

Finance Theory Group (FTG): Past, Present, and Future

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Ten years ago, we started the FTG. It is a great pleasure to be here today with you all for the 10-year anniversary celebration. No doubt, the FTG has developed far beyond our expectations. So, let us take this opportunity to go back and remember how it all started, what we were trying to achieve, and what we think should be some guiding principles for the future.

How Did We Start

In the summer of 2009, a few of us – theorists – had dinner at the Western Finance Association in San Diego. As it was usually the case in meetings of financial-economics theorists, the conversation quickly centered on the frustration of being a theorist in the profession:

- 1) It is hard to get papers into conferences;
- 2) When you present in conferences you have to focus on the empirical implications, and people around you are usually empiricists who may not care as much about the details of the model.

We decided to take action and organize a conference for theorists that would focus on presentation and discussion of theory papers, aiming to go deeper into modeling details. We organized the first meeting at MIT in November of 2009. There were 36 attendees. We funded the meeting with our own research budgets (breakfast, lunch, and refreshments only!). Despite the very barebones structure of the meeting, the active and deep discussions that took place showed us that we were on a good path and that we should continue in it.

The success among the finance theory community was so big that we all decided to move on to the next meeting, and the next one, etc. As we kept going, the number of participants in these meetings kept growing.

In 2011, FTG was formally created with a set of bylaws. With the bylaws, we expanded the group by welcoming fellows, prominent scholars working in finance theory. We also created the Best PhD theory paper prize, which initially was financed by the board of directors.

Where are We Now

With a formal structure the FTG grew into a vibrant group of 143 members and 37 fellows.

The core activity of two meetings a year to present selected theory papers is still in place. We are now at the 21st meeting. Over time, the group identified room for expansion into other activities and territories:

- 1) Summer school for PhD students and faculty: building foundations for the young generation.
- 2) Open meetings in Europe: connecting to the broader population of theorists in the profession.
- 3) Theory and empirics meeting: connecting to the broader profession and increasing the impact of theory (forthcoming).

Over these past ten years, FTG conferences provided an outlet for many theory papers, allowing authors to get unique feedback and the audience to engage in productive discussion. We heard that many co-authorships were spurred by discussions in FTG meetings. With the summer school, the group has helped train many PhD students in finance theory. Members of the group grew into leadership positions in the profession, helping to foster theoretical research and mentor younger researchers.

The Role of Theory

To understand the importance of FTG, we need to understand the role of theory. We all know that Finance is primarily an empirical field. This is not surprising given the abundance of data. In the current era of big data, the tendency towards empirical work will probably grow even stronger. However, there is a big risk in focusing only on data. One needs to understand the data generating process. Without it, empirical analysis can be misguided and misleading.

This is where theory comes in, and it has an essential role in the development of the finance field, which will not disappear even with data sources becoming richer and more sophisticated. Theory provides the story behind the data, the discipline for empirical work, and the way by which one can decide what to test, how to test, and what the interpretation ultimately is. Theory is needed to organize our thoughts about the complex world around us.

Despite all that, one commonplace view is that all relevant theory has already been developed in the early days of finance and all that there is left are marginal improvements over the existing literature. We disagree with this view in at least three ways:

- 1) *New tools and paradigms arise.* For example, new developments in models of information and coordination, dynamic programming, or network theory have been successfully brought to finance theory models helping explain important real-world phenomena. Behavioral finance relaxes the central paradigm of rationality that permeates most of the finance theory models, and helps explain empirical regularities. Many areas of finance, but especially household finance, have benefited from the use of behavioral finance.
- 2) *The world changes.* New structures require new theory to be developed. For example, in the increasingly knowledge-based economy, the relevance of data and innovation cannot be overstated. These are arguably the most important assets of modern companies. How does that change our original view of the firm? Moreover, new financial contracts/structures are created. In the recent past we saw the emergence of the LBO, IPO, ABS, CDS, HFT, ETF, CLO, ICO, etc... Theory can help us understand the role of these new contracts/structures.
- 3) *We actually still know little about well-studied areas.* As the recent financial crisis has shown us, we still have a lot to understand about banking and financial intermediation. In fact, the collapse of the financial sector in 2008 spurred a new wave of theoretical research in banking and financial intermediation.

Why a Theory Group

So, with this in mind, the importance of having a finance theory group is apparent. Writing good theory is a combination of art and science. One needs to have a good story of how the world works, but also use the most appropriate tools to develop this story and demonstrate its coherence, consistency, and robustness.

These are things that develop with hard work, learning, acquiring expertise, and constant feedback. For this, it is important to be in touch with other theorists, get an opportunity to present and get feedback, see how others are tackling problems, and constantly exchange information.

The profession did not provide enough of this before the FTG, given its empirical tilt. This puts pressure on theorists to stop doing theory and move to other things. The FTG was an opportunity to change this path and make a difference.

The idea was to create a forum where people present and talk about models, so that the art and science of writing models in finance will be supported and pushed forward.

Some Challenges We Had

Problem: How can we create a group where people are committed to come and attend on a regular basis? There are not many examples of this in the profession, as people mostly go to conferences when they are on the program (one exception is NBER).

Solution: Membership is made conditional on attendance. People who miss a number of meetings lose their membership

Problem: How do you make this a valuable enough venue, so that people indeed want to pay the price and stay members?

Solution: Limited size; membership by invitation only. Start from a well-defined young cohort and expand over time.

Problem: What type of work should be included? Where are the boundaries?

Solution: Since the goal is to promote theory, focus should be on “pure” theory in financial economics. Stay away from quantitative, structural, etc. Definition started with a narrower corporate finance focus, and expanded to include broader financial-markets work, based on demands of people in the group.

Problem: How to manage the demographics?

Solution: Junior scholars need most support, but senior scholars have to find it worthwhile to continue so that the dialogue between junior and senior scholars happens. Hence, create room for both in the growing organization.

What the Group Should and Should Not Be

We think that going forward the group ***should be***: A forum that helps theorists develop their skills and tastes and write better models that are more competent, creative, and relevant.

On the other hand, we think it ***should not be***: A forum that isolates theorists from the rest of the profession, encouraging them to work and talk with each other, but not with empiricists.

Hence, the big challenge going forward is to enhance the impact of the FTG by connecting the theoretical contributions to empirical work and demonstrating why theory is so crucial for the development of the finance profession at large.

Theorists should be encouraged to be masters of their craft, writing elegant, rich, and sophisticated models that convey insights with clarity. But, at the same time, they should be encouraged to write relevant models that are of interest to the broader profession. Theory should inform the empirical work and help improve it. At the same time, theorists should be informed by empirical work when developing their models.

Theorists should not “fall in love” with the math of their models and try to make it ever more complex. The emphasis should be on trying to help us understand the world better.

We should note however that this does not necessarily mean developing “empirical implications” that are immediately testable. Relevant models may not have direct empirical implications – e.g., Modigliani-Miller, Grossman-Stiglitz, or Diamond-Dybvig – but still help us understand very important real-world phenomena.

Thanks to...

To conclude, we think the FTG is on a great path. We are very proud of what we started and look forward to more interactions in the future.

It is important to note that we owe big thanks to many people, including: All the members (and those who had to leave...), all the other past presidents (Adriano, Simon, Uday, Philip, Christine, Ohad, Ron), all the board members and meeting organizers, and all the fellows who contributed in their own ways. Special thanks go to the people who joined us in the first board – Adriano, Uday, Ilya. Their contribution was instrumental for picking things up quickly and getting FTG moving and developing into what it is

today. We still remember very fondly the intense debates we had that helped shape the FTG for years to come.