**Fall 2005**
**B 9303**
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# Finance Theory II

The course is intended for doctoral students who are seriously thinking about writing a dissertation in finance. The course will focus on the behavioral approach to financial economics.

The course is very demanding. Each student will have to give at least one class presentation, write a research proposal and a final exam. The reading list is long.

I will be teaching an MBA course on Behavioral Finance this term. It meets on Tuesday and Thursday between 11:45 and 1:15. I urge you to audit this course since it will greatly enhance your knowledge of the subject.

All students in the course must have taken Finance Theory I, or at least take it concurrently.

We will meet every Tuesday between 4 and 7 in room 329.

## Student presentations

A presentation should consist of the following items:

1. Motivation. How does the reviewed work fit into the literature and why is it potentially interesting?
2. What are the main results?
3. How reasonable are the results? How surprising are they?
4. Should the interpretation be qualified in some ways because of weaknesses of the design or the data?
5. Possible follow-up issues.

## Student papers

By Friday, November 18 every student will have to submit an empirical research proposal on or near a topic covered in the course.

The proposal should consist of the following:

1. What are the questions to be addressed?
2. Why are these questions interesting?
3. What are the data and methodologies that will afford looking at these questions?
4. How will the proposed study be conducted?

Clarity on #1 is important. Beyond that, the student should describe the data he would look at, and how he would look at the data – what are the relevant statistics. What are the possible values the statistics can take? What is the interpretation of each possible value of the statistics? Which of the possible values shed light on the original research question? Are there other possible interpretations of the data?

The proposals should consist of 5-10 page typed paper, in hard and electronic copies

I will review these papers and distribute them to the other students in the course. Every student will read his class mates' papers. I will choose one student for each paper as a discussant. The discussions will take place in the class meetings of November 29 and December 6. They will assess the extent to which the paper accomplished the goals I set out for the papers.

The grade will be based on a final exam, class presentations, and the paper.

I am generally available in my office, 807 Uris. (Phone: 854 4100; email: gh16@Columbia.edu. If you must reach me at home, please call 932 0748.)

**List of Topics:**

Before the first meeting: Read Chapter 12 of Keynes' The General Theory of Employment, Interest and Money, "The State of Long-Term Expectation." (Available at www.marxists.org/reference/subject/economics/keynes/general-theory/ch12.htm)

My lectures:
1. Behavioral oddities, prospect theory.
2. The disposition effect and its implications for asset pricing.
3. Attention.
4. Institutional trading.
5. Valuation of money managers (Later in the course, after a student's lecture on closed-end funds.)

Students' lectures:
6. Why trade?

7. Models of speculation.
8. Limits of arbitrage.
9. Closed-end funds.
10. Individual attributes and individuals' behavior: familiarity, over-confidence, trusting.

Links to work on Behavioral finance:

1. NBER: **Behavioral Finance**
2. Robert Shiller's 2002 **pdf** "From Efficient Market Theory to Behavioral Finance" [43pp] abstract
3. Barberis and Thaler, A survey of **behavioral finance**
4. Behavioral Finance Resources
5. Hirshleifer, David, 2001, "Investor Psychology and Asset Pricing," *Journal of Finance*, Vol. 56, pp. 1533-1597.
6. Shleifer, Andrei, 2000, *Inefficient Markets: An Introduction to Behavioral Finance*, Oxford University Press.

Papers relevant to this course:

**Behavioral Oddities and Prospect Theory.**

Fama, Eugene, 1991, "Efficient Capital Markets II", *Journal of Finance*, Vol. 46, No. 5, pp. 1575-1617

Fama, Eugene, 1970, "Efficient Capital Markets: A Review of Theory and Empirical Work", *Journal of Finance*, Vol. 25, No. 2, pp. 383-417

Kahneman, Daniel, and Mark W. Riepe, 1998, "Aspects of Investor Psychology", *Journal of Portfolio Management*, Vol. 24, pp. 52-65

Kahneman, Daniel, and Amos Tversky, 1983, "Choices, Values and Frames", *American Psychologist*, Vol. 39, No. 4, pp. 341-350

Kahneman, Daniel, and Amos Tversky, 1979, "Prospect Theory:  An Analysis of Decision under Risk", *Econometrica*, Vol. 47, No. 2, pp. 263-292

Kahneman, Daniel, and Amos Tversky, 1974, "Judgment under Uncertainty: Heuristics and Biases", *Science*, Vol. 185, pp. 1124-1131

Kahneman, Daniel, and Amos Tversky, 1973, "On the Psychology of Prediction", *Psychological Review*, Vol. 80, pp. 237-251

Shiller, Robert, 1984, "Stock prices and social dynamics", *Brookings Papers on Economic Activity*, No. 2, pp. 475-510 (also ch. 7 in Thaler)

Thaler, Richard H., and Eric J. Johnson, 1990, "Gambling With the House Money and Trying to Break Even: The Effect of Prior Outcomes on Risky Choice", *Management Science*, Vol. 36, No. 6, pp. 643-660

Tversky, Amos, and Daniel Kahnman, 1992, "Advances in prospect theory: Cumulative representation of uncertainty", *Journal of Risk and Uncertainty*, Vol. 5, pp. 297-323

**Disposition effect**

Odean, Terrance, 1998, "Are Investors Reluctant to Realize Their Losses?" *Journal of Finance*, Vol. 53, No. 5, pp. 1775-1798

Weber, Martin, and Colin F. Camerer, 1998, "The Disposition Effect in Securities Trading: An Experimental Analysis," *Journal of Economic Behavior & Organization*, Vol. 33, No. 2, pp. 167-184

Grinblatt, Mark, and Bin Han, 2005, "Prospect Theory, Mental Accounting, and Momentum," forthcoming in *Journal of Financial Economics*.

Frazzini, Andrea, 2006, "The Disposition Effect and Underreaction to News," forthcoming in *Journal of Finance*.

**Attention**

Huberman, Gur, and Tomer Regev, 2001,"Contagious Speculation and a Cure for Cancer: A Nonevent that Made Stock Prices Soar," *Journal of Finance*, Vol. 56, No. 1, pp. 387-396

Dellavigna, Stefano, and Joshua Pollet, 2005, Attention, Demographics, and the Stock Market, working paper

Franzoni, Francesco, and Jose M. Marin, 2006, "Pension Plan Funding and Stock Market Efficiency, forthcoming in *Journal of Finance*

**Institutional trading**

Coval, Joshua, and Erik Stafford, 2005,"Asset Fire Sales (and Purchases) in Equity Markets" working paper.

Lamont, Owen A., and Andrea Frazzini, 2005, "**Dumb Money: Mutual Fund Flows and the Cross-Section of Stock Returns**," working paper.

Lakonishok, Josef, Andrei Shleifer, and Robert W. Vishny, 1992, “The impact of institutional trading on stock prices”, *Journal of Financial Economics*, Vol. 32, No. 1, pp. 23-43

**Valuation of Money Managers**

Gur Huberman, "What is the NPV of Expected Future Profits of Money Managers?" working paper, 2005.

Why Trade?

Milgrom, Paul, and Nancy Stokey, 1982, “Information, Trade and Common Knowledge”, *Journal of Economic Theory*, Vol. 26, pp. 17-27

Tirole, Jean, 1982, “On the Possibility of Speculation under Rational Expectations,” *Econometrica*, Vol. 50, No 5, pp. 1163-1181

Grinblatt, Mark, and Matti Keloharju, 2001, “What makes investors trade?,” *Journal of Finance*, Vol. 56, No. 2, pp. 589-616

Grinblatt, Mark, and Matti Keloharju, 1999, “The investment behavior and performance of various investor types: a study of Finland’s unique data set”, *Journal of Financial Economics*, Vol. 55, pp. 43-67

Kandel, Eugene, and Neil D. Pearson, 1995, “Differential Interpretation of Public Signals and Trade in Speculative Markets”, *Journal of Political Economy*, Vol. 103, No. 4, pp. 831-872

Odean, Terrance, 1998, “Volume, Volatility, Price, and Profit When all Traders are Above Average”, *Journal of Finance*, Vol. 53, No. 6, pp. 1887-1934

**Models of speculation**

Harrison, J. Michael, and David M. Kreps, 1978, “Speculative Investor Behavior in a Stock Market with Heterogeneous Expectations,” *Quarterly Journal of Economics*, Vol. 92, No. 2, pp. 323-336

Scheinkman, Jose A., and Wei Xiong, 2003, “Overconfidence and Speculative Bubbles,” *Journal of Political Economy*, Vol. 111, No. 6, pp. 1183-1219

Harris, Milton, and Artur Raviv, 1993, “Differences of Opinion Make a Horse Race”, *The Review of Financial Studies*, Vol. 6, No. 3, pp. 473-506

**Limits of Arbitrage**

De Long, J. Bradford, Andre Shleifer, Lawrence H. Summers, and Robert J. Waldmann, 1989, "Noise Trader Risk in Financial Markets", *Journal of Political Economy*, Vol. 98, No. 4, pp. 703-738

Shleifer, Andrei, and Lawrence Summers, 1990, "The Noise Trader Approach to Finance", *Journal of Economic Perspectives* Vol. 4, No. 2, pp. 19-33

Shleifer, Andrei, and Robert Vishny, 1997, "The Limits of Arbitrage", *Journal of Finance*, Vol. 52, No. 1, pp. 35-55

**Closed-end Funds**

Ross, Stephen A., 2005, "A neoclassical Look at Behavioral Finance: The Closed-End Fund Puzzle," in *Neoclassical Finance*, Princeton: Princeton University Press, pp. 66-94.

Chen, Nai-Fu, Raymond Kan, and Merton H. Miller, 1993, "Are the Discounts on Closed-End Funds a Sentiment Index", *Journal of Finance*, Vol. 48, No. 2, pp. 795-800

Chopra, Lee, and Andrei Shleifer, 1993, "Yes, Discounts on Closed-End Funds are a Sentiment Index", *Journal of Finance*, Vol. 48, No. 2, pp. 801-808

Hardouvelis, Gikas, Rafael La Porta, and Thierry Wizman, 1994, "What Moves Discounts on Closed End Country Funds?" in *The Internationalization of Equity Markets*, Jeffrey A. Frankel, Ed. Chicago: University of Chicago Press, pp. 345-403. (also FDRBNY paper #9324)

Klibanoff, Peter, Owen Lamont, and Thierry Wizman, 1998, "Investor Reaction to Salient News in Closed End Country Funds", *Journal of Finance*, Vol. 53, No. 2, pp. 673-699

Lee, Charles M.C., Andrei Shleifer, and Richard H. Thaler, 1991, "Investor Sentiment and the Closed-End Fund Puzzle", *Journal of Finance*, Vol. 46, No. 1., pp. 75-109

Pontiff, Jeff, 1996, "Costly Arbitrage: Evidence from Closed End Funds", *Quarterly Journal of Economics*, Vol. 111, No. 4, pp. 1135-1152

**Individual Attributes and behavior in financial markets**

Huberman, Gur, 2001, "**Familiarity Breeds Investment**," *Review of Financial Studies*, Vol. 14, No. 3, pp. 659-680

Guiso, Luigi, Paola Sapienza, and Luigi Zingales, 2005, "Trusting the Stock Market" , working paper.

Plous, S., 1993, "Overconfidence," in *The Psychology of Judgment and Decision Making*, New York: McGraw-Hill, pp. 217-230

Yates, J. F., J. W. Lee, and J.G. Bush, 1998, "General knowledge overconfidence: Cross-national variations, response style, and "reality,"" *Organizational Behavior and Human Decision Processes*, Vol. 70, No. 3, pp. 87-94

Erev, I., T.S. Wallsten, and D.V. Budescu, 1994, "Simultaneous over- and underconfidence: The role of error in judgment processes," *Psychological Review*, Vol. 101, No. 3, pp. 519-527

Koriat, A., S. Lichtenstein, and B. Fischhoff, 1980, "Reasons for Confidence," *Journal of Experimental Psychology: Human Learning and Memory*, Vol. 6, No. 2, pp.107-118

Weber, E. U., U. Bockenholt, D.J. Hilton, and B. Wallace, 2000, "Confidence judgments as expressions of experienced decision conflict," *Risk, Decision and Policy*, Vol. 5, pp. 69-100

Camerer, C., and D. Lovallo, 1999. "Overconfidence and excess entry: An experimental approach,"*American Economic Review*, Vol. 89, No. 1, pp. 306-318

Kahneman, D., and D. Lovallo, 1993, "Timid Choices and Bold Forecasts - a Cognitive Perspective on Risk-Taking," *Management Science*, Vol. 39, No. 1, pp. 17-31

Barber, Brad, and Terrance Odean, 2001, "Boys will be BoysGender, Overconfidence, and Common Stock Investment" , *Quarterly Journal of Economics*, Vol. 116, No. 1, pp. 261-292

Gervais, Simon, and Terrance Odean, 2001, "Learning to be Overconfident" , *Review of Financial Studies*, Vol. 14, No. 1, pp. 1-27