Edwin T. Burton
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SPRING 2022: BEHAVIORAL FINANCE

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Tuesdays and Thursdays
9:30 AM – 10:45 AM
in Ridley Hall G008

Office Hours: 11-12 on Tuesdays and Thursdays or by Appointment

About this course

This course is about 'pathologies' in finance, meaning things that should not happen if markets are 'efficient.' Put simply, do markets work the way they should. While we have always known that some strange things take place in financial markets from time to time, the real question is are these strange things 'systematic' in some way — predictable, for example.

The theme here is similar to that of Michael Lewis's famous book, "Money Ball." This book, in a very entertaining manner, showed that baseball teams were run in a manner not consistent with winning the most baseball games.

Instead, baseball teams operated by 'rules-of-thumb,' old (bad) habits and a failure to think through much of the strategy of baseball. Much has changed since Lewis wrote that book.

The question this course raises is are 'pathologies' or 'market inefficiencies' systemic in finance. Are they, in some sense, built in.

This field of study began in earnest in the mid-1980s and encountered fierce resistance on the part of finance economist community, though many in Wall Street cheered the early stirrings of behavioral finance. Behavioral Finance has begun an immense area of academic research and is now a 'mainstream' topic, though it is rarely if ever taught to undergraduates.

We cover three main areas of behavioral finance:

1. **Is there a theoretical argument available to explain what a market price might not be right and might continue to not be right?**
2. **What research in psychology, pioneered by Daniel Kahneman and Amos Tversky, has taught us.**
3. **What does the data tell us: do small stocks outperform, do value stocks outperform, is there really a January effect, etc?**

Required Books

There are two main books used in this course:

***Thinking: Fast and Slow* by Daniel Kahneman and Amos Tversky**

***Behavioral Finance* by Edwin T Burton and Sunit Shah**

Exam Schedule

First Prelim Exam	Tuesday, March 1st, 2022
Second Prelim Exam	Thursday, April 7th, 2022
Final Exam	Thursday, May 5th, 2022 (beginning at 2 PM)

Topic Schedule for Lectures

Jan 20th – Feb 24th: "The Limits to Arbitrage" and the Efficient Market Hypothesis

This period constitutes the first one-third of the course. There are two objectives. First, we review the various definitions of EMH (the 'Efficient Market Hypothesis'), we review the arguments pro and con for these differing definitions. Second, we spend time of the 'Shleifer

Model,' which actually was a product of four different academics, not just Andrei Shleifer. It is this model that is the foundational basis for the concept of "limits to arbitrage."

The readings for this third of the course are:

Shleifer, Etal on "Noise Trader Risk," 1997
Articles by Shiller, Malkiel, Fama, Black

(these articles can be found in Resources section of this course's Collab site in the folder "Review of EMH and Behavioral Finance)

Mch 3 – April 5: Anomalies and Research Results from Psychology Experiments

Apr 12 – May 3: What the Data Shows: Mean Reversion, Small Cap and Value Effects, Calendar Effects, Liquidity

Notes: It is important to check the final exam schedule before enrolling in this course. We do not offer alternative times for the final exam. Students must take the final exam on the date scheduled and a time that significantly overlaps with the scheduled time. Otherwise an incomplete will be given as the final grade. Exam grades are weighted 30/30/40 with the largest weight on the final. Any student with an excused absence from one of the mid-terms will have their other mid-term weighted 3/7 and final 4/7 to calculate raw exam score for this course. Failure to take either mid-term will result in an automatic incomplete, even if the final is taken. Students must take both the final and at least one mid-term to get a grade other than an incomplete. Any absence from a mid-term must be an excused absence.
