FD 602: BEHAVIORAL FINANCE

Course Objectives:

The objective of this paper is to introduce the students to the role of human behaviour in financial decision making. It discusses the various biases, Equity Premium Puzzles and arbitrage opportunities.

Learning Outcomes:

This will enable the students

- To understand some psychological biases which lead to various anomalies
- To understand the various effects like endowment, disposition etc.
- To understand investors' behaviour in secondary markets

Course Contents:

Unit 1 **(2 weeks)**

Introduction to Behavioral Finance-Overview, History of Behavioral Finance; From standard finance to behavioral finance- Are financial markets efficient?, Limits to arbitrage-Fundamental Risk, Noise Trader Risk, Implementation cost, evidence of limits to arbitrage

References:

Forbes, William, "Behavioural Finance", Student ed, Wiley Publication [chapters – 1, 2,3,4 & 5]

Unit II **(3 weeks)**

Cognitive biases, beliefs and heuristics-Preferences: Prospect Theory, Ambiguity aversion, Loss aversion, Framing, Non-consequentialism: Disjunction Effect, Self-deception, Neuro-finance (introduction only); Mental Accounting, Self-control, Regret avoidance and Cognitive dissonance, Representativeness and Availability, Anchoring and Belief perseverance, Overconfidence, Optimism and wishful thinking, Overreaction and Conservatism, Self-attribution, Regency bias

References:

Forbes, William, "Behavioural Finance", Student ed, Wiley Publication [chapters – 6, 7, 8, 9]

BEHAVIORAL FINANCE

Unit III **(2 weeks)**

Endowment effect, Disposition effect, reference price effect, Herd Behavior, hindsight, winners' curse, cognitive dissonance, familiarity bias, status quo bias, law of small numbers, information overload

References:

Forbes, William, "Behavioural Finance", Student ed, Wiley Publication [chapters – 10, 11, & 12]

Unit IV **(4 weeks)**

Application-The Aggregate Stock Market: Equity Premium Puzzle-prospect theory, loss aversion; The Volatility Puzzle-beliefs, p References:; The Cross Section of Average returns-size premium, long term reversals, predictive power of scaled price ratios, momentum, event studies

Application-The closed end funds and co movement: investor behavior (saving and investment)-insufficient diversification, naïve diversification, excessive trading, the selling decision, the buying decision.

Application-Corporate Finance: Security Issuance, Capital structure and Investment, Dividends, Managerial Irrationality.

References:

Forbes, William, "Behavioural Finance", Student ed, Wiley Publication [chapters – 13, 14, & 15]

Text Books:

1. Forbes, William, "Behavioural Finance", Student ed, Wiley Publication
2. Shleifer, Andrei. "Inefficient Markets-An Introduction to Behavioral Finance". Oxford University Press

Additional Readings:

1. Thaler, Richard & Barberis, Nicholas. (2002) A Survey of Behavioral Finance, http://dx.doi.org/10.2139/ssrn.327880
2. Kahneman, Daniel & Tversky, Amos. (2000). "Choices, Values and Frames". Cambridge University Press

The latest published research papers will be used for teaching to a greater extent.

BEHAVIORAL FINANCE

Teaching Learning Process:

Class room lecture, Case study discussion, Numerical Problem solving, Class presentation on the assigned topic by students individually or in group, Workshop, Tutorials, Role play

Assessment Method

1. Internal evaluation of 25% marks
    a. Attendance 5% marks
    b. Two internal evaluations by the teacher with 10% marks each out of which one must be a class test and other may be another test or home assignment or presentation. Faculty may take more than two assignments and (or) tests but total will be only 20% marks.

2. End term University Exam of 75% marks

Key words:

Noise Trader Risk, Cognitive biases, Equity Premium Puzzle, Disjunction Effect, Endowment effect, Self-attribution