F520 – Behavioural Finance

Outline: The course introduces students to behavioural finance. This area of research examines how psychological factors have an impact on the behaviour of asset prices, corporate finance, and various financial institutions and practices. We start by briefly reviewing the efficient markets hypothesis, rational choice and expected utility theory. An overarching objective of the course is to understand observed deviations from the predictions of the efficient market hypothesis with the goal of providing better insights into the functioning of financial markets. We will consider alternative models of decision making, with a particular focus on Prospect Theory. We will then consider evidence from psychology on the biases that arise in individual decision-making and in particular the role of herding and investor sentiment.

Below is a list of indicative readings. The complete reading list will be provided at the beginning of the course.

- Baker, M. and Wurgler, J., 2006. Investor sentiment and the cross-section of stock returns. The Journal of Finance, 61(4), pp.1645-1680.
- Barberis, N. and Thaler, R., 2003. A survey of behavioral finance. Handbook of the Economics of Finance, 1, pp.1053-1128.
- Daniel, K., Hirshleifer, D. and Subrahmanyam, A., 1998. Investor psychology and security market under-and overreactions. The Journal of Finance, 53(6), pp.18391885.
- De Long, J.B., Shleifer, A., Summers, L.H. and Waldmann, R.J., 1991. The survival of noise traders in financial markets. Journal of Business, 64: 1-20.
- De Long, J.B., Shleifer, A., Summers, L.H. and Waldmann, R.J., 1990. Positive feedback investment strategies and destabilizing rational speculation. The Journal of Finance, 45(2), pp.379-395.
- Dow, J. and Werlang, S.R., 1992. Uncertainty aversion, risk aversion, and the optimal choice of portfolio. Econometrica, pp.197-204.
- Malkiel, B.G. and Fama, E.F., 1970. Efficient capital markets: A review of theory and empirical work. The Journal of Finance, 25(2), pp.383-417.
- Mehra, R. and Prescott, E.C., 1985. The equity premium: A puzzle. Journal of Monetary Economics, 15(2), pp.145-161.
- Shleifer, A., 2000. Inefficient markets: An introduction to behavioural finance. OUP Oxford.
- Tversky, A. and Kahneman, D., 1992. Advances in prospect theory: Cumulative representation of uncertainty. Journal of Risk and Uncertainty, 5(4), pp.297-323.