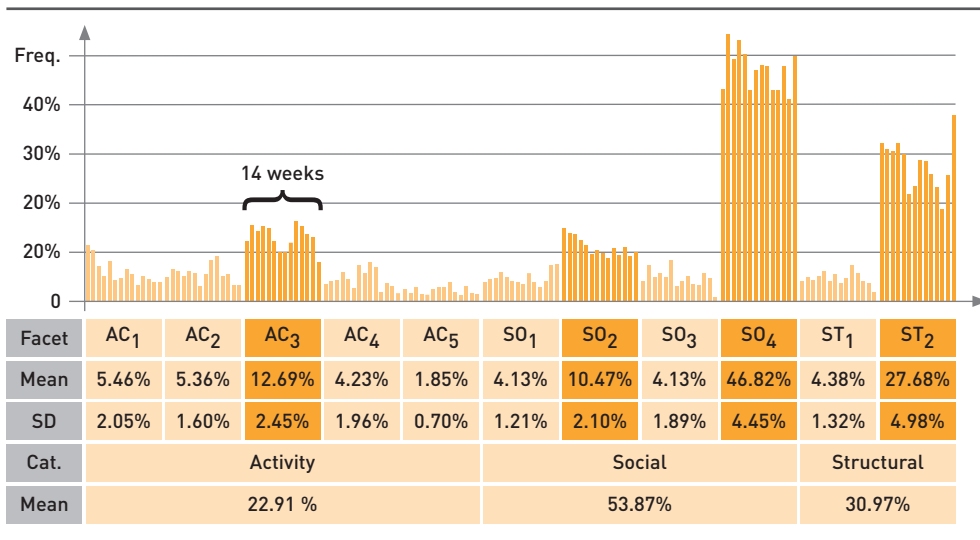


Figure 2: Freq. of Awareness Information Categories and Facets per Message over Time (weekly)

The conceptual model depicted in Figure 1 illustrates the relations between these elements based on the initial definition of SA. Accordingly, the model's structure is based on four steps: 1) information extraction, 2) information integration, and based upon, 3) development of a mental picture, to guide 4) further action. The information extraction step describes the ability of an individual to extract emerging activity, social or structure awareness information in a timely manner. In the information integration step, the individual needs to integrate this new awareness information in its specific context in order to make sense out of it. Finally, SA emerges as a mental picture of the situation and may then provide guidance regarding an individual's further actions. From a distributed collaboration view, this may lead to more effective interaction between collaborating individuals.

Empirical Results

To demonstrate how the conceptual model might be utilized, we evaluate a social collaboration platform regarding its ability to support SA. Specifically, we analyze the content of a

Category	Facet
Activity awareness	AC ₁ : What are others currently doing?
	AC ₂ : What intend others to do in the future?
	AC ₃ : What need others from me?
	AC ₄ : How have activities to be done?
	AC ₅ : What is the purpose or goal of an activity?
Structure awareness	SO ₁ : Who is interested in a specific issue?
	SO ₂ : What is the emotional state of others?
	SO ₃ : Who is busy or available?
	SO ₄ : Who is talking to whom?
Social awareness	ST ₁ : Who is a contact person for what?
	ST ₂ : Who has which positions regarding an issue?

huge dataset of EMB messages obtained from a bank's system to measure to what extent the system provides awareness information to its users. For this purpose, we developed a coding scheme which operationalizes each of the three awareness information categories and their specific facets given in the table below.

The results of our analysis show that the messages exchanged via the EMB platform are a rich source of awareness information. 72% of the analyzed posts contain at least one of the three categories of awareness information. Specifically, more than 50% of the messages support users with social awareness information (SO) about their colleagues. However, with a share of more than 30% for structural (ST) and 22% for activity (AC) awareness information, the other two types are well represented in the messages, too. As Figure 2 illustrates, AC3, SO2, SO4 and ST2 occur with highest frequency among all 11 facets of awareness information. At a level of more than 10%, the tool was utilized for exchanging information about what employees needed from each other (AC3) to do their work. Information about the emotional state of the users (SO2) is represented by approximately 10%. Almost every third message contains information about the positions and opinions of the users (ST2). With an average frequency of 46%, the system supports its users with information about who talks to whom (SO4).

Conclusion

The conceptual model developed explains how SA emerges from the extraction and process-

ing of awareness information and illustrates the important role of IS as bridging the gap between geographically distributed workers. Further, we developed a broad categorization of different subtypes of SA and derived categories and facets of awareness information needed to maintain them.

From a practical view, our conceptualization of awareness information might help to form the basis for a rigorous specification and evaluation technique of IS designed to support SA. Further, practitioners may want to assess to what extent existing systems already support SA. Moreover, our conceptualization could be helpful to determine guidelines for the design of new collaboration platforms and their evaluation.

Finally, our work contributes to the few studies on social collaboration platforms, and their usefulness and value for business. Our analysis of the bank's system illustrates how EMB supports the creation and maintenance of SA within financial service institutions as an important dynamic capability to meet the challenges of turbulent environments. Since SA is an important prerequisite for successful collaboration, we thus conclude that EMB can play a crucial role to generate business value from improved SA among employees.

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Research Report

Good Financial Advice – Wanted but not followed

THIS STUDY INVESTIGATES WHAT HAPPENS WHEN RETAIL CUSTOMERS ARE OFFERED FREE AND UNBIASED ADVICE. USING A LARGE FIELD EXPERIMENT IT SHOWS THAT THOSE WHO ACCEPT THE OFFER (5%) ARE MORE LIKELY TO BE MALE, OLDER, WEALTHIER, MORE EXPERIENCED AND MORE FINANCIALLY SOPHISTICATED. HOWEVER, EVEN THOUGH THE ADVICE WOULD HAVE HELPED, IT ACTUALLY LARGELY FAILED TO HELP BECAUSE THE CUSTOMERS DID NOT LISTEN TO IT. OVERALL, OUR RESULTS SUGGEST THAT THE MERE AVAILABILITY OF UNBIASED FINANCIAL ADVICE IS A NECESSARY BUT NOT SUFFICIENT CONDITION FOR BENEFITING RETAIL CUSTOMERS.

Utpal Bhattacharya
Simon Kaesler
Steffen Meyer

Introduction

Using data from a field study, we are among the first to examine the demand side of financial advice and to show that an offer of free and unbiased financial advice is accepted by only 5% of the clients approached. Of those clients who accept the offer, only very few ultimately follow the recommendations made. Thereby, the study contributes to the current discussion on consumer protection in the context of financial advice and questions the effectiveness of supply side solutions, since better information alone does not seem to improve the decision making of private investors.

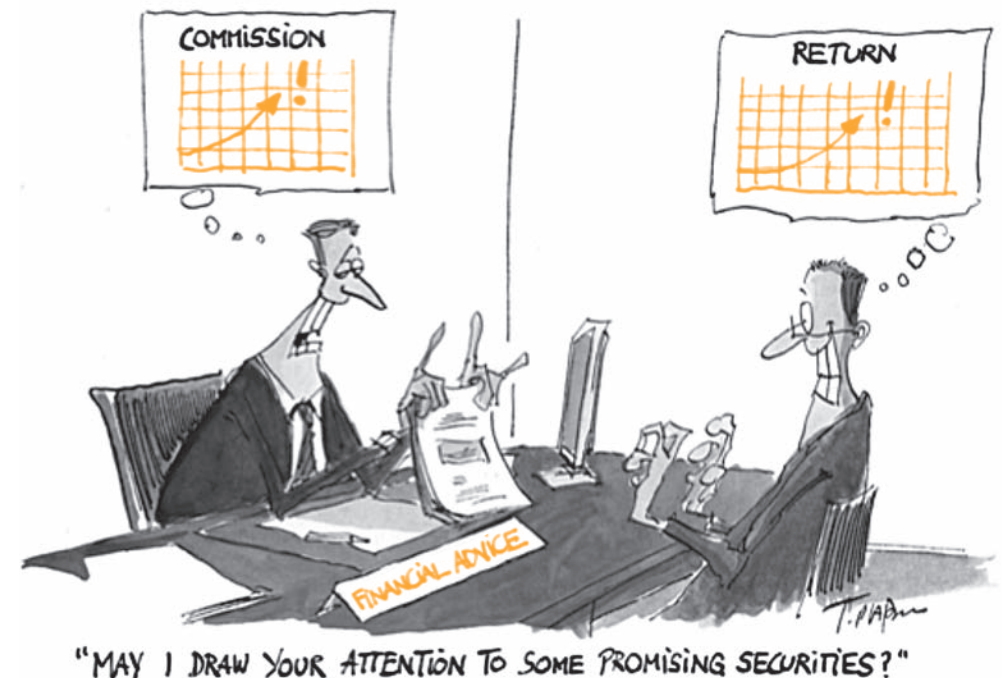
Andreas Hackethal
Benjamin Loos

There is a large and growing body of literature on household finance, which documents that retail investors make serious investment mistakes by deviating from the prescriptions of normative finance. The majority of households do not even participate in the stock market despite the large equity premium that exists. The few households that do participate in equity markets hold under-diversified portfolios. Under-diversification with regard to geographical diversification is particularly pronounced – investors are found to exhibit both a home bias and a preference for local stocks (for a summary of investment mistakes, please refer to Campbell, 2006).

Other investment mistakes in the trading behavior of private investors have also been documented. We observe inertia, resulting in insufficient portfolio adjustments of individual investors to general market movements. Investors trade too much because they are overconfident. Investors tend to sell winners too early and hold on to losers too long, an investment mistake called the disposition effect.

Are these investment mistakes serious? Barber

and Odean (2000), by looking at the consequences of overconfidence, find that overconfidence leads to substantial return decreases after the deduction of transaction cost due to excessive trading. The more people trade, the worse their net returns are. For the aggregate portfolio of individual Taiwanese investors, Barber et al. (2009) document an annualized loss of 3.8%. They find individual investors to be even the worst performing group of all investors in the Taiwanese market.



In his presidential address Campbell (2006) points out that next to financial education, default options or regulation are potential remedies for private household's investment mistakes. Yet, another potential remedy for private households' investment mistakes is financial advice. Thereby, the business of providing financial advice is large all over the world. For example, in the U.S., the Financial Planning and Advice Industry is estimated to equal a size of 37 billion dollars. The Investment Company Institute also remarks that over 80% of respondents state that they use financial advice from professional advisors. The same holds true for Germany. A survey among retail investors indicates that more than 80% of investors consult a financial advisor before making investment decisions.

If you build it, they will come

However, the literature also shows that the professional advice given to retail investors is often conflicted and that retail investors who obtain such advice actually worsen their investment performance, because advisors may have incentives to increase primarily their commissions instead of recommending good products for the client (for example, Inderst and Ottaviani, 2009). An obvious supply side cure to improve portfolio efficiency and mitigate the investment mistakes of retail investors is therefore to offer unbiased and theoretically sound financial advice that brings advisees closer to efficient portfolios. If the abovementioned conflict is resolved,

advice may help improve investors' performance. In other words, it could be expected that expressed in colloquial terms: "If you build it, they will come".

The Field Experiment

We test whether this supply side solution works. Can unbiased financial advice steer retail investors towards efficient portfolios? To answer this question, we work with one of the largest brokerages in Europe, which has several hundred thousand active retail customers. This brokerage started offering financial advice to about 8,000 of its customers, all of whom were chosen randomly, in 2009. The clients were contacted via an e-mail to the personal mailbox within their brokerage account. If the customers did not react to the e-mail, they were called and asked whether they wanted to accept the offer.

The advice was free of charge for a limited period of time and, ex-ante, unbiased as it was generated from a commercial portfolio optimizer that improves portfolio efficiency and did not push specific products with high commissions. It was even free of commissions for the period of this field study and terminated automatically. This advice was also sound, because it substantially improved diversification. For example, the share of well-diversified index funds in the portfolios sharply increased and the home bias, i.e., the tendency to excessively hold German stocks, was also reduced. In order to illustrate this

point: The share of German stocks amounted to 52 % in the original portfolio of investors and would have been reduced to 31 % if the recommendation would have been implemented. Diversification across asset classes was improved as well. All this left customers with a significantly more efficient portfolio than they had before. This rests on the assumption that they fully implemented the recommendations.

Due to the fact that we have data on all the retail customers in our sample, i.e., for those who accepted the advice and also for those who did not accept the advice, including administrative for the time before the advice was offered and for up to ten months thereafter, we can answer some key questions using a difference-in-difference methodology: How many and which types of customers accept the offer? If customers accept the offer, is the advice provided followed? Does portfolio efficiency improve for the average advisee who accepts the offer? Does portfolio efficiency improve for the average advisee who follows the advice given? Are those investors most in need of financial advice also the ones most likely to get it?

The Findings

By answering these questions, we explore the demand side of financial advice. We link the recommendations of advisors with actual customer behavior after the advice has been given. First, we find that only about 5% of

clients accept the offer for free and unbiased advice. These clients are more likely male, are older, have more money, possess a higher level of financial sophistication, and are also more likely to have a longer relationship with the brokerage.

Second, when regarding those who accept the offer, the advice given is hardly followed. The majority of investors do not follow the recommendations at all. More than one third of the investors act even against the advice by buying securities that were not recommended and selling securities that they were advised to keep (see Figure 1). Third, portfolio efficiency improves for the average advisee who follows the advice. But it would have improved even more for those investors who accepted the general offer, but did not subsequently follow the recommendations made. Portfolio performance improves most for the least financially sophisticated investors. Thus, we document that this unbiased financial advice can indeed help investors improve their portfolio performance, but it can only work if people follow the recommendations.

Fourth, it seems that those investors most in need of financial advice are the ones least likely to get it and vice versa. The ones who experienced the worst performance in the past and could benefit much more from the advice are less likely to accept the offer. In other words, to speak colloquially "the sick do not go to the doctor".

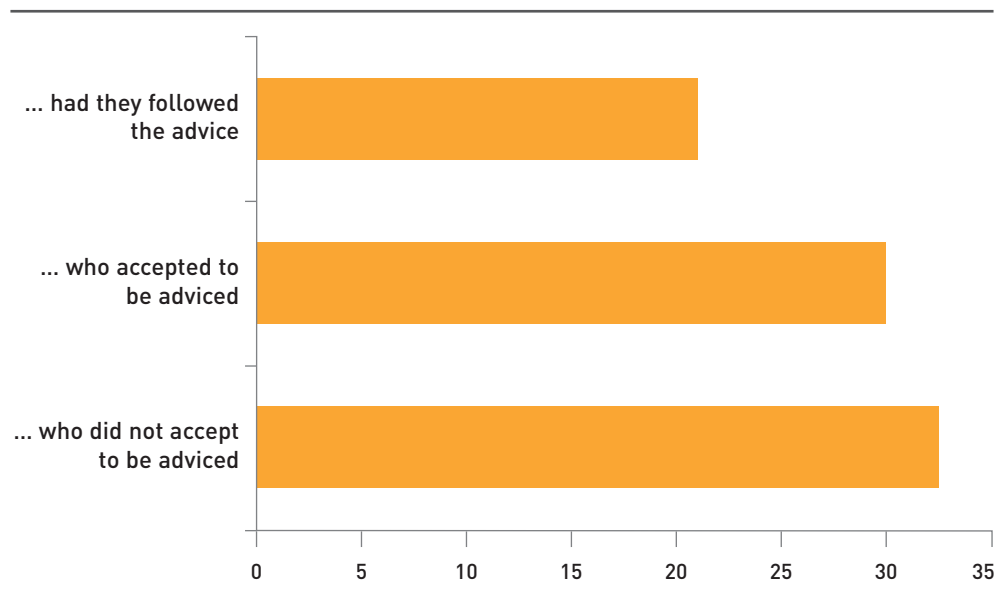


Figure 1: Unsystematic risk share in % of selected investors...

Overall, our results imply that the mere availability of unbiased and theoretically sound financial advice is a necessary but not a sufficient condition for benefiting retail customers. Thus, as the saying goes: "You can lead a horse to water, but you can't make it drink".

You can't make a horse drink

These findings highlight that the optimization of investment decisions made by private investors is to a large extent a demand side problem, while regulators are currently focusing on the supply side.

In the U.S., a new agency called the Consumer Finance Protection Agency was created

under the financial reform bill (i.e., the Restoring American Financial Stability Act of 2010) to deal with mostly supply side problems. Likewise, the Markets in Financial Instruments Directive (MiFID) implemented in Europe aims to enhance protection of retail investors by increasing the transparency of financial products. In the UK, the FSA has even launched the Retail Distribution Review (RDR) that, among others, suggests minimizing conflicts of interest by prohibiting commissions or defining minimum qualification standards for financial advisors after 2012. Moreover, in Germany, the new Securities Trading Act forces financial services firms to disclose any fees – kickbacks, bonuses, etc. – related to a (potential) prod-

uct sale. Yet, more information and disclosure is only valuable if customers are able to translate these into better investment decisions, which is found questionable by this study.

Our results apply not only to financial products, but also to patients' adherence to medical advice, which has been shown to be very low. This is because patients believe they know more than the doctor, are lacking social support, or are simply unreasonable about what they are told. It is up to future research to identify the factors that prevent investors from following beneficial financial advice.

Experimenting with alternative ways to offer advice is therefore a useful avenue to explore in the future. For example, in our study, the advice would require people to turn over 75% of their portfolios on average, since investors' existing portfolios are largely inefficient. Investors in our sample may have found it too complicated or too cumbersome to implement the full list of recommendations, though they did turn over 70% of their portfolios every year during the pre-advice period. Therefore, making the implementation of the recommendations easier might enhance the degree of following.

Moreover, although the information given to our advisees is extensive and clear, it may not be much different from other less theoretically anchored sources of investment advice, to which people might be exposed

outside the brokerage. Perhaps future settings could therefore seek to build greater trust with advisees.

To conclude, much more needs to be done to understand why and how financial advice is actually followed and how it can help individual investors. Finally, the question remains: What makes the horse drink?

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Insideview

Financial Supervision in the EU

INTERVIEW WITH DR. BERNHARD SPEYER, DEUTSCHE BANK RESEARCH

As a response to the financial crisis, the European Commission proposed a reform of the structure of financial supervision in the European Union (EU). Since January 2011, the newly formed European System of Financial Supervision (ESFS) monitors financial stability within the EU. Until last, Germany and the United Kingdom favored national supervisory authorities over the pan-European solution. What are the benefits of a holistic European system from your perspective?

There are two aspects to this: First, the intertwining of macro- and micro-prudential supervision under a common roof, the ESFS. This is sensible, because only the combination of the two can ensure financial stability. Having said this, while this is conceptually evident, putting into place an effective intertwining of both types of supervision in day-to-day practice is difficult. But the framework established is sound and will, for sure, grow into a holistic approach over time. The second aspect is the desirability of pan-European supervision: In a

single EU financial market with large cross-border institutions, only an EU-level structure can ensure effective supervision and financial stability and will avoid competitive distortions.

How far is the current set-up away from a truly holistic independent system? Where do you see critical points limiting the success of the current consent?

In the area of micro-prudential supervision, the main weakness of the new set-up is that the European Supervisory Agencies (ESAs) have only very limited direct supervisory powers. To what extent they will be able to gain weight vis-à-vis national supervisors through setting rule-books, peer review, arbitration and emergency powers is an open question. As to macro-prudential supervision, the European Systemic Risk Board (ESRB), too, has only limited hard power, but will have to exert influence by projecting "soft power", i.e., through the quality of its analysis and recommendations and by means of communicating with the markets.



Dr. Bernhard Speyer
Deputy Head
Deutsche Bank Research

Does the ESFS, as it is designed and in operation, now reflect the right conclusions drawn from the financial crisis?

Only partly. The ESRB clearly closes an identified gap in the supervisory structure. While its structure appears a bit unwieldy, it will nonetheless be a crucial element in preventing financial imbalances, which may threaten financial stability, from arising in the first place. In contrast, the ESAs are clearly too weak to really put the stability of Europe's financial markets on a firmer footing and to deal more effectively with cross-border crises compared to what we saw in the past couple of years. I fear that too many policy-makers still have not grasped that nation-based financial supervision is ultimately not compatible with a fully integrated financial market. Either we move towards EU-level supervision or there will be market re-fragmentation.

Does Deutsche Bank Research expect significant changes to the banks' business

model due to the implementation of the ESFS?

No, it is not necessary to change entire business models in reaction to the establishment of the ESFS. But banks will need to monitor closely, in particular, the actions of the ESRB. Macro-prudential supervision, by definition, affects banks irrespective of their own risk situation and may limit the growth of business even if the bank itself had ample capital at its disposal and a healthy asset base.

How vocal and forceful do you expect the ESRB to be?

Initially, the ESRB will probably move cautiously. Tools for macro-prudential supervision are largely untested and in the current market environment, the ESRB will want to avoid creating further uncertainty. Also, experience must be gained on how markets and authorities react to ESRB warnings and recommendations.

Thank you for this interesting conversation.

Infopool

News

Honorary Membership in the Council of the E-Finance Lab

Jochen Partsch, acting mayor of the city of Darmstadt, accepts the honorable membership in the Council of the E-Finance Lab. Mr. Partsch follows his predecessors, former Mayor Walther Hoffmann, in encouraging the cooperation between the E-Finance Lab and the Technische Universität Darmstadt. The E-Finance Lab gives Mr. Jochen Partsch a very warm welcome!

Awards and Dissertations

Prof. Dr. Skiera's and Nadia Abou Nabout's paper is one of three finalists for the Gary L. Lilien Practice Prize. The goal of the Gary L. Lilien Practice Prize is to highlight and celebrate outstanding marketing science work that has had significant organizational impact. Among others, the price committee includes colleagues from Harvard Business School, NYU, Duke and Dartmouth College.

The Alcatel-Lucent Foundation annually awards two dissertations in the field of "Communications and Information Technology" with a price of € 5,000. For his dissertation thesis "Management and Evolution of Global IS Outsourcing Relationships: A Longitudinal Case Study," Dr. Robert W. Gregory (formerly with layer 1) was one of the two laureates awarded by the foundation. The award ceremony takes place in Stuttgart on October 7th, 2011. Congratulations!

Dipl.-Wirtsch.-Inf. Martin Wolf (layer 1) has received his doctoral degree on August 1st, 2011 with his dissertation on "An Integrative Perspective on IT Innovation Assimilation in the Financial Services Industry". Congratulations!

Team Members

As a new member of the cooperative Ph.D. program Dipl.-Kffr. Sabine Fremdt joined the team of layer 1 in July 2011. After completing her studies in business administration at the Justus-Liebig-University in Giessen, Ms. Fremdt has started to work as a consultant in the Financial Services division of IBM Global Business Services. Within the E-Finance Lab, Ms. Fremdt is supervised by Prof. Dr. Roman Beck.

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For a comprehensive list of all E-Finance Lab publications see

<http://www.efinancelab.com/publications>

Infopool

RESEARCH PAPER: RETHINKING MARKETING

Companies use advanced technologies to understand and interact with customers, yet most still depend on mass media marketing to drive impersonal transactions. To compete, companies must shift from pushing individual products to long-term customer relationships building. The marketing department must be reinvented as a "customer department" that replaces the CMO with a chief customer officer, who makes product and brand managers subservient to customer managers, and oversees customer-focused functions including R&D, customer service, market research, and CRM. These changes shift the firm's focus from product profitability to customer profitability, as measured by metrics such as customer lifetime value and customer equity. This organizational transformation will uproot entrenched interests and so must be driven from the top management level.

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In: Harvard Business Review, 88 (2010) 1, pp. 94-101.

RESEARCH PAPER: WHEN A HALT IS NOT A HALT: AN ANALYSIS OF OFF-NYSE TRADING DURING NYSE MARKET CLOSURES

The relevance of stock market interruptions has experienced a major shift since the ongoing fragmentation and the increasing technological advancement of nowadays financial markets. The authors investigate the interdependence between trading venues and the impact on the price discovery process before, during and after trading halts at the primary market. Revealing an improvement in the price discovery process when trading migrates to alternative venues, this comes at the cost of significant higher spreads and increasing volatility during the interruption. These opposing effects have to be weighted carefully in terms of market quality and investor protection.

Chakrabarty, B.; Corwin, S.; Panayides, M.

In: Journal of Financial Intermediation, 20 (2011) 3, pp. 361-386.

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