Behavioral Finance, Summer term 2009

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Tuesday 8:30-10:00, F428

Content

On the level of the individual, "standard" financial theory is based on the assumption that agents in the financial market are rational expected utility maximizers. On the market level, this translates into the efficient market hypothesis, which means that prices reflect all (publicly) available information. Note that markets may be efficient even if not all agents are rational. It is sufficient that there are some agents who make arbitrage and by doing so correct the errors of irrational actors. In recent years, behavioral finance has fundamentally questioned this view. First, it has been shown that individuals do not always behave as predicted by expected utility theory. There are significant and consistent deviations from rationality. For example, people are loss averse, they are overconfident and care about irrelevant anchors. Second, empirical evidence suggests that financial markets are not always efficient. Phenomena that question the efficient market hypothesis are the equity premium puzzle, the closed end funds puzzle and stock market bubbles. Third, behavioral finance provides theoretical models that help understanding these phenomena. In particular, the limits of arbitrage are investigated. In one of these models, it is shown why arbitrators do not completely correct the errors of irrational traders. Other models even show that a larger share of rational traders can move prices away from the fundamental value. In the lecture we will discuss all three issues. The main focus is on the presentation of the models.

Table of content

1. Introduction: Market anomalies
2. Limits of arbitrage: a noise traders model
3. The closed-end funds puzzle
4. Psychology for finance I
5. Psychology for finance II
6. A closer look at the disposition effect
7. Loss aversion, mental accounts and the equity premium puzzle
8. Professional arbitrage
9. A model of investor sentiment
10. Stock market bubbles, empirical evidence and theory
11. Stock market bubbles, experiments
12. Inequity aversion and asset prices
13. Topics in behavioral corporate finance
14. Questions and answers

Main literature used in the lecture

The lecture is mainly based on the book by Shleifer (2000). For the lectures, you will receive slides and handouts. The content of the lectures and these handouts are relevant for the exam.

Andrei Shleifer, Inefficient Markets, An introduction to Behavioral Finance, Oxford University Press 2000.

Nicholas Barberis and Richard Thaler, A Survey of Behavioral Finance, in the Handbook of the Economics of Finance, June 2003.

Thorsten Hens and Kremena Bachmann, Behavioural Finance for Private Banking, John Wiley & Sons, 2008.

James Montier, Behavioural Finance - Insights into Minds and Markets, Wiley Finance Series, Sussex GB, 2002.

Shefrin: Beyond Greed and Fear, Harvard Business School Press, 2000.

Shefrin, Hersh M., A Behavioral Approach to Asset Pricing. Burlington, MA: Academic Press, Elsevier, 2005.

Robert J. Shiller: Irrational Exuberance. Princeton University Press 2000.

Robert J. Shiller: From Efficient Markets Theory to Behavioral Finance, Journal of Economic Perspectives—Volume 17, Number 1—Winter 2003—Pages 83–104.

More ideas
Bubbles and coordination: Morris Shin, Birchler Fischbacher
Guessing games: strategic complements/substitutes
Disposition effect.