Topics in Economics: Behavioral Financial Economics
Syllabus for Fall 2012
11:00 a.m. — 1:45 p.m. M
Friday 381

Instructor: Dmitry Shapiro
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Office hours: 10:00 - 11:00; 2:30-4:30 M, or by appointment.

Course Description: Much of modern financial economics works with models in which agents are rational and arbitrageurs can fix any mis-pricing. Behavioral Financial Economics is the area of finance which relaxes both of these assumptions. Behavioral models usually have two building blocks: limits to arbitrage, which make it difficult for rational traders to undo the dislocations caused by less rational traders; and psychology, which catalogues the kinds of deviations from full rationality we might expect to see. We discuss these two topics, and then consider a number of applications such as asset pricing (the aggregate stock market and the cross-section of average returns) or individual investor portfolio choice and trading behavior.

Prerequisites: For master students the prerequisites are Master level Microeconomics and Finance classes. Students who took only one class can take this course but perhaps should discuss it with me first.

Objectives: The objective of this course is to introduce students to the field of behavioral financial economics. Upon completion of the course students should be familiar with the main concepts and a recent research in the area.

Requirements and Grading: The grade will be based on class participation and presentations. In addition to that there will be the final exam in the end of the class.

Course Text: There is no required text for this course. You are mostly expected to read papers. Recommended books are:

Strongly recommended:


Optional:

**SURVEY PAPERS**

**Required:**


**Optional:**


**A Tentative Course and Further Reading**

**RESEARCH ARTICLES**

Starred articles are required. You will occasionally see suggestions on where to track down hard-to-find articles. Several of the articles are in *Inefficient Markets* or in one of the two Advances books. The non-starred readings are optional. Even though they are optional, you will learn something from all of them, so take a look at as many of them as you can.

References to a Survey in the reading list refer to the survey by Nick Barberis with Richard Thaler, listed above.

1. **INTRODUCTION**

   * *Inefficient Markets, Chapter 1.*

2. **LIMITS TO ARBITRAGE. Theory**

   * Survey, pages 2-8.
   * *Inefficient Markets, Chapters 2, 4.*


3. LIMITS TO ARBITRAGE. Evidence

* Survey, pages 8-11.

4. PSYCHOLOGY: PREFERENCES AND BELIEFS

**Books**


**Survey Papers**


Research articles


5. APPLICATIONS. INDIVIDUAL INVESTOR BEHAVIOR

* Survey, pages 47-52.
* Barberis, Nicholas, Ming Huang and Richard Thaler (2003), "Individual Preferences, Monetary Gambles and Stock Market Participation," Working paper, Yale University.


6. APPLICATIONS. ASSET PRICING: THE AGGREGATE STOCK MARKET

Survey, pages 21-32.

Facts and Rational Approaches


**Behavioral Approaches (equity premium puzzle)**


**Behavioral Approaches (volatility puzzle)**


7. ASSET PRICING: THE CROSS-SECTION OF AVERAGE RETURNS

* Survey, pages 33-44.

**Facts**


* Chen, Hsiu-Lang and Russ Wermers “Style Migration and the Cross-Section of Stock Returns, working paper, 2010


Rational Approaches


Behavioral Approaches (Beliefs)


** Behavioral Approaches (Beliefs + Institutional Frictions)


Behavioral Approaches (Preferences)


8. BEHAVIORAL CORPORATE FINANCE


