June 2024

MGMTMFE 431-4
Behavioral Finance
Misvaluation and Trading Activity in Equity Markets
(Fall 2024)

This course will introduce and explain the evidence of anomalous return behavior found in US equities markets. We will also present some paradigms of stock price movements that are rooted in studies from psychology, and seek to explain trading activity in equity markets. We will begin by exploring some of the evidence that contradicts the standard risk-return paradigm. We will then introduce some of the psychological biases that researchers suspect are inherent to investors. We will then employ some of the results from the psychology literature to explain the irrationalities encountered in the finance literature. Thereafter, we will present the latest evidence on why individual investors trade and how individual and institutional investors form their portfolios.

Grading will be based on a take-home final examination (60%), at three pre-announced quizzes, two inclass, and one takehome (20%), and a data project (20%). The final examination will be based on class presentations by the instructor, so class attendance is required. Students should come to class prepared to understand the central points of the required readings. As you read the papers, consider the methodology and the implications yielded by the results. You will observe that some weeks require more reading than others. It is in your best interest to read ahead during the weeks of light reading. The data project will require an analysis of financial markets by backtesting strategies described in the research articles. Each student will be assigned a specific equity market strategy to analyze in detail using the methodology appropriate for that strategy.

The course is designed to encourage students to think critically about topics in behavioral finance. Students are expected to develop their insights coherently in an attempt to understand the field. The schedule follows on the succeeding pages. Each class session is approximately three hours of class time.

Part I: Introduction/Basic Motivation

Class 1: Risk and return
CAPM/APT Review
Fama/French (1992, 1993)

Class 2: Problems with the risk-return paradigm
Daniel/Titman (1997), Lakonishok/Shleifer/Vishny
Chordia/Subrahmanyam/Anshuman, Haugen/Baker

Class 3: Problems with the risk-return paradigm, contd.
Jegadeesh/Titman, Hong/Lim/Stein (2000), Bernard/Thomas
Daniel/Titman (2006)
Diether/Malloy/Scherbina,

Class 4: Value investing
Novy-Marx, Piotroski, Mohanram

Part II: Psychological approaches to stock price movements

Class 4:
Tversky/Kahneman, Daniel/Hirshleifer/Subrahmanyam

Part III: Applications to Corporate Finance

Class 5:
Malmendier/Tate I (CEO overconfidence..), Loughran/Ritter, Malmendier/Tate II (Superstar CEOs), Graham/Harvey

Part IV: Investor moods

Class 6:
Hirshleifer/Shumway, Cao/Wei, Rashes, Huberman/Regev

Part V: Investment behavior of individual investors

Class 7:
Odean (1998), Odean (1999)
Barber/Odean (2001) (Boys will be Boys…), Barber/Odean (2000), Coval/Shumway, Benartzi/Thaler, Hong/Kubik/Stein

Part VI: Performance and investment behavior of professional investors, and concluding remarks

Class 8 and onward: Chevalier/Ellison, Falkenstein

References

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Data Project

Each student individually will replicate one of the set of stock market anomalies discussed in class for the period 1990 to 2021. The instructor will assign the anomaly to the student. You may use a WRDS account and SAS, or any other program for this purpose. Use a portfolio approach and a Fama/Macbeth regression approach, and document the results as well as the code used for this purpose. The project should be started after 11/15 as the required material will not be covered until that time.