FINA 690E: Behavioral Finance - Spring 2004
Time: 14:30-17:50 Saturdays; Venue: LTE143

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Prerequisite
FINA527 and FINA528 (or FINA521 and FINA522)

Required Textbooks:
Hersh Shefrin, 2002, *Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing*, Revised, Oxford University Press: New York.

Recommended Materials:
James Montier, 2003, *Behavioral Finance*: *Insights into Irrational Minds and Markets*, John Wiley & Sons, Ltd.: New York

Objectives:
Traditional finance seeks to understand financial markets assuming that investors are "rational." Rationality means that investors can access to and have the ability to process information correctly and that competition between investors ensures that securities are correctly priced to reflect all available information. That is, the market is efficient. However, recent studies suggest that markets are not efficient and that investors are not fully rational. For example, particular trading strategies based on past information such as past returns and accounting information are able to outperform the markets. In addition, studies find that investors are committed to certain heuristic-based biases and frame dependent such as overconfidence, optimism, self-attribution, loss aversion, representativeness heuristic, anchoring, availability, ambiguity aversion, hindsight, flaming, etc. Behavioral biases combined with limits to arbitrage may result in securities not to be correctly priced.

Behavioral finance examines how individuals' attitudes and behavior affect their financial decisions and financial markets. In particular, behavioral finance uses psychological evidence to model investor behavior in order to get a better understanding of the financial market. In this course, we will emphasize the role of *heuristic-driven biases* and *flame dependent* on the market inefficiency and how to train yourself to be more objective, patient, humble, and disciplined so that you can become a more successful investors. Topics include: review of psychological foundations, imperfect markets and limited arbitrage, stock market anomalies, and historical bubbles.

The success of the course will depend on your effort and participation, especially questionnaires and discussions, so that attendance is required.

Teaching Format

The course will be consisted mainly of my lecture and your class discussions. A team-based project alone with a presentation in the class is required. Each team will be consisted of 4-5 people. I will also invite one or two outside speakers from financial industry to share their experience with you.

Assignments

There are one team-based project, a learning report (optional) and the final. The final will count for 70%, and the team project will count for 30%. The grade for the team-based project will be determined by your oral and written presentations. The learning report can be used to substitute 20% of the final. That is, the final is reduced to 50% and the report is counted as 20%. The exceptional participation may improve your final letter grade.

The assignments for the course are summarized as follows:

	Assignments	Weight
1.	Written and oral presentation (team project)	30%
2.	Final (individual) or Final plus Learning report	70%
3.	Class participation (encourage)	
	Total	100%

Team-based Project Assignment

Each team needs to find an interesting case related to behavioral finance and then documents and analyzes the case. I encourage you to search for cases in Hong Kong and China. The formal written report is limited to 15 pages excluding references, tables, figures, and appendix. The report must be typed. The format is very important and will be counted as 10% of the report. The specification of the format is as follows: A4 paper, double space with one-inch margin on all sides, a font of 12 Times New Roman. The formal written report must be submitted in hardcopy. In addition, an MS power point presentation document must also be submitted on the electronic form. A short presentation (about 10 minutes) for each team is also required.

Learning Report (individual and optional)

Write a report of your past decisions that were heuristic-based biases (must be related to investment or finance). Investigate the decision, the decision process, and the outcome. Give explanation of how it happens, why it happens, and make suggestions for how to make use of new insights to correct these biases. The report must be typed and the above format is applied.

Complaints, Comments and Suggestions:

If you have any complaints, comments or suggestions, please feel free to talk to or discuss with me. If you have special information or knowledge want to share with me, please come to talk to me. The best time to talk to me is just after class or in the evening.

Course Outline: (Note: *The schedule is tentative and is subject to change. In addition, we may not be able to cover all the materials*.)

1. Introduction:
    a. Overview of efficient market hypothesis (EMH)
    b. Challenges to EMH
    c. Behavioral finance
    Reading:
    - Fama, E. (1998), "Market efficiency, long-term returns and behavioral finance", Journal of Financial Economics 49:283-307.

2. Limits of arbitrage
    a. The law of one price
    b. Arbitrage costs and risks
    c. Cases for limits to arbitrage
    d. Other factors affecting limits to arbitrage
    e. Examples
    f. A model for noise trader risk
    Readings:
    - Owen A. Lamont and Richard H. Thaler (2004), "Can the market add and subtract? Mispricing in tech stock carve-outs," Journal of Political Economy, forthcoming.
    - Mitchell, M., T. Pulvino and E. Stafford (2002), "Limited arbitrage in equity markets", Journal of Finance, 57:551-584.

3. Psychological foundations
    a. Heuristic-based biases (Biases of judgment)
        - Representativeness heuristics
        - Availability biases
        - Anchoring
        - Overconfidence
        - Over-optimism
        - Conservatism bias
        - Confirmation bias
        - Cognitive dissonance
    b. Frame dependence and prospect theory (Errors of preference)
        - Narrow Framing
        - Prospect theory
        - Loss aversion
        - Ambiguity aversion
    Readings:
    - Amos Tversky and Daniel Kahneman (1974), "Judgment under uncertainty: Heuristics and biases," Science 185, 1124-1131.
    - Gretchen B. Chapman and Eric J. Johnson (2004), "Incorporating the Irrelevant: Anchors in Judgments of Belief and Value," to appear in T. Gilovich, D. W. Griffin, D. Kahneman (Eds.), *The Psychology of Judgment: Heuristics and Biases*. New York: Cambridge University Press.
    - Daniel Kahneman and Amos Tversky (1979), "Prospect theory: An analysis of decision under risk," Econometrica 47, 263-292.

4. Application: The aggregate stock market

a. Equity premium puzzle
b. Volatility puzzle
c. Predictability puzzle

5. Applications: The cross-sectional of stock returns
   a. The long-term reversals
   b. The Size premium
   c. The predictive power of scaled-price ratios
   d. Momentum
   e. Post-earnings drifts
   f. Dividend initiations and omissions
   g. Repurchases
   h. IPOs and SEOs
   i. Accruals
   j. Capital investments

6. Applications: Closed-end funds and co-movement
   a. Closed-end fund discounts
   b. Closed-end fund co-movement

7. Applications: Investor behavior
   a. Insufficient diversification
   b. Naïve diversification
   c. Excess trading
   d. The buying and selling decisions

8. Applications: Feeling and stock returns
   a. Weather and stock returns

9. Applications: Corporate finance