

HD Behavioural Finance, Autumn 2011

Vaglfrit progressionsfag – udbydes på HD (F) og HD (FR)

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What is Behavioral Finance?

The standard rational paradigm of the last fifty years has been highly successful in explaining the movements of financial markets. However, anomalies have been accumulating that are difficult to explain in terms of the standard rational paradigm, many of which are consistent with recent findings from psychology. Behavioral finance makes this connection, applying insights from psychology to financial economics. It puts a human face on the financial markets, recognizing that market participants are subject to biases that have predictable effects on prices. It thus provides a powerful new tool for understanding financial markets and one that complements, rather than replaces, the standard rational paradigm.

At its core, behavioral finance analyses the ways that people make financial decisions. Besides the impact on financial markets, this also has relevance to corporate decision making, investor behavior, and personal financial planning. Our psychological biases have real financial effects, whether we are corporate managers, professional investors, or personal financial planners. When we understand these biases, we can make better decisions ourselves, and better understand the behaviors of others and of markets.

Content, structure, and teaching:

The objective of the course “Behavioral Finance” is to provide students with a broad understanding of how human psychology affects financial decisions, with specific reference to the impact on financial markets, corporate finance, and personal financial decisions. The teaching is interactive and students are expected to participate in class discussions and short experiments.

The course’s development of personal competences:

The course will provide students with an understanding of how human psychology leads to biases and mistakes in the financial decisions of others and potentially of themselves. Through an awareness of these biases and mistakes, students will be better able to mitigate them as finance industry professionals, managers in non-financial firms, and investors of their own money.

Objectives:

To attain the top grade, students are required to have a good understanding of the major concepts and issues in behavioral finance. This includes the ability to:

- Identify and apply psychological concepts to financial markets and financial decision-making.
- Compare and contrast behavioral and non-behavioral explanations of financial phenomena.
- Apply the psychological and behavioral finance concepts to new problems outside the finance discipline.

Type of examination, exam aids, and assessment:

4 hour written final exam “closed book”.

Pensum

Textbook

Ackert, Lucy, and Richard Deaves, 2009, *Behavioral Finance: Psychology, Decision-Making, and Markets*. South-Western Cengage Learning

Articles (Preliminary List)

- Baker, Malcolm, and Jeffrey Wurgler, 2007, Investor Sentiment in the Stock Market, *Journal of Economic Perspectives* 21(2): 129–151
- Barber, Brad, and Terrance Odean, 2001, The Internet and the Investor, *Journal of Economic Perspectives*, 15(1): 41-54
- Benartzi, Shlomo and Richard H. Thaler, 2007, Heuristics and Biases in Retirement Savings Behavior, *Journal of Economic Perspectives* 21(3): 81–104
- Caginalp, Gunduz, David Porter, and Vernon Smith, 2001, Financial Bubbles: Excess Cash, Momentum, and Incomplete Information, *Journal of Behavioral Finance*, 2(2): 80-99
- Doya, Kenji, 2008, Modulators of decision making, *Nature Neuroscience* 11(4): 410-416
- Federal Reserve Bank of San Francisco, 2008, *The Subprime Mortgage Market: National and Twelfth District Developments*, 2007 Annual Report: 6-17
- Financial Crisis Interviews, 2011, Various (to be circulated)
- Garber, Peter M., 1990, Famous First Bubbles, *Journal of Economic Perspectives*, 4(2): 35-54
- Hong, Harrison, and Jeremy C. Stein, 2007, Disagreement and the Stock Market, *Journal of Economic Perspectives* 21(2): 109–128
- Hvidkjaer, Soeren, 2008, Small Trades and the Cross-Section of Stock Returns, *Review of Financial Studies* 21(3): 1123–1151
- Kahneman, Daniel, and Dan Lovallo, 1993, Timid Choices and Bold Forecasts: A Cognitive Perspective on Risk Taking, *Management Science* 39(1): 17-31
- Loewenstein, George, and Richard Thaler, 1989, Anomalies: Intertemporal Choice, *Journal of Economic Perspectives*, 3(4): 181-193
- Malmendier, Ulrike, and Geoffrey Tate, 2008, Who makes acquisitions? CEO overconfidence and the market's reaction, *Journal of Financial Economics* 89(1): 20-43
- McClure, Samuel M., David I. Laibson, George Loewenstein, and Jonathan D. Cohen, 2004, Separate Neural Systems Value Immediate and Delayed Monetary Rewards, *Science* 306(5695): 503 – 507
- Nocera, Joe, 2008, The Reckoning: As Credit Crisis Spiraled, Alarm Led to Action, *New York Times*, 1 October 2008
- Odean, Terrance, 1999, Do Investors Trade Too Much? *American Economic Review*, 89: 1279-1298
- Peston, Robert, 2010, Regulators agree 7% capital ratio for banks, *BBC News*, 9 September 2010: http://www.bbc.co.uk/blogs/thereporters/robertpeston/2010/09/regulators_agree_7_capital_rat.html
- Platt, Michael L., and Scott A. Huettel, 2008, Risky business: the neuroeconomics of decision making under uncertainty, *Nature Neuroscience*, 11(4): 398-403
- Reimers, Stian, Elizabeth A. Maylor, Neil Stewart, and Nick Chater, 2009, Associations between a one-shot delay discounting measure and age, income, education and real-world impulsive behavior, *Personality and Individual Differences*, 47(8): 973-978
- Shiller, Robert J., 2003, From Efficient Markets Theory to Behavioral Finance, *Journal of Economic Perspectives* 17(1): 83-104
- Siegel, Jeremy J., and Richard H. Thaler, 1997, Anomalies: The Equity Premium Puzzle, *Journal of Economic Perspectives*, 11(1): 191-200
- Sorkin, Andrew R., 2008, Lehman Files for Bankruptcy: Merrill Is Sold, *New York Times*, 14 September 2008

- Thaler, Richard H., 1999, Mental Accounting Matters, *Journal of Behavioral Decision Making* 12: 183-206
- Thaler, Richard H., and Eric J. Johnson, 1999, Gambling with the House Money and Trying to Break Even: The Effects of Prior Outcomes on Risky Choice, *Management Science* 36(6): 643-660
- Tversky, Amos, and Daniel Kahneman, 1974, Judgment under Uncertainty: Heuristics and Biases, *Science* 185(4157): 1124-1131

Recommended literature:

Books

- Fox, J., 2009, *The Myth of the Rational Market: A History of Risk, Reward, and Delusion on Wall Street*. Harper Business, New York
- Shrefrin, Hersh, 2000, *Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing*. Oxford University Press
- Thaler, Richard H., and Cass R. Sunstein, 2009, *Nudge: Improving Decisions About Health, Wealth, and Happiness*. Yale University Press

Lesson Plan (Preliminary) Version 1.0

(Notes: (i) Students are *not* expected to complete the assigned readings before class, except for the final class. The exam will cover material from the assigned readings, with the main focus being the material discussed in class.)

Class 1 Readings	<i>Introduction and Overview</i> Chapter 2
Class 2 Readings	<i>Overconfidence and Bubbles</i> Chapters 6, 14.3-14.4 Garber (1990); Ciginalp, Porter & Smith (2001)
Class 3 Readings	<i>Bubbles and Market Efficiency</i> Chapter 4.3
Class 4 Readings	<i>Overconfidence and Financial Decision Making</i> Chapter 9 Odean (1999); Hvidkjær (2008); Barber & Odean (2001)
Class 5 Readings	<i>Risk Preferences, Framing & Mental Accounting (I)</i> Chapters 1, 3, 10.4-10.5 Thaler (1999); Thaler & Johnson (1990)
Class 6 Readings	<i>Risk Preferences, Framing & Mental Accounting (II)</i> As Class 5
Class 7 Readings	<i>Emotions</i> Chapters 7.1, 7.3-7.8, 10.1-10.3, 10.6, 20 Doya (2008); Platt & Huettel (2008)
Class 8 Readings	<i>Stock Market Effects</i> 14.1-14.2, 14.5-14.6 Siegel & Thaler (1997); Shiller (2003)
Class 9 Readings	<i>Heuristics, Biases & Financial Decision Making (I)</i> Chapters 5, 8 Tversky & Kahneman (1974)

Class 10 Readings	<i>Heuristics, Biases & Financial Decision Making (II)</i> As Class 9
Class 11 Readings	<i>Individual Stock Effects (I)</i> Chapter 4.1-4.2, 13, 19 Hong & Stein (2007); Baker & Wurgler (2007)
Class 12 Readings	<i>Individual Stock Effects (II)</i> As Class 11
Class 13 Readings	<i>Time Preference</i> Reimers et al. (2009); McClure et al. (2004); Loewenstein & Thaler (1989)
Class 14 Readings	<i>Personal Financial Planning</i> Chapters 17, 18 Benartzi & Thaler (2007)
Class 15 Readings	<i>Social Forces (I)</i> Chapter 11
Class 16 Readings	<i>Social Forces (II)</i> As Class 15
Class 17 Readings	<i>Corporate Finance (I)</i> Chapters 15, 16 Malmendier & Tate (2008); Kahneman & Lovallo (1993)
Class 18 Readings	<i>Corporate Finance (II)</i> As Class 17
Class 19 Readings	<i>Case Study: The Financial Crisis (I)</i> FRB San Francisco (2008); Sorkin (2008); Nocera (2008); Peston (2010); Financial Crisis Interviews (2011)
Class 20 Readings	<i>Case Study: The Financial Crisis (II) and Course Review</i> As Class 19