



THE UNIVERSITY  
OF QUEENSLAND  
AUSTRALIA

CREATE CHANGE

# FINM3407 – Behavioral Finance

## Revision Lecture:

FINM3407 Behavioral Finance

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August 2024

## Agenda This Week

- **Summary of Topic 1 - 3**
- *Disclaimer: This is not an exhaustive list of what we have learned in the first 3 topics.*
- **Mid Exam Instruction**
- **Brief Discussion of the Assignment**
- **Q&A**

# Topic 1: Introduction to Behavioral Finance and Traditional Finance Theories

Reference: AckertDeaves Chapters 1 & 2

## [Part One – Introduction to Behavioral Finance]

- **Overview of neoclassical economics**

- (1) Preference Relation
- (2) Utility Function and Expected Utility Theory
- (3) Brief Introduction to Behavioural Finance

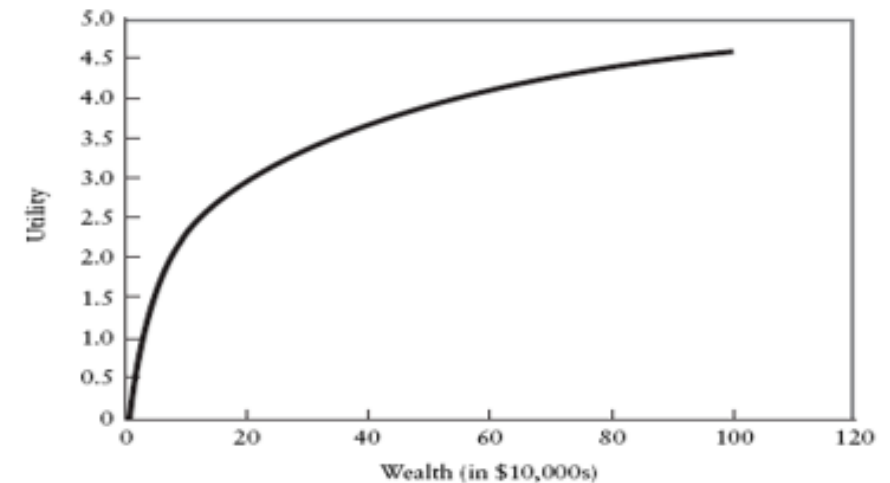
## [Part Two – Foundations of Finance]

- **Foundations of Finance II: Asset Pricing, Market Efficiency and Agency Relationships**

- (1) Risk and Return Relationship
- (2) CAPM model and Fama and French
- (3) Market Efficiency (brief introduction => more details in Topic 3)
- (4) Agency Relationships and Corporate Governance

# Part One

- Neoclassical economics (normative theory)
  1. Rational preferences
    - Completeness
    - Transitivity
  2. Maximise utility
    - The Expected Utility Theory of Prospect
    - Properties of Utility Functions
    - Certainty Equivalents
  3. Independent decisions based on all “relevant” information
- Introduction to Behavioural Finance
  - Loss Aversion
  - Representative
  - Mental Accounting
  - Fear of Regret



# Part Two

- Foundations of Finance
  1. Portfolio Risk & Return
    - Portfolio Expected Return & Standard Deviations
    - Efficient Frontier & CML
  2. CAPM Model
  3. Market Efficiency (more discussed in Lecture 3)
  4. Agency Relationships & Corporate Governance
    - Agency Costs (Direct vs Indirect)

## Topic 2: Prospect Theory, Framing and Mental Accounting

Reference: AckertDeaves Chapters 3

### [Part One – Prospect Theory]

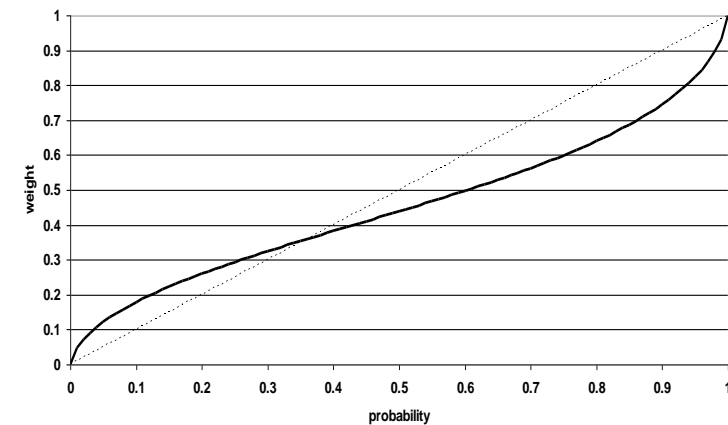
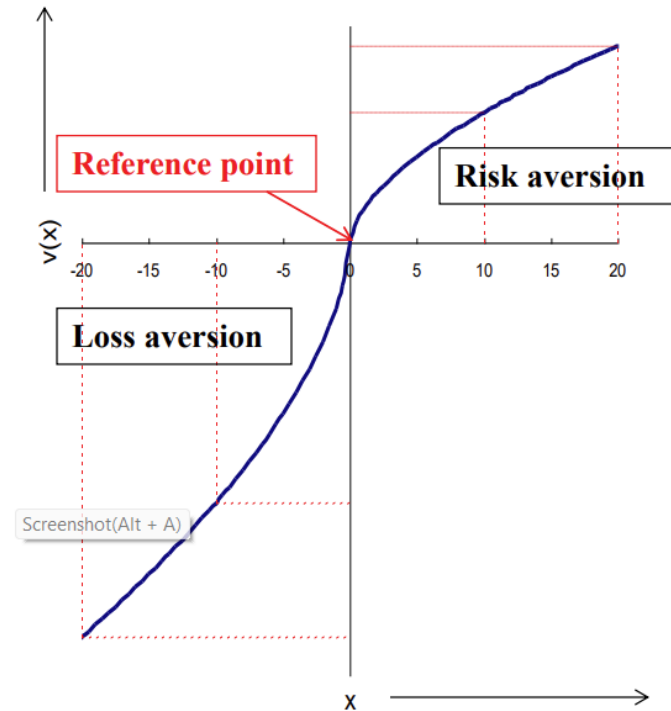
- **Overview about Prospect Theory**
  - (1) Risk Aversion vs. Risk Seeking
  - (2) Development of Prospect Theory
- **Prospect Theory Value Function**
- **The Weighting Function**

### [Part Two – Mental Accounting]

- **Mental Accounting**
  - (1) Integration vs. Segregation
  - (2) Theater Ticker Problems
  - (3) Opening and Closing Accounts

# Prospect Theory

1. Risk aversion vs Risk seeking vs Loss aversion
2. Value Function
  - Reference dependent
  - Risk averse in positive domain
  - Risk seeking in negative domain
    - Loss aversion
3. Weighting Function
  - Overweighting low probabilities
  - Underweighting medium-high probabilities
  - Certainty effect
4. Framing & Mental Accounting Effect
  - Segregation vs Integration (reference point)
  - Silver lining effect & House money effect



## Topic 3: Challenges to Market Efficiency

Reference: AckertDeaves Chapters 4

### [Part One – Efficient Market Hypothesis]

- Overview of Efficient Market Hypothesis
- Theoretical foundations and assumptions

### [Part Two – Challenges to Market Efficiency]

- Rationales supporting the Efficient Market Hypothesis
- Theoretical Challenges and Empirical challenges



# Market Efficiency

1. 3 levels of efficiency
2. Implications: Better off do passive investing
3. Random Walk vs. EMH
  - “Prices are right” vs “No free lunch”
4. Theoretical Foundations
  - Universal Rationality
  - Uncorrelated Errors
  - Unlimited Arbitrage
5. Rationales Supporting Efficiency vs Effective Trading Rules (Anomalies?)

# Arbitrage

1. Triangular Arbitrage
2. Limits to Arbitrage
  - Fundamental Risk
  - Noise-trader Risk
  - Implementation Costs

## **MID EXAM – 25% of the Total Weight**

## Online Mid Exam

- Mid Exam will be an **online exam**. The link will be available on Blackboard.
- Open Book, all course materials are permitted.
- Exam Time: 10:00 AM – 11:10 AM
- Total Duration: 70 minutes (10 reading + 60 working)
- Submission Time: 15 minutes
- Format: 20 MCQ
- Task Description:

**The Mid Exam will be based on all materials covered in the first 3 lectures (from Topics 1-3).**

## How to Prepare for the Exam

- Go through the slides in detail (including examples & appendix)
- Practice lecture examples, tutorial questions, and practice exam and try to get a deep understanding of the examples and questions.
- Read the **reference chapters of the textbook and other references** (for the relevant content)

# Case Study – Individual Assignment

- Weight: 25% of the total weight
- Due: 11 Oct 2024 (Friday), 1:00 PM AEST
- Page limit: Maximum of 5 pages excluding references, tables, figures, and appendix
- Tasks: Answer the 2 questions based on the Rudy Wong case & additional research
- Additional requirement:
  1. At least 4 relevant sources.
  2. Format
  3. Introduction & Conclusion
  4. Academic Writing

# Short Survey



**THANK YOU**