Behavioral Finance

Module 2, 2017-2018

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Course description

Behavioral Finance (BF) is relatively new area in Economics and Finance. Currently it lives through the period of growth of popularity and acknowledgment. Recent Nobel awards to Khaneman and Thalor is evidence of such popularity.
The idea of BF is to overcome the limits of traditional paradigm of "rationality" by taking more realistic approach to decisions making in finance.
The first part of the course introduces the contributions from psychology to BF and studies systematic biases people are subjects to. Then we will cover limits to arbitrage: topic in academic research, which justifies the presents of inefficiencies in financial markets. Finally, the course will discuss applications of BF to stock market and trading strategies.
The classes will be very interactive, you will be participating in several mini-expreriments.

After the course students are supposed:
• learn, which psychological biases people are subject to
• to be familiar with prospect theory
• to know why there are limits to arbitrage
• to know about market inefficiencies and trading strategies, which exploit them

Course requirements, grading, and attendance policies

Prerequisites: Basic knowledge of finance and economics.
Requirements: Class attendance is required: you are supposed to attend at least 12 from 14 lectures.
Grading: The final grade will be based on:
1. 3 homework problem sets (30%)
2. Class participation (20%)
3. Take-home project (50%)

Course contents

○ Introduction to BF
○ Cognitive Biases – Preferences:
■ Prospect Theory: Value and Probability Weighting functions
■ Prospect Theory: Framing Effects, , Ambiguity aversion, Hyperbolic discounting
○ Cognitive Biases – Beliefs: Overconfidence, Representativeness, Conservatism, Anchoring, Availability biases.
○ Limits to Arbitrage: Market efficiency, Risks induced by arbitrage: Fundamental risk, Noise trader risk, Horizon risk; Evidence on limited arbitrage
○ Applications of Behavioral Finance:
■ The aggregate stock market: Puzzles, Behavioral explanations
■ Cross-section of average returns: Anomalies, Behavioral explanations; Closed-end funds puzzle, Co-movement

■ Sub-prime crisis 2007, CDO pricing. Behavioral explanations.
○ Trader Psychology and Trading Strategies:
■ Luck and skills in trading; What is the difference between “good” and “bad” traders
■ Market inefficiencies: bubbles, crushes, mean-reversion, trends, other anomalies.
■ Trading strategies

Description of course methodology
- Lectures
- Mini-experiments

Course materials

Required textbooks and materials
○ Lecture notes
○ Daniel Kahneman, Thinking, fast and slow
○ A survey of behavioral finance by N. Barberis and R. Thalor

Additional materials
○ To be provided during the course

Academic integrity policy

Cheating, plagiarism, and any other violations of academic ethics at NES are not tolerated.